

Independent Contractor VS. Employee Status

Tax Gap includes \$72 billion of underreported employment taxes

Tax withheld from employee wages accounts for approximately 70% of annual revenue collected by the IRS. When last measured, underreported and unpaid employment taxes represented approximately \$72 billion of the overall US tax gap. As of September 2015, more than \$59 billion of tax reported on employment tax returns remained unpaid.

The IRS has “early interaction initiatives” in place to encourage employers to comply with their tax obligations, including the current use of the Federal Tax Deposit Alert, which allows revenue officers to know within 13 weeks of a missed deposit. By early 2017, the IRS intends to implement an Electronic Federal Tax Payment System that will alert revenue officers within 72 hours that an employer missed a deposit.

Independent Contractors

Contract labor and commission expenses are deductible when paid to an independent contractor (IC). Form 1099 must be issued if \$600 or more is paid for services to an unincorporated individual or business. The issue involved in both the commission expense and the contract labor deduction is whether the worker is properly classified as an employee of the business or an IC.

Voluntary Classification Settlement Program (VCSP) Revised

In an effort to get business to comply voluntarily with worker reclassification, the VCSP provides partial relief from federal employment tax penalties for eligible taxpayers that agree to treat prospectively workers as employees. Under the originally adopted VSC Program, eligible employers can sustain relief from prior period federal payroll taxes and related penalties if they prospectively reclassify workers as employees for federal tax purposes. The VSCP is optional. To participate, an employer must meet certain eligibility requirements, apply to participate in the VCSP, and enter into a closing agreement with the IRS. To participate in the revised VCSP, employers must complete an application (Form 8952) and meet the following qualifications:

- Consistently treated workers in the past as nonemployees
- Filed all required Form 1099 for the workers for the previous three years
- Employers cannot be currently contesting in court the classification of the class or classes of workers from a previous audit by the IRS or the Department of Labor

- Such employer cannot be currently under an employment tax audit by the IRS, the Department of Labor, or a state agency. If the employer is a member of an affiliated group within the meaning of 1504(a), none of the members of the group is currently under an employment tax audit

Note:

See the IRS Voluntary Classification Settlement Program website for additional information

The IRS Common Law Approach on Workers Classification: Three Categories of Evidence (1) Behavioral Control, (2) Financial Control, and (3) Parties View (Independent Contractor) Self-Employed or Employee, July 7, 2016

Most of the difficulty in deciding if a worker is an employee or an independent contractor stems from the fact that an employer's goals conflict with those of the IRS. Conferring independent contractor status upon a worker often benefits the employer, since the employer is not obligated to withhold income taxes, to pay social security and unemployment taxes, or to provide employee benefits. Conversely, classifying workers as employees makes it easier for the IRS to collect the worker's taxes because it shifts much of the collection burden to the employer. The IRS has developed a 20-factor test to assess this degree of control, with factors generally skewed towards concluding that the worker is an employee (see Rev. Rul. 87-41 and Form SS-8). Most of these tests have summarily been rejected by the courts and Congress. In addition, state law determinations (or other government or industry imposed regulation) are not a relevant indicator of employer-employee status.

Recognizing the direction the wind is blowing, the IRS's worker classification training manual sets forth three categories of evidence it thinks are most significant in making a determination of a worker's status under common law. The IRS training guide moves its focus gathering evidence that illustrates "the extent of an employer's behavioral and financial control" over the worker and "how the parties view their relationship."

Following is an abbreviated synopsis of each factor.

Does behavioral control over worker exist?

Behavioral control focuses on whether the business has the right to direct or control how the work is done.

- **To what extent are instructions given and taken?** An employee is generally subject to the business's instructions about when, where and how to work; an IC is not. 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. Pertinent evidence includes: (1) needing approval before proceeding, (2) rendering services personally, and (3) hiring, supervising and paying assistants.
- **What training does the business give the worker?** Employees may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods. The business's orientation course, safety seminars, and voluntary unpaid educational programs are to be disregarded.

Do financial controls over worker exist?

These factors illustrate whether there is a right to direct or control how the business aspects of the worker's activities are conducted:

- **Can the worker realize a profit or incur a loss?** An IC can make a profit or loss whereas employees can only make a profit. The IRS discloses that the worker's dependence on the job is not a factor.
 - **Is the worker's investment significant?** An IC often has a significant investment in the equipment or facilities he or she uses in performing services for someone else. However a significant investment is not required. The IRS has listed business expenses expected to be found on the taxpayer's business return.
- **To what extent does the worker make services available to the general public?** Pertinent evidence includes: (1) advertising, (2) working for more than one firm, and (3) long-term contracts or WOM advertising
- **How does the business pay the worker?** An employee is generally paid by the hour, week or month. An IC is generally paid a flat fee or by the job, even though it is common in some professions, such as law or accounting, to pay hourly. The payment of commissions indicates both are possible.

What type of relationship exists between the parties?

These factors illustrate how the worker and the business perceive their relationship between each other:

- **Does a written contract exist that describes the relationship the parties intend to create?** This factor is generally less important to the IRS but of more importance to the courts as the substance, not the label, governs the worker's status.
- **Does the business provide the worker with employee-type benefits, such as insurance, a pension plan, vacation or sick pay?** Employee benefits are ONLY paid to employees.
- **How permanent, ongoing, is this relationship?** Permanent and indefinite relationships indicate an employer-employee relationship whereas, the IRS divulges, long-term and temporary relationships are not important evidence.
- **To what extent are the services performed by the worker a key aspect of the regular business of the company?** Is the success of the business dependent, to an appreciable degree, upon the worker's performance. If so, an employee-employer relationship exists. Example: Even though an appliance store needs an accountant, bookkeeping is not the store's regular business and therefore this work can be done equally well by independent contractors or employees.

Other factors used by courts to determine if a worker is an employee or self-employed

1. The skills required
2. The source of instrumentalities and tools
3. The location of the work
4. The duration of the relationship
5. Whether the business has the right to assign additional projects to workers
6. The extent of the worker's discretion over when and how long to work
7. The method of payment
8. The worker's role in hiring/paying assistants
9. Whether the work is part of the regular work of the business
10. The providing of worker benefits
11. The tax treatment of the worker