



PENALTIES AT STAKE IN CLASSIFICATION OF INDEPENDENT CONTRACTORS VS. EMPLOYEES

The IRS is increasing worker reclassification efforts, in particular focusing on improper treatment of workers as independent contractors vs. employees. This costs the government tax revenues, in the form of lost withholding, unemployment, workers' compensation, and Social Security and Medicare taxes. This has led to renewed compliance efforts, also resulting in the risk of greater fines and penalties for employers who fail to comply.

Most employers are now aware of the Patient Protection and Affordable Care Act (PPACA), which requires employers with at least 50 full-time employees to provide health care insurance or pay a penalty. Of course, some employers have decided that the way to avoid new taxes and requirements under PPACA is to reduce payrolls, treating workers as independent contractors instead of employees. So there are many compelling reasons for the government to be even more stringent.

Voluntary Classification Settlement Program

In 2011, the IRS began the Voluntary Classification Settlement Program (VCSP), which is a new optional program that provides taxpayers with an opportunity to reclassify their workers as employees for future tax periods for employment tax purposes with partial relief from federal employment taxes for eligible taxpayers who agree to prospectively treat their workers (or a class or group of workers) as employees. To participate in this new voluntary program, the taxpayer (employer) must meet certain eligibility requirements, apply to participate in the VCSP by filing Form 8952, Application for Voluntary Classification Settlement Program, and enter into a closing agreement with the IRS.

Common Law Rules

Several years ago, in *IRS Revenue Ruling 87-41*, the government identified "20 Common Law Factors" for contractor vs. employee classifications. These are:

1. **Instructions:** If the person for whom the services are performed has the right to require compliance with instructions, this indicates employee status.
2. **Training:** Worker training (e.g., by requiring attendance at training sessions) indicates that the person for whom services are performed wants the services performed in a particular manner (which indicates employee status).
3. **Integration:** Integration of the worker's services into the business operations of the person for whom services are performed is an indication of employee status.
4. **Services rendered personally:** If the services are required to be performed personally, this is an indication that the person for whom services are performed is interested in the methods used to accomplish the work (which indicates employee status).
5. **Hiring, supervision, and paying assistants:** If the person for whom services are performed hires, supervises or pays assistants, this generally indicates employee status. However, if the worker hires and supervises others under a contract pursuant to which the worker agrees to provide material and labor and is only responsible for the result, this indicates independent contractor status.
6. **Continuing relationship:** A continuing relationship between the worker and the person for whom the services are performed indicates employee status.



7. **Set hours of work:** The establishment of set hours for the worker indicates employee status.
8. **Full time required:** If the worker must devote substantially full time to the business of the person for whom services are performed, this indicates employee status. An independent contractor 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 for whom the services are performed, this indicates employee status, especially if the work could be done elsewhere.
10. **Order or sequence test:** If a worker must perform services in the order or sequence set by the person for whom services are performed, that shows the worker is not free to follow his or her own pattern of work, and indicates employee status.
11. **Oral or written reports:** A requirement that the worker submit regular reports indicates employee status.
12. **Payment by the hour, week, or month:** Payment by the hour, week, or month generally points to employment status; payment by the job or a commission indicates independent contractor status.
13. **Payment of business and/or traveling expenses.** If the person for whom the services are performed pays expenses, this indicates employee status. An employer, to control expenses, generally retains the right to direct the worker.
14. **Furnishing tools and materials:** The provision of significant tools and materials to the worker indicates employee status.
15. **Significant investment:** Investment in facilities used by the worker indicates independent contractor status.
16. **Realization of profit or loss:** A worker who can realize a profit or suffer a loss as a result of the services (in addition to profit or loss ordinarily realized by employees) is generally an independent contractor.
17. **Working for more than one firm at a time:** If a worker performs more than de minimis services for multiple firms at the same time, that generally indicates independent contractor status.
18. **Making service available to the general public:** If a worker makes his or her services available to the public on a regular and consistent basis, that indicates independent contractor status.
19. **Right to discharge:** The right to discharge a worker is a factor indicating that the worker is an employee.
20. **Right to terminate:** If a worker has the right to terminate the relationship with the person for whom services are performed at any time he or she wishes without incurring liability that indicates employee status.

New IRS Guidance

To help with employers who found *IRS Revenue Ruling 87-41* to be confusing, the IRS recently identified three categories of evidence in [IRS Publication 1779](#) which explains that "The courts have considered many facts in deciding whether a worker is an independent contractor or an employee. These relevant facts fall into three main categories: behavioral control, financial control, and relationship of the parties. In each case, it is very important to consider all the facts – no single fact provides the answer. Carefully review the following definitions.

Facts that provide evidence of the degree of control and independence fall into three categories:



1. Behavioral: Behavioral control refers to facts that show whether there is a right to direct or control how the worker does the work. A worker is an employee when the business has the right to direct and control the worker. The business does not have to actually direct or control the way the work is done – as long as the employer has the right to direct and control the work. The behavioral control factors fall into the categories of:

- *Type of instructions given*
- *Degree of instruction*
- *Evaluation systems*
- *Training*

2. Financial: Financial control refers to facts that show whether or not the business has the right to control the economic aspects of the worker's job. The financial control factors fall into the categories of:

- *Significant investment*
- *Unreimbursed expenses*
- *Opportunity for profit or loss*
- *Services available to the market*
- *Method of payment*

3. Type of Relationship: Type of relationship refers to facts that show how the worker and business perceive their relationship to each other. The factors, for the type of relationship between two parties, generally fall into the categories of:

- *Written contracts*
- *Employee benefits*
- *Permanency of the relationship*
- *Services provided as key activity of the business*

Businesses must weigh all these factors when determining whether a worker is an employee or independent contractor. Some factors may indicate that the worker is an employee, while other factors indicate that the worker is an independent contractor. There is no “magic” or set number of factors that “makes” the worker an employee or an independent contractor, and no one factor stands alone in making this determination. Also, factors which are relevant in one situation may not be relevant in another.

The keys are to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally, to document each of the factors used in coming up with the determination.

Do not assume that someone is an independent contractor just because you are told that he/she has his or her own business, has a website, has his or her own corporation, etc. While these are factors that can help show true independent contractor status, the totality of the situation and what the person is actually doing for your company must be taken into consideration.

Consider fixing the problem retroactively to reduce your total liability.

For independent contractors who would legitimately pass the tests, make sure you have a well-drafted written agreement in place as well as documentation that would help you prove that your classification was legitimate (a copy of the contractor's business license, proof of business insurance, copies of all 1099 forms filed, etc.)

In summary, the risks for misclassifying an independent contractor are significant! There is no substitute for competent, case-specific advice. Please contact us if you require assistance.



So what should an employer do?

One might think that with such an effort to collect additional revenue through these programs, the IRS would make the rules abundantly clear for employers, as per above. There have been successful court cases in which employers have fought the IRS over worker reclassification. However, it isn't recommended that this be your strategy. While we do suggest that you seek professional guidance for your particular situation, here are some considerations:

- *Be aware of the independent contractors that your company is using*
- *Perform a review of each independent contractor*
- *If any current contractors do not meet the requirements, convert them to employee status*
- *For those contractors who do meet the standards, have agreements and documentation in place*
- *Review workers who received Form W-2 in the past but are now treated as contractors*
- *Review your vendor list, check register, and accounts payable to determine whether you filed a Form 1099 or W-2 for each independent contractor who should receive these forms*

There are significant risks for misclassifying an independent contractor. As such, seek assistance from an experienced CPA and/or attorney. For more information, please contact our office.