Employee or Independent Contractor?

Whether or not a worker is an employee or independent contractor affects employer’s tax, employee benefit and employment law obligations. Misclassifying workers as independent contractors can create significant exposure under state and federal tax and other laws.

We will cover:
• How to determine whether worker is an employee or independent contractor for tax withholding purposes
• Consequences of misclassification
• What to do upon determining that they have misclassified employees.
Classification Tests

- Common Law Test
- IRS Test
- “20-Factor” Test
- Other Relevant Factors
- State Tests
- Employment Related Tests

1. Common Law Test – “Right to Control”

Generally an employer-employee relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services as to the 1) result to be accomplished, and 2) “means and methods” by which that result is accomplished.

In general, if an individual is subject to control or direction of another merely as to the result to be accomplished and not as to the “means and methods” for accomplishing the result, that person is an independent contractor.

Treas. Reg. §§ 31.3121(d)-1(c)(2).
2. IRS Test

- Recent IRS guidance creates a test using three categories of factors that evidence degree of control and independence:
  
  - **Behavioral:** Does the business control or have the right to control what the worker does and how the worker does his or her job?
  
  - **Financial:** Are the business aspects of the worker’s job controlled by the payer? (e.g., how worker is paid, whether expenses reimbursed, who provides tools/supplies, etc.)
  
  - **Type of Relationship:** Are there written contracts or employee benefits (e.g., 401(k), healthcare, vacation pay, etc.)? Will relationship continue and is the work a key aspect of the business?

3. The “20-Factor” Test

Prior to current guidance, the IRS used the 20-factor test, established in Revenue Ruling 87-41. The 20-factor test is still a predominant method for determining a worker’s status.

(Grab a coffee glass of wine, this could take a while....)
The “20-Factor” Test (Cont.)

1. Level of Instructions
2. Mandatory training
3. Integration into business operations
4. Services rendered personally (or right to assign)
5. Hiring, supervising, and paying assistants
6. Continuing relationship
7. Flexibility of schedule

8. Full time required
9. Work on employer’s premises
10. Order or sequence of services
11. Oral or written report required
12. Method of Payment (hour, week, month)
13. Payment of business and/or traveling expenses
14. Furnishing tools and materials
The “20-Factor” Test (Cont.)

15. Investment in Facilities
16. Realization of profit or loss
17. Working for more than one business at a time
18. Making services available to the general public
19. Company’s right to discharge at will
20. Individual’s right to terminate at will

4. Other Relevant Factors

The courts and the IRS have identified other relevant factors that do not clearly fall under the factors listed above. These include:

- Parties’ intent to create an employer-employee relationship and indicators of intent
- Whether the worker is required to comply with certain policies and procedures
- Special considerations for professionals (Law Office of Gerard C. Vince LLC v. Board of Review, Department of Labor et al., case number A-5441-17T2, Superior Court of New Jersey, Appellate Division, September 3, 2019)
5. State Tests

- Majority of states reference the federal test or common law test for determining whether workers are employees or independent contractors for state tax purposes.

- Other states do not explicitly reference the federal tests but outline a similar test.

- Only a few states have substantially different tests, such as Ohio and Oregon.

6. Employment-Related IC Tests

Courts and state agencies tend to apply one of the following four independent contractor tests in the employment setting:

- The “Right to Control” Test
- The “Economic Realities” Test
- The “Hybrid” Test
- The ABC Test
The ABC Test

- The ABC Test starts with a presumption that the worker is an employee!

- To establish independent contractor status, an employer must prove:
  (A) The employee is free from control or direction over the performance of the work; and
  (B) The work performed is outside the usual course of the employer’s business; and
  (C) The worker is customarily engaged in an independent trade, occupation, profession, or business.

- Each of the factors must be established; it is not a balancing test like the others.

- The ABC Test has now been adopted for wage and hour purposes in a handful of states.

Misclassification & What to Do

- Risk Upon Misclassification

- Section 530 Safe Harbor

- IRS Voluntary Classification Settlement Program (VCSP)
Risk Upon Misclassification

TAX/FINES
- Federal/state fines - up to 100% of employment tax due
- Federal/state income tax
- Withholdings – medicare, social security, unemployment & workers compensation
- IRS audits

ERISA/WAGE & HOUR/OTHER
- Employee benefits – health insurance, paid leave, 401(k) (retirement plan may cover independent contractors), etc.
- Expense reimbursement
- Wage & hour claims – minimum wage, unpaid overtime, wage statement violations
- DOL audits
- Unemployment and workers compensation insurance

Section 530 Safe Harbor

- If a company mistakenly treated certain employees as independent contractors, relief from federal employment taxes may be available under s. 530 of the Revenue Act of 1978. Following criteria must be met:
  - Taxpayer did not treat worker (or any other individual in substantially similar position) as an employee for any period.
  - Taxpayer filed all federal tax returns for worker consistent with treating him/her as an independent contractor.
  - Taxpayer had reasonable basis for treating worker as an independent contractor. This can be shown by reliance on:
    - Judicial precedent or published rulings
    - Past IRS audit of taxpayer
    - Long-standing industry practice of significant segment of industry in which worker was engaged
    - Contemporaneous reliance on prospective professional advice
Voluntary Classification Settlement Program

Employers can also seek partial relief through the Voluntary Classification Settlement Program (VCSP). A taxpayer participating in the VCSP prospectively treats the workers as employees for future tax periods in exchange for paying 10% of employment tax liability that would have been due on compensation paid to the workers for most recent tax year. Employer is not liable for any interest or penalties on the amount and cannot be subject to an IRS employment tax audit with respect to the worker classification for prior years.

To qualify, an employer must:

1. Have been consistently treating workers as independent contractors,
2. Filed all required Forms 1099 over past three years, and
3. Not be under an IRS employment tax audit or any DOL/state audit concerning worker classification.

CONCLUSION

Best Practices

- Undertake review using appropriate test to determine if employee or independent contractor
- Review independent contractor agreements
- Avoid having independent contractors do exact same work as employees
- Require staffing agencies to provide proof of benefits/insurance
- Have independent contractors sign release stating that they are not entitled to employee benefits
- Avoid handing out job description, SPD, employee handbook etc.
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