

IS YOUR WORKER AN EMPLOYEE OR INDEPENDENT CONTRACTOR? AND WHY IT MATTERS.

**ANDREW B. FAULKNER
NEWLAND & ASSOCIATES, PLLC
10 CORPORATE HILL DRIVE, SUITE 330
LITTLE ROCK, AR 72205
(501) 221-9393
afaulkner@newlandassociatespllc.com**

I. Introduction.

It is critical that you, the employer, correctly determine whether the individuals providing services for you are employees or independent contractors. Generally, you must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee. You do not generally have to withhold or pay any taxes on payments to independent contractors. In addition, as you will see in these materials, whether a worker is an employee or independent contractor also has significant implications regarding your liability under different federal and state laws.

II. The IRS' Position On Whether Your Worker Is An Employee Or Independent Contractor.¹

Before you can determine how to treat payments you make for services, you must first know the business relationship that exists between you and the person performing the services. The person performing the services may fall into one of the following categories:

1. An independent contractor,
2. A common-law employee,

¹ The information contained in this Section of the materials came from the IRS' website (www.irs.gov).

3. a statutory employee, or
4. a statutory nonemployee.

In determining whether the person providing service is an employee or an independent contractor, all information that provides evidence of the degree of control and independence must be considered.

A. How does the IRS define an “independent contractor?”

The IRS has found that people such as lawyers, contractors, subcontractors, and auctioneers who follow an independent trade, business, or profession in which they offer their services to the public, are generally not employees. However, whether such people are employees or independent contractors depends upon the facts in each case.

The general rule is that an individual is an independent contractor if you, the person for whom the services are performed, have the right to control or direct only the result of the work and not the means and methods of accomplishing the result.

Here is an example:

Vera Elm, an electrician, submitted a job estimate to a housing complex for electrical work at \$16 per hour for 400 hours. She is to receive \$1,280 every 2 weeks for the next 10 weeks. This is not considered payment by the hour. Even if she works more or less than 400 hours to complete the work, Vera Elm will receive \$6,400. She also performs additional electrical installations under contracts with other companies that she obtained through advertisements. The IRS has determined that Vera is an independent contractor under this scenario.

B. How does the IRS define a “common-law employee?”

Under common-law rules, anyone who performs services for you is your employee if you can control what will be done and how it will be done. This is so even when you give the employee freedom of action. What matters is that you have the right to control the details of how the services are performed.

Here is an example:

Donna Lee is a salesperson employed on a full-time basis by Bob Blue, an auto dealer. She works 6 days a week, and is on duty in Bob’s showroom on certain assigned days and times. She appraises trade-ins, but her appraisals are subject to the sales manager’s approval. Lists of prospective customers belong to the dealer. She has to develop leads and report results to the sales manager. Because of her experience, she requires only minimal assistance in closing and financing sales and in other phases of her work. She is paid a commission and is eligible for prizes and bonuses offered by Bob. Bob also pays the cost of health insurance and group-term life insurance for Donna. The IRS has determined that Donna is an employee of Bob Blue.

C. How does the IRS define a “statutory employee?”

If workers are independent contractors under the common law rules, such workers may nevertheless be treated as employees by statute for certain employment tax purposes if they fall within any of the following four categories and meet the three conditions under Social Security and Medicare taxes, below.

1. A driver who distributes beverages (other than milk), meat, vegetable, fruit or bakery products; or who picks up and delivers laundry or dry cleaning, if the driver is your agent or is paid on commission.

2. 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.
3. An individual who works at home on materials or goods that you supply and that must be returned to you or to a person you name if you also furnish specifications for the work to be done.
4. A full-time traveling or city salesperson who works on your behalf and turns in orders to you 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 you must be the salesperson's principal business activity.

You must withhold Social Security and Medicare taxes from the wages of statutory employees if all three of the following conditions apply:

1. The service contract states or implies that substantially all the services are to be performed personally by them.
2. They do not have a substantial investment in the equipment and property used to perform the services (other than an investment in transportation facilities).
3. The services are performed on a continuing basis for the same payer.

D. How does the IRS define a “statutory nonemployee?”

There are generally two categories of statutory nonemployees: direct sellers and licensed real estate agents. They are treated as self-employed for all Federal tax purposes, including income and employment taxes, if:

1. Substantially all payments for their services as direct sellers or real estate agents are directly related to sales or other output rather than the number of hours worked, and
2. Their services are performed under a written contract providing that they will not be treated as employees for Federal tax purposes.

II. IRS’ Standard: Degree of Control & Independence

As stated earlier, when determining whether a person is an employee or an independent contractor, the IRS will look at all information that provides evidence of the degree of control and independence you have over the person.

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

1. Behavioral: Does the company control or have the right to control what the worker does and how the worker does his or her job?
2. Financial: Are the business aspects of the worker’s job controlled by the payer? (These include things like how a worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)
3. Type of Relationship: Are there written contracts or employee type benefits (i.e., pension plan, insurance, vacation pay, etc.)? Will the

relationship continue and is the work performed a key aspect of the business?

A. Additional Information on Behavioral Control

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:

1. Type of instructions given
2. Degree of instruction
3. Evaluation systems
4. Training

An employee is generally subject to the business's instructions about when, where, and how to work. All of the following are examples of types of instructions about how to do work:

1. When and where to do the work.
2. What tools or equipment to use.
3. What workers to hire or to assist with the work.
4. Where to purchase supplies and services.
5. What work must be performed by a specified individual.
6. What order or sequence to follow when performing the work.

Degree of instruction means that the more detailed the instructions, the more control the business exercises over the worker. More detailed instructions indicate that the worker is an employee. Less detailed instructions reflects less control indicating that the worker is more likely an independent contractor.

One thing to note, the amount of instruction needed varies among different jobs. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. A business may lack the knowledge to instruct some highly specialized professionals; in other cases, the task may require little or no instruction. The key consideration is whether the business has retained the right to control the details of a worker's performance or instead has given up that right.

If an evaluation system measures the details of how the work is performed, then these factors would point to an employee. If the evaluation system measures just the end result, then this can point to either an independent contractor or an employee.

If the business provides the worker with training on how to do the job, this indicates that the business wants the job done in a particular way. This is strong evidence that the worker is an employee. Periodic or on-going training about procedures and methods is even stronger evidence of an employer-employee relationship. However, independent contractors ordinarily use their own methods.

B. Additional Information on Financial Control

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:

1. Significant investment
2. Unreimbursed expenses
3. Opportunity for profit or loss
4. Services available to the market
5. Method of payment

An independent contractor often has a significant investment in the equipment he or she uses in working for someone else. However, in many occupations, such as construction, workers spend thousands of dollars on the tools and equipment they use and are still considered to be employees. There are no precise dollar limits that must be met in order to have a significant investment. Furthermore, a significant investment is not necessary for independent contractor status as some types of work simply do not require large expenditures.

Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services that they perform for their business.

The opportunity to make a profit or loss is another important factor. If a worker has a significant investment in the tools and equipment used and if the worker has unreimbursed expenses, the worker has a greater opportunity to lose money (i.e., their expenses will exceed their income from the work). Having the possibility of incurring a loss indicates that the worker is an independent contractor.

An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.

An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is usually paid by a flat fee for the job. However, it is common in some instances, such as hiring a plumber under a time and materials arrangement, to pay independent contractors hourly.

C. Additional Information on 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:

1. Written contracts
2. Employee benefits
3. Permanency of the relationship
4. Services provided as key activity of the business

Although a contract may state that the worker is an employee or an independent contractor, this is not sufficient to determine the worker's status. The IRS is not required to follow a contract stating that the worker is an independent contractor and is responsible for paying his or her own self employment tax. How the parties work together determines whether the worker is an employee or an independent contractor.

Employee benefits include things like insurance, pension plans, paid vacation, sick days, and disability insurance. Businesses generally do not grant these benefits to independent contractors. However, the lack of these types of benefits does not necessarily mean the worker is an independent contractor.

If you hire a worker with the expectation that the relationship will continue indefinitely rather than for a specific project or period, this is generally considered evidence that the intent was to create an employer-employee relationship.

If a worker provides services that are a key aspect of the business, it is more likely that the business will have the right to direct and control his or her activities. For example, if an electrical contractor hires a master electrician, it is likely that it will present the master electrician's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

Businesses must weigh all of the factors (i.e., behavioral, financial, and type of relationship) 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.

III. IRS Form SS-8

If, after reviewing the three categories of evidence (i.e., behavioral, financial, and type of relationship), it is still unclear whether a worker is an employee or an independent contractor, Form SS-8, “Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding,” can be filed with the IRS. The form may be filed by either the business or the worker. The IRS will review the facts and circumstances and officially determine the worker’s status. There is no fee for requesting an SS-8 determination letter from the IRS.

Be aware that it can take at least six months to get a determination, but a business that continually hires the same types of workers to perform particular services may want to consider filing the Form SS-8.

IRS Form SS-8 is also a great tool for you to use when analyzing whether a person is an employee or independent contractor. There are relevant questions on the form that help guide you through the analyses process. Attached to these materials is a copy of IRS Form SS-8.

IV. What Happens If You Have Misclassified A Worker?

If you classify an employee as an independent contractor, and you have no reasonable basis for doing so, you may be held liable for employment taxes for that worker. Put another way, every employer who is required to withhold tax on wages is liable for payment of the tax whether or not it is collected. In addition, any “responsible person” – typically a corporate officer or employee – who willfully fails to withhold, account for, or pay over withholding tax to the government is subject to a penalty equal to 100 percent of such tax. This penalty is typically a collection device, usually assessed

only when the tax cannot be collected from the employer, and results in personal liability not dischargeable by bankruptcy. Civil and criminal penalties can also be imposed if an employer willfully fails to furnish a Form W-2 statement to an employee.

If you have a reasonable basis for not treating a worker as an employee, you may be relieved from having to pay employment taxes for that worker. This is termed as Section 530 Relief. To receive relief, you must meet all three of the following requirements:

1. Reasonable Basis
2. Substantive Consistency
3. Reporting Consistency

A. What is considered “reasonable basis?”

To establish that you had a reasonable basis for not treating the workers as employees, you can show that:

1. You reasonably relied on a court case about federal taxes or a ruling issued to you by the IRS (i.e., Form SS-8);
2. Your business was audited by the IRS at a time when you treated similar workers as independent contractors, and the IRS did not reclassify those workers as employees;
3. You treated the workers as independent contractors because you knew that was how a significant segment of your industry treated similar workers; or
4. You relied on some other reasonable basis. For example, you relied on the advice of a business lawyer or accountant who knew the facts about your business.

If you did not have reasonable basis for treating the workers as independent contractors, you do not meet the relief requirements.

B. What is considered “substantive consistency?”

In addition, you must have treated the workers in question, and any similar workers, as independent contractors. If you treated similar workers as employees, this relief provision is not available.

C. What is considered “reporting consistency?”

Finally, you must have filed Form 1099-MISC for each worker unless the worker earned less than \$600. Relief is not available for any year you did not file the required Forms 1099-MISC. If you filed the required Forms 1099-MISC for some workers but not for others, relief is not available for the workers for whom you did not file Forms 1099-MISC.

V. Other Than Potential Tax Liability, What Other Laws Are Affected By The Determination Of Whether A Worker Is An Employee Or Independent Contractor?

A. Unemployment Benefits²

Under Arkansas law, a business will be liable for unemployment insurance withholding for an employee and not an independent contractor. The Arkansas Department of Workforce Services considers the following factors in determining whether a person is an employee or independent contractor:

1. An employer-employee relationship exists where the services performed are a regular part of your business. It is presumed that in order to protect your

² The information contained in this Section of the materials came from the Arkansas Department of Workforce Services’ “Unemployment Insurance Handbook for Arkansas Employers.”

business interests you have the right to control the manner in which workers perform services for you.

2. The services may be performed on a full-time, part-time, temporary, seasonal, or probationary basis. They may be performed on or off your premises or in employees' own homes. Corporate officers, including officers of closely-held corporations, are employees of the corporation whether or not they receive wages.
3. In contrast, independent contractors are customarily engaged in an independent trade, occupation, profession, or business. They usually advertise their services, are in a position to realize profit or suffer a loss as a result of their services, and usually have a significant investment in the business.

If you have misclassified an employee as an independent contractor, your unemployment account could still be charged for his benefit and the Department of Workforce Services could still assess you for all unemployment monies not deposited for the misclassified employee.

B. Workers' Compensation

The Arkansas Workers' Compensation laws apply to all "employers" who are "carrying on any employment." Ark. Code Ann. § 11-9-102. The term "employment" is defined as:

1. Every employment in the state in which 3 or more employees are regularly employed by the same employer in the course of business;
2. Every employment in which 2 or more employees are employed by any person engaged in building or building repair work;

3. Every employment in which 1 or more employees are employed by a contractor who subcontracts any part of his contract; and
4. Every employment in which 1 or more employees are employed by a subcontractor. *See id.*

The Workers' Compensation laws define an "employee" as generally "any person employed in the service of an employer under any contract of hire or apprenticeship, written or oral, expressed or implied, but excluding one whose employment is causal and not in the course of the business of his employer and excluding one who is required to perform work for a municipality or county or the state or federal government upon having been convicted of a criminal offense or while incarcerated." *See id.*

Despite not specifically stating the words "independent contractor" in the definition of an "employee," an independent contractor is excluded from coverage under this law per the exclusion for one whose employment is causal and not in the course of the business of his employer.

Practically speaking, it is a good idea to have a worker whom you believe is an independent contractor to apply to the Arkansas Workers' Compensation Commission for a "Certificate of Non-Coverage." Your worker can contact the Commission and fill out the necessary paperwork to receive this Certificate from the Commission that certifies that this particular worker is not covered under a Workers' Compensation policy and that the worker is essentially an independent contractor.

C. National Labor Relations Act ("NLRA")

The National Labor Relations Board ("NLRB") is the federal agency that enforces the NLRA. The NLRB's jurisdiction extends only to the relationship between an

employer and its “employees;” it does not encompass the relationship between a company and its “independent contractors.”

Under the NLRA, the term “employee” includes “any employee . . . but shall not include . . . any individual having the status of an independent contractor.” Employment status under the NLRA is dependent upon common law principles of agency. 29 U.S.C. § 152(3) (2000). Common law agency principles require an analysis of the “right of control.” *See Dial-A-Mattress Operating Corp.*, 326 NLRB No. 75 (1998); *NLRB v. United Ins. Co. of Am.*, 390 U.S. 254, 256 (1968).

Like the IRS’ classification methods, no specific formula exists to determine whether a given worker is an independent contractor or employee under the NLRA. Rather, all of the incidents of the relationship must be assessed and weighed with no one factor being decisive. What is important is that the total factual context is assessed in light of the pertinent common law agency principles. *See id.*

D. Equal Employment Opportunity (“EEO”) Statutes: ADEA, ADA, Title VII³

The Equal Employment Opportunity Commission (“EEOC”) is the federal agency that enforces the various equal employment opportunity laws, i.e., Age Discrimination in Employment Act (“ADEA”), Americans with Disabilities Act (“ADA”), and Title VII (collectively the “EEOC Statutes”).

Like the NLRB, the EEOC’s jurisdiction extends only to the relationship between an employer and its “employees;” it does not encompass the relationship between a company and its “independent contractors.” The EEOC Compliance Manual states that

³ The information contained in this Section of the materials came from the EEOC’s website (www.eeoc.gov).

the common law “right to control” test rationale applies under the EEO Statutes. Factors the EEOC considers to be evidence that an employer-employee relationship exists include the following:

1. The employer has the right to control when, where, and how the worker performs the job.
2. The work does not require a high level of skill or expertise.
3. The employer furnishes the tools, materials, and equipment.
4. The work is performed on the employer’s premises.
5. There is a continuing relationship between the worker and the employer.
6. The employer has the right to assign additional projects to the worker.
7. The employer sets the hours of work and the duration of the job.
8. The worker is paid by the hour, week, or month rather than the agreed cost of performing a particular job.
9. The worker does not hire and pay assistants.
10. The work performed by the worker is part of the regular business of the employer.
11. The employer is in business.
12. The worker is not engaged in his/her own distinct business occupation or business.
13. The employer provides the worker with benefits such as insurance, leave, or workers’ compensation.
14. The worker is considered an employee of the employer for tax purposes (i.e., the employer withholds federal, state, and Social Security taxes).

15. The employer can discharge the worker.
16. The worker and the employer believe that they are creating an employer-employee relationship.

This list is not exhaustive. The determination must be based on all the circumstances in the relationship between the parties regardless of whether the parties refer to it as an employee or as an independent contractor relationship.

VI. Pending Legislation

There are currently two bills pending with Congress that are relevant to this issue – the Independent Contractor Proper Classification Act of 2007 and the Taxpayer Responsibility, Accountability, and Consistency Act of 2008. These two bills have been introduced in Congress to beef-up enforcement of worker classification by the IRS.

The Independent Contractor Proper Classification Act of 2007 (S. 2044) would establish a detailed enforcement scheme shared by several federal administrative agencies, including the IRS and the U.S. Department of Labor (“DOL”). The IRS and DOL would be required to issue annual reports and exchange information on worker misclassification cases. The bill would prohibit employers from retaliating against workers who petition the IRS for review of their classification. It would also require employers to notify independent contractors of their federal tax obligations, the legal protections that are inapplicable to independent contractors, and their right to seek a determination from the IRS.

The Taxpayer Responsibility, Accountability, and Consistency Act of 2008 (H.R. 5804) would repeal the Section 530 safe harbor and replace it with a new but similar safe harbor.

VII. Conclusion

As you can see, the determination of whether a worker is an employee or independent contractor is not an easy one. You also have the added pressure of your determination causing a law to apply to you or not. In the end, you must weigh the circumstances surrounding the person's employment and make the call yourself. If you do not feel comfortable making the determination yourself, you can always file an SS-8 Form with the IRS and let them tell you what category your worker falls into.

CHECKLIST: INDEPENDENT CONTRACTOR OR EMPLOYEE

Check each statement that is true, remembering that the final determination depends on all the facts and circumstances and that no single issue is dispositive. Checking off any of the statements below may indicate an *employer-employee* relationship.

- The employer controls the time, place, and manner of the work.
- The employer provides or requires training, or requires attendance at training meetings.
- The employer integrates the worker into regular operations.
- The employer requires that the worker specifically perform the work.
- The employer hires and controls the worker's assistants.
- The employer and the worker have a long-term working relationship.
- The employer requires the worker to work certain hours or a certain schedule.
- The employer requires a certain number of hours.
- The employer requires work at a specific location.
- The employer controls the order of the work or the technique used.
- The employer requires reports from the worker.
- The employer pays on a regular basis, rather than on receipt of invoices.
- The employer pays the worker's work-related expenses.
- The employer furnishes tools or other needed equipment for the job.
- The employer provides work facilities, rather than the worker maintaining separate space.
- The worker does not risk loss through completion of the job.
- The worker works only for the employer or for the employer's customers.
- The employer may terminate the worker's services or the worker may quit at any time.