

Client Memorandum

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EMPLOYEE OR INDEPENDENT CONTRACTOR?.. and why the determination is essential to a business ©

Most business owners would like to treat as many of their workers as possible as independent contractors. Why? Because if an individual is truly an independent contractor, the ‘employer’ is not responsible for the withholding of income taxes or for any portion of payroll taxes on the earnings of the worker. An independent contractor is ‘self employed’, and is responsible for the reporting and payment of his or her own payroll taxes.

As additional background, FICA establishes a tax that is assessed by the federal government based on wages paid to workers, and the money collected from the FICA tax is used to fund the Social Security Trust Fund. Under a traditional employer-employee relationship, an employer withholds from the employee’s paycheck a percentage of the employee’s wages based on the applicable FICA wage rate. The money withheld from the employee’s paycheck is then paid to the government, making it, in essence, a tax paid by the employee. At the same time, the employer itself pays a FICA “excise tax” that is equal in amount to the percentage wage rate paid by the employee. In a traditional employer-employee relationship, therefore, the employee pays half of the total FICA tax owed and the employer pays the other half. For independent contractors and other self-employed workers, however, there is no separate “employer” to pay half of the tax. As a result, the self-employed worker pays both the employee’s tax and the employer’s tax, adding up to the full 100 percent of the money due under FICA. An employer who hires independent contractors does not have to pay any excise taxes for these workers, as the workers are responsible for their own payments.

Following are a number of bullet-point guidelines in making the determination of whether a worker is an independent contractor or an employee:

* General rule: For most businesses, your workers are employees. (Not true in all businesses however, such as real estate agents, who are generally termed as *statutory non-employees*. Other relatively common exceptions *may* include insurance agents, and various other sales positions). While it is possible that a single individual may perform work as both an independent contractor and an employee for the same employer (*See Rev. Rul. 58-505*), this occurs in relatively rare instances.

* The IRS ‘rule’ can be summarized as follows: “A worker is an independent contractor if YOU or your company (i.e., the person for whom the services are performed) have the right to control or direct *only* the result of the work and not the means and methods of accomplishing the result”. This statement is taken directly from the IRS’ website, at <http://www.irs.gov/businesses/small/article/0,,id=99921,00.html>. The key here is whether you have the ‘right’ to control, whether exercised fully or not.

* Several key items that point to employee status are: the setting of the worker’s work hours by the company; control over how the worker performs his or her job; whether the employer provides work tools, work space, etc; and how the worker is paid. If paid a fixed ‘wage’ or paid ‘hourly’, the worker will generally be an employee (even if eligible for commissions or bonuses/sales incentives on top of the regular wages).

* Specifically, the IRS has provided a list of 20 factors to consider in the determination of a worker’s status. These are set forth in *Rev. Rul. 87-41*, and cited in *Hospital Resource Personnel, Inc. v. U.S.*, 68 F. 3d 421 (C.A. 11 (Ga) 1995), as follows:

Those [factors] indicative of employee status include: (1) instructions from the employer; (2) training; (3) integration of worker’s services into employer’s business; (4) worker’s services rendered personally; (5) a continuing relationship between worker and employer; (6) set hours of work; (7) mandatory full-time employment; (8) work on employer’s premises; (9) set order of tasks; (10) oral or written reports; (11) payment by the hour, week, or month; and (12) right to discharge for reasons other than nonperformance.

Those [factors] indicative of independent contractor status include: (13) worker's right to hire, supervise, and pay assistants; (14) payment of own business and/or travel expenses; (15) furnishing own tools and materials; (16) significant investment; (17) realization of profit or loss; (18) right to work for more than one firm at a time; (19) right to make service available to the general public; and (20) right to terminate without incurring liability.

*The inclusion of 'non-competition' provisions in an agreement with an independent contractor should generally be avoided. While this is not an absolute bar to treatment as an independent contractor, it is generally considered one strong indicia of an employment relationship.

* The providing of 'employee benefits' also generally demonstrates strong indications that an employer-employee relationship exists. Employee benefits include things like health insurance, retirement plans, paid vacation, sick days, and disability insurance, to name a few. Businesses generally do not grant these type of benefits to independent contractors. However, the *lack* of these type of benefits does not necessarily mean the worker is an independent contractor.

* WHY is it a big deal? Because if you misclassify a worker without a reasonable basis for doing so, you, the employer, will be held liable for the employment taxes that should have been withheld. By the time this is caught by the Service a year or two or three after the fact, there will also be *substantial* penalties and interest, which can easily double the amount that is due!

* The bigger concern, perhaps, is that payroll taxes are 'trust fund' taxes. What this means is that if you improperly and without reasonable basis misclassify workers, and they are held to be employees, then the business owner and even the officers or directors may be held personally liable for the amounts due. (See the Client Memorandum on our website entitled "The Importance of Properly Handling Payroll Taxes"). Furthermore, trust fund taxes are NOT dischargeable in bankruptcy.

* Example from IRS website:

Example: Donna Lee is a salesperson employed on a full-time basis by Bob Blue, an auto dealer. She works 6 days a week, and is on duty in Bob's showroom on certain assigned days and times. She appraises trade-ins, but her appraisals are subject to the sales manager's approval. Lists of prospective customers belong to the dealer. She has to develop leads and report results to the sales manager. Because of her experience, she requires only minimal assistance in closing and financing sales and in other phases of her work. She is paid a commission and is eligible for prizes and bonuses offered by Bob. Bob also pays the cost of health insurance and group-term life insurance for Donna. Donna is an *employee* of Bob Blue.

The proper classification of workers as employees or independent contractors is perhaps more important in the current environment than ever. This can be attributed to several factors, including the federal budget deficits, the projected shortfalls in the social security program, and the employment tax gap estimated at \$15 billion, of which \$14 billion is attributed to Federal Insurance Contribution Act (FICA) taxes, which fund old age retirement benefits and Medicare/Medicaid. The IRS is currently in the process of randomly selecting for examination Forms 941. The examinations are part of a study by the National Research Program (NRP) within the IRS Office of Research, Analysis & Statistics to measure reporting and payment compliance for employment taxes. One of the primary focuses of the examination project is the classification of workers.

The improper classification of workers as independent contractors can have a disastrous affect on a business and its owner, exposing the business (and its owners/officers/directors) to back payroll taxes, interest, and tax penalties, and in egregious or intentionally fraudulent situations, criminal liability.

If you have any question as to whether a worker is an independent contractor or employee, you are strongly encouraged to seek competent legal advice.