

HIRING INDEPENDENT CONTRACTORS

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As a CPA, one of the most frequent questions I receive from clients relates to the issue of employee vs independent contractor. It is very common to have a verbal agreement stating that the employer is hiring an individual as an independent contractor. But will this oral understanding be enough to protect you in the event of an IRS audit?

Fast forward 12 months and the employer's newest independent contractor is unable to pay all of his tax liabilities. As the IRS collection machine starts to collect the outstanding balance, the independent contractor makes statements to the IRS that it was his/her understanding that the employer agreed to pay the payroll taxes. This will eventually lead to an IRS audit of the employer to determine proper classification of the individual.

This scenario occurs all too often in the business world and there are serious consequences to the employer who thought he/she hired an independent contractor. Incorrect classification of an employee as an independent contractor can result in substantial penalties. Typical penalties include employer paying federal, state, and local taxes not withheld, unpaid overtime, penalties for not withholding, and past social security/unemployment insurance contributions. Once the IRS has successfully re-classed your independent contractor to employee status, you can be assured your state government will be paying you a visit to discuss the same issue.

So what does an employer have to do to avoid the above scenario?

Understanding the IRS 20 Factor Test

An employer that desires to classify an independent contractor in lieu of an employee should attempt to have as many aspects of its relationship comply with the IRS 20 Factor Test.

As an aid to determining whether an individual is an employee under the common law rules, twenty factors or elements have been identified as indicating whether sufficient control is present to establish an employer-employee relationship. The twenty factors have been developed based on an examination of cases and rulings considering whether an individual is an employee. The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed. They are designed only as guides for determining whether an individual is an employee. Special scrutiny is required in applying the twenty factors to assure that formalistic aspects of an arrangement designed to achieve a particular status do not obscure the substance of the arrangement (that is, whether the person or persons for whom the services are performed exercise sufficient control over the individual for the individual to be classified as an employee). The twenty factors are described below:

1. **INSTRUCTIONS.** A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed has the **RIGHT** to require compliance with instructions.

2. **TRAINING.** Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed wants the services performed in a particular method or manner.
3. **INTEGRATION.** Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must necessarily be subject to a certain amount of control by the owner of the business.
4. **SERVICES RENDERED PERSONALLY.** If the services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results.
5. **HIRING, SUPERVISING, AND PAYING ASSISTANTS.** If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor status.
6. **CONTINUING RELATIONSHIP.** A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals.
7. **SET HOURS OF WORK.** The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control.
8. **FULL TIME REQUIRED.** If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor on the other hand, is free to work when and for whom he or she chooses.
9. **DOING WORK ON EMPLOYER'S PREMISES.** If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere. Work done off the premises of the person or persons receiving the services, such as at the office of the worker, indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee. The importance of this factor depends on the nature of the service involved and the extent to which an employer generally would require that employees perform such services on the employer's premises. Control over the place of work is indicated when the person or persons for whom the services are performed have the

right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required.

10. **ORDER OR SEQUENCE SET.** If a worker must perform services in the order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker's own pattern of work but must follow the established routines and schedules of the person or persons for whom the services are performed. Often, because of the nature of an occupation, the person or persons for whom the services are performed do not set the order of the services or set the order infrequently. It is sufficient to show control, however, if such person or persons retain the right to do so.
11. **ORAL OR WRITTEN REPORTS.** A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control.
12. **PAYMENT BY HOUR, WEEK, MONTH.** Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on straight commission generally indicates that the worker is an independent contractor.
13. **PAYMENT OF BUSINESS AND/OR TRAVELING EXPENSES.** If the person or persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities.
14. **FURNISHING OF TOOLS AND MATERIALS.** The fact that the person or persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employer-employee relationship.
15. **SIGNIFICANT INVESTMENT.** If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed for such facilities and, accordingly, the existence of an employer-employee relationship. Special scrutiny is required with respect to certain types of facilities, such as home offices.
16. **REALIZATION OF PROFIT OR LOSS.** A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor. But the worker who cannot is an employee. For example, if the worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to

both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.

17. **WORKING FOR MORE THAN ONE FIRM AT A TIME.** If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.
18. **MAKING SERVICE AVAILABLE TO GENERAL PUBLIC.** The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship.
19. **RIGHT TO DISCHARGE.** The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications.
20. **RIGHT TO TERMINATE.** If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer- employee relationship.

If you are unsure whether an individual is to be classified as an employee or independent contractor, you should contact your CPA to discuss the situation. If you incorrectly classify an employee as independent contractor, it will come back to haunt you.