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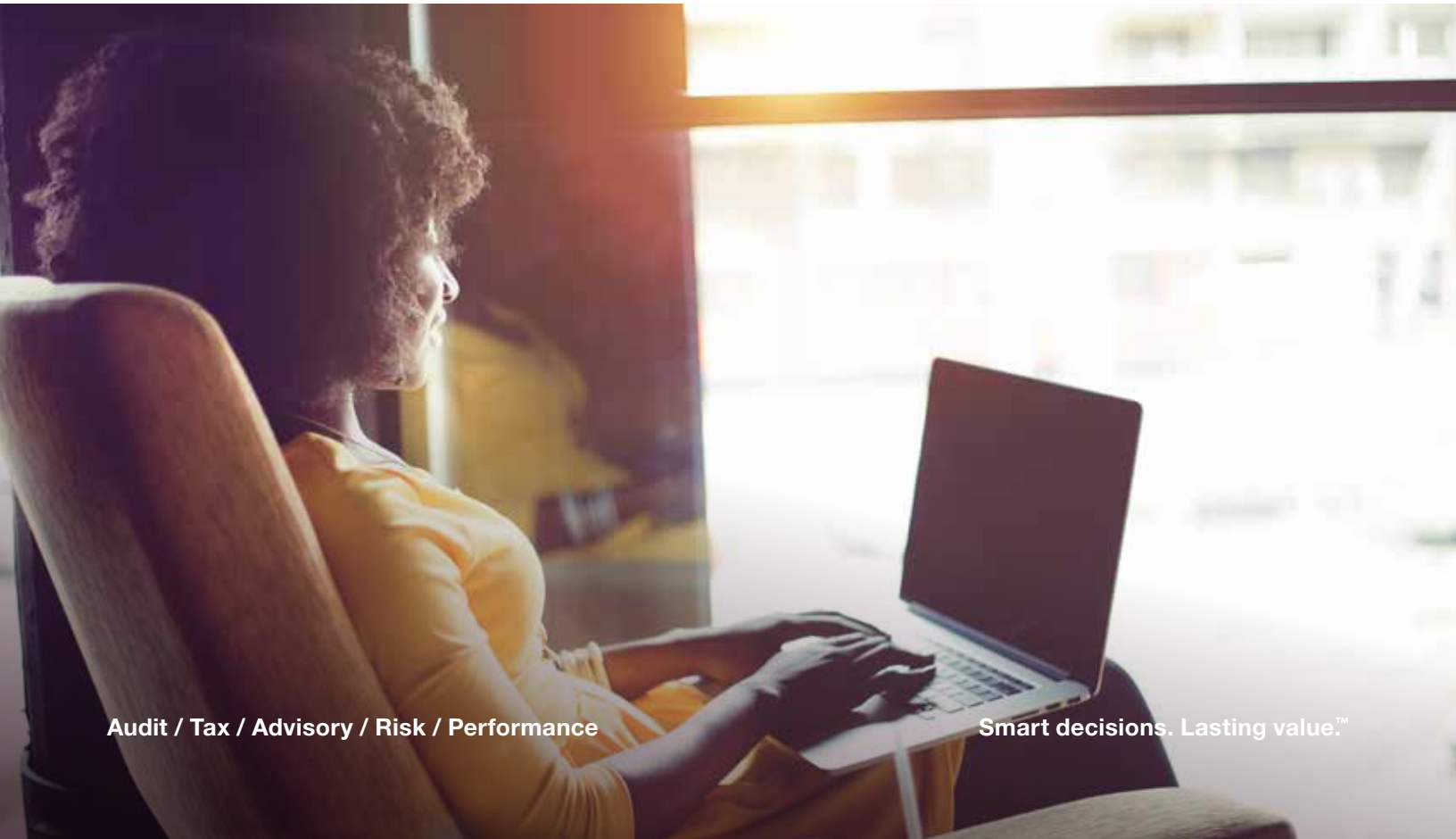
Employee or Contractor?

How to Navigate Federal Tax Law for Employee Status

An article by Gary T. Johnson, CPA, and Laurie J.S. Marson, CPA



As businesses seek to cut costs while expanding workforces, statutory nonemployees, or independent contractors, are becoming more of a viable option. This trend is a reflection of the sharing economy in which contract workers are responsible for more of the overhead in exchange for greater independence and work/life flexibility.

The sharing economy model runs counter to the traditional paradigm baby boomers have enjoyed for decades. Long-term employment scenarios once promised the security of pensions and other financial and health benefits. But an increasingly volatile economy disrupted that traditional paradigm. Today, employers have the option of hiring full-time employees or independent contractors. Each classification presents challenges, especially when it comes to oversight by federal tax authorities.

Cost Benefits

Cost weighs heavily in the push for independent contractors. In 2017, employers will pay a 7.65 percent tax for each employee's compensation up to $127,200, and an additional 1.45 percent for any compensation above that amount.[1] Employers also are responsible for federal and state unemployment taxes and worker's compensation insurance. When employees are full-time, expanded healthcare costs also are incurred under the *Affordable Care Act* (ACA), and employers might be responsible for other benefits such as profit sharing, bonuses, and compensation for vacations, holidays, and sick leave.

With independent contractors, costs are limited. Fees are assigned per project, and there is no employer responsibility for the benefits associated with employees, such as bonuses, paid time off, or payroll taxes. Per the mutually agreed upon contract, the responsibilities of the contractor and the employer are straightforward: Independent contractors must deliver the result based on a certain date or face forfeiture of their fee.

So while the relationship between both parties is clear and the cost savings are evident, do other factors exist that determine which worker relationship is best for a particular company?

U.S. federal and state tax reporting requirements apply separately to both classifications and can be complex. Rules guiding determination of status may vary depending on specific tax jurisdictions in which the work is performed. One tax jurisdiction may agree to an independent contractor designation for a group of workers, while another may not be bound by that decision.

According to U.S. tax law, three sets of guidelines determine an employee's status: common law, court decisions, and the *Fair Labor Standards Act* (FLSA) of 1938.

Common Law

At the center of common law guidelines is the level of control a company exercises over the services or tasks performed by the worker. Control is often considered a critical test to determine an independent contractor's status because the very nature of their status is determined by the lack of day-to-day control by their employer.

However, no single factor determines employment status. Employers should consider a number of questions, including:

- Does the worker get a regular paycheck?
- Does the worker determine how or when he or she will be paid?
- Has the worker been performing services for the company for an extended period of time?
- Who supplies the necessary materials, the worker or the company?
- Can the worker set his or her own schedule or does the company set the schedule?
- Is the work integral to the ongoing business activities, or is it a short-term need?
- Does the worker work for many companies or only one continually?
- Does the worker carry his or her own worker's compensation or liability insurance policy, or is he or she covered under a company's policy?
- Does the company provide direct reimbursement of travel and other business costs via an expense reimbursement program?
- Does the company reimburse most or all of the worker's business-related expenses?
- Does the worker have the opportunity to increase profits or incur losses as a direct result of his or her decisions?
- Does the company have the right to control much of the worker's activities, even if such control is not exerted?
- Does the company mandate and provide specialized or specific company training?
- Does the worker receive pension, insurance, vacation, or other benefits?
- Does the company provide employment manuals to the worker?
- Is the worker required to follow company policies?
- Is the worker required to have independent licensure?
- Is the temporary or seasonal work recurring?

Court Decisions

Court decisions are classified into two categories: control and economic dependence.

If the company is in control of the work, even if that control is not exercised, the worker is deemed an employee. When a worker is economically dependent on a company, the worker is deemed an employee.

When a worker clearly is operating an independent business (such has hiring others to do work, determining which projects to accept, negotiating pricing of projects, determining when and where to work, working for multiple entities, and maintaining business records of profits and losses), the worker's status is deemed to be independent contractor.

Companies should review litigated cases to see if the judicial decisions involve similar company models or situations. Given that the courts already have decided a wide spectrum of different work arrangements, companies should use these cases to verify their planned independent contractor model.

FLSA

In order to determine worker status, courts apply an "economic realities test." Per the Department of Labor (DOL), "A worker who is economically dependent on an employer is suffered or permitted to work by the employer. Thus, applying the economic realities test in view of the expansive definition of 'employ' under the Act, most workers are employees under the FLSA. The application of the economic realities factors must be consistent with the broad 'suffer or permit to work' standard of the FLSA."[2]

Most labor law experts agree the intent of the FLSA is to provide a broad scope of statutory protection for workers by treating them as employees by default. The DOL's ongoing assertion is that, under the statute, most workers are employees. While the FLSA offers no bright-line checklist for worker determination, it is no surprise that most worker situations are considered employment. Therefore, it is incumbent on the company to substantiate when independent contractor status applies.

The economic realities test is used to assess the total situation as opposed to individual factors. Some points involved to determine employment status are:

- If a large portion of income is derived from a single company, there is a larger chance an employment relationship exists.
- If a company has significant control over the work performed, there is a significant argument an employment relationship exists.
- If a company provides materials, supplies, and equipment, there would appear to be an employment relationship.
- If the worker is performing in a permanent or indefinite position, it most likely is an employment situation.
- If the work performed by the worker is integral to the ongoing business and required to be performed on a specific schedule under supervision, it is most likely an employment situation.
- If hourly, weekly, or monthly pay schedules are used, there is a significant argument for an employment arrangement.
- If a worker can unilaterally terminate his or her work for a company without liability, there most likely is an employment relationship.

If the following conditions exist, they likely represent evidence of independent contractor status:

- The worker has invested in his or her business, tools, and licensure to provide services to multiple companies.
- The worker can be exposed to loss or increased profit (not simply as a result of taking extra shifts or working more hours) as a result of his or her management of his or her activities.
- The activities of the worker require business skills, judgment, and initiative that are independent from the technical skills of the actual work performed.
- The worker can contract someone else to do the work as his or her representative.
- Payment is made on a commission or project completion basis.
- The worker cannot terminate services without liability under his or her contract or arrangement.

However, as always with tax law, there are exceptions. For U.S. federal tax purposes, certain special worker situations are defined as employment.[3] The following individuals are considered statutory employees, per the IRS:

- A driver who distributes beverages (other than milk), meat, vegetable, fruit, or bakery products, or who picks up and delivers laundry or dry cleaning, whether as an agent or 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 company-supplied materials or goods that will be returned to the company (or a company-named agent) while following company-furnished specifications for the work to be done.
- A full-time traveling or local salesperson who works on behalf of a company and submits orders 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 the company must be the salesperson's principal business activity.

In addition, statutory nonemployees, or independent contractors, are classified into three categories: direct sellers, licensed real estate agents, and certain companion sitters. According to the IRS, direct sellers and licensed real estate agents are treated as self-employed for all federal tax purposes only if 1) most payments for services are related directly to sales or other output rather than the number of hours worked and 2) services are performed under a written contract providing that they will not be treated as employees for federal tax purposes. Companion sitters who are not employees of a companion sitting placement service generally are treated as self-employed for all federal tax purposes.

Penalties

Penalties exist when employees are misclassified as independent contractors. When a local, state, or federal government agency successfully disputes a classification of workers as independent contractors, the company will be liable for back and current tax withholding amounts, employer Social Security contributions, unemployment contributions, workers' compensation insurance premiums, unpaid overtime, and certain other employee benefits, as well as interest and penalties for all years and for all payments to all reclassified workers. Additional wages also may be due if minimum wage requirements were not met. In other words, the total reclassified employee bill could be very substantial.

Companies can avoid reclassification penalties by not treating an independent contractor like an employee. Instead, treat the worker as an independently owned business entity.

To avoid classifying independent contractors as employees, employers should not:

- Supervise or give specific directions on how to accomplish agreed work
- Pay independent contractors on the same schedule as employees
- Give independent contractors employee manuals or handbooks
- Provide independent contractors training similar to employees
- Allow independent contractors to have business cards or stationery with the company name or logo
- Grant independent contractors company titles or positions
- Offer independent contractors employment benefits such as vacation pay, sick leave, pension, or healthcare
- Invite independent contractors to employee meetings or functions
- Refer to independent contractors as employees or allow independent contractors to refer to the company as their employer
- Establish project deadlines that prevent independent contractors from working for other companies
- Assign independent contractors the same activities as employees
- Renew contracts automatically or automatically assign a different project or contract
- Offer work to one bidder solely or repeatedly without considering multiple bids

Independent contractors should be able to:

- Work for other companies
- Submit invoices for completed work to get paid
- Set their own work hours
- Provide their own tools, materials, and supplies as part of their contract
- Work at their own work locations wherever possible
- Hire additional workers to perform tasks of the contract
- Cease providing services when a project or contract is finished

Reasonable Basis and Voluntary Classification Settlement Program (VCSP)

Under Section 530 of the *Revenue Act of 1978*, P.L. 95-600, companies may proceed with using independent contractors with a certain level of protection if their contractor models have not been nullified under common law, prior court cases, or the FLSA. This protection is referred to as Section 530 relief, and it creates a safe harbor for companies against misclassification claims by the IRS.[4] Companies can avoid liability for back employment taxes when they show a reasonable basis for classifying certain workers as nonemployees.

Reasonable basis is established by demonstrating any of the following:

- A final litigated case, a published IRS ruling, or a private IRS ruling for the company
- A previously completed IRS audit in which the company's treatment of workers as nonemployees was determined to be correct
- A long-standing industry practice of the specific industry segment of the company in which workers are treated as nonemployees
- Any other reasonable basis

Once companies establish reasonable basis, they must file all required returns consistent with their classification of the workers. In the case of independent contractors, companies should provide issued Forms 1099-MISC, "Miscellaneous Income," for the relevant workers. Companies also must show that any other workers who are similarly situated were not treated as employees.

Fortunately, companies have time before employees' statuses are contested to reclassify their workers as employees if they fail to demonstrate they are not employees, or if companies are unsure they can actually claim Section 530 relief and are already treating some workers as independent contractors. Under the VCSP, companies can limit exposure to back employment taxes and penalties, provided that certain eligibility requirements are met. Prospectively, companies also agree to treat the specific class of workers as employees. The penalty is 10 percent of the employment tax liability that would have been due on compensation paid to these workers for the most recent tax year under Section 3509(a), which is an option for an employer to self-correct its situation at very favorable rates.[5]

An accepted VCSP agreement protects companies from liability for any interest, penalties, or other tax liabilities for prior years, and it exempts companies from being subject to an employment tax audit on affected workers for those prior years.

Classify Carefully

Worker classification does matter and cannot be determined solely by a desire to have one type of worker over another. Companies cannot force any worker whose work they control to become an independent contractor. Employment relationships are protected by specific and numerous laws and regulations both in the U.S. and around the world. Smart businesses are those that assess the entire landscape of the requirements surrounding worker classification and make the right choices for themselves and their workers.

Learn More

Gary Johnson
Managing Director
+1 404 495 7087
gary.johnson@crowe.com

Laurie Marson
+ 1 404 495 7093
laurie.marson@crowe.com

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[1] "OASDI and SSI Program Rates & Limits," Office of Retirement and Disability Policy, October 2016, https://www.ssa.gov/policy/docs/quickfacts/prog_highlights/RatesLimits2017.html

[2] David Weil, Administrator's Interpretation No. 2015-1, "The Application of the Fair Labor Standards Act's 'Suffer or Permit' Standard in the Identification of Employees Who Are Misclassified as Independent Contractors," U.S. Department of Labor, July 15, 2015, https://www.dol.gov/whd/workers/Misclassification/AI-2015_1.htm

[3] Publication 15-A, "Employer's Supplemental Tax Guide" Supplement to Pub. 15, Employer's Tax Guide), Internal Revenue Service, Department of the Treasury, 2017, https://www.irs.gov/publications/p15a/index.html

[4] "Do You Qualify for Relief Under Section 530?," IRS Publication 1976 (Rev. 05-07, Cat. No. 22927M), Internal Revenue Service, Department of the Treasury, revised May 2007, https://www.irs.gov/pub/irs-pdf/p1976.pdf

[5] Internal Revenue Bulletin 2012-51, Announcement 2012-45, "Voluntary Classification Settlement Program," Internal Revenue Service, Department of the Treasury, Dec. 17, 2012, https://www.irs.gov/irb/2012-51_IRB/ar16.html

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