

Independent Contractor or Employee?

Worker Classification Rules under IRS Guidelines

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Introduction

What do AT&T, JPMorgan Chase, Microsoft, Staples, UPS and Wal-Mart have in common?

They all have faced multi-million dollar lawsuits accusing them of misclassifying employees as independent contractors.

How does a worker's classification as an employee or independent contractor affect the worker and the company he or she works for?

Unlike employees, independent contractors are *not* entitled to:

overtime pay,

family and medical leave,

employer-sponsored benefits and

worker's compensation insurance.

In addition, employers are not required to pay *employment taxes* on compensation paid to independent contractors or to *withhold federal income taxes* from their compensation.

Therefore, classifying workers as independent contractors, can do a lot for a company's bottom line.

An employer who misclassifies employees as independent contractors can have as much as a 30% advantage over an employer who complies with the law.

Misclassification can also be costly and can include:

- liability for federal and state income taxes that should have been withheld from workers' compensation;
- employer and employee share of Social Security taxes;
- federal and state unemployment taxes; and
- penalties and interest on these amounts.

Taxpayer Relief

While the potential liability exposure is significant, it is important to note that absent bad faith or clear disregard for the law, there is relief available to employers who mistakenly misclassify workers through Section 530 of the Internal Revenue Act of 1978 or certain provisions of the Internal Revenue Code.

According to the Department of Labor (DOL), up to 30% of employers are misclassifying employees.

The Government Accountability Office (GAO) reports that misclassification results in \$4.7 billion per year in unpaid income taxes.

Government Initiatives

To address this problem, the DOL recently proposed a \$25 million “Employee Misclassification Initiative” to target employers who misclassify employees as independent contractors.

Internal Revenue Service

The Internal Revenue Service (IRS) is also increasing its efforts at uncovering and penalizing misclassification.

IRS Initiative

In February 2010, the IRS began audits of 6,000 randomly selected employers. One objective is to determine whether employers are misclassifying employees as independent contractors in order to avoid payment of taxes.

Questionable Employment Tax Practice Initiative

The IRS has signed a memorandum of understanding with the Labor Department, state revenue agencies and state workforce commissions that allow these agencies to exchange audit information.

This program is aimed at deterring misclassification of workers.

Other Reasons for Audits

One of the most common reasons for an IRS audit is a worker's filing of a Form SS-8.

IRS Form SS-8

Any independent contractor can request a determination of his or her status by filing IRS Form SS-8.

This filing will initiate an audit of the worker's status for purposes of employment and federal income taxes.

This presentation is designed to assist businesses in determining whether workers are properly classified as employees or independent contractors under the rules applied by the IRS.

Common Law Employment Test

The primary test used by the IRS in determining whether a worker is an employee or independent contractor is the *common law employment test*.

Common Law Employment Test

The common law employment test is based on court decisions over many years – in fact, decades.

This test determines liability for FICA, FUTA and the obligation to collect income tax at the source, or federal income tax withholding obligations.

Common Law Employment Test

The common law test of employment requires the examination and balancing of a number of factors. No one factor is determinative; rather, all the facts and circumstances of the relationship are examined.

Right to Direct and Control

The most important factor is whether the business for which services are performed has the *right to direct and control* a worker with respect to:

- (1) the result of what is to be accomplished, and
- (2) the details and means of accomplishing the result.

Other Factors:

- The right to hire and fire;
- Whether the workers are involved in distinct occupations or businesses;
- Whether occupation involved is generally performed by employees or by specialists who are independent contractors;
- Whether the business provides the instrumentalities, tools and place of work;

Other Factors, cont'd

- The method of payment;
- The length of time, level of skill and/or training required;
- Whether the work is part of the regular business of the purported employer;
- Whether the principal (worker) is in business; and
- Whether the parties believe that they are establishing an employer-employee relationship.

Third-Party Arrangements

The common law test of employment is also used to determine whether a worker is the employee of a labor supplier or the client for whom services are provided.

Revenue Ruling 87-41

In Rev. Rul. 87-41, the IRS provided guidance on worker classification where a third-party, a labor supplier, was involved.

Twenty Factors

In Rev. Rul. 87-41, the IRS provided a checklist of twenty factors that it considered in determining whether a common law employment relationship existed between the worker, the labor supplier, and the business for which services were provided.

Twenty Factors

1. Instructions
2. Training
3. Integration
4. Services Rendered Personally
5. Hiring, Supervising, and Paying Assistants
6. Continuing Relationship
7. Set Hours of Work
8. Full-Time Requirement

Twenty Factors, cont'd

9. Doing Work on Employer Premises
10. Order or Sequence Set
11. Oral or Written Reports
12. Payment by Hour, Week, Month
13. Payment of Business and/or Travel Expenses
14. Furnishing of Tools and Materials
15. Significant Investment

Twenty Factors, cont'd

16. Realization of Profit or Loss
17. Working for More Than One Firm at a Time
18. Making Service Available to General Public
19. Right to Discharge
20. Right to Terminate

Current IRS Test

More recently, the IRS has reorganized these factors into three groups:

- Behavioral control factors
- Financial control factors
- Relationship factors.

IRS Training Materials

IRS Training Materials illustrate how the IRS currently applies these factors.

IRS Training Materials

According to the Training Materials, the primary inquiry is whether the worker is an independent contractor or an employee *under the common law standard*.

IRS Training Materials

- The employment tax regulations provide that an employer-employee relationship exists when the business for which the services are performed has the **right** to direct and control the worker who performs the services ... not only as to the result to be accomplished by the work, but also the means and details by which that result is accomplished.
- It is not necessary that the business actually direct or control the manner in which the services are performed; it is sufficient if the business has the **right** to do so.

IRS Training Materials

- Because business relationships change over time, the IRS recognizes that information important in helping determine worker status may change over time.
- As a result, some of the twenty factors listed in Rev. Rul. 87-41 are no longer as relevant as they once were.

IRS Training Materials

- Auditors are instructed to:
 - gain an understanding of the way a business operates
 - focus is on what the business does and how the job gets done.
- The relationship between the business and its clients or customers also is important.

IRS Training Materials

Auditors are instructed to identify and evaluate evidence in the *context of the business being examined*.

IRS Training Materials

- The relationship between a business and a worker often has several facets, some indicating the business has control, while others indicate it does not.
- Control is a matter of degree.

IRS Training Materials

- There is no “magic number” of relevant evidentiary facts.
- Whatever the number of facts, they should be used in evaluating *the extent of the right to direct and control*.

Behavioral Control

- Behavioral control factors:
 - include training and instructions, which substantiate the right to direct and control the details and means by which a worker performs his or her work.

Behavioral Control

Training and instructions are important in evaluating the right to direct and control.

Behavioral Control

- Virtually every business will impose some form of instruction on workers, whether independent contractors or employees.
- Therefore, this fact *alone* is not sufficient evidence to determine the worker's status.

Behavioral Control

The goal is to determine whether the business has retained the right to control the details of a worker's performance, or instead, has ceded its right to control those details.

Instructions

Instructions cover a wide range of topics:

- When to do the work
- Where to do the work
- What tools or equipment to use
- What workers to hire to assist with the work
- Where to purchase supplies or services
- What work must be performed by a specified individual (including ability to hire assistants)
- What routines or patterns must be used
- What order or sequence to follow.

Instructions

The requirement that a worker obtain *approval* before taking certain actions is an example of an instruction that indicates right of direction and control.

Example 1

L was hired by manufacturing company X as a management consultant for its sales department. According to X, L's responsibilities are:

- to ensure that the sales department is fully staffed
- to ensure that all materials used by the sales agents are stocked and available
- to review all sales contracts.

While developing the facts listed above, you discover that X requires L to secure prior approval:

- to hire and/or fire within the sales department
- to purchase additional materials, as needed by the sales agents
- to accept any sales contract prepared by the sales department.

X's requirement that L secure prior approval is evidence of L's behavior in the performance of L's services.

If prior approval not required, L's behavior would be in his own service.

Instructions

The absence of detailed instructions as to how L will perform the job function is evidence of L's autonomy in work performance.

Instructions

Degree of instruction and the *effect on the worker in the event of noncompliance* are useful for identifying whether the business keeps control over the manner and means of work performance (employee status), or only over a particular product or service (independent contractor status).

Example 2

J is an independent truck driver. J received a call from manufacturing company Y to make a delivery run from the Gulf Coast to the Texas Panhandle. J accepts the job and agrees to pick up the cargo the next morning. Upon arriving at the warehouse, J is given an address to which to deliver the cargo and is advised that the delivery must be completed within two days. This is direction of **what** is to be done rather than **how** it is to be done and is consistent with independent contractor status.

Instructions

If instructions are imposed by the business only to comply with governmental regulations, then such rules are should be given little weight in determining the worker's status.

Suggestions v. Instructions

A **suggestion** does not constitute the right to direct and control.

For example, a dispatcher may suggest avoiding Highway X because of traffic congestion. However, if compliance with the **suggestions** is mandatory, then the **suggestions** are, in fact, **instructions**.

Uniforms and Logos

- In the past, a requirement that a worker wear a uniform or put a business logo on a vehicle was viewed as the type of instruction consistent with employee status.
- Because of increasing concerns about safety, many businesses now provide customers with identification of people gaining access to their homes or workplaces.
- If the nature of the worker's occupation is such that the worker must be identified with the business for security purposes, wearing a uniform or placing the business's name on a vehicle is a neutral fact in analyzing whether an employment relationship exists.

Degree of Direction and Control

The nature of a worker's occupation also affects the degree of direction and control necessary to determine worker status.

Highly trained professionals such as doctors, accountants, lawyers, engineers, or computer specialists may require very little, if any, training and/or instruction on how to perform their services.

Degree of Direction and Control

However, highly trained and professional workers have been found to be employees in some circumstances.

Evaluation Systems

- Virtually all businesses use evaluations to monitor the quality of work performed, whether by independent contractors or employees.
- IRS auditors are instructed to look for evidence of how the evaluation system may influence the worker's behavior in performing the details of the job.
- If an evaluation system measures compliance with performance standards concerning the **details** of **how** the work is to be performed, the system is evidence of control over the worker's behavior.

Training

Training is a classic means of explaining detailed methods and procedures to be used in performing a task.

Training

- Periodic or on-going training about procedures to be followed and methods to be used indicates that the business wants services performed in a particular manner.
- This type of training is strong evidence of an employer-employee relationship.

Training

- Training that is disregarded includes:
 - Orientation or information sessions about the business's policies, new product line, or applicable statutes or government regulations
 - Programs that are voluntary and are attended by a worker without compensation.

Financial Control

- Financial control factors:
 - include significant investment, whether expenses are reimbursed, and other factors that demonstrate a worker's opportunity to realize a profit or loss.

Financial Control

Focus is on whether the business has the right to direct or control the economic aspects of the worker's activities.

Financial Control

If a business has the right to direct and control the financial aspects of how the worker performs services, this will affect whether the worker has an opportunity for the realization of profit or loss.

Investment

A significant investment is evidence that an independent contractor relationship may exist.

There is no dollar limit, but the investment must have substance.

Example 3

C is a backhoe operator for Y distributing company. Y treats C as an independent contractor. Y claims that C has a significant investment in the \$75,000 backhoe that C uses. Further investigation finds that C leases the backhoe at less than fair rental value and can turn it in at any time without liability for further payments. Y pays for liability insurance and regular maintenance on the backhoe. C has expenses for the backhoe rental but, based on these facts, evidence of a significant investment has not been established.

Expenses

The extent to which a worker *chooses* to incur expenses and bear their costs impacts the worker's opportunity for profit or loss.

This constitutes evidence that the worker has the right to direct and control the financial aspects of the business operations.

Expenses

- Almost every independent contractor will incur an array of business expenses either in the form of direct expenditures or in the form of fees for pro rata portions of one or several expenses.
- These may include: rent and utilities, tools and equipment, training, advertising, payments to business managers and agents, wages or salaries of assistants, licensing/certification/professional dues, insurance, postage and delivery, repairs and maintenance, supplies, travel, leasing of equipment (if substantive), depreciation, and inventory/cost of goods sold.

Business Opportunities

- 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 for the relevant market.

Method of Payment

A worker who is compensated on an hourly, daily, weekly, or similar basis is guaranteed a return for labor.

Generally evidence of an employer-employee relationship.

Method of Payment

However, in some lines of business, such as law, it is typical to pay independent contractors on an hourly basis.

Method of Payment

Performance of a task for a flat fee is generally evidence of an independent contractor relationship.

Method of Payment

A commission-based worker may be either an independent contractor or employee.

The worker's status may depend on the worker's ability to realize a profit or incur a loss as a result of services rendered.

Profit or Loss

The ability to realize a profit or incur a loss is probably the *strongest evidence* that a worker controls the business aspects of services rendered.

Relationship Control

- Relationship control factors:
 - include written contracts, employee benefits, and other factors that indicate that the parties intended to create an employment relationship.

Relationship Control

In determining a worker's status, courts often look at the **intent** of the parties.

A written agreement describing the worker as an independent contractor is evidence of the parties' **intent**.

Relationship Control

However, a contractual designation, by itself, is not sufficient evidence for determining worker status.

Facts and circumstances under which a worker performs services determine the worker's status.

Relationship Control

The **substance** of the relationship, **not the label**, governs the worker's status.

In difficult cases, the **intent** of the parties, as reflected in the contractual designation, is an effective way to resolve the issue.

Formation of Business Entity

If corporate formalities are properly followed and at least one non-tax business purpose exists, the corporate form is generally recognized for federal tax purposes.

Employee Benefits

If a worker receives employee benefits, such as paid vacation days, paid sick days, health insurance, life or disability insurance, or a pension, this constitutes some evidence of employee status.

Discharge or Termination

- Traditionally, a business's ability to terminate a worker at will, without penalty, provided a highly effective method of control.
- Conversely, a business could only terminate an independent contractor relationship for failure to provide a product or services.

Discharge or Termination

- Today, businesses do not have total flexibility in discharging employees.
- Also, independent contractors may enter into short-term contracts where nonperformance remedies are not relevant, or may negotiate limits on liability for nonperformance.

Discharge or Termination

Due to this uncertainty, the right to discharge or terminate should be used with caution.

Permanent or Long-term Relationship

If a business engages a worker with the expectation that the relationship will continue indefinitely, rather than for a specific period or project, this is evidence that an employment relationship has been created.

Permanent or Long-term Relationship

- Permanency should not be confused with a long-term relationship.
- A long-term relationship may exist between a business and either an employee or independent contractor.

Permanent or Long-term Relationship

- The relationship between an independent contractor and a business may be long-term for several reasons:
 - the contract may be a long-term contract; or
 - a contract may be renewed successively due to superior service, competitive costs, or lack of alternative service providers.

Less Important Factors

- Part-time or full-time work
- Place of work
- Work in one location vs. multiple locations
- Hours of work

Section 530

Section 530 of the Revenue Act of 1978 provides some relief in certain circumstances.

Section 530

- In an audit, the first step is to determine whether Section 530 relief is available.
- The auditor is *required* to inform the company of the possibility of Section 530 relief.

Section 530

- Two main requirements:
 - consistency requirement, and
 - reasonable basis requirement.

Consistency Test

- Reporting consistency:
 - the business must have timely filed Forms 1099 for all periods
 - Issuance of Form 1099 for independent contractors is critical to Section 530 relief

Consistency Test

- Substantive consistency
 - Section 530 does not apply if the business, or a predecessor, treated the workers, or any worker holding a substantially similar position, as an employee at any time after 12-31-1977.

Reasonable Basis Test

The business must have reasonably relied on one of the following safe havens:

- judicial precedent,
- past audit, or
- industry practice.

Reasonable Basis Test

If a business cannot use one of the safe havens, the business may still be entitled to Section 530 relief if it can demonstrate any other reasonable basis for the way in which workers were classified.

Judicial Precedent

- Judicial precedent safe haven includes:
 - court decisions;
 - published IRS rulings;
 - technical advice memoranda; and
 - private letter ruling or determination letter issued to the company.

Prior Audit

- Prior audit safe haven includes:
 - any audit that began before 1-1-1997; or
 - past IRS audit for employment tax purposes, if audit began after 12-31-1996

Industry Practice

- Industry practice safe haven requires:
 - long-standing recognized practice of a significant segment of industry, but
 - need not be uniform throughout industry.

Other Reasonable Basis

- Other reasonable basis can include:
 - reliance on advice of attorney or accountant
 - state and non-tax federal law determinations
 - common law standard
 - prior audit of predecessor
 - private letter ruling or determination letter of predecessor.

Resources

- IRS Publication 1779, *Independent Contractor or Employee ...*
- IRS Publication 15-A, *Employer's Supplemental Tax Guide*
- www.irs.gov

Questions

Please feel free to email your questions to
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