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BY RICH SHAVELL

Employee or Independent Contractor: Tax Considerations

The IRS estimates that employers continue to misclassify millions of workers as independent contractors, and state-level studies show that 10-20% of employers tend to misclassify at least one worker as an independent contractor.¹ In order to prevent complications due to employee misclassification, companies must properly distinguish employees and independent contractors.

If a worker is an employee, then the company must withhold federal income and payroll taxes, pay the employer's share of FICA taxes on the wages plus FUTA tax, and provide the worker with fringe benefits that they provide to other employees. There may also be state tax obligations.

However, not all of these obligations apply to a worker who is an independent contractor. For example, if the amount is \$600 or more a year, then businesses will usually only send the independent contractor a Form 1099-MISC for the year showing the amount paid to the contractor.

Employers without a reasonable basis for their classifications may be held liable at both the federal and state level for back taxes, back wages, overtime, benefits, penalties, legal fees, and damages.

This article will further examine tax issues regarding the proper classification of employees and independent contractors.

Determining Worker Status

Under common-law rules, anyone who performs services for a company is considered an employee if the company has the right to assign work and control how that work is performed.² Regardless of whether the company gives that person freedom of action, he or she is considered an employee because the company ultimately holds the right to control how his or her work is performed.

The tax court views the degree of control – or the control exercised by the person for whom the work is performed over the individual who renders the services – as the fundamental factor when deciding worker classification cases.

It also makes no difference how any given employer-employee relationship is labeled. The substance of the relationship, not the label, determines the worker's status, and it doesn't matter whether the individual is employed full- or part-time.

On the other hand, those who hold certain professions such as doctors, veterinarians, and auctioneers who follow independent trades or businesses in which they offer services to the public are usually not considered employees.³ However, their designations can still vary from case to case.

When a contractor is making a determination for its workers, it is important to look at the relationship as a whole and document each factor involved. No one factor alone proves the degree of control and independence, as the IRS considers a broad array of factors in its 20 Factor Test that covers three categories: behavioral, financial, and type of relationship.

Category One: Behavioral Factors

Behavioral factors address the question: "Does the company control or have the right to control what the worker does, and how the worker does his or her job?"⁴

Behavioral factors address the following four concerns:

- 1) Type of instructions given
- 2) Degree of instruction
- 3) Evaluation systems
- 4) Training

A worker who is required to comply with others' 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 have the right to require compliance with instructions.⁵

Generally, the more detailed the instructions are, the more control a business exercises over the worker. Once again, it is important to note that even in situations where no instruction has been given, if the employer has the right to issue instruction, then sufficient behavioral control may exist.



An employer that evaluates how the work is performed (as opposed to solely evaluating the end product) probably has an employee rather than an independent contractor.

An employer that provides job training, whether one time or periodically, likely has an employee. The reasoning behind these circumstances is that independent contractors likely have their own ways of doing things – they are paid to perform certain jobs, and they self-govern how to accomplish those tasks.

Category Two: Financial Factors

Financial factors address the question: “Are the business aspects of the worker’s job controlled by the payer?” Financial control factors fall under the following five categories:

- 1) Significant investment
- 2) Unreimbursed expenses
- 3) Opportunity for profit or loss
- 4) Services available to the market
- 5) Payment method

As employees, workers tend not to invest in the places they work. In most cases, employees neither pay for rent maintenance of work facilities, nor purchase their own tools, materials, or other equipment. However, it is important to note that workers can make significant investments and still be considered employees.

In 2017, FedEx Ground Package System, Inc., agreed to pay drivers in 19 states about \$227 million to settle lawsuits relating to the misclassification of drivers as independent contractors.⁶ In a separate case, FedEx reached an approximate \$228 million settlement in California in 2015 involving the misclassification of workers.⁷

Prior to the ruling, FedEx required its drivers to purchase their own delivery routes as well as their own vans and any necessary maintenance, uniforms, proprietary mapping software, and a FedEx barcode scanner. The idea was that each delivery driver was operating his or her own business. FedEx even had its drivers sign contracts to denote themselves as independent contractors. In spite of this, courts in California, Kansas, Indiana, and Illinois reached verdicts that led to the above settlements totaling \$454 million.

Independent contractors are more likely to have unreimbursed expenses that are generally fixed, ongoing costs. They are also generally free to seek out business opportunities

in the market; having a possibility of incurring a loss is also a characteristic of independent contractors. Finally, independent contractors are usually paid per job via a flat fee, while employees are usually guaranteed a regular wage for a certain period of time.

Category Three: Relationship Factors

Relationship factors address the questions:

- 1) Are there written contracts or employee type benefits (e.g., pension plan, insurance, vacation pay)?
- 2) Will the relationship continue?
- 3) Is the work performed a key aspect of the business?⁸

As discussed in the previously mentioned FedEx case, having a written contract does not necessarily mean that a worker is an independent contractor (even in cases where the contract specifically denotes said status). The IRS is not required to follow any such contractual provision. Also, workers are more likely to be classified as employees if they are receiving benefits, if they are hired with an expectation of permanency, and/or if they provide services that are essential to the business.

To reiterate, no one factor will conclusively answer the question of whether a worker is an employee or an independent contractor. Rather, the answer amounts to the sum of the relationship and the amount of control held by the employer. It is also important to document the factors used when making a determination.

Consequences & Remedies from the IRS

According to the IRS, if any employer fails to deduct and withhold any taxes with respect to employment taxes because a worker has been misclassified, then the employer will be liable for a tax equal to 1.5% of each misclassified employee’s annual wages (for withholding taxes), and a tax equal to 20% (up to a threshold defined yearly) of each misclassified employee’s annual wages (for social security tax).⁹

In addition, if the employer is found to have willfully neglected the reporting requirements, then those percentages increase to 3% and 40%, respectively.¹⁰ Willful neglect is usually the result of an employer not filing anything as it pertains to its worker.

If the employer believed the worker is/was an independent contractor, then a 1099-MISC should have been filed for that worker (assuming the worker was paid more than \$600 that year).

It is important to note that these penalties do not affect the employee's tax liability. Thus, employees are still liable for the income tax on their wages even in the event of misclassification. In addition, the employer is not entitled to recover from the employee any amount for which the business is found liable.

These particular penalties also do not apply in cases of intentional disregard, which occurs when:

- The employer intentionally disregards the requirement to deduct and withhold income tax from the employee's wages;¹¹ or
- The employer treats a worker as an employee for income tax purposes, but not for FICA purposes.¹²

In the event of an employment tax examination, a business may qualify for relief from federal employment taxes for each misclassified employee.¹³ To receive relief, a business must have reporting consistency, substantive consistency, and a reasonable basis.

First, all federal tax returns for the misclassified employee (including information returns) must have been timely filed for the employee misclassified as an independent contractor.

Second, all of the misclassified workers need to have been treated similarly. If different determinations were made for workers doing similar jobs, this could be grounds for losing relief under these provisions.

Finally, there must be a reasonable basis for the decision. As mentioned, documenting how a decision was developed under the 20 Factor Test helps to establish reasonable basis.

Voluntary Classification Settlement Program (VCSP)

The IRS developed an optional program, the Voluntary Classification Settlement Program (VCSP), to give taxpayers the opportunity to reclassify their workers as employees for future tax periods. Partial relief from federal employment taxes will be given to eligible taxpayers who agree to prospectively treat these workers as employees.

In order to be eligible, the taxpayer must have consistently treated the workers who could be reclassified as independent contractors or other nonemployees, including having filed all requisite Forms 1099 for the workers for the previous three years.

Additionally, the taxpayer cannot currently be under employment tax audit by the IRS, and the taxpayer cannot be under audit concerning the classification of the workers by the Department of Labor or by a state government agency. The concept is that there is an incentive to change employment status before an audit occurs.

To participate in the VCSP, a taxpayer must apply using Form 8952, Application for Voluntary Classification Settlement Program. The application should be filed at least 60 days prior to the date the taxpayer wants to begin treating its workers as employees. Once approved, the taxpayer:

- Will pay 10% of the employment tax liability that would have been due on compensation paid to the workers for the most recent tax year;
- Will not be liable for any interest and penalties on the amount; and
- Will not be subject to an employment tax audit with respect to workers being reclassified under the VCSP for prior years.¹⁴

For example, in 2016, suppose your company paid \$500,000 to workers who are the subject of the VCSP. All workers identified in the VCSP application were compensated at or below the social security wage base (e.g., under \$118,500 for 2016). You submit the VCSP application on November 1, 2017, so that your company could start treating the class or classes of workers as employees on January 1, 2018.

You look to amounts paid to the workers in 2016 for purposes of calculating the VCSP amount, because 2016 was the most recently completed tax year at the time the application was filed. Under §3509(a), the employment taxes applicable to \$1,500,000 would be \$154,200 (10.28% of \$1.5 million). Under the VCSP, your payment would be 10% of \$154,200, or \$15,420.¹⁵

Summary

There is no single test to determine whether a person is an employee or an independent contractor. Different agencies use different tests to determine a worker's status within an organization. While the IRS uses the 20 Factor Test, for example, less than half of state-taxing authorities use this method. The remaining states use what is known as an "ABC Test,"¹⁶ and the Department of Labor uses an "economic reality test."

Therefore, due to the complexity of the issue, it is important to consult with a tax adviser and/or attorney before making any determinations or deciding whether to participate in the VCSP program. ■



Endnotes

1. www.epi.org/publication/independent-contractor-misclassification.
2. Laws developed over the course of time from the rulings of judges, as opposed to law embodied in statutes passed by legislatures.
3. Reg § 31.3401(c)-1(c); Reg §31.3121(d)-1(c)(2).
4. www.irs.gov/businesses/small-businesses-self-employed/behavioral-control.
5. www.michigan.gov/documents/wca/wca_irs_revenue_ruling_87-41_390318_7.pdf.
6. www.ibj.com/articles/63687-judge-approves-227-million-in-fedex-driver-suit-settlements.
7. *Ibid.*
8. www.irs.gov/businesses/small-businesses-self-employed/type-of-relationship.
9. IRS Code § 3509(a).
10. IRS Code § 3509(b)(1).
11. IRS Code § 3509(c).
12. IRS Code § 3509(c)(2).
13. www.irs.gov/pub/irs-pdf/p1976.pdf.
14. www.irs.gov/irb/2012-51_IRB#ANN-2012-48.
15. Assumes (1) Federal Withholding Tax at 1.5%, (2) Employee/Employer Social Security Tax at 7.04%, and (3) Employee/Employer Medicare Tax at 1.74% for a total of 10.28%.
16. For example, New Jersey: www.lwd.dol.state.nj.us/labor/ea/empinfo/EmployeeIndependentContractor.html.

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