

INDEPENDENT CONTRACTOR OR EMPLOYEE?

Worker classification can be a hotly contested audit issue that has caused anxiety or business owners all across the country. Whether a worker is classified as an employee or as an independent contractor can mean a substantial difference in the amount of employment taxes that the business pays. If the IRS or other tax agency is successful in reclassifying workers, there is the potential of a substantial tax bill, consisting of employer's back payroll taxes, interest, and penalties. You may have heard the horror stories of tax liens that crippled an otherwise successful business. Even when potential employment tax liabilities are not overwhelming, it's important to remember that misclassification can also cause pension plan difficulties.

If you currently use or are thinking of using an independent contractor, we recommend a review of some of the key factors the IRS and other tax agencies look at in determining whether a worker is really an employee. The primary inquiries fall into three categories:

- Behavioral Control
- Financial Control
- Type of Relationship

Behavioral Control - Facts that show whether the business has a right to direct and control how the worker does the task for which the worker was hired include the type and degree of:

- **Instructions the business gives the worker** - An employee is generally subject to the business's instructions about when, where, and how to work. The following are examples of types of instructions about how to do work:
 1. When and where to do the work.
 2. What tools or equipment to use.
 3. What workers to hire or to assist with the work.
 4. Where to purchase supplies and services.
 5. What work must be performed by a specified individual.
 6. What order or sequence to follow.

The amount of instruction needed obviously varies among different jobs. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. For example, a business may lack the knowledge to instruct some highly specialized professionals or the task may be so simple that it requires little or no instruction. The key consideration is whether the business has retained the right to control the details of a worker's performance or instead has given up that right.

- **Training the business gives the worker** - An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods. Ongoing training, as opposed to an initial training session, usually points towards employee classification.
- **Supervision** - Frequent call-ins and scheduling weekly meetings, such as sales meetings, are typical requirements of an employer. Having salespeople check in occasionally with the sales manager is probably okay.
- **Right to do work for other companies** - Independent contractors have the freedom to choose the companies for which they perform work.

Financial Control - Facts that show whether the business has a right to control the business aspects of a worker's job include:

- **The extent to which the worker has unreimbursed expenses** - Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is being currently performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services they perform for their business.
- **The extent of the worker's investment** - An independent contractor often has a significant investment in the facilities he or she uses in performing services for someone else. A home office and/or a home computer are usually not considered significant investments. However, a significant investment is not necessary for independent contractor status.
- **The extent to which the worker makes services available to the relevant market** - An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.
- **How the business pays the worker** - An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is usually paid a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.
- **The extent to which the worker can realize a profit or loss** - An independent contractor's business can result in a loss, as well as a net profit. It would be a very rare circumstance that would find an employee generating a loss from his/her work.

Type of Relationship - Facts that show the parties' type of relationship include:

- **Written contracts describing the relationship the parties intended to create** - Typical contracts include language that has an enforceable liquidated damages provision.
- **Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.**
- **The permanency of the relationship** - If you engage a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that your intent was to create an employer-employee relationship.
- **The extent to which services performed by the worker are a key aspect of the regular business of the company** - If a worker provides services that are a key aspect of your regular business activity, it is more likely that you will have the right to direct and control his/her activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship. Conversely, if a manufacturing company hired an attorney to draw up legal documents related to trade secrets or special transactions, this would indicate independent contractor status.

Other factors, which have lesser importance than the factors mentioned above, are:

- Whether or not the work is performed on the business's premises.
- Whether the worker has flexibility in setting hours.
- Whether the work is full- or part-time.
- Whether the worker actually performs services for one or more businesses.

No single factor is determinative of worker classification, and not all factors apply in each situation. The tax agencies look at all the facts surrounding a worker's classification and makes a determination based on the whole picture. The proper classification is not always straightforward. Some employees may have two or more jobs, while an independent contractor may have only one customer. Some workers may be considered employees even if they have little or no supervision, while others may be tightly controlled by the business and still qualify as independent contractors.

Confused? There is some good news in all this intricacy. The IRS has felt the same pressure on this issue that businesses have. A special safe-haven rule may prevent the IRS from reclassifying your workers as employees if you meet the following requirements:

- Your business has never treated the workers in question as employees.
- Your business has treated the workers in question as independent contractors on all of its federal tax returns.
- Your business has filed all the necessary information returns, including Form 1099 and, as of January 1, 2001, Form DE 542 with the EDD when applicable.
- Your business has never treated anyone holding a substantially similar position to the workers in questions as an employee for employment tax purposes after 1977.
- Your business has a "reasonable basis" for not treating the workers in question as employees. A "reasonable basis" automatically exists if:
 1. The IRS has audited your business and has never hit you with an employment-tax bill based on your treatment of anyone holding a substantially similar position to the workers in question;
 2. A court decision or IRS ruling specifically has said that that similarly situated employees were independent contractors rather than employees; or
 3. A significant segment of your business's industry has historically treated similarly situated workers as independent contractors.

If you are unsure of how to classify a worker or you are facing an audit, we can assist you in making the proper determination and minimizing your exposure to a reclassification. We can also assist you in a settlement with the IRS to minimize the amount that you have to pay. Please give us a call if you have any questions or would like some assistance.