

Independent contractor vs. Employee.

If it looks like a duck and quacks like a duck, IRS will tax it like a duck (plus penalties!). What are the rules?

At some point in the life of a business many distributors face the challenge of bringing in someone to help out. Whether it is a student to file the mounds of catalogs, someone to answer the phone or a salesperson to help bring in business, the time comes when an extra (or several extra) pair of hands is needed.

Hiring a new employee costs more than just the paycheck. An employer must generally withhold income taxes, withhold and pay social security and Medicare taxes, and pay unemployment taxes on wages paid to an employee. The temptation to avoid the costs and the hassles by hiring an “independent contractor” is a strong one. A business owner does not generally have to withhold or pay any taxes on payments to independent contractors and it may seem that there is a cost savings there. It may even seem to the person hired that the take home pay is greater without the withholding of taxes, Social Security, etc. A business owner needs to proceed with caution before starting down that road.

The IRS makes the decision if a person performing work for a business is an employee or an independent contractor. A business who misclassifies an employee as an independent contractor usually gets caught when there is an IRS audit of the business, an unemployment claim is filed by a former worker, or a claim filed for worker's compensation benefits is filed. The former worker who thought they had a good deal with the higher take home pay (because taxes were not withheld) finds on April 15th that they owe even more money because of the 15.3% self employment tax. That shock may send your former worker straight to the IRS to file an SS-8 (Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding).

The consequences of being “caught” and having an independent contractor reclassified as an employee can be high. The employer becomes responsible for both the employers and employees FICA (15.3% of gross wages), FUTA (currently \$56 per year per employee), as well as Federal income tax withholding. The IRS may also bring in the state and the employer becomes liable for the state income tax, as well as state unemployment and worker's compensation. Employers may also face a penalty equal to the amount of the back taxes owed. Likewise, the employer will owe interest on all back taxes from the due dates.

The question of whether a worker is an employee or independent contractor is not cut and dried. The IRS internal training manual on the subject is 162 pages long! In the past there were 20 questions that the IRS used to determine if a worker was an employee or an independent contractor, but now those have been boiled down to three general guidelines.

First, **who has control of the employee?** Your worker is an employee when you have the **right** to direct and control him or her. This control refers not only to what work is done – the result of the work – but also to **how** the work gets done. It is not necessary that you actually direct or control the manner in which the services are performed; it is sufficient if you have the **right** to do so. This can include when to do the work, where to do the work, what tools or equipment to use, what workers to hire to assist with the work, where to purchase supplies or services, what work must be performed by a specified individual (including ability to hire assistants), etc. For example, the requirement that a worker obtain approval before taking certain actions shows control.

Financial control also becomes an issue. The extent to which a worker incurs expenses, bears the cost of doing business, and has his own profit or loss may be an indicator of an independent contractor. Although not every independent contractor need make a significant investment, almost every independent contractor will incur business expenses. This issue is particularly helpful in determining the status of a salesperson. Expenses may include tools and equipment. Does your new salesperson supply their own computer? Advertising - are they paying for their own business cards? Wages or salaries of assistants? Do they pay a secretary or do you? A contractor is more likely to pay for their own assistant. An employee usually lets the business owner foot the bill. Insurance? If they have an accident while making sales calls, which insurance covers it? If theirs, they are an independent contractor. If your insurance kicks in, they are an employee. Supplies, travel, and other items are on the list.

Does your commission salesperson have the right to sell for other distributors? Or to sell product in other industries? An independent contractor is generally free to seek out business opportunities. If they are prohibited through your agreement, the IRS may well classify them as employees.

Relationship of the Parties: Facts indicate how the parties view their relationship. These can include intent of parties/written contracts, employee benefits, discharge/termination rights and regular business activity.

Already in trouble? The IRS has three general guidelines for “relief” from incorrectly classifying an employee as a contractor. Relief is your “get out of Jail Free” card. First, do you have a reasonable basis for believing they were contractors? If you reasonably relied on a court case or a ruling issued to you by the IRS; or your business was audited by the IRS at a time when you treated similar workers as independent contractors and the IRS did not reclassify those workers as employees you have reasonable basis to treat them as contractors.

Second, Substantive Consistency: if you (and any predecessor business) treated the workers, and any similar workers, as independent contractors you are consistent. If you treated similar workers as employees, or have other workers that do the same work and they are considered employees, the relief provision is not available.

Third, Reporting Consistency. You must have filed Form 1099-MISC for each worker, unless the worker earned less than \$600. Any year you did not file the required Forms 1099-MISC the IRS will assume you were just trying to beat the system and will treat you accordingly.

In a nutshell, if you control the worker and pay them an hourly rate or salary, chances are they are an employee. And even if you pay on a commission basis, if you still control the worker, and they only work for you, they are an employee.

Treating an employee as an independent contractor unfairly shifts the tax burden to the worker. If you get caught, you will pay much more in penalties, interest and taxes than the taxes you saved.