

# Classifying Workers to Meet the Tax Law



January 2009

## Running a company carries a list of responsibilities as you well know

Employers typically have decided if a worker was to be classified as a contractor or an employee, and at times, employers opt to take on a worker as an independent contractor to either: fill a temporary need, work on a short term project, perform seasonal work, or possibly avoid paying employer payroll taxes, worker's compensation insurance and the typical benefits most employees receive as full time workers.

Today's business owner must now pay extra attention to be sure to properly classify all workers according to the IRS's recent activity. As a result of multiple abuses, the IRS is taking a stand in the classification of employees as independent contractors, and will be auditing employers in this area. **What does this mean for you? In one word ... Reclassify.** Employers must look at each Independent Contractor to be sure to correctly classify each and every one working at the company, and reclassify if necessary.

There is no better time to take a look at this at your company than at the beginning of a new year. The **GKE Tax Practice Group** has broken down the classification rules for employers to look at:

## Independent Contractor or Employee?

In October 2008, the Kiplinger Newsletter sent an update on the recent tax developments:

*"Contracts stating workers are not employees can be disregarded, an appeals courts says. If a firm exerts enough control over the workers, they are treated as employees for tax purposes, no matter what the contract says." - Kiplinger Newsletter Oct 2008*

Classifying a worker as an independent contractor or as an employee can be difficult. The **GKE Tax Practice Group** offers the below table to use in your classification process. This information is a guideline only. We suggest contacting your GKE tax professional for clarification and interpretation, specific for your company.

## Occupational Groups

### EMPLOYEE defined by law [IRC§ 3121 (d)]:

**Corporate officer** - A corporate officer is generally an employee. An officer is an employee even if he or she is the sole shareholder and has control of his or her own duties and remuneration. A corporate officer who performs only minor services or no services is not an employee if no payment is received nor is entitled to be received, directly or indirectly.

**Common law employee** - Common law employee status is determined by applying a number of common law factors to each individual case to verify if an employer/employee relationship exists. The factors include areas such as the degree of control, economic relations, continuity of the relationship, etc. If the person for whom the worker performs services has the legal right to control and direct the worker, such a relationship exists.

**Statutory Employee** - The Tax Code lists four occupational groups that are not employees under the common law rules, but are employees under the statutory rules and for FICA tax purposes.

1. **Agent Drivers or Commission Drivers** - Limited to workers who distribute meat, vegetables, fruit, bakery, beverage (other than milk) products or laundry/dry cleaning services.
2. **Full-Time Life Insurance Salesperson** - For one company.
3. **Homeworkers** - Work at home for one employer making clothing, needlecrafts, bedspreads, buttons, quilts, gloves, etc.
4. **Traveling/City Salesperson** - Sells for one principal employer.

### **NONEMPLOYEE defined by law:**

**Corporate directors.** [Reg. §31.3121 (d)-1(b)] A director acting in his or her capacity as a director is not an employee of a corporation.

**Statutory nonemployee:** [IRC §3508(a)]

1. **Qualified Real Estate Agent** - Must be licensed and paid on a commission basis, and a contract must exist stating the agent will not be an employee for federal tax purposes.
2. **Direct Seller** - Sells consumer products outside a permanent retail establishment and is paid on a commission basis, and a contract exists stating the salesperson will not be an employee for federal tax purposes. (NOTE: Includes newspaper carriers) Statutory nonemployees are treated as self-employed for all federal tax purposes, including income and employment taxes.

In a contractor relationship, payers are required to file information returns to report certain types of payments made to independent contractors, on Form 1099-Misc, Miscellaneous Income. The form 1099 Misc is filed with the IRS to report payments of \$600 or more to non-employees or independent contractors.

### **Section 530 Relief Provisions**

Employers must evaluate a list of factors to determine an appropriate classification of workers that do not fall in the category of "Employee or Non Employee".

If the business has trouble convincing the IRS that a worker is an independent contractor under the common law or statutory employee/nonemployee rules, the business may use Section 530 of the Revenue Act of 1978.

**Requirements** - A business is entitled to treat a worker as an independent contractor for employment tax purposes if ALL of the following conditions are met:

1. **Reporting Consistency** - The business has filed all federal tax returns (including information returns) on a basis consistent with the worker not being an employee.
2. **Substantive Consistency** - The business has not treated the worker or others performing substantially similar work as employees after December 31, 1977.

**3. Reasonable Basis** - The business can provide a reasonable basis for not treating the worker as an employee. **Any one of the following indicates the worker is NOT an employee:**

a) Judicial precedents, published rulings or determination letters from the IRS that may relate to that business situation.

b) Prior IRS audit of the business which was concluded without any assessment attributable to the business' treatment for employment tax purposes of workers similar to the worker now in question. An employer can only rely on a past audit history if the audit included an examination for employment tax purposes of whether the worker (or a worker in a similar position) was properly classified.

c) Business can rely on the longstanding recognized practice of a significant segment of their industry (25% or more of the industry). The practice does not have to be the same throughout the entire industry. The IRS cannot require a fixed length of time for a particular industry.

The above requirements can be summed up as, a taxpayer may treat an individual, or class of individuals as independent contractors rather than employees if the taxpayer has treated this group as independent contractors in good faith (example: the taxpayer has acted in good faith if the above Sec. 530 requirements are met). The taxpayer is deemed to not act in good faith if any factors are deemed to be negligent or intentional disregard for the rules.

\* \* \*

Below highlights a list of items that may assist you in determining when the worker is an Employee or Non Employee. **Utilize the checklist below** to determine if the worker needs to be reclassified ... **Contact your GKE Tax Professional to answer any questions you may have on ANY of your checkmarks ( X )!**

#### **FACTOR: Investment in Your Business Scenario**

Employer typically invests in facilities, tools, materials and other equipment for use by an employee.

If a worker invests in the facility, tools, materials and other equipment, tends to indicate a Non Employee.

#### **FACTOR: Qualifications for Job**

Employer typically provides for employee training including the type of training to be received, supervision of the delivery of training and corresponds with worker on the training event.

If a non-employee takes part in the scheduled employee training it tends to indicate an employee.

#### **FACTOR: Nature of Services Provided**

Employees do not provide services to the public, but perform services which are integrated into the business, on a personal basis to one firm (or a number of firms under the same service agreement). The worker performs this work over a continuing period.

Independent Contractors and/or Non Employees provide services to a company, at the same time this worker may perform services for another unrelated firm. Once the service is delivered, the relationship ceases.

#### **FACTOR: Work Location and Time**

Employers require work to be performed on their premises, and set work hours. In some cases, employees are given permission to work from home but under supervision.

Non Employees and/or Independent Contractors are not restricted from doing other gainful work at times they desire.

#### **FACTOR: Responsibilities During Assignment**

\_\_\_ Employers hire, supervise, and pay employees to perform services. Employers have the right: 1) to require compliance with instructions about when, where, and how an assignment is to be completed; 2) to set the order/sequence or routines/schedules for employee assignments; and 3) to require employees to submit written reports about services performed, on a regular basis.

\_\_\_ Non Employees usually hire, supervise, and pay other assistants. They are not required to comply with payer instructions about when, where, and how to complete an assignment or to provide regular or written reports. They establish their own work routines and schedules, and are responsible only for the attainment of a result.

### **FACTOR: Compensation and Rewards**

\_\_\_ Employers usually pay employees by the hour, week, or month, and pay for their business and travel expenses, employees are not exposed to an economic loss. Since employees do not have a significant investment in a business or its related liabilities, they limit their loss exposure.

\_\_\_ Non Employees are paid by the job or straight commission. They are required to pay their own business and travel expenses. Non Employees can realize a profit or loss from services, and subject themselves to a real risk of economic loss due to significant investments or liabilities for expenses.

### **FACTOR: Job Security**

\_\_\_ Employers generally have the right to discharge employees. The threat of dismissal can cause the employee to obey an employer's instructions.

\_\_\_ Non Employees cannot be fired so long as they produce a result that meets contract specifications. Termination of services for other reasons may result in liability to the payer.

## **Risks of IRS Reclassifying Independent Contractors to Employees**

### **If the IRS reclassifies a worker as an employee, the employer:**

1. Becomes liable for:
  - Employment taxes that should have been withheld from the worker's pay, such as FICA, federal and state income taxes,
  - The employer's share of FICA taxes,
  - State and federal unemployment taxes
  - Penalties and interest for failure to (a) pay these taxes, and (b) file payroll tax returns and
2. May have a retirement plan retroactively disqualified, which could cause all vested accrued benefits to become taxable for employees enrolled in the plan.

When an employer produces a list of factors he believes is relevant to prove a worker is an Independent Contractor, the DEGREE of importance of each factor varies depending upon the occupation and the explanation of the services performed. Each case must stand on its own facts.

There are resources for employers to turn to if you are unable to determine if a worker is an employee or an independent contractor. The IRS offers a Form SS-8 to obtain a specific IRS determination. The form is available from the IRS website at [www.irs.gov](http://www.irs.gov). The review can take at least six months to obtain a determination, but a business owner that continually hires the same types of workers to perform particular services may want to consider filing the Form SS-8.

### ***In Conclusion ...***

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 factors used in coming up with the determination.