PUBLICATION

Developments in the Employee/Independent Contractor Distinction

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The distinction between employees and independent contractors has never been an easy one for business owners. The general lack of guidance from the Internal Revenue Service (IRS) has made the decision-making process a difficult one, and the consequences of misclassification can be dire. Despite the confusion, the IRS has placed a renewed focus on employee classification audits, likely due in large part to expanding federal deficits coupled with pressure on Washington to not raise taxes. Although the worker classification process can often be a burdensome one, there are some helpful pieces of guidance in existence, as well as amnesty programs which, though not free from risk, can offer taxpayers some relief.

Why Classification Matters

The employee/independent contractor distinction is an important one that carries heavy consequences. The determination affects not only the IRS, but a variety of other federal administrative agencies, including the Department of Labor (DOL), the Department of Health and Human Services (DHS), the Social Security Administration (SSA) and others. The state-level counterparts of these agencies are generally affected as well.

The primary focus of the IRS, and oftentimes the motivation for an employee classification audit, is to determine whether employment taxes are being properly collected and remitted. An employer has a responsibility to not only collect and remit income tax withholding from its employees, but to also collect, and pay one-half of, FICA taxes. A service recipient owes no such duty to the IRS for sums paid to an independent contractor and is generally only responsible for issuing a Form-1099. Perhaps not surprisingly, the IRS tends to favor the classification of workers as employees and will generally only permit classification as an independent contractor in clear cut cases.

Making the Determination

Despite the heavy penalties and interest that can result from a worker misclassification, the IRS has offered little in the way of taxpayer guidance. The determination should be based on all of the facts and circumstances surrounding the worker relationship. Generally, the IRS will only allow independent contractor classifications when the company hiring the contractors can show it lacks the necessary control over the workers that would otherwise indicate an employer-employee relationship. However, before analyzing control, any worker classification analysis should begin with these two threshold questions:

- Does the hiring company pay its regular employees to perform essentially the same duties as the subject worker who is treated as an independent contractor?
- Has that worker previously been paid by the company as an employee to perform essentially the same task?

If the answer to either of these questions is yes, the worker in question very likely is an employee for federal tax purposes.

Beyond these threshold questions, the IRS also considers the following 20 factors to determine whether the company hiring the worker actually has control over the worker:

1. **Instructions**. A worker who is required to comply with another person's instructions regarding when, where and how to perform the work is ordinarily an employee.
2. **Training**. Training a worker indicates that the company wants the services performed in a particular method or manner, which also indicates control.
3. **Integration**. Integration of the worker's services into the company's core business operations generally shows that the worker is subject to direction and control.
4. **Services Rendered Personally**. If the worker must personally perform services for the company, this will indicate control by the company. Alternatively, if the worker is free to engage others to perform the service for the company (i.e., subcontractors), a lack of control by the company is indicated.
5. **Hiring, Supervising and Paying Assistants**. If the worker is unable to hire, supervise and pay assistants to perform services for the company, control by the company is indicated. However, a lack of control is indicated when the worker is able to hire his or her own assistants and pay them from the worker's own funds.
6. **Continuing Relationship**. A lengthy and continuing relationship between the worker and the company indicates that an employment relationship exists.
7. **Set Hours of Work**. If the worker works certain hours set by the company, employment status is indicated. If the company does not control the hours of the worker, independent contractor status is indicated.
8. **Full Time Required**. If the worker must devote substantially full time to the company's business, control is indicated.
9. **Work Performed on Employer's Premises**. If the work is performed on the company's premises, the company is considered to have control over the worker, especially if the work could be done elsewhere. Control is also indicated when the company has 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 or Sequence Set**. If a worker must perform services in the order or sequence as determined by the company, the worker is generally subject to an employer's control. However, if the worker chooses his or her own method for completing a job, a lack of control exists.
11. **Oral or Written Reports**. A requirement that a worker submit regular or written reports is an indicator of control.
12. **Payment by Hour, Week, Month**. Hourly, weekly or monthly payments generally point to an employment relationship. On the other hand, payments based on a contract or for completing a particular job or task will generally indicate an independent contractor relationship.
13. **Payment of Business and/or Traveling Expenses**. If the company ordinarily pays the worker's business and traveling expenses, the worker is ordinarily an employee.
14. **Furnishing of Tools and Materials**. If the company furnishes significant tools, materials and other equipment, an employment relationship is indicated.
15. **Significant Investment**. If the worker does not invest in his or her own facilities, control is indicated because the worker depends on the company for such facilities.
16. **Realization of Profit or Loss**. A worker who cannot realize a profit beyond an ordinary salary or suffer a loss is generally considered to be an employee.
17. **Working for More Than One Firm at a Time**. If the worker cannot perform services for more than one company at a time, the company generally controls the worker. However, a lack of control is indicated when the worker is able to perform services for multiple companies at the same time.
18. **Making Service Available to General Public**. If a worker is not free to advertise his or her services to the general public on a regular basis, control is indicated. Workers who advertise their services are generally considered independent contractors.

19. **Right to Discharge**. The right of the company to discharge a worker without breaching a contract indicates an employment relationship as control is exercised through the threat of dismissal.
20. **Right to Terminate**. If, at any time without incurring liability, the worker has the right to end his or her relationship with the company, an employment relationship is indicated.

While it is important to consider these factors when classifying workers, it is also important to remember that no single factor is determinative of the nature of the relationship and that the list is far from an exhaustive one.

Correcting Misclassification

Due to the fact-intensive nature of determining whether a worker is an employee or independent contractor, even a slight change in one factor can alter the classification. Since the consequences of improper classification can be dramatic, a company may prefer simply not to change the classification of a worker, but rather to modify prospectively the facts and circumstances, to support either retention of the existing classification or a change in classification. For example, decreasing the types or levels of required job reporting may be enough of a changed circumstance to support the continued independent contractor classification. On the other hand, if the worker should be classified as an employee given all the facts and circumstances, then to help defend the prior classification as an independent contractor and highlight the reason for the change in classification, the company may wish, for example, to prospectively increase the types and/or levels of required reporting.

Other options may also be available to a company faced with reclassifying an independent contractor as an employee. For example, if a company becomes aware of a classification defect before an IRS audit, that company may consider voluntarily correcting any income tax reporting and withholding problems. Under this approach, the company must revise Forms 1099 and W-2 for the misclassified workers and, where necessary, pay back taxes for the years of correction. The company will usually be eligible for reduced assessment rates for employment taxes under the Internal Revenue Code, provided that the failures were unintentional.

A further option, dependent upon the particular facts, may be to continue the independent contractor classification and, in the event of an audit which results in retroactive status as an employee, argue that the company is entitled to relief under Section 530 of the Internal Revenue Code. Section 530 relief is significant when applicable, as it can absolve the company of all back employment taxes due to misclassification. However, the relief is only available on audit, and only if the company has a reasonable basis for the independent contractor classification. A reasonable basis is normally based upon case law, published IRS rulings, prior audit or long-standing industry practice.

One final option involves the possibility of participation in the relatively new Voluntary Classification Settlement Program (VCSP) that was announced by the IRS in September 2011. The VCSP is available to any service recipient that is willing to begin treating a class(es) of workers as employees for federal income tax purposes. This status change could apply to any worker(s) that the service recipient has previously treated as an independent contractor rather than as an employee. In order to be eligible for VCSP, the service recipient must have consistently not treated the worker(s) as employees in the past, and must have filed all required Forms 1099 for such workers in each of the past three years. Additionally, the taxpayer cannot be under audit by the IRS, nor can the taxpayer be under audit concerning worker classification by the DOL or by a state government agency. Taxpayers who have previously been under any such audits will only be eligible if they are found to be compliant with the results of that audit.

By participating in VCSP and agreeing to prospectively treat the affected class of workers as employees, taxpayers are possibly able to insulate themselves from a federal tax audit risk, insofar as employment taxes for the workers to which the reclassification applies. In exchange, the service recipient must pay ten percent of the employment tax liability that would otherwise be due on compensation paid to workers in the relevant

class(es) in the most recent year and to treat the class of workers as employees in the future. Taxpayers entering the VCSP must also agree to extend the period of limitations on assessment by three years for each of the first three calendar years that begin after the date which the taxpayer agrees under the VCSP to begin treating workers as employees.

To read our September 2011 alert on the VCSP, click here.

Risks Associated with Worker Reclassification and VCSP Participation

Any taxpayer considering applying to the VCSP, or otherwise reclassifying workers, should carefully assess and weigh all potential risks. Although some may consider the VCSP rather generous, it is important to remember that the IRS does not speak for the federal government as a whole, nor does the IRS speak for any state governmental agency, nor for the workers themselves. A service recipient entering the VCSP certainly takes on risks. For example, what is the scope of the "class" that will be treated as employees? What is the effect of a failure to adhere strictly to a VCSP closing agreement with the IRS? What are the nature and extent of other economic exposures that may arise as a result of VCSP participation?

It should be noted that on September 19, 2011, the IRS and the DOL signed an agreement to share information regarding worker misclassification. The DOL, in turn, has indicated that it has similar agreements in place to share information with the Occupational Safety & Health Administration, the Office of Federal Contract Compliance Programs, the Office of the Solicitor and several states. It is thus possible that the details of a taxpayer's participation in the VCSP will be shared by the IRS with the DOL and, in turn, shared by the DOL with other federal and state agencies, none of which has any apparent amnesty program for VCSP participants. Conversely, information provided to the DOL by other federal and state agencies may be shared with the IRS for audit and enforcement purposes. Remaining to be determined is whether these other federal and state agencies will interpret such prospective reclassification for VCSP purposes, and payment of the associated past employment taxes required under VCSP, as an admission that workers were classified incorrectly for other purposes in prior years.

What You Should Know

The classification of a worker as an employee or independent contractor is an important one, and often a decision that is not easily made. Because the determination is based in large part on specific facts and circumstances, there are some general guidelines that are helpful in the decision making process. As no single factor is determinative, and the consequences of misclassification or reclassification can be dire, it may very well be in the best interests of any taxpayer to seek the advice of a tax professional should the situation dictate it.