The Employee vs. Independent Contractor Issue

Small businesses often do not understand the effect of classifying an individual as an employee or an independent contractor. Properly classifying a worker as an independent contractor may save a company money and benefits, such as pension, group health and workers' compensation insurance, as well as social security and unemployment insurance taxes   In most cases, the only tax form employers have to complete is Form 1099-MISC at the end of the tax year for workers classified as independent contractors.

Classifying workers as employees, on the other hand, requires that the company: withhold federal, state, and local income taxes; pay half of the tax mandated under the Federal Insurance Contributions Act (for social security and Medicare); pay the full tax mandated under the Federal Unemployment Tax Act and any state unemployment insurance tax laws; pay for workers' compensation; file a number of returns during the course of the year with the various tax authorities; and provide W-2'ss by January 31. The employee may also have rights to any employee benefits, such as health insurance, vacations, holidays, or retirement plans.

In 1966, the IRS released new guidelines to its agents to help determine worker status. In the past, a list of 20 factors compiled by the IRS has been used in court decisions to determine worker status. The list, sometimes called the 20 Factor Test, will still be used as an analytical tool although some of the factors are no longer as relevant as they once were. The new guidelines direct agents to focus on the overall situation rather than to emphasize one or two of the 20 factors.

The determination of whether a worker is an employee or an independent contractor is based on common law rules. The determination depends primarily on the extent to which the person receiving the services has the right to direct and control the service provider with regard to what is to be done and how it is to be done. An employer generally has the right to control how an employee performs the service. Independent contractors determine for themselves how the work is to be performed.

Common law rules look at the relationship of the worker and the business, taking into consideration all evidence of control and independence. To help in this, the IRS has developed new "categories of evidence" to be used to indicate the extent of direction and control present in any work situation. These categories of evidence are used in connection with IRS audits concerning worker status. Not all facts need to be present in any given situation, and no single fact is controlling.

Facts that provide evidence of the degree of control and independence fall into three categories: behavioral control, financial control, and the type of relationship of the parties as shown below.

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 is hired include the type and degree of:

- *Instruction the business gives the worker*. An employee is generally subject to the business's instructions about when, where, and how to work. 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.
- *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.

Financial Control

- *The extent to which the worker has unreimbursed business expenses.* Independent contractors are more likely to have unreimbursed expenses than employees. Fixed ongoing costs that are incurred regardless of whether work is currently being

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. However, a significant investment is not required.
- *The extent to which the worker makes services available to the relevant market.*
- *How the business pays the worker.* An employee is generally paid by the hour, week, or month. An independent contractor is usually paid by 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 incur a loss.* An independent contractor can make a profit of loss.

Types of Relationships

Facts that show the parties' type of relationship include:

- *Written contracts describing the relationship the parties intend to create.*
- *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 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 or 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.

Behavioral Control	**Financial Control**	**Relationship of the Parties**
Facts which illustrate whether there is a right to direct or control how the worker performs the specific task for which he or she is engaged: • Instructions • Training	Facts which illustrate whether there is a right to direct or control how the business aspects of the worker's activities are conducted: • Significant investment • Unreimbursed expenses • Services available to the relevant market • Method of payment • Opportunity for profit or loss	Facts which illustrate how the parties perceive their relationship: • Intent of parties/written contracts • Employee benefits • Discharge/termination • Regular business activity

Risks faced when you misclassify employees

Intentionally misclassifying employees as independent contractors may result in penalties and interest double what should have been paid by the business. The exposure for unintentional misclassification of an employee is serious, but not as serious as the risk for an intentional misclassification. Here's what at stake:

Unintentionally misclassifying an employee (and the employer filed a form 1099) limits an employer's liability for income taxes to 1.5% of the employee's wages. The employer's liability for FICA taxes that should have been paid by the employee would be limited to 20% of that amount. And, the employer would have no rights to recover from the employee what is due to the IRS. If an employer has not filed any information returned, such as the Form 1099, that were required, the percentage amounts are doubled. The employer must pay 3% for federal withholding and 40% of the employee's portion FICA in addition to the employer's share of FICA.

Additionally, the employer would still be liable for its share of FICA and unemployment taxes. Interest and penalties could be assessed by the IRS, but only on the amount of the employer's liability. The employer's liability includes the percentage of tax that should have been withheld. For example, interest for failure to collect FICA would be based on the employer's share of FICA plus the 20% of the tax that should have been withheld fro the employee.

Intentionally misclassifying an employee, on the other hand, could result in the following employer liabilities; the full amount of income tax that should have been withheld (with an adjustment if the employee has paid or does pay part of the tax); the full amount of both the employer and employee shares for FICA (but might receive an offset if the employee paid FICA self-employment taxes); interest and penalties, computed on far larger amounts than in the case of an unintentional misclassification.

Playing it safe

When in doubt about how to classify a worker, classify him or her as an employee. Or, seek professional advice and ask your accountant. The hiring firm has the burden of proving that it had no control over the work or the worker where the worker was classified as an independent contractor. And when a former worker files an unemployment insurance claim, an investigation is automatically triggered to determine the status of the employee.

The IRS will use the new guidelines (see the chart above) and the 20 factor test to determine proper classification but will also look to a written contract for independent contractor classification. Any such contract should set forth the terms of the relationship between the employer and individual, including:

- A statement that the independent contractor is not entitled to employee benefits programs;
- A joint severability clause stating that if part of the contract is struck down, the rest of it survives;
- Acknowledgment that the independent contractor is free to work elsewhere at any time.

A contract between the employer and the worker may be immaterial, however, based on the facts and circumstances of the case.

Common myths to avoid in classifying workers

A hiring firm is safe if:

- The worker wanted to be treated as an independent contractor.
- The worker signed a contract.
- The worker does assignments sporadically, inconsistently, or is on call.
- The worker is paid commission only.
- The worker does assignments for more than one company.

The Internal Revenue Service does have a form to request a determination of status of a particular individual, known as Form SS-8. The IRS will use the information provided on the form, as well as any other information that can be obtained from the other parties involved, to determine whether an individual is covered under the payroll tax laws. Although a taxpayer may seek worker classification guidance by submitting Form SS-8, such guidance is taxpayer specific and is not intended as guidance for other members of the industry involved.

Safe Harbors

Congress has established "safe harbors"- defenses for employers who misclassify a worker as an independent contractor. For example, an employer may have a defense if it had a "reasonable basis" for not treating the worker as an employee. This defense may apply if an employer reasonably relied on:

- Judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer.
- Past IRS audits. This safe harbor applies only if there was no tax assessment related to the business's treatment of individuals holding substantially similar position. However, in order to rely on a prior audit that began after December 31, 1996, the audit must have included an examination for employment tax purposes of whether or not the worker, or anyone in a substantially similar position, should be treated as an employee.
- Long-standing, recognized practice of a significant portion of the industry.

An employer may be denied the protection of a safe harbor if it inconsistently classified workers who are doing the same tasks, or if the employer has not filed the appropriate tax forms consistent with the treatment of a worker as an independent contractor. Therefore, an employer is encouraged to treat all individuals considered to be an "independent contractor" consistently, and to file federal tax forms as required. Check with you accountant or attorney for professional advice in this subject.

Classification Settlement Program

The IRS added a new classification program which began March 5 1996, for a two-year test period. The program gives IRS examiners more authority to try to resolve worker classification issues at the field level, and gives IRS auditors more flexibility in applying the safe harbor provisions.

IT IS IMPORTANT FOR SMALL BUSINESSES TO UNDERSTAND THE EMPOLYEE VS INDEPENDENT CONTRACTOR MATTER. CORRECTLY CLASSIFLYING WORKERS BEFORE THEY PERFORM SERVICES CAN SAVE A BUSINESS CONFUSION, HASSLES, AND POSSIBLE FINES DOWN THE ROAD.

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