






## News Archives

### Is Your Contractor Really Independent?

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#### PROCEDURE & ADMINISTRATION

With the perception that employers are attempting to circumvent payroll taxes by classifying workers as independent contractors, the IRS has recently stepped up its efforts to more closely scrutinize this long-controversial area.

This item provides an overview of the factors examined by the IRS and offers insight into how to better secure independent contractor status.

#### Advantages of Independent Contractor Status

Traditionally, many consultants have considered themselves self-employed with a view toward enjoying several tax benefits. For example, by positioning themselves as independent contractors, they avoid having payroll and income taxes withheld from their paychecks. They can establish generous retirement plans, such as SEPs, Keoghs, or solo 401 (k)s. They can deduct many types of business expenses unavailable to employees.

#### The IRS Perspective

To help determine whether a worker is an employee or an independent contractor, the IRS has relied on a 20-factor control test based on common law principles (Rev. Rul. 87-41). This test is an analytical tool only. There is no "magic number" of relevant points, and the factors merely point to facts to be considered in evaluating the extent of the employer's right to direct and control the worker.

The 20 factors to be weighed in evaluating whether an individual is an employee are:

- Instructions: A worker who is required to comply with another's set of instructions is ordinarily an employee.
- Training: Formal or informal training at an employer's expense indicates an employer-employee relationship.
- Integration: Integrating the worker's services into the business's operations generally shows that the worker is subject to control.
- Services rendered personally: If the services have to be personally rendered, the employer probably controls the means as well as the results.
- Hiring, supervising, and paying assistants: Unless the worker hires, supervises, and pays his or her own assistants (if any), the worker is likely an employee.
- Continuing relationship: The longer the relationship, the more likely the worker is an employee.
- Set hours of work: An independent contractor controls his or her own time (though with the

advent of flexible hours, employees also have more input on their hours).

- Full time required: A full-time position indicates an employer-employee relationship, whereas an independent contractor works when he or she chooses.
- Working on the employer's premises: The weight of this factor might depend on the nature of the work, and working off premises does not necessarily suggest that the worker is not an employee, especially with the rise of telecommuting.
- Order or sequence set: Only a nonemployee is free to determine his or her own approach, pattern, priority, and schedule.
- Oral or written reports: Regular accountability of progress is usually a sign of control.
- Payment by the hour, week, or month: Independent contractors are typically paid by the job, not in a regular pattern.
- Payment of expenses: Reimbursement tends to support an employer-employee relationship.
- Tools and materials: An independent contractor provides his or her own.
- Significant investment: If the worker invests in facilities that he or she uses in performing services and those facilities are not typically maintained by employees, such as an office rented from a third party, the worker is probably not an employee.
- Realization of profit or loss: A worker who is subject to the risk of economic loss due to a liability for expenses is an independent contractor.
- Multiple assignments: If a worker performs more than minimal services for more than one

business at a time, the worker is likely an independent contractor.

- Making services available to the public: This flexibility and freedom of control signals independent contractor status.
- Right to discharge: An independent contractor generally cannot be fired as long as he or she meets contractual specifications (though in today's workplace employees and independent contractors are gradually becoming subject to similar discharge provisions).
- Right to terminate: A worker who can end the working relationship without incurring liability is an employee (though, like the right to discharge, this line is also becoming less defined).

Due to the difficulties in properly classifying workers as employees or independent contractors, Congress passed Section 530 of the 1978 Revenue Act, P.L. 95-600, precluding the IRS in certain cases from reclassifying as employees persons that an employer treated as independent contractors, until such time as Congress legislates as to such classification. This exemption, which has been called Section 530 relief and affects employment taxes more than income taxes, is not available to skilled workers hired through technical service firms in the areas of engineering, design, computer programming, system analysis, or other similar fields.

#### **Safeguards**

Because an IRS audit can result in an assessment of penalties and interest in addition to the payroll taxes that will be due, it becomes incumbent to take measures to preserve the intended working relationship.

Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, can be filed with the IRS to clarify in advance whether a worker is an employee. The form focuses on behavioral control, financial control, and the relationship of the parties.

Another suggestion is to enter into a written "consulting" agreement with language coordinated to the 20-factor control test. The contract should specify the nature of the work to be performed, discuss the terms and conditions, and state the responsibilities of the independent contractor.

Industry practice may also provide a safe harbor. For example, an employer might be able to show that independent contractor treatment is consistent with recognized practices of a particular industry.

#### **State Interpretations**

Some states, such as New Jersey, apply their own standards, often stricter than the IRS rules in terms of reclassifying independent contractors into employees. Under New Jersey's three-pronged "ABC" test, the employer has the burden to prove that the relationship is that of an independent contractor rather than an employee.

An individual would not be considered an employee if:

- The individual has been free from control and direction;
- The services are either outside the usual course of business or outside the physical place of business; and
- The individual is customarily engaged in an independently established trade, occupation, profession, or business and performs work for others.

#### **Summary**

Business owners should analyze whether a potential employer-employee relationship might exist under the government's heightened search for revenue, especially since the IRS has targeted this area for closer scrutiny.

The IRS can impose penalties on employers for failure to withhold income and employment taxes, and qualified retirement plans could be jeopardized if employees who should be covered are not, due to misclassification as independent contractors.

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