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EMPLOYEE OR INDEPENDENT CONTRACTOR?

Anyone running a company must develop policies relating to a myriad of topics regarding employees. What medical insurance should we provide? How do we structure a retirement plan for employees? What is a fair vacation policy? There is one issue, however, that is often overlooked: proper employee classification. Are these people independent contractors or employees? It is a crucial decision. Companies of all types and sizes are making use of contract labor in lieu of full-time (or even part-time) employees. Often contracting labor makes sense for good reasons such as:

- specific skills which may be required for a short-term project;
- more personnel may be required to get through a seasonal busy period;
- the company may not be financially able to attract top talent for an employer/employee relationship.

WHO IS AN EMPLOYEE?

A general rule is that anyone who performs services for you is your employee *if you can control what will be done and how it will be done.*



WHO IS AN INDEPENDENT CONTRACTOR?

A general rule is that the payer has the *right to control or direct only the result of the work* done by an independent contractor, and *not the means and methods of accomplishing the result*.

What difference does it make to classify a worker as an independent contractor instead of as an employee? Here are some of the requirements of an employer-employee relationship:

- **Employee Withholding.** Employers are responsible for the withholding and timely remittance of federal income taxes, state and local income taxes, and FICA taxes from wages paid to their employees.
- **Employer Payroll Taxes.** Employers owe, and must remit, their own share of payroll taxes, such as FICA and federal and state unemployment insurance, on employee wages.
- **Labor Laws.** Worker's compensation, working condition, and minimum wage laws all impose on employers certain financial and other requirements for the benefit of employees.
- **Employee Benefits.** Employees generally enjoy employer funded benefit programs such as vacations, holidays with pay, health insurance, and pension and profit sharing plans; contractors generally do not receive these benefits.
- **Reporting.** Wages paid to employees (along with the amounts of the various taxes withheld) are reported on Form W-2; amounts paid to contractors are reported on Form 1099. Additionally, Forms 940 and 941 (and perhaps others) must be filed for wages paid to employees.

In a payer-contractor relationship, payers are required to file information returns to report certain types of payments made to independent contractors during the year. For example, Form 1099-MISC, Miscellaneous Income, is filed with the IRS to report payments of \$600 or more to persons not treated as employees (e.g., independent contractors) for services performed for the payer's trade or business.

Consequences of treating an employee as an independent contractor. Why is this important? Let's face it, no one wants to deal with an IRS audit...and possible fine. With

more companies using independent contractors, the IRS and State Revenue departments are increasingly viewing the usage of contract labor with suspicion. Any company using contract labor solely to avoid withholding and payment of payroll taxes should beware. If an employer misclassifies an employee as an independent contractor with no reasonable basis for doing so, that employer may be held liable for employment taxes for that worker as if the amount required to be deducted and withheld were equal to 1.5 percent of the employee wages. In other words, penalties for a person earning \$30,000 per year would be calculated on \$45,000 per year relative to the back taxes due. This is just the beginning. Other fines likely apply. *Ouch!*

THERE ARE SOME SPECIAL CIRCUMSTANCES.

Direct sellers and real estate agents are considered *Statutory Non-Employees* and are treated as self-employed for all Federal tax purposes, including income and employment taxes, if:

1. Substantially all payments for their services as direct sellers or real estate agents are directly related to sales or other output, rather than to the number of hours worked and
2. Their services are performed under a written contract providing that they will not be treated as employees for Federal tax purposes.

To further complicate things, you might be dealing with *Statutory Employees*. Excluding milk truck drivers (an interesting exemption), independent contractors may be treated as statutory employees for certain employment tax purposes if they fall within any one of the following four categories and meet some other conditions.

- A driver who distributes beverages (other than milk) or meat, vegetable, fruit, or bakery products; or who picks up and delivers laundry or dry cleaning, if the driver is your agent or is paid on commission.
- A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.
- An individual who works at home on materials or goods that you supply and that must be returned to you



You must examine the relationship between the worker and the business carefully. Simply stated, if you have behavioral control and financial control, you likely have an employee in that situation.

or to a person you name, if you also furnish specifications for the work to be done.

- A full-time traveling or city salesperson who works on your behalf and turns in orders to you from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for you must be the salesperson's principal business activity.


Unless you are dealing with a statutory employee or a statutory non-employee as outlined above, three guidelines exist to determine whether a worker is an independent contractor under common law:

1. **Behavioral Control**—If the business directs or controls how the work is done through instructions, training, or other means, the worker is an employee.
2. **Financial Control**—If the business controls the financial and business aspects of the worker's job, you are dealing with an employee. These questions will guide you to classifying a worker as a contractor:
 - Does the worker have unreimbursed business expenses,
 - Does the worker invest in the facilities used in performing services,
 - Does the worker makes his services available to the relevant market,
 - How the business pays the worker, and
 - Can the worker realize a profit or incur a loss?
3. **Type of Relationship**—How do the parties perceive their relationship? This includes things like:
 - Written contracts describing the relationship the parties intended to create,
 - The extent to which the worker is available to perform services for other similar businesses,
 - 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, and
- The extent to which services performed by the worker are a key aspect of the regular business of the company.

You must examine the relationship between the worker and the business carefully. Simply stated, if you have behavioral control and financial control, you likely have an employee in that situation.

This can become very complicated. Don't worry, there is another resource available to employers. If, after applying the Common Law test, you are unable to determine whether a worker is an employee or a contractor, you may request a specific IRS determination by filing *Form SS-8*. Instructions and the appropriate address of the IRS service center for mailing purposes are listed on the form. You can get a copy of *Form SS-8* from the IRS website at www.irs.gov. 

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