

Proper Worker Classification 06/17/09

Reenactment of presentation by Rick Schampers of 2009 IRS National Phone Forum

Basic Definitions

One of the biggest tax challenges for companies is determining whether workers are employees or independent contractors. If a worker is an employee, then the employer is responsible for withholding income tax and the employee's portion of Social Security and Medicare tax from amounts paid to the worker. The employer is also responsible for paying over to the IRS the employer's portion of Social Security and Medicare tax, as well as paying the federal unemployment tax.

On the other hand, the business is not responsible for any payroll taxes for independent contractors. Many companies believe that they can choose whether to treat any given worker as an employee or independent contractor. However, there are laws that determine whether the worker is an employee or an independent contractor. So the first step is to properly classify the worker.

An employee is an individual who performs services for you, and who is subject to your control regarding what will be done and how it will be done. If the employer retains the right to direct and control the means and details of the work, then the worker is an employee. We call this the right to direct and control. It is the only definition, outside of court cases, you will find, and it can be found in Treasury Regulations Section 31.3121(d)-(1)(c), paragraphs (1) and (2). Remember this term, right to direct and control, because you will hear it throughout this presentation.

In contrast, an independent contractor is an individual who performs services for you, but you control only the result of the work, not the means and methods of accomplishing the result.

The information that we are covering is discussed in the Publication 1779, titled Independent Contractor or Employee, and is available on the IRS Web site.

Employee versus Independent Contractor

IRS Revenue Ruling 87-41 contains factors, commonly referred to as the twenty common law factors, that assess whether or not a business has the right to direct and control the actions of the worker. Although this revenue ruling is still valid today, the IRS has grouped the more relevant ones into three main categories of evidence that show whether a worker is an employee or an independent contractor:

- One: **behavioral control**
- Two: **financial control, and**
- The third is the **relationship of the parties.**

I will discuss these in more detail, but I would like to point out that the businesses must weigh all these factors 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 make the worker an employee or an independent contractor, and no one factor stands alone in making this determination. Also, factors that are relevant in one situation may not be relevant in another.

The key is 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.

Next, we will look at each of these factors in more detail.

First, let’s look at **behavioral control**. The key issues for behavioral control are instructions and training.

Types of instructions include things like:

- When and where to do the work
- What tools or equipment to use
- What workers to hire or to assist with the work
- Where to purchase supplies and services
- What work must be performed by a specified individual, and
- What order or sequence to follow when performing the work

You would also want to consider the degree of instruction. 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 reflect less control, indicating that the worker is more likely an independent contractor.

The next factor under behavioral control is the evaluation system. If an evaluation system measures the details of how the work is performed, then these factors could point to an employee. On the other hand, if the evaluation system measures just the end result, then this could point to either an independent contractor or an employee.

And finally, there’s training. Training means explaining detailed methods and procedures to be used in performing a task. 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 ongoing training about procedures and methods is even stronger evidence of an employer-employee relationship.

When looking at behavioral control, the key factor to consider is whether the business retains the right to control the worker and the details of how the services are performed, regardless of whether the business actually exercises that right.

Here’s an example:

A plumber agrees to install plumbing in a new warehouse being built. Upon arriving at the warehouse, the plumber is given the building plans showing where the plumbing is to be installed, and advised that the plumbing must be completed within five days. This is direction of what is to be done, rather than how it is to be done and is consistent with independent contractor status.

Here’s another example that points more to an employee:

A plumber works out of the local plumbers’ union office. The warehouse general contractor

tells the plumber what plumbing has to be done, gives specific instructions on installation, the tools to use, the type of pipe to use, and the order and sequence in which the plumbing is to be installed. These are specific instructions on how the work is to be performed and are consistent with employee status.

Now let's look at the second category of evidence, financial control.

Financial control refers to whether or not the business has the right to direct and control the financial aspects of the worker's job. Let's talk about several different ways a business exercises financial control.

First, there's investment. 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 hundreds 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.

Next are expenses. Employers are more likely to reimburse employees for their job expenses, while businesses usually do not reimburse independent contractors for expenses. However, employees may also incur expenses that are not reimbursed.

Here's an example:

A teacher buys erasers, posters and other minor supplies throughout the year. She is not reimbursed for these expenses, but minor expenses incurred by an employee do not indicate an independent contractor relationship. She is an employee.

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 – for example, their expenses will exceed their income from the work. The possibility of incurring a loss indicates that the worker is an independent contractor.

We also want to consider the availability of services. Are the worker's services available to the market? Independent contractors often advertise, maintain a visible business location and are available for the relevant market. Also, an independent contractor is generally free to seek out business opportunities.

Finally, the method of payment must be considered. What type of payment does the worker receive? Is he paid by the job or the hour? Hourly, weekly, or similar basis for payment in return for labor generally is evidence of an employer-employee relationship. A flat fee is generally evidence of an independent contractor, especially if the worker incurs the expenses of performing the services. Furthermore, if a worker continues to be paid during down time, this is evidence the worker is an employee.

Again, just as with the behavioral control factors, there is no one factor that takes precedence over the others. It's a matter of looking at the whole relationship and seeing where the "preponderance of evidence" lies.

The third category of evidence is the relationship of the parties.

Let's take a look at some of the elements that may be present in the type of relationship between the two parties.

Is there a written contract? 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 that simply states that the worker is an independent contractor, 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.

- Are employee-type benefits provided? 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.
- How permanent is the relationship? 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. As mentioned earlier, if the worker continues to be paid during down periods, this points toward a more permanent employer-employee relationship.
- Are the services provided a key activity of the business? If a worker provides services that are a key aspect of your regular business activity, it is more likely that you will have the right to direct and control his or her activities. For example, a baker is a key element in the bakery business. It is likely that the bakery would have the right to control or direct that work of the baker because his or her success determines the success of the bakery. This would indicate an employer-employee relationship.

We often get questions from business owners about how to treat 'casual labor' or day labor. For each worker you will need to look at all of the factors we've just discussed, and see whether they indicate an employee or an independent contractor. The length of time the worker performs services for you is not a stand-alone factor in determining his or her status. A worker can be an employee even if he or she only performs a few hours of services.

What if you're still not sure?

After reviewing these three categories of evidence, if you are still unsure whether a worker is an employee or an independent contractor, you can file Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, 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.

The IRS does not charge a user fee for an SS-8 determination, but you should expect to wait at least at least six months for the determination, especially as the volume of SS-8s increases. However, it may be worth it for a business that will continually hire the same types of workers to perform particular services.

Form 8919

There may be circumstances where a determination has been made that a worker is an employee, however, the employer continues to treat the worker as an independent contractor and issue him or her a Form 1099 in lieu of a W-2. Form 8919, entitled Uncollected Social Security and Medicare Tax on Wages is now available for this situation. Workers who believe they have been improperly classified as independent contractors can use this form to tell the IRS they believe they should be employees, and report only their share of Social Security and Medicare taxes in lieu of self-employment tax. This form is attached to Form 1040.

On the form, workers must select one of eight reasons why they believe they were employees rather than independent contractors. For some of the reason codes, a Form SS-8 must already have been filed. For others, the worker is required to file the SS-8 before filing his or her tax return.

Let's talk about officer compensation.

You might think you might have to go through all these tests to determine the worker status for officers, but you don't, because officers are specifically included within the definition of employees for purposes of FICA, FUTA, and federal income tax withholding. Officers are employees by statute under Internal Revenue Code section 3121(d)(1).

The common law standard is not applicable. However, there is a narrow exception. An officer is not considered to be an employee of the corporation if two requirements are met:

- One: the officer does not perform any services or performs only minor services; and
- Two: the officer is not entitled to receive, directly or indirectly, any remuneration.

Sometimes corporations attempt to compensate officers for their services using methods other than wages. These can include:

- Distributions
- Loans to shareholders
- Payments of personal expenses
- Excessive rent payments
- Management fees and/or
- Fringe benefits

There are several court cases and rulings indicating that the IRS has the authority to reclassify all or part of these payments made to a corporate officer as wages.

Misclassification of Workers

As we have seen, the status of a worker as either an independent contractor or an employee must be determined accurately in order to ensure that workers and businesses can anticipate and meet their tax responsibilities. Businesses decide whether to hire employees or independent contractors depending on individual needs, customer expectations, and worker availability. Either worker classification – independent contractor or employee – can be a valid and appropriate business choice.

The majority of classifications of workers are not challenged by the IRS. However, when IRS reclassifications are made, it can result in the assessment of significant employment tax liabilities. Congress recognized this in 1978 and passed Section 530 of the Revenue Act of 1978. Section 530 provides businesses with relief from federal employment tax obligations if certain requirements are met. It terminates the business's, but not the worker's, liability for the following employment taxes: federal income tax withholding, Social Security and Medicare taxes (FICA), and Federal Unemployment Tax (FUTA). It also means the business is not required to pay any interest or penalties resulting from the liability for employment taxes.

Information on Section 530 relief can be found in [Publication 1976](#) (PDF), titled Section 530 Relief Requirements. This publication is on the IRS Web site.

Section 530 Relief Requirements

Now let's take a few minutes to address the application of Section 530 of the Revenue Act of 1978. In certain circumstances, Section 530 can relieve businesses of employment tax liability resulting from worker misclassification, but the business must meet specific requirements under the law.

The business must meet the following three requirements to receive relief under Section 530:

- Reporting consistency
- Substantive consistency, and
- Reasonable basis

The business must meet ALL three tests. Meeting these three tests means that the business will not owe employment taxes for the workers in question.

Let's talk about the two consistency tests.

The business must demonstrate two types of consistency:

1. First, the business must treat all workers in similar positions the same. This is called substantive consistency. The business (and any predecessor business) must not have treated the workers, or any similar workers, as employees. If you treated similar workers as employees, this relief provision is not available. In other words, treatment of the workers must be consistent with the position that they were not employees. For example, if the business treated a worker as an independent contractor, it must treat all workers in a similar position as independent contractors. Let's say a business employed 20 workers performing the same duties under the same direction and control, and treated 15 as employees and 5 as independent contractors. In this scenario, the substantive consistency test would not be met.
2. Second, the business must file all required federal tax returns on a consistent basis. This is called reporting consistency. This means that if a business believes a particular worker or group of workers are properly classified as independent contractors, then the business must demonstrate to the IRS that they have been filing the required forms – for example, Form 1099-MISC – for those independent contractors.

Relief is not available for any year the business did not file the required Forms 1099-MISC. If they filed the required Forms 1099-MISC for some workers, but not for others, relief is only available for the workers for whom the 1099-MISC was filed.

Section 530 - Reasonable Basis

In addition to meeting both consistency tests, the business must also have a reasonable basis for not treating the workers as employees. To establish that you had a reasonable basis for not treating the workers as employees, you can show that:

- You reasonably relied on a court case about federal taxes or a ruling issued to you by the IRS; or
- Your employment tax liabilities were audited by the IRS at a time when you treated similar workers as independent contractors and we did not reclassify those workers as employees; or
- You treated the workers as independent contractors because you knew that was how a significant segment of your industry treated similar workers; or
- You relied on some other reasonable basis. For example, you relied on the written advice of a business lawyer or accountant who knew the facts about your business.

It is the position of the IRS that the judicial precedent relied upon must have been in existence at the time you made the decision to treat the workers as independent contractors. Additionally, if you are relying on industry practice, you will need to show that you knew, at the time you began treating your workers as independent contractors, that this was the industry practice – for example, a survey of the industry prior to your treatment.

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

Resources

If you would like more information on worker classification, we have several resources available on our Web site, IRS.gov. These include:

- [Publication 1779](#) (PDF)
- [Form SS-8](#) (PDF), and
- [Publication 1976](#) (PDF), Section 530 Relief Requirements

Just type the words worker classification into the search box.

This concludes my presentation on "Proper Worker Classification." Please note that the information in this program was accurate at the time of recording, and is subject to change. For the IRS, I'm Rick Schampers.

<http://www.irsvideos.gov/ProperWorkerClassification>