

Chapter 10 Appendix: Independent Contractors

Although employers may be tempted to classify workers as independent contractors to reap tax savings from lower payroll cost, the cost of a later reclassification to employee status by the IRS could be devastating. Employers are required to withhold social security taxes and Medicare taxes, and to pay unemployment taxes on wages paid to employees. If the employer fails to make the required withholdings and payments, the employer is held liable for the payment of all taxes.

In addition to the tax liability, the employer is also held liable for penalties and interest. The Internal Revenue Code imposes a 20 percent penalty for the amount of underpayment of taxes that is due to negligence or disregard of the rules of the Code or Income Tax Regulations. Furthermore, there is a 100 percent penalty based on the amount of tax due in those cases where an individual required to collect, account for, and pay over any tax, willfully fails to do so, or willfully attempts to evade or defeat its payment. Consequently, it is extremely important that employers correctly classify employees and independent contractors.

Independent contractors are generally people who offer their services to the public and are not employees. Examples are people such as lawyers, contractors, subcontractors, accountants, etc., who follow an independent trade, business, or profession. However, whether such people are employees or independent contractors depends on the facts and circumstances in each case. Generally, an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not the means and methods of accomplishing the results.

The Internal Revenue Service has issued guidance to help determine whether an individual is an employee or an independent contractor. Under these common-law rules, the IRS has identified 20 factors that are used as guidelines to determine whether sufficient control is present to establish an employer-employee relationship. The 20 factors indicating whether an individual is an employee or an independent contractor are listed below.

- (1) **Instructions:** Control is present and the worker is classified as an employee if the hirer has the right to require the worker to conform to instructions about when, where, and how to do a job. A worker with autonomy over time, place, and method has the characteristics of an independent contractor.
- (2) **Training:** A worker who must be trained, either personally by the hirer, by an employee of the hirer, or otherwise, is an employee. An independent contractor already has the necessary skills to perform the job.
- (3) **Integration:** A worker whose services are an integral part of the operation of a business is normally subject to control and direction by the hirer and is therefore an employee. A worker whose services are secondary to the business is not an employee.

- (4) **Services rendered personally:** An employer/employee relationship exists if the hirer requires the worker to personally perform (an indication that the method rather than just the result is important). An independent contractor is responsible for the end result and does not guarantee personal service.
- (5) **Hiring assistants:** An independent contractor has the freedom to hire, supervise, and pay assistants to help in the completion of a job. A worker who may not delegate work to another, or only to an assistant provided by the hirer, is an employee.
- (6) **Continuing relationship:** A worker and hirer who have a long lasting or permanent relationship are considered employee and employer. An independent contractor is generally hired for a certain period of time, or for a certain job.
- (7) **Set hours of work:** Employer control is present if a hirer specifies the number or set of hours for a worker. An independent contractor usually has the ability to determine the number of hours needed and set the time of work.
- (8) **Full-time required:** A worker whose services are required full-time by the hirer is subject to the control of the hirer. An independent contractor can assign working time to different hirers.
- (9) **Work done on premises:** A hirer who requires a worker to perform services on the hirer's premises or within a specified area has an employer's control over the worker. An independent contractor has the freedom to choose the location at which to perform services and is not subject to direct control by the hirer.
- (10) **Order or sequence set:** An employee must follow a set pattern or sequence or established routine for a job. A worker who can establish an unconstrained routine has the freedom of an independent contractor.
- (11) **Reports:** An employer/employee relationship exists when the worker is required to submit written or oral reports to the hirer at regular intervals. Independent contractors generally are not required to submit interim reports.
- (12) **Payments:** Employees are usually paid by the hour, day, week, or month. Independent contractors are usually paid by the job or on a straight commission.
- (13) **Expenses:** An independent contractor is liable for travel and business expenses related to the services performed. Direct payment or reimbursement of these expenses by the hirer is a means of controlling an employee.
- (14) **Tools and materials:** An independent contractor supplies the tools, materials, and equipment needed to complete a job. An employee uses the tools, materials, and equipment supplied by the employer.
- (15) **Investments:** A worker who has no significant investment in facilities needed to perform services is dependent on the provider of those facilities and is an employee. An independent contractor personally provides the facilities.
- (16) **Profit or loss:** An independent contractor can realize a profit or suffer a loss as a result of the services performed for a hirer. An employee does not earn a profit in excess of the compensation specified in the compensation contract.

- (17) **Works for more than one person or firm:** An employee generally performs services for only one employer at a time. An independent contractor can work for a number of hirers simultaneously.
- (18) **Offers service to the general public:** The services of an independent contractor are available to the public on a regular and consistent basis. An employee is not usually openly available to the public.
- (19) **Right to fire:** An employee can be terminated prior to the completion of a job or service. An independent contractor cannot be dismissed unless the work performed does not meet contract specifications.
- (20) **Right to quit:** A worker who has the right to quit at any time without incurring a liability is an employee. An independent contractor is bound to a contract and may incur penalties for violating the contract.

These factors should be considered guidelines and all factors are not applicable to every situation. In unclear cases, the facts will determine whether or not there is an actual employer-employee relationship. If you want help in determining whether a worker is an employee, discuss the issue with your accountant, or you may consider filing **Form SS-8**, Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding, with the IRS.