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Employee or Independent Contractor?

As employers look for ways to cut costs and reduce taxes, they sometimes misclassify the people who work for them. There are significant risks involved, however, that could prove costly to your business. It should be noted that the IRS has increased worker reclassification activity – there have been more cases in 2015 than in the last five years combined!

Issue of Correct Classification

There are important distinctions between a person who works for a business as an employee and one who works as an independent contractor. As you consider classifying individuals in your organization, remember three things:

1. The IRS makes the final determination of whether a person performing work for a business is an employee or an independent contractor; not you as the business owner.
2. It is quite common for a business that misclassifies an employee as an independent contractor to get caught -- either through an IRS audit of the business or after a former contractor files Form SS-8 (Determination of Employee Work).
3. There are many possible negative consequences if you are caught and must reclassify an independent contractor as an employee.
 - a. You become responsible for both the employer's and employee's FICA (15.3% of gross wages), FUTA (currently \$56 per year per employee), as well as the federal income tax (20% of gross wages).
 - b. The IRS also may involve the state and, as a result, you may become liable for the state income tax (n/a for Washington), as well as state unemployment and worker's compensation.
 - c. You may face a penalty equal to the amount of the back taxes owed.
 - d. Likewise, you will owe interest on all back taxes from the due dates.
 - e. You may be required to support an injured person for the rest of his life.

The following information provides guidance to help you properly classify your workers.

IRS Common Law Approach on Worker Classification

The IRS uses 20 questions to determine if a worker is an independent contractor or an employee. If the answer is *yes* for any one of the questions (except #16), it may mean the worker is an employee.

1. Is the worker required to comply with instructions about when, where and how the work is done?
 2. Is the worker provided training that would enable him/her to perform a job in a particular method or manner?
 3. Are the services provided by the worker an integral part of the business' operations?
 4. Must the services be rendered personally?
 5. Does the business hire, supervise, or pay assistants to help the worker on the job?
 6. Is there a continuing relationship between the worker and the person for whom the services are performed?
 7. Does the recipient of the services set the work schedule?
 8. Is the worker required to devote his/her full time to the person he/she performs services for?
 9. Is the work performed at the place of business of the company or at specific places set by the company?
 10. Does the recipient of the services direct the sequence in which the work must be done?
 11. Are regular oral or written reports required to be submitted by the worker?
 12. Is the method of payment hourly, weekly, monthly (as opposed to commission or by the job?)
 13. Are business and/or traveling expenses reimbursed?
 14. Does the company furnish tools and materials used by the worker?
 15. Has the worker failed to invest in equipment or facilities used to provide the services?
 16. Does the arrangement put the person in a position of realizing either a profit or loss on the work?
 17. Does the worker perform services exclusively for the company rather than working for a number of companies at the same time?
 18. Does the worker in fact make his/her services regularly available to the general public?
 19. Is the worker subject to dismissal for reasons other than non-performance of the contract specifications?
 20. Can the worker terminate his/her relationship without incurring a liability for failure to complete the job?
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IRS Auditor Training Materials – 3 Categories of Evidence

If you are audited, it would be a much better strategy to limit the employee vs. independent contractor discussion to the three categories of evidence and reference the IRS's worker classification manual!

Does behavioral control over worker exist?

Behavioral control focuses on whether the business has the right to direct or control **how** the work is done, e.g., **how** the worker performs the specific task for which he or she is hired. Factors include:

1. ***To what extent are instructions given and taken?*** An employee is generally subject to the business's instructions about when, where, and how to work; an independent contractor is not. 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. Pertinent evidence includes: (1) needing prior approval before proceeding, (2) rendering services personally, and (3) hiring, supervising, and paying assistants.
2. ***What training does the business give the worker?*** Employees may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods. The business's orientation course, safety seminars, and voluntary unpaid educational programs are to be disregarded.

Do financial controls over worker exist?

These factors illustrate whether there is a right to direct or control how the **business** aspects of the worker's activities are conducted:

1. ***Can the worker realize a profit or incur a loss?*** An independent contractor can make a profit or loss whereas employees can only make a profit. The IRS discloses that the worker's dependence on the job is NOT a factor.
 2. ***Is the worker's investment significant?*** An independent contractor often has a significant investment in the equipment or facilities he or she uses in performing services for someone else. However, a significant investment is not required. Pertinent evidence includes: (1) amount of unreimbursed expenses, (2) payment of business and/or travel expenses, (3) furnishing of tools and materials, and (4) analysis of lease arrangements between worker and business. The IRS has listed business expenses expected to be found on the taxpayer's business return.
 3. ***To what extent does the worker make services available to the general public?*** Pertinent evidence includes: (1) Yellow Page advertising, (2) working for more than one firm, and (3) identifying when advertising not required, e.g., use of word-of-mouth advertising and having long-term contracts.
 4. ***How does the business pay the worker?*** An employee is generally paid by the hour, week, or month. An independent contractor is generally paid a flat fee or by the job, even though it is common in some professions, such as law and accounting, to pay hourly. The payment of commissions indicates both are possible.
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What type of relationship between the parties exist?

These factors illustrate how the worker and the business perceive their relationship between each other:

1. ***Does a written contract exist that describes the relationship the parties intend to create?*** This factor is generally considered of lesser importance by the IRS (but more important by the courts!) as the substance, not the label, governs the worker's status. A written contract contains other evidence - e.g., method of compensation, what expenses are unreimbursed, and how work is to be performed.
 2. ***Does the business provide the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay?*** Employee benefits are only paid to employees! The IRS surprisingly discloses that W-2s do not necessarily indicate employee status and that incorporated workers generally will not be recharacterized as the business's employees.
 3. ***How permanent, ongoing, is this relationship?*** Permanent and indefinite relationships indicate an employer-employee relationship whereas, the IRS divulges, long-term and temporary relationships are not important evidence - i.e., independent contractors can have long-lasting relationships.
 4. ***To what extent are the services performed by the worker a key aspect of the regular business of the company?*** Is the success of the business dependent, to an appreciable degree, upon the worker's performance? If so, an employer-employee relationship exists. For example, as restaurants need cooks and cashiers and law firms need lawyers, these workers are generally employees. But, even though it is essential for an appliance store to retain good accountants, bookkeeping is NOT the store's regular business, and, therefore, this work can be done equally well by independent contractors or employees.
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Other Factors Used by Courts to Determine if Worker Is Employee or Self-Employed

The question of whether an individual is an employee or self-employed is factual. Factors that have been considered by courts in making this determination are:

1. the skills required
2. the source of instrumentalities and tools
3. the location of the work
4. the duration of the relationship
5. whether the business has the right to assign additional projects to workers
6. the extent of the worker's discretion over when and how long to work
7. the method of payment
8. the worker's role in hiring/paying assistants
9. whether the work is part of the regular work of the business
10. the providing of worker benefits
11. the tax treatment of the worker

No one factor is dispositive and the various aspects of the relationship are weighed and balanced to reach a result.

Statutory Employees and Statutory Non-Employees

The Federal code lists the following four occupational groups as not being employees under the Common Law Rules (20 questions), but are employees under the Statutory Rules:

1. Agent Drivers or Commission Drivers: Must be licensed, paid on a commission basis, and a contract must exist stating the agent will not be an employee for federal tax purposes.
2. Full-time Life Insurance Salesperson (one company)
3. Homemakers: Work at home for one employer making clothing, needlecrafts, bedspreads, buttons, quilts, gloves, etc.
4. Traveling or City Salesperson: Sells for one principal employer.

The following are Statutory Non-Employees according to the Federal code. They are considered not to be employees, but are independent contractors under statutory rules.

1. Qualified Real Estate Agent: Must be licensed, paid on a commission basis, and a contract must exist stating the agent will not be an employee for federal tax purposes.
 2. Direct Seller: Sells consumer products outside a permanent retail establishment, is paid on a commission basis, and a contract must exist stating the salesperson will not be an employee for federal tax purposes.
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Strategies for Business Owners

To support your assertion and to convince the IRS about the status of an independent contractor, ensure that the individual:

- Signs a written agreement attesting to the fact that he/she is an independent contractor.
- Bills the business for the services rendered.
- Is required to have personal worker's compensation coverage.
- Be given as much independence as possible about hours worked, where the job is to be performed, etc.
- Provide personal tools, computer, supplies, training, transportation, etc.

This whitepaper evaluates only the IRS guidelines and evidence they gather during examinations. Other considerations for business owners would be broaden your review to include Washington State's Labor and Industries, and the Department of Labor.

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