



EMPLOYEE OR INDEPENDENT CONTRACTOR?

"I'll just make everyone an Independent Contractor, so I don't have to worry about all that 'stuff' we call payroll taxes!" How many times have I heard business people tell me that while we are working on their business plan and financials? My response is, "Run, don't walk, to your best tax accountant(s)/advisor(s) and ask them for advice!"

Business owners can be headed for **BIG** trouble with the U.S. Internal Revenue Service if they don't fully understand and comply with the rules that determine whether the person(s) being contracted is truly an employee or an Independent Contractor (IC). Following is a general overview of some of the factors that a business should consider before determining to classify a worker as an Independent Contractor or employee.

IRS Criteria

In general, the IRS uses three different measures to determine whether someone is truly an Independent Contractor or employee.

BEHAVIORAL CONTROL

- The amount of control that the business has over how the task/job is done

FINANCIAL CONTROL

- The IC's non-reimbursable business expenses
- The worker's investment
- Whether the IC contracts with other businesses
- Whether the IC can make a profit or take a loss
- The way in which the business pays the IC

TYPE OF RELATIONSHIP

- The type of written contracts between the IC and business
- The extent to which there are employee-type benefits such as insurance
- The length of the contract/job (i.e., indefinite relationship vs. specific project or period of time)
- The extent to which the IC performs key functions of the contracting business

Twenty Common Law Factors

In addition, the IRS has identified twenty common law factors that the business can use in determining whether a worker is an employee or Independent Contractor. It is not just one of the factors but all of them together that determine the classification of a worker. As a rule of thumb, it is wise to err on the side of classifying the worker as an employee if there is any doubt. The IRS is more inclined to rule that the worker is an employee without convincing evidence from the business to prove otherwise.

INSTRUCTIONS

Employee: Required to comply with employer's instructions as to how to do the job.

IC: Follows own instructions.

TRAINING

Employee: Trained on how to do the job by the employer.

IC: If training is required, provides own training through own resources.

INTEGRATION

Employee: Services are a key aspect to the business and are a regular business activity.

IC: Services provided are not an integral part of the business.

PERSONAL

Employee: Required to perform the services personally.

IC: May hire a substitute without business's knowledge.

ASSISTANTS

Employee: Hired, supervised, and paid by the business.

IC: Hires own assistants and required only to attain the specified result.

CONTINUITY

Employee: Existence of a continuing relationship between the employee and business. May include work performed at frequently recurring, though somewhat irregular intervals.

IC: No assumption of continuing relationship beyond the specified contract.

HOURS OF WORK

Employee: Business establishes the hours.

IC: Free to establish own hours, although there may be times when the contractor must work when the facilities are open and complete the entire job within a certain period of time.

TIME REQUIRED

Employee: Must devote full-time to the business and may be restricted from working for others.

IC: May choose for whom and when to work.

WORK LOCATION

Employee: Performs work on business premises. If off premises, still controlled by the business.

IC: Work may be performed anywhere as determined by the contractor.

SEQUENCE OF WORK

Employee: Performs work under direction of business in the order and sequence determined by the business.

IC: Free to determine own sequence of work.

REPORTS

Employee: Makes oral or written reports to business on a regular or periodic basis.

IC: Not required to submit regular reports.

PAYMENT

Employee: Paid by the hour, week, or month.

IC: Paid by result or lump sum, as dictated by the contract for specified results.

EXPENSES

Employee: Is reimbursed by business for expenses.

IC: Pays own expenses, although expenses may be paid by employer if included in contract.

TOOLS AND MATERIALS

Employee: Generally, provided by the business with some exceptions in certain occupations where it is customary for the employees to furnish their own tools.

IC: Provides own tools and materials to accomplish work.

FACILITY INVESTMENT

Employee: Generally, has no investment in facilities as they are provided by the business.

IC: Has investment in facilities either by renting or owning facilities used to accomplish the work.

PROFIT OR LOSS

Employee: Cannot realize a profit or loss for services provided.

IC: Is in the position of realizing a profit or loss from the services provided.

NUMBER OF EMPLOYERS

Employee: Generally, performs work for a single business.

IC: Generally, performs work simultaneously for more than one, unrelated person or entity.

AVAILABLE TO GENERAL PUBLIC

Employee: Does not make services available to the general public.

IC: Makes services available to the general public on a regular basis.

POWER TO FIRE

Employee: Business can discharge employee and thereby control the nature and pace of work through threat of dismissal.

IC: Cannot be discharged so long as the results are satisfactory.

TERMINATION

Employee: Has the right to quit the job at any time without liability.

IC: Usually, agrees to complete a specific job and is responsible for its satisfactory completion or faces the risk of breach of contract liability.

Risks Associated with “Misclassifying” Employees

Unintentionally misclassifying employees as Independent Contractors, in which case the business filed 1099 forms, is serious and may subject the company to paying limited FICA taxes and income taxes as well as unemployment taxes. The IRS could assess the company interest and penalties on the amount of the employer’s liability.

Intentionally misclassifying employees as Independent Contractors, which would require the above taxes, could result in substantial penalties as well as interest charged at double the rate it might otherwise have been assessed if it were the result of unintentional classifications.

When in doubt, seek professional advice from your accountant. It is up to the business to prove that it has no control over the work or the worker when there is an audit by the IRS or other government agencies. An audit can be triggered if a former Independent Contractor files an unemployment claim or disgruntled employees report their suspicions to the IRS. The IRS uses the 20 factors listed above to determine the proper classification, in addition to the contract itself.

When setting up a contract with a company that is a true Independent Contractor, it is important to include the following statements in the contract:

- The Independent Contractor is NOT entitled to employee benefit programs
- A “joint severability clause” which states that, if part of the contract is struck down, the rest of it survives
- An acknowledgement that the Independent Contractor is free to contract work with other businesses at any time.

Myths That Can Get a Business in Trouble

Many times, businesses are ill-advised by friends that they are safe in classifying an employee as an Independent Contractor if the worker:

- Requests to be treated as an Independent Contractor
- Signs a contract
- Does assignments sporadically, inconsistently, or is on call
- Is paid commission only
- Does assignments for more than one company

It is always wise to remember: When in doubt, seek help. Check with an experienced tax accountant who knows your business type and size. The IRS can also provide you with assistance. Just download the form SS-8 from the IRS website: www.irs.gov. Fill it in and mail it to the IRS. It is important to note that this IRS classification guidance is taxpayer-specific and not intended as guidance for other members of the industry involved. Each company needs to submit its own request to the IRS for valid information.

Disclaimer

The above article is intended as an overview only and is not intended to take the place of accounting, legal, or any other professional advice. If accounting or legal advice is required, it is advisable that you seek the services of qualified tax accountants and attorneys.

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