



DAILY TAX REPORT



IRS Gives 10 Tips on Employees Versus Independent Contractors

By **ROBERT W. WOOD**

If you are a small business owner, whether you hire people as independent contractors or as employees will impact your own taxes as well as the taxes you withhold from worker paychecks.

Plus, it will affect many costs, including workers' compensation and unemployment insurance, liability insurance, employee benefit costs, and more. It will influence your recordkeeping and information return filing requirements and your liability for compliance with many federal and state laws impacting the workplace.

The Internal Revenue Service and many other agencies expect you to know this. Still, IRS occasionally tries to offer a bit of advice, directing it not to tax practitioners where most of their guidance goes, but rather to business owners.

That is what IRS did in August in releasing "Summertime Tax Tip 2009-20."¹

You cannot help but notice IRS's cutesy title. Perhaps giving tax advice a title that sounds more like barbecue advice may make it more palatable. IRS often strives to clean up its nomenclature.

Recently, for example, the revamped IRS changed the moniker for its network of IRS "Service Centers" where millions of returns and other tax filings are processed. They are now called "IRS Campuses." Maybe this will make you feel better. It may give you a kind of

college-bound euphoria when you mail off your tax return and a big check.

In the meantime, here from IRS are the top 10 things every business owner should know about hiring people as independent contractors versus hiring them as employees. The IRS text appears in bold and is boxed, with my unofficial comments appearing thereafter.

1. Three Factors

1. Three characteristics are used by the IRS to determine the relationship between businesses and workers: Behavioral Control, Financial Control, and the Type of Relationship.

Most people think of IRS as having a 20-factor standard. It is based on the common law right of control test that is so prevalent in the case law (tax and non-tax alike). IRS set out its 20-factor hit list in Revenue Ruling 87-41.²

Lately, though, IRS thought it might be easier for people to consider three factors or groups of factors, and that is what IRS is referring to here. You can use either approach, and for most taxpayers the old 20-factor view is superior. Among other things, these 20 factors invite scrutiny into some quite concrete issues:

- **1. Instructions.** The more instructions that are given, the more likely is employee status.
- **2. Training.** The more training, the more likely is employee status.
- **3. Integration.** The more closely integrated the work is with the employer's business, the more likely is employee status.
- **4. Services Rendered Personally.** If the worker must personally do the work, employee status is more likely.

² 1987-1 C.B. 296.

¹ See Summertime Tax Tip 2009-20, Aug. 21, 2009, <http://www.irs.gov/newsroom/article/0,,id=173423,00.html>.

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■ **5. Hiring, Supervising, and Paying Assistants.** A person who does these things will often be an independent contractor.

■ **6. Continuing Relationship.** The longer the arrangement's term, the more likely is employment status.

■ **7. Set Hours of Work.** Set hours tend to indicate employment status.

■ **8. Full Time Required.** Working full time tends to indicate employment status.

■ **9. Doing Work on Employer's Premises.** Working on the employer's premises may suggest employment status.

■ **10. Order or Sequence Set.** Performing services in a particular order or sequence suggests employment status.

■ **11. Oral or Written Reports.** Reports to an employer tend to suggest employee status.

■ **12. Payment by Hour, Week, or Month.** Payment by the hour, week, or month suggests employee status.

■ **13. Payment of Business and Traveling Expenses.** Payment of business and traveling expenses suggests employee status.

■ **14. Furnishing of Tools and Materials.** A company furnishing significant tools, materials, and other equipment suggests employee status.

■ **15. Significant Investment.** A worker's significant investment tends to indicate independent contractor status.

■ **16. Realization of Profit or Loss.** A worker's potential to realize a profit or suffer a loss suggests independent contractor status.

■ **17. Working for More Than One Firm at a Time.** Working for more than one firm at the same time suggests independent contractor status.

■ **18. Making Service Available to the General Public.** Making services available to the general public on a regular and consistent basis suggests independent contractor status.

■ **19. Right to Discharge.** The right to discharge a worker suggests employee status.

■ **20. Right to Terminate.** A worker's right to terminate the relationship without incurring a liability suggests employee status.

2. Behavioral Control

2. Behavioral Control covers facts that show whether the business has a right to direct or control how the work is done through instructions, training or other means.

If you are going to use the new three-factor approach, behavioral control is arguably the most important. The essence of an employer-employee relationship is that of master and servant. The employee can be ordered to do just about anything.

One common way of describing the issue is that an independent contractor can only be ordered to produce the widget. An employee can be ordered to produce the

widget in a particular way and using particular means. It is the difference between an end result and a process.

As the old 20-factor IRS test makes clear, the more you train the workers, the more likely they will be employees. Similarly, the more you require an order or sequence (rather than just the end result), the closer toward employment you get.

Of course, this is not so much about whether you actually do these things. It is more about whether you have the right to do them.

If your form of contract gives you the right to control every aspect of the arrangement, the mere fact that you do not exercise those rights may not save you from employee status for the workers.

3. Financial Control

3. Financial Control covers facts that show whether the business has a right to direct or control the financial and business aspects of the worker's job.

You will get more out of reading the 20 factors than this amorphous financial control test. Consider such aspects as whether you pay the worker by the hour, week, month, or by the job. Flat fees for certain work (\$10,000 to build a fence) sound more "independent" than \$20 per hour.

Also consider whether the worker can experience a profit or loss. The loss side of the equation is particularly important. For example, if you buy all the tools, you supply all the fence materials, and you pay the worker \$20 per hour, the worker cannot experience a loss. On the other hand, if you pay a flat fee of \$10,000, and that is to include materials, supplies, tools, and the fee for construction, the worker might actually suffer a loss.

4. Type of Relationship

4. The Type of Relationship factor relates to how the workers and the business owner perceive their relationship.

This factor arguably is not too important, since in most disputes there is a written document that says what the relationship is and how the parties will treat it. Usually, there is a written contract that says the worker is an independent contractor and not an employee.

The authorities (both inside and outside of the tax arena) seem uniform in saying that written documents supporting independent contractor treatment will not save you from recharacterization if the actual practice

and experience of the relationship is materially different.

Nevertheless, there is at least some stock put in what the parties say and understand about the nature of their working relationship. In the IRS Summertime Tax Tip 2009-20, they use this issue as a jumping off point for a more detailed discussion of the right to control.

5. Right to Control

5. If you have the right to control or direct not only what is to be done, but also how it is to be done, then your workers are most likely employees.

This one is obvious. Of course, bear in mind that even in a bona fide independent contractor relationship, the principal will necessarily control a number of things.

For example, if you contract with a pool installer to put a swimming pool in your back yard, you surely will tell them exactly where you want the pool and how deep you want it. That does not make the installer your employee.

6. Result Versus Means

6. If you can direct or control only the result of the work done—and not the means and methods of accomplishing the result—then your workers are probably independent contractors.

It is important to distinguish legal rights from actual practice. Do not merely consider whether you as the employer actually control the details of the work being done, but whether you can control it.

That means if your contract with your “independent contractor” says that you can tell the worker the order of work, where to do it, how to do it, how to dress, what hours to work, to do it themselves rather than to delegate it, etc., the worker is likely to be your employee.

This will be true even if you do not exercise any of these rights. The mere fact that you possess these rights will be enough.

7. Consequences of Misclassification

7. Employers who misclassify workers as independent contractors can end up with substantial tax bills. Additionally, they can face penalties for failing to pay employment taxes and for failing to file required tax forms.

This IRS comment is hardly a surprise. One of the inherent difficulties in this area is temporal. Often, by the time you realize you have a problem, it is a very large problem. If you are required to start treating a class of your workers as employees prospectively, that might not sting too much. But a retroactive recharacterization is a different story.

IRS will often seek retroactive recharacterization, and will provide the employer with what may be a staggering calculation of what IRS thinks the employer owes. There can be ways to ameliorate the numbers, as by proving (if the employer is able) that all of its independent contractors in fact paid all of their own taxes. Even then, the figure can still be large.

One further answer is to try to negotiate a deal with IRS in which the employer admits no liability for the past but agrees to treat the workers as employees prospectively. This kind of compromise is far more common than you might think.

8. Worker Benefits

8. Workers can avoid higher tax bills and lost benefits if they know their proper status.

This is a curious comment by IRS. The second part of the sentence is clear, since most employees receive at least some “employee benefits.” In fact, some benefit packages can be positively enormous.

If workers have a choice, that can make the choice between contractor and employee an easy one from the worker’s perspective. Conversely, the prevalence and cost of employee benefits is a prime reason that many companies want to push the independent contractor envelope as far as they reasonably can.

The first part of the IRS sentence above (suggesting that workers can avoid higher tax bills) is curious. So, workers who are being treated as independent contractors will have a higher tax bill if they are converted to employee status? That seems counterintuitive.

I think IRS is alluding to the fact that an independent contractor normally files a Schedule C (as a proprietor) to his or her IRS Form 1040. The contractor/proprietor would include all gross income, and then would deduct all business expenses on the Schedule C. If the worker is recharacterized and must be treated as an employee, many of these expenses will not be deductible.

Employees can usually deduct business expenses only as miscellaneous itemized deductions, which are subject to many limits. In fact, IRS recently issued Notice 989 on just this point.³ This is another recent IRS release, addressing (and trying to answer) commonly asked questions once a worker is recharacterized from independent contractor to employee.

In Notice 989, IRS made clear that workers who are recast from independent contractor to employee status may lose out on many deductions. Plus, IRS said that in such a case the worker must file amended tax returns to correct this.

The latter point is troubling, since the Treasury regulations state that a person “should” file an amended return but do not make the obligation mandatory.⁴ Whether IRS can trump a regulation with an IRS notice is an open question.⁵

9. Form SS-8 Determinations

9. Both employers and workers can ask the IRS to make a determination on whether a specific individual is an independent contractor or an employee by filing a Form SS-8—Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding—with the IRS.

IRS is right that either worker or company can file this form. In fact, it is surprising that more of these forms are not filed. If you supply accurate information, you can at least show your good faith, which can help in any subsequent dispute over worker status.

Plus, achieving a favorable determination (that is, that the worker in question is a bona fide independent contractor) can have a kind of estoppel effect. Such a determination may help you later with IRS (and sometimes even with other parties) when the status of workers is being called into question.

One reason more Forms SS-8 are not filed may simply be fear of the unknown and an understandable desire for anonymity. There is also the concern that a Form SS-8 filed by an employer can backfire. As an old saying goes, if you cannot stand the answer, do not ask the question.

³ See Notice 989 (Rev. 7-2009), 153 TaxCore, 8/12/09.

⁴ See Treasury Regulations Sections 1.451-1(a) and 1.461-1(a)(3).

⁵ For discussion, see Robert W. Wood, *Ten Things IRS Wants Workers to Consider When Contractors Become Employees*, Daily Tax Report, 156 DTR J-1, 8/17/09.

10. Additional Resources

10. You can learn more about the critical determination of a worker’s status as an Independent Contractor or Employee at IRS.gov by selecting the Small Business link. Additional resources include IRS Publication 15-A, Employer’s Supplemental Tax Guide, Publication 1779, Independent Contractor or Employee, and Publication 1976, Do You Qualify for Relief under Section 530? These publications and Form SS-8 are available on the IRS Web site or by calling the IRS at 800-829-3676 (800-TAX-FORM).

This last IRS tidbit is very good advice, for IRS is giving suggestions where you should go for further information. These IRS resources are worth reading, no matter what your stake is in worker status issues. Bear in mind, though, that you will get a one-sided view of the matter.

As you might expect, IRS is giving its view of worker status matters, not the views of taxpayers or even the courts. As a kind of baseline, however, you should be familiar with the IRS resources and the IRS views. They can help keep you out of trouble.

Conclusion

If you are a worker working as an independent contractor, or own or represent a company with some of its workforce working on an independent contractor basis, you may find that you know less about this area than you should. This is particularly the case for companies.

It is not overly dramatic to say that companies may be playing a form of Russian roulette if they do not periodically assess both their contracts with putative independent contractors and their actual practice.

If you are a lawyer, accountant, or business adviser to companies using such workers, you should also reflect on your role and on how the business is using independent contractors. If you are an officer or director of a company, you should consider whether you should voice concerns over such matters. It is not far-fetched to suggest that even outside directors may conceivably face personal liability in some cases of worker misclassification.

IRS may not have brightened anyone’s summer with its latest “Summertime Tax Tips.” Like an inoculation at a holiday picnic, though, this medicine clearly has value.