

# Independent Contractor or Employee?

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Worker classification has become an area of high priority for the government. The IRS has announced that they will be aggressively scrutinizing worker classification in 2010 through random employment tax audits. According to a *BNA Daily Tax Report*, the IRS is expected to audit approximately 6,000 U.S. companies under its National Research Program (NRP), an IRS program designed to collect data to measure payment, filing, and reporting compliance. Recently, the Congressional Research Service issued a report on proposed legislation regarding misclassification of employees as independent contractors including increased Form 1099 reporting requirements.

*Why is worker classification an important issue?*

If the worker is an employee, the employer is responsible for federal, Social Security, and Medicare tax withholding as well as the employer's portion of Social Security and Medicare taxes, and federal and state unemployment taxes. If the worker is an independent contractor, the company is not responsible for any payroll taxes. Classifying a worker is not as simple as choosing one category over the other. Misclassification of an employee may prove to be extremely costly as the IRS steps up compliance enforcement.

*Who is an employee?*

The definition of an employee is shaped by common law, safe harbor rules, and IRS Revenue Ruling 87-41. Under common law, a worker is an employee if the employer can control what the worker does and how the worker does it.

Questions to consider when evaluating degree of control include:

Is the worker evaluated on how the work is performed or the end result of the job?

Does the company provide training for the worker?

Does the company provide work space, tools, or supplies needed for the job?

Does the company offer benefits to the worker such as health insurance, vacation, or retirement benefits?

Is the worker required to wear a company uniform?

Is the worker reimbursed for expenses incurred?

Is the worker guaranteed a regular wage?

Is the relationship job specific or indefinite?

Does the worker contract with other companies?

Are the worker's services available to other companies?

The lack of or presence of any of these elements alone does not ultimately determine a worker's status. These factors work together in determining whether a worker is classified as an employee or an independent contractor.

*What happens if the IRS reclassifies my independent contractors?*

Because determining worker classification is subjective, a safe harbor is available if you can establish a reasonable basis for the classification of a worker, consistently apply and report the classification of all workers with the same or similar characteristics. A reasonable basis is established by demonstrating that the employer relied on a court case or ruling by the IRS, industry treatment of similar workers, or some other reasonable basis such as advice from a lawyer or accountant familiar with the employer's business.

Listed below are the 20 factors the IRS considers when determining whether or not an employee-employer relationship exists, pursuant to Rev. Rul. 87-41.

1. *Instructions.* A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed have the right to require compliance with instructions.
2. *Training.* Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner.
3. *Integration.* Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must necessarily be subject to a certain amount of control by the owner of the business.
4. *Services Rendered Personally.* If the services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results.
5. *Hiring, Supervising, and Paying Assistants.* If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor status.
6. *Continuing Relationship.* A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals.
7. *Set Hours of Work.* The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control.

8. *Full Time Required.* If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor, on the other hand, is free to work when and for whom he or she chooses.
9. *Doing Work on Employer's Premises.* If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere. Work done off the premises of the person or persons receiving the services, such as at the office of the worker, indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee. The importance of this factor depends on the nature of the service involved and the extent to which an employer generally would require that employees perform such services on the employer's premises. Control over the place of work is indicated when the person or persons for whom the services are performed have the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required.
10. *Order of Sequence Set.* If a worker must perform services in order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker's own pattern of work but must follow the established routines and schedules of the person or persons for whom the services are performed.
11. *Oral or Written Reports.* A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control.
12. *Payment by Hour, Week, Month.* Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor.
13. *Payment of Business and/or Traveling Expenses.* If the person or persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities.
14. *Furnishing of Tools and Materials.* The fact that the person or persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employer-employee relationship.
15. *Significant Investment.* If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed for such facilities and, accordingly, the existence of an employer-employee relationship. Special scrutiny is required with respect to certain types of facilities, such as home offices.

16. *Realization of Profit or Loss.* A worker who can realize a profit or suffer a loss as a result of the worker's service (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but the worker who cannot is an employee. For example, if the worker is subject to a real economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.
17. *Working for More Than one Firm at a Time.* If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.
18. *Making Service Available to General Public.* The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship.
19. *Right to Discharge.* The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specification.
20. *Right to Terminate.* If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship.

Even after carefully evaluating these factors, the IRS may still challenge your classification. If you would like the blessing of the IRS, you can file Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, to request a determination.

*Metcalfe Hodges, PS is a CPA firm located in Bellingham, WA specializing in business consulting, tax preparation and planning services. Please contact us at 360.733.1010 or email [our team](#).*

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