WORKER CLASSIFICATION

EMPLOYEE OR INDEPENDENT CONTRACTOR?

Wolters Kluwer

UNDERSTANDING WORKER CLASSIFICATION: Employee or Independent Contractor?

When you hire workers for your business, you have to decide if they are employees or independent contractors. The distinction is very important for federal tax purposes. If you incorrectly classify an employee as an independent contractor, the financial penalties can be steep. The IRS is looking for employers that misclassify their workers, and more often it is the case that employees are misclassified as independent contractors.

This booklet explains the important distinctions between employees and independent contractors and can help you avoid common problems.

TAX CONSEQUENCES

When you hire an individual as an employee, the law imposes many tax requirements on you. Most importantly, you are responsible for federal payroll taxes: FICA (which is Social Security and Medicare), FUTA (unemployment insurance), and federal income tax withholding. When you hire an independent contractor, he or she is responsible for federal payroll taxes and federal income tax. All you do is pay the individual for his or her services.

It is tempting to classify workers as independent contractors because of the money employers save from payroll overhead costs. Classification as an independent contractor can also help employers avoid the additional cost of sharing fringe benefits and retirement plan contributions with these workers.

Work Opportunity Tax Credit

The Work Opportunity Tax Credit (WOTC) provides an incentive to hire individuals from certain disadvantaged groups with a particularly high unemployment rate. The credit expired at the end of 2013, but in the past when the program's authority lapsed, Congress has retroactively reauthorized the program; thus, the Department of Labor suggests that employers continue to submit WOTC applications in anticipation of a retroactive reauthorization. Generally, for each eligible employee hired, an employer can claim a credit.

The amount of the credit depends on the target group in which the individual falls, the wages paid to the individual in the first year of employment, and the hours worked by the individual.

Previously, Congress expanded the Work Opportunity Tax Credit to provide incentives for employers to hire unemployed veterans. Employers that hire veterans who have been looking for employment for more than six months may be eligible for a credit of up to $5,600 per employee. Those who hire veterans who were unemployed for fewer than six months may be eligible for a credit of up to $2,400 per employee. Employers that hire veterans with service-connected disabilities and who have been looking for employment for more than six months may be eligible for a credit of up to $9,600 per employee.

Comment. Hiring an independent contractor will not qualify an employer for the credit.

PAYROLL TAXES

The cornerstone of federal tax revenue is the billions of dollars in payroll tax collected from millions of employers every year. This means the government has a vested interest in classifying nearly all workers as employees. Otherwise, most workers would be independent contractors and employers would not be responsible for payroll taxes.

STRICT IRS CRITERIA

The employment tax sections in the Internal Revenue Code impose taxes on employers under FICA and FUTA based on wages paid to employees. The term "employee" for FICA and FUTA purposes, refers to "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee."

In the eyes of the IRS, most workers are employees and are not independent contractors. If you believe your workers really are independent contractors, you need to be prepared to document your position in light of this opposite assumption.

The IRS considers three aspects of control when determining whether a worker is an employee:

(1) Behavioral control;
(2) Financial control; and
(3) Relationship of the parties.

Behavioral control is shown by facts regarding the right to direct or control how the worker performs the specific tasks for which he or she is hired. Financial control is shown by facts regarding a right to direct or control the financial aspects of the worker's activities. These include whether there is a significant investment by the worker, whether

the worker's success depends on entrepreneurial skill and whether the worker makes his or her services available to the relevant market in addition to the service recipient. The relationship of the parties is generally shown by the parties' agreements and actions with respect to each other, paying close attention to those facts which show not only how they perceive their own relationship but also how they represent their relationship to others.

TRADITIONAL FACTORS

Traditionally, the IRS used a list of 20 factors from court cases to determine worker status. Today, the IRS looks at all the facts and circumstances as well as these factors. The IRS considers these factors to the extent they are relevant in illustrating behavioral controls, financial controls and the relationship of the parties.

The 20 traditional factors are:

(1) A person who is required to comply with instructions about when, where and how to work is ordinarily an employee. The control factor is present if the employer has the right to instruct, whether or not he does so.

(2) Training by an experienced employee is a factor of control because it is an indication that the employer wants the services performed in a particular method or manner.

(3) Integration of the person's services in the business operation generally shows that the person is subject to the employer's direction and control.

(4) If the services must be rendered personally, it indicates that the employer is interested in methods as well as results.

(5) Hiring, supervising and paying assistants by the employer generally shows control over all of the workers on the job.

(6) The existence of a continuing relationship between an individual and the person for whom he performs services is a factor tending to indicate the existence of an employer-employee relationship.

(7) The establishment of set hours of work by the employer is a factor indicative of control.

(8) If the worker is required to devote full time to the business of the employer, it is implied that the

worker is restricted from doing other gainful work, whereas an independent contractor may choose for whom and when to work.

(9) Doing the work on the employer's premises implies that the employer has control.

(10) If the person must perform services in the order or sequence set by the employer, it shows that the worker may be subject to control, although the fact that the employer retains the right to order the work may also show control.

(11) If regular oral or written reports must be submitted to the employer, it indicates control.

(12) An employee is usually paid by the hour, week, or month; payment on a job basis is customary when the worker is an independent contractor.

(13) Payment by the employer of the worker's business or traveling expenses is a factor indicating control.

(14) The furnishing of tools, materials, equipment, etc., by the employer is indicative of control.

(15) A significant investment by a worker in facilities he uses in performing services for someone else tends to show independent status, while the furnishing of all necessary facilities by the employer tends to indicate employee status.

(16) People who are in a position to realize a profit or suffer a loss as a result of their services are generally independent contractors.

(17) If a person works for a number of employers or firms at the same time it usually indicates an independent status.

(18) Workers who make their services available to the general public are usually independent contractors.

(19) The right to discharge is an important factor indicating that the person possessing the right is an employer.

(20) An employee has the right to end the relationship with an employer at any time the employee wishes without incurring liability, as distinguished from an independent contractor who usually agrees to complete a specific job and is responsible for its satisfactory completion or is legally obligated to make good for failure to complete the job.

Caution. These factors have been developed over many years of litigation between employers and the IRS about who is an independent contractor. All of them do not apply in every situation, especially as the workplace has undergone radical change in recent years. For example, many of these cases were decided long before telecommuting became viable, allowing employees to work remotely from the job site. In today's economy, many individuals also work multiple jobs.

BEHAVIORAL CONTROL

Behavioral control looks to the degree of control the employer has over the worker's activities. An important factor is worker training.

An employee is generally subject to the business' instruction about when, where and how to work. Examples include:

- When and where to do the work;
- What tools or equipment to use;
- What workers to hire or to assist with the work;
- Where to purchase supplies and services;
- What work must be performed by a specified individual; and
- What order or sequence to follow.

The degree of behavioral control necessary to make a worker an employee and not an independent contractor varies depending on the job. Workers can be deemed employees when the degree of control is low if it is commensurate with the simple nature of the worker's task.

> ***Example.*** Alex, Jean and Dave work as crab-meat pickers. The job requires no training. They can work or take breaks whenever they want. They are not supervised in the details of their work. They are paid on a per-pound basis. Despite some factors that could signal they are independent contractors, the IRS determined that they are employees. The simple nature of the job did not require detailed supervision and the employer inspected the final product for compliance with food regulations and would dismiss anyone whose work was consistently in noncompliance.

However, just because an unsupervised job is simple does not mean that the worker is an employee. Financial or relationship factors may point to independent contractor status.

> ***Example.*** Freddie works as a grocery store bagger. The job is simple and is unsupervised. The IRS determined that Freddie is an independent contractor because he worked only for tips, could work elsewhere, worked under the direction of a "head" bagger elected by all the baggers, and had to pay for the cost of a smock and any damage done to the groceries.

Although companies that pay drivers generally do not closely supervise their work, they often exert enough control to qualify the relationship as employer-employee.

> ***Example.*** ABC Co. requires its drivers to call in daily to report their location and progress. It also controls which loads the drivers haul and the prices charged. ABC Co. determines if repairs to the trucks should be performed on the road or deferred until the driver returns to company headquarters. The IRS determined that ABC Co. exerts sufficient control to qualify its truckers as employees.

Caution. While it is good to have workplace standards, it's best not to give "employee handbooks" to independent contractors. Recently, the owner of a dance studio gave the dance instructors, who were all independent contractors, "employee manuals." The manuals told the instructors what to do in case of an emergency and asked them not to play offensive music. During an audit, an IRS agent determined that the instructors were not independent contractors but employees. The agent used the "employee manual" as her evidence that the instructors were employees.

FINANCIAL CONTROL

Financial control looks to whether the employer has the right to direct or control the financial aspects of the worker's activities. Factors to consider include whether there is a significant investment by the worker, whether the worker's success depends on entrepreneurial skill and whether the worker makes his or her services available to the relevant market in addition to the service recipient.

Tools and equipment. A worker who makes a substantial financial investment in tools, equipment or a place to work is more likely to be an independent contractor than is a worker for whom the employer provides tools, equipment or a place to work.

Here are some examples:

- A newspaper columnist who used her own equipment and supplies on her own premises in writing columns for the paper;
- An ice cream salesman who worked from a truck rented from the distributor and paid for the gasoline used in the operation of the truck;
- Truckers who owned their own trucks, provided their own equipment, maintenance and drivers and generally maintained a facility for servicing their equipment; and
- A watch repairman who conducted a watch repair business in a jewelry store, paying the owner a percentage of the profits and using his own equipment to complete the work.

Entrepreneurial risks. A worker is more likely to be deemed an independent contractor if he or she undertakes some entrepreneurial risks. The possibility of a profit or loss through the exercise

of managerial skills is one indicator of entrepreneurial risk. Having more than one client is another.

RELATIONSHIP BETWEEN EMPLOYERS AND WORKERS

The relationship of the parties is generally shown by the agreements and actions between the employer and the worker. Factors to consider are the intent of the parties, as expressed in written contracts; the providing of, or lack of, employee benefits; the right of the parties to terminate the relationship; the permanency of the relationship; and whether the services performed are part of the service recipient's regular business activities.

Discharge. The right to discharge is an important factor in indicating if a worker is an employee or an independent contractor. For example, the IRS determined that models were employees when they were free to refuse assignments but could be discharged for refusing too many. Similarly, associate physicians were held to be employees when they could be fired for failing to meet hospital standards of performance. On the other hand, an independent contractor cannot be fired so long as he or she produces a result that meets contract specifications, rather than employer standards of performance.

Services integral to employer's business. A worker is more likely to be deemed an employee rather than a contractor if he or she performs services integral to the employer's business rather than services outside of the company's normal business. For example, the IRS determined that an architect was an employee when she was paid according to the difficulty of the job and performed services that were essential to the business of the employer.

Employer perception. One indication of whether a worker is an employee is how the employer views the worker. For example, if an employer issues a W-2 to the worker, this tends to show that the employer views the worker as an employee.

However, how the employer and the worker view things is just one factor. So, for example, if a worker is designated an independent contractor while other factors establish that the worker is in fact an employee, the designation is not controlling.

> ***Example.*** Dexter works as a "car shuttler" -- he moves cars from one location to another. There was a contractual clause indicating that the car movers were independent contractors. The IRS determined that the car movers were employees because they were under the firm's control, all costs were reimbursed, and they brought no particular skill to the job. The clause in the contract was not controlling.

MISTAKEN CLASSIFICATIONS

If you misclassify an employee as an independent contractor, the mistake can be costly. You will be liable for employment taxes for him or her. The IRS can also impose some hefty penalties.

Section 530 Safe Harbor

A safe harbor, known as "Section 530 relief," (after Section 530 of the *Revenue Act of 1978*) protects employers that have consistently treated workers as independent contractors. An individual who has not been treated as an employee will not be reclassified as an employee if the employer:

(1) Had a reasonable basis for not treating the individual as an employee;
(2) Did not treat the worker or any worker in a similar position as an employee for payroll tax purpose; and
(3) Filed all required federal tax returns, including information returns, in a manner consistent with the worker not being an employee.

Reasonable basis. You are considered to have a reasonable basis for not treating an individual as an employee if your treatment was based on any of the following:

- Judicial precedent, published rulings, or technical advice;
- A past examination by the IRS; and or
- Long-standing industry practice.

Caution. Reliance on any of these factors is insufficient unless the reliance was reasonable. If no reasonable person could have believed that the worker was anything other than an employee, you are ineligible for this safe harbor relief.

Caution. The safe harbor governs employer status only for employment taxes and not for other purposes. If required information returns are not timely filed, no relief is granted from income tax withholding and FICA and FUTA taxes.

Example. ABC Co. has consistently treated Barbara, a computer programmer, as an independent contractor and has a reasonable basis for not treating her as an employee. However, ABC Co. has failed to file all of the required information returns with respect to Barbara. The safe harbor does not apply, because ABC Co. failed to satisfy the requirement that all required federal tax returns, including information returns, be filed. However, Barbara is not automatically reclassified as an employee. Instead, her status is determined according to the common-law rules for determining whether an individual is an employee or an independent contractor.

IRS Notification. If the employment status of any worker is going to be a subject of an audit, the IRS must give you written notice of the Section 530 safe harbor before or at the start of the audit.

Other reasonable basis. Courts have noted that, in addition to the Section 530 safe harbor, an employer may demonstrate any other reasonable basis for the treatment of an employee for tax purposes. Congress intended that the courts construe this reasonable basis inquiry liberally in favor of the taxpayer.

REPORTING PAYMENTS TO INDEPENDENT CONTRACTORS

Employers use Form W-2 to report wages, tips and other compensation paid to employees to the IRS. In the case of independent contractors, employers use Form 1099-MISC to report payments to another person who is not an employee.

There are some general criteria for reporting a payment as non-employee compensation. They are:

(1) Payments to the worker were at least $600 during the year;
(2) The payment was made to a non-employee; and
(3) The payment was made for services provided in the course of business.

> ***Example.*** Lucy operates a small business. Lucy pays Anne Marie $30 each week to help her prepare invoices and do other bookkeeping. Anne Marie is not Lucy's employee. Because Lucy paid a non-employee more than $600 during the year for services provided in the course of business, Lucy must report this payment to the IRS on Form 1099-MISC.

QUESTIONS ABOUT WORKER STATUS

If you are unsure about a worker's status, you can ask the IRS to make a determination. Likewise, a worker can ask the IRS to determine his or her status. The IRS has prepared a special form for making this request. It is Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.

If the worker requests the determination, the IRS will send the employer a letter asking you to complete Form SS-8. Failing to reply will not prevent the IRS from making a determination. The IRS will use the information it has from the worker.

> ***Caution.*** An employer or worker may request a status determination only to resolve federal tax matters.

Form SS-8 explores in detail the extent of behavioral control the employer exercises over the worker and the relationship between the employer and the worker. The IRS wants to know what training and/or instruction the employer gives the worker. How does the worker receive assignments? Is the worker required to provide the services personally or is he or she allowed to hire substitutes?

The IRS also wants to know the extent of financial control the employer has over the worker. Does the worker provide his or her own supplies, equipment, materials, and property? What expenses does the worker incur in the performance of services for the employer? Are the expenses reimbursed by the employer or another party? Does the worker receive a salary, commission, hourly wage, or lump sum? Does the employer carry workers' compensation insurance on the worker? Are benefits, such as sick pay, pensions, or bonuses paid to the worker?

Form SS-8 also asks who can terminate the relationship. Are there any agreements prohibiting competition between the worker and the employer while the worker is performing services or at any subsequent time? If Form SS-8 is submitted after the relationship ends, the IRS wants to know the employer-worker relationship terminated.

> ***Comment.*** There is no fee to request a determination by the IRS about a worker's status using Form SS-8.

EXEMPT ORGANIZATIONS

Tax-exempt organizations also need to determine if an individual providing services to the organization is an employee or an independent contractor. A tax-exempt organization can be held liable for employment taxes, plus interest and penalties, if an individual is incorrectly classified as an independent contractor.

STATUTORY EMPLOYEES

Some individuals are classified by statute as employees for FICA tax purposes even though they might be classified as independent contractors otherwise. They are:

- An agent-driver or commission-driver distributing meat products, vegetable products, bakery products, beverages other than milk, or laundry or dry cleaning services;
- A full-time life insurance sales representative;
- A home worker performing work, according to specifications furnished by the person for whom the services are performed, on materials or goods furnished by that person which are required to be returned to that person or a person designated by him or her; or
- A traveling or city salesman, other than an agent-driver or commission-driver, engaged on a full-time basis in the solicitation on behalf of, and the transmission to, his principal of orders from wholesalers, retailers, etc., for merchandise for resale or for supplies.

An individual who belongs to one of these groups is not an employee unless:

- The contract of service indicates that substantially all of the services are to be performed personally by him or her;
- He or she has no substantial investment in facilities, other than those for transportation, used in connection with the performance of the services; and
- The services are part of a continuing relationship with the person for whom they are performed and are not a single transaction.

The contract of service may be formal or informal but the worker may not have the authority to delegate a substantial part of the work to any other person. However, a salesman can hire a chauffeur without affecting the personal service requirement because the chauffeur's services are incidental to the selling activity. Similarly, a worker can hire a substitute or an assistant occasionally without losing employee status under this test.

> ***Comment.*** If the individual's services are not performed as part of a continuing relationship with the person for whom the services are performed, but are in the nature of a single transaction, the person performing the services is not considered an employee. However, the fact that services are not performed on consecutive days of work does not indicate that the services are not performed as part of a continuing relationship.

> ***Caution.*** The statutory employee rules do not apply for income tax withholding purposes.

STATUTORY NON-EMPLOYEES

There are special tax rules for treating some workers as self-employed. These workers are called statutory non-employees. They are:

- Direct sellers; and
- Licensed real estate agents.

These workers are treated as self-employed if substantially all payments for their services are directly related to sales or other output rather than the number of hours worked directly. Additionally, they perform their services under a written contract that states they will not be treated as employees for tax purposes.

TIPS FOR USING INDEPENDENT CONTRACTORS

Here are some things you can do to help ensure that those who work for you are treated as independent contractors.

- Be careful, when advertising for independent contractors, to avoid using phrases such as salary, wages, or steady work. Instead, look for independent contractors who have placed their own ads under "Situations Wanted" or "Trade Services."
- When establishing the relationship, avoid setting a regular pattern of daily or weekly hours. A self-

employed individual presumably has the opportunity to select when and where he will work in relation to all his customers.

- Allow contractors to supply their own tools, supplies and equipment wherever possible in the performance of the services required. This will demonstrate that there is a risk of loss as well as an opportunity for profit.
- Use contractors who normally advertise their services in some manner. It's a good idea to keep on file any business cards, circulars, or even telephone directory ads.
- Allow contractors to hire their own assistants, if necessary. Insist that the contractor pay the payroll taxes normally required for such employees.
- Do not include contractors under the insurance coverage for workers' compensation, health insurance, or other benefits that are provided for employees.
- If possible, compensate independent contractors on a per-job basis rather than by hour or by week.
- Always ask for an invoice or statement before paying for any work that has been performed. If possible, make checks payable to a company rather than to an individual.
- Do not directly reimburse contractors for any expenses they might have, for gasoline, meals, etc. These expenses should stand as part of the contractor's set fees.
- Remember that in theory you cannot discharge a contractor from employment. If dissatisfied with a contractor's performance, look to your contract for a remedy. If there is no contract, sever relations with the contractor by offering no more work.

MISCLASSIFIED WORKERS

The IRS has developed a form for employees who have been misclassified as independent contractors by their employer. These individuals should use Form 8919, Uncollected Social Security and Medicare Tax on Wages. Individuals who use this form will ensure that their Social Security and Medicare taxes are credited to their Social Security record.

VOLUNTARY WORKER CLASSIFICATION SETTLEMENT PROGRAM

In 2011, the IRS launched the Voluntary Classification Settlement Program

(VCSP) for employers that have misclassified employees as independent contractors and wish to voluntarily rectify the situation. The VCSP enables employers to resolve worker misclassifications outside of the IRS examination process to achieve certainty under the tax law at a low cost.

Benefits of voluntary reclassification are that for the most recent tax year employers will not be liable for any interest and penalties on the employment tax liability, which should have been due on compensation paid to the employees misclassified as independent contractors. Employers will instead pay 10 percent of that employment tax liability. In addition, the taxpayer who agrees to classify workers as employees for the future will not be subject to an employment tax audit for prior years.

Not all taxpayers are eligible to participate in the program, but the key component for eligibility is the entirely voluntary nature of the program participation. The IRS's requirements for eligibility, specify, among other things, that the taxpayer:

- Is currently treating and has consistently treated the workers as non-employees;
- Has satisfied its Form 1099 requirements for the past three calendar years;
- Has no dispute with the IRS as to employee or independent contractor status;
- Is not currently under an IRS employment tax examination;
- Is not under examination by the Department of Labor or any state agency regarding the proper classification of workers; and
- Has either not previously been subject to IRS or DoL examination for the classification of workers or complied with the prior examination.

To participate in the VCSP, taxpayers must use Form 8952, Application for Voluntary Classification Settlement Program.

FAIR LABOR STANDARDS ACT

The *Fair Labor Standards Act (FLSA)* is an important federal law governing treatment of workers. It has its own definition of independent contractor that is slightly different from the IRS's definition of an independent contractor. To be truly sure that you're safe in treating workers as independent, you must meet both definitions.

Under the *FLSA*, independent contractors are not "employees" and are, therefore, not entitled to minimum wage and overtime protections.

There are six factors for determining whether a worker is an "employee"

under the *FLSA*, as opposed to an independent contractor:

(1) The degree of the alleged employer's right to control the manner in which the work is performed;
(2) The alleged employee's opportunity for profit or loss depending upon managerial skill;
(3) The alleged employee's investment in equipment or materials required for the work;
(4) Whether the service rendered requires special skills;
(5) The degree of permanence of the working relationship; and
(6) Whether the service rendered by the worker is an integral part of the alleged employer's business.

No single factor is more important than the others in determining independent contractor status. Courts consider whether, as a matter of economic reality, a worker is dependent on the business to which a service is rendered for continued work. The greater the dependence, the more likely the worker will be found to be an employee.

It's very important to realize that having a worker sign an independent contractor agreement will not automatically create such status if the worker does not meet the requirements of the tests described above. Workers employed by an independent contractor are not employees of the organization, which the contractor is serving. They are employees of the contractor.

CONCLUSION

Worker classification is very fact-sensitive. Jobs come in all shapes and sizes and change as the economy changes. It's important to remember that even though you may label a worker an independent contractor or an employee, the facts, as determined by the IRS, may speak differently. The IRS generally frowns on independent contractors and looks for factors that indicate a worker is an employee. If you have any questions about the status of a person working for you, contact our office.