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Independent Contractor Or Employee ???

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As pointed out elsewhere in this program, there are some major tax and other advantages in hiring independent contractors rather than employees to work in your business. Not only do you effect considerable payroll tax savings (no FICA, FUTA or state unemployment tax), but there are fewer administrative headaches, since you don't have to withhold income and payroll taxes from payments to an independent contractor (generally) , you don't have to provide workers' compensation coverage for them, you don't have to worry about the Age Discrimination in Employment Act and the Americans with Disabilities Act of 1990 (since both Acts apply only to employees, not independent contractors), and you don't have to cover them in your retirement plan or other employee fringe benefit plans.

Too good to be true? Yes, if the people in question don't qualify to be treated as other than employees. Unfortunately, just because you agree with someone you hire that they will be an independent contractor does NOT make it so for tax and legal purposes. Thus, before you attempt to hire anyone to work for you as an independent contractor, you need to take a hard look at whether the IRS or a court of law would consider that person to be your employee, rather than an independent contractor. The IRS uses the following 20 factors to test and evaluate whether or not a person is an employee:

CONTROL. If a worker is required to comply with directions about when, where and how the job is to be done, he or she is usually an employee. (This is the key factor to consider.)

TRAINING. Where the owner trains a worker, it indicates that control is being exercised over the means by which results are to be accomplished. Ergo, the worker is an employee.

WHO MUST RENDER SERVICES? If the services must be rendered personally, it suggests that the employer controls both the means and the results of the work.

INTEGRATION. When the continued operation of a business depends on the rendition of certain services by the worker, those services are necessarily subject to a certain amount of control by the business.

HIRING, SUPERVISING & PAYING ASSISTANTS. Control is exercised if the company hires, supervises and pays assistants of the worker in question.

CONTINUING RELATIONSHIP. A continuing relationship between the worker and company is indicative that an employer-employee relationship has been created.

HOURS OF WORK. If set hours of work are established, it suggests control, and therefore is indicative that an employer-employee relationship exists.

FULL TIME REQUIREMENT. If the worker is required to devote full time to the one "client," it strongly indicates that the "client" is exercising control over the worker's time, and is thus his or her employer.

WORKING ON EMPLOYER'S PREMISES. Control is indicated if the work is performed on the company's premises.

ORDER OR SEQUENCE OF WORK IS SET. If the worker is not free to choose his or her own pattern of work, but must perform services in the order or sequence set by the company, it is indicative of control by the company.

ORAL OR WRITTEN REPORTS. A requirement that the worker must submit regular oral or written reports to the company suggests control by the company.

PAYMENT BY THE HOUR, WEEK, OR MONTH. Payment by the hour, week or month usually (but not always) is indicative of an employer-employee relationship.

PAYMENT OF BUSINESS/TRAVELING EXPENSES. Payment of the worker's business and/or traveling expenses gives the appearance that the worker is an employee.

FURNISHING OF TOOLS & MATERIALS. If the company furnishes significant tools, materials and other equipment, it strongly points to an employer-employee relationship.

SIGNIFICANT INVESTMENT. If the worker invests significantly in facilities that are not typically maintained by employees (such as an office rented at fair market value from an unrelated party) he or she will usually be considered to qualify as an independent contractor.

RISK OF PROFIT OR LOSS. If a worker can make either a profit or a loss (in addition to the profit or loss ordinarily realized by employees), it indicates independent contractor status; if he or she cannot, then the worker is an employee.

WORKING FOR MORE THAN ONE FIRM. If a worker performs significant services for a number of unrelated persons at the same time, he or she is an independent contractor, not an employee.

MAKING SERVICES AVAILABLE TO THE GENERAL PUBLIC. A worker is considered to be an independent contractor if making his or her services available to the general public on a regular and consistent basis. (Just printing up some business cards won't do the trick, however, and will not fool any but the most dim-witted Revenue Agents.)

RIGHT TO DISCHARGE. The right of a company to discharge a worker indicates the worker is an employee.

RIGHT TO TERMINATE. A worker is an employee if he or she has the right to end the relationship with the company at any time he or she wishes without incurring any liability.

Other factors that the courts may look at in deciding this issue include a determination of whether the kind of work the person does for you is of a kind normally done by employees (such as secretarial work, for example), and whether the worker is a licensed professional of any type (such as a lawyer, architect, etc.).

Unless you are quite clear that the work relationship will not be considered that of employer-employee, be VERY careful about hiring someone as a so-called independent contractor. The consequences of being wrong can be severe, and few people ever suspect the enormous risks in using independent contractors until it is too late. A state or federal audit that disallows independent contractor status can mean personal financial disaster for you as a small business owner or a Sole Proprietorship.

The IRS "business plan" has recently focused heavily on the independent contractor vs. employee issue, and the IRS is generating large amounts of revenue from this issue on tax audits. In recent audits, the average reclassification assessment was \$68,000, according to one report, and some 90% of the IRS audits found misclassified independent contractors working for the firms that were audited.

HARD FACTS: During the period from 1988 to 1995, the Internal Revenue Service performed 12,983 employment tax audits, which resulted in re-classification of some 527,000 workers as employees. Their employers were assessed \$830 million in back taxes, penalties, and interest.

Some of the things (none of them good) that can happen if your "independent contractor" is held to be an employee include the following:

You are liable for not only the employer payroll taxes you failed to pay, but also a portion of the

employee taxes you failed to withhold (income taxes, FICA) If you treat someone as an independent contractor, you should report payments of \$600 or more to that person on IRS Form 1099-MISC. If you do, and the IRS later determines that the person was really an employee, the back taxes you are liable for are limited to: (a) the employer payroll taxes, (b) 20% of the employee's FICA tax you failed to withhold, and (c) income tax withholding equal to only 1.5% of the wages you paid the person. But if you do NOT file a Form 1099-MISC and the person is re-classified as an employee by the IRS, you are liable for 40% of the employee's FICA tax and income tax withholding equal to 3% of the wages (twice as much as where you have filed the 1099-MISC) Furthermore, there is now a \$100 penalty for failure to file the 1099-MISC and you will owe interest on the taxes due. You may also be assessed other penalties if you did not have a reasonable basis for treating the person as a non-employee and may be liable for up to 100% of the FICA and income tax which you failed to withhold.

If the person is hurt on the job and you have not provided workers' compensation coverage, you could be liable for extensive legal damages.

If your firm has a qualified retirement plan and you have not contributed to the plan on behalf of the person because he or she was not thought to be an employee at the time, the retirement plan could be disqualified for tax purposes for failing to cover the employee in question.

Needless to say, if you try to hedge your bets by covering your "independent contractors" under workers' compensation and your qualified retirement plans, you are also virtually admitting that they are actually employees.

Be aware that if you do take the precaution of filing the 1099-MISC form, you will be inviting an IRS investigation, if not a full-blown audit. The IRS has recently instituted a major "search and destroy mission" for following up on 1099-MISC filings to determine if the so-called "independent contractors" shown on such forms should in fact be considered employees.

BOTTOM LINE: Don't let yourself be stampeded into the independent contractor game by friends and business associates who tell you how simple and easy it is to avoid paying all those payroll taxes---unless you are planning to become a part of the subterranean economy.

"SAFE HARBOR" EXEMPTION FOR CERTAIN COMPANIES TREATING WORKERS AS INDEPENDENT CONTRACTORS SINCE 1977 OR EARLIER

Section 530 of the Revenue Act of 1978 provides an exemption or "safe harbor" from reliance on the 20 common law factors that are ordinarily used to determine if a worker is to be treated as an employee or an independent contractor for tax purposes. This exemption, which is sort of a "grandfather clause," is available only if all the following conditions are met:

Since December 21, 1977, the hiring company has consistently treated all similar workers as independent contractors, not as employees; and

the hiring company has filed all required IRS forms relating to such workers (Form 1099-MISC, for example); and

the hiring company has a reasonable basis for treating the workers in question as independent contractors, because of the existence of any ONE of the following three factors:

- . a prior judicial precedent; or
- . reliance upon a prior IRS audit; or
- . long-standing industry practice of treating such workers as independent contractors.

(CAUTION: In 1986, Congress amended the Section 530 safe harbor, eliminating its protections for the engineering and computer industries.)

Obviously, this safe harbor exception will not be of much use to companies that did not begin business or begin hiring persons as independent contractors before December 21, 1977, but if your company has been around that long and meets the above requirements, this can be a very important shield against devastating liabilities that might be imposed on you as a result of an IRS audit, where the persons your firm treats as independent contractors do not qualify under the 20-factor test. If you meet the above “safe harbor” requirements, it will be crucial that you continue to timely file Forms 1099-MISC and be consistent in treating all such workers as independent contractors, in order to maintain your eligibility to utilize the Section 530 exemption.

LATEST CONGRESSIONAL/IRS ACTION TO CLARIFY THE CONFUSION OVER THE INDEPENDENT CONTRACTOR ISSUE

The complex and subjective 20-factor test the IRS has used in the past has not been discarded, but the new IRS Manual indicates that it will now give more weight to written contracts that state that a worker is to be considered an independent contractor, and to other factors favorable to employers. Also, Congress enacted a new federal law in 1996 that will make it somewhat easier for the taxpayers and IRS to determine whether a worker is an employee or an independent contractor.

IRS MANUAL. The newest release of the IRS Manual, used by IRS agents as guidance in doing audits, contains the following key changes relating to the independent contractor controversy:

CONTRACTS. The Manual now says that, although a “contractual designation, in and of itself, is never sufficient evidence for determining worker status, if evidence outside the contract is so evenly balanced that it is difficult, if not impossible, to decide whether a worker is an employee or an independent contractor, the contractual designation is an effective way to resolve the issue.”

ADVERTISING. The IRS usually treats advertising as an important indicator of contractor status, but in the past has usually only given weight to published ads in telephone books or newspapers. The Manual now recognizes that some contractors, such as professionals, hold themselves out to the public largely by word of mouth, rather than by published ads.

TIME AND PLACE. Previously, if work had to be done at a certain time and place, the IRS generally treated this as evidence that the company “controlled” the worker, suggesting an employer-employee relationship existed. The Manual now recognizes that this is a factor that has “...little meaning in its own right. Some work must by its nature be performed at a specific time.”

SUGGESTIONS VS. INSTRUCTIONS. In the past, the IRS took the position that “instructions” to a worker, as compared to “suggestions,” indicated employee status. The new Manual recognizes that virtually every business will impose on workers, whether employees or contractors, some form of instruction, and tells IRS agents to look to other factors in determining workers’ status.

REQUIRED UNIFORMS. The Manual now notes that the fact a company requires individuals working on its premises to wear uniforms will not have a bearing on their status as employees or independent contractors.

FLEXIBILITY. The Manual now recognizes that a worker can be a contractor, even if some factors indicate the status of an employee. Also, it recognizes that a worker can be an employee for some purposes and an independent contractor for others, with the same company.

PROFESSIONALS. The Manual makes it easier now for various professionals to qualify as contractors. For example, hourly pay for professionals such as lawyers is no longer a sign of employee status. Also, persons who perform their services through a one-person corporation they have created will now almost always be recognized as independent contractors, and the reimbursement of some of the worker’s expenses is no longer cited as evidence of employee status in the new Manual.

LAW CHANGES. The Small Business Jobs Protection Act, which was signed into law in August of 1996, creates some additional protection for employers against back taxes for having treated workers as independent contractors. The new legislation provides that:

If a company can prove it had a “reasonable basis” for its categorization of a worker as an independent contractor, it can prevail on the determination. Under prior law, a company could not raise this defense until after the IRS audit was completed and the IRS had determined that a worker was an employee.

A company may now have a “reasonable basis” for its treating an employee as a contractor even if only 25% of the industry uses independent contractors to perform the same work, even if 25% of the industry has done so only recently, within the last 10 years. Previously, the IRS would only consider industry practices that had been in existence for at least 10 years.

WAYS TO AVOID HAVING INDEPENDENT CONTRACTORS TREATED AS EMPLOYEES

There are a number of steps you may be able to take to make a stronger case for someone who does work for you being treated as an independent contractor. Obviously, not all of the following steps will necessarily be feasible in every case, and a number of these steps, if implemented, may require some significant changes in the way you do business. But if you can follow most of the suggestions below with regard to a given worker, you should at least improve your odds against having that worker reclassified as an employee.

Have a written agreement, signed by both parties, which makes it clear that the company doesn’t have the right to control the methods or procedures for the worker to accomplish the work contracted for. Include language in the agreement that it is the worker’s obligation to pay income and self-employment taxes on amounts earned, and that he or she will receive a 1099 reflecting amounts earned, if \$600 or more.

Try to **avoid setting working hours** by day or week. It would be acceptable to specify starting and completion dates for the work.

Make it clear that if additional workers are needed to help, the **contractor will hire and pay** them.

If tools are needed, the **contractor should provide and select them for the job**.

The arrangement should make it clear that **the contractor is not limited to working exclusively for you**, but is free to take on other work from other customers.

Compensation should be based on what work is performed rather than the time spent to do it. This may require careful estimates so that the worker is fairly paid, and not overpaid for the work done.

Avoid providing office space to the contractor on a regular basis.

Let the workers be **responsible for their own training**, if that is possible.

Each worker should be advised, in writing, to provide for their **own liability, workers’ compensation, health and disability insurance** coverage.

Costs such as **meals, transportation, and clothing should be built into the contract price** of the job, rather than being billed directly to your account.

It should be clear in your agreement with the worker that he or she can’t be fired, and can’t quit. Their **job is to fulfill a given work contract**.

Don't give the worker other work to "fill in" during downtime. This may mean, of course, that you will have to pay the workers somewhat more for the work done than you otherwise would, if you wish to keep them happy.

Don't EVER pay bonuses to a person you treat as an independent contractor.

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