

INDEPENDENT CONTRACTOR

OR

EMPLOYEE?

For federal tax and legal purposes, this is an important distinction. Worker classification affects how you pay your federal income tax, social security and Medicare taxes, how you file your tax return, and whether you may be liable for acts of your workers. Classification affects your eligibility for employer and social security and Medicare benefits and your tax responsibilities. If you aren't sure of your work status, you should find out now.

The courts have considered many facts in deciding whether a worker is an independent contractor or an employee. These relevant facts fall into three main categories: (1) behavioral control; (2) financial control; and (3) relationship of the parties. In each case, it is very important to consider all the facts - no single fact provides the answer.

BEHAVIORAL CONTROL

These facts show whether there is a right to direct or control how the worker does the work. A worker is an employee when the business has the right to direct and control the worker. The business does not have to actually direct or control the way the work is done- as long as the employer has the right to direct and control the work. For example:

- \$ Instructions- if you receive extensive instructions on how work is to be done, this suggests that you are an employee. Instructions can cover a wide range of topics for example:
- \$ how, when, or where to do the work
- \$ what tools or equipment to use
- \$ what assistants to hire help with the work
- \$ where to purchase supplies and services

If you receive less extensive instructions about what should be done, but not how it should be done, you may be an independent contractor. For instance, instructions about time and place may be less important than directions on how the work is performed. For example, if the business provides you with training about required procedures and methods, this indicates that the business wants the work done in a certain way, and this suggests that you may be an employee.

FINANCIAL CONTROL

These facts show whether there is a right to direct or control the business part of the work. For example:

- § Significant Investment-if you have a significant investment in your work, you may be an independent contractor. While there is no precise dollar test, the investment must have substance. However, a significant investment is not necessary to be an independent contractor.
- § Expenses-if you are not reimbursed for some or all business expenses, then you may be an independent contractor, especially if your unreimbursed business expenses are high.
- § Opportunity for Profit or Loss- if you can realize a profit or incur a loss, this suggests that you are in business for yourself and that you may be an independent contractor.

RELATIONSHIP OF THE PARTIES

These are facts that illustrate how the business and the worker perceive their relationship. For example:

- § Employee Benefits- If you receive benefits, such as insurance, pension, or paid leave, this is an indication that you may be an employee. If you do not receive benefits, however, you could be either an employee or an independent contractor.
- § Written Contracts- a written contract may show what both you and the business intend. This may be very significant yet not controlling in the final outcome.
- § Your employer must withhold income tax and your portion of social security and Medicare taxes. Also, your employer is responsible for paying social security, Medicare, and unemployment (FUTA) taxes on your wages. Your employer must give you a Form W-2, Wage and Tax Statement, showing the amount of taxes withheld from your pay.
- § You may deduct un-reimbursed employee business expenses on Schedule A of your income tax return, but only if you itemize deductions and they total more than two percent of your adjusted gross income.
- § The business may be required to give you Form 1099-MISC., Miscellaneous Income, to report what it has paid to you.

§ You are responsible for paying your own income tax and self-employment tax (Self-Employment Contributions Act-SECA). The business does not withhold taxes from your pay. You may need to make estimated tax payments during the year to cover your tax liabilities.

§ You may deduct business expenses on Schedule C of your income tax return.

Industry Examples

The following examples may help you properly classify your workers:

Building and Construction Industry

Example 1. Bill has an agreement with Wendy to supervise the remodeling of her house. She did not advance funds to help him carry on the work. She makes direct payments to the suppliers for all necessary materials. She carries liability and workers' compensation Insurance covering Barney and others that he engaged to assist him. She pays them an hourly rate and exercises almost constant supervision over the work. Bill is not free to transfer his assistants to other jobs. He may not work on other jobs while working for Wendy. He assumes no responsibility to complete the work and will incur no contractual liability if he fails to do so. He and his assistants perform personal services for hourly wages. Bill and his assistants are **employees** of Wendy.

Example 2. Mary, an experienced tile-setter, orally agreed with a corporation to perform full-time services at construction sites. She uses her own tools and performs services in the order designated by the corporation and according to its specifications. The corporation supplies all materials, makes frequent inspections of her work, pays her on a piecework basis, and carries workers' compensation insurance on him. She does not have a place of business, or hold herself out to perform similar services for others. Either party can end the services at any time; Mary is an **employee** of the corporation.

Example 3. James agreed with the Sawdust Co. to supply the construction labor for a group of houses. The company agreed to pay all construction costs. However he supplies all the tools and equipment. He performs personal services as a carpenter and mechanic for an hourly wage. He also acts as superintendent and foreman and engages other individuals to assist him. The company has the right to select, approve, or discharge any helper. A company representative makes frequent inspections of the construction site. When a house is finished, James is paid a certain percentage of its costs. He is not responsible for faults, defects of construction, or wasteful operation. At the end of each week, he presents the company with a statement of the amount that he has spent, including the payroll. The company gives him a check for that amount from which he

pays the assistants, although he is not personally liable for their wages. James and his assistants are **employees** of the Sawdust Co.

Example 4. Richard Tree contracted with Elm Corporation to complete the roofing on a housing complex. A signed contract established a flat amount for the services rendered by Richard Tree. Richard is a licensed roofer and carries workers' compensation and liability insurance under the business name, Richard Tree Roofing. He hires his own roofers who are treated as employees for Federal employment tax purposes. If there is a problem with the roofing work; Richard Tree Roofing is responsible for paying for any repairs. Richard Tree doing business as Richard Tree Roofing, is an **independent contractor**.

Example 5. Ben, an electrician, submitted a job estimate to a housing complex for electrical work at \$16 per hour for 400 hours. He is to receive \$1280 every 2 weeks for the next 10 weeks. This is not considered payment by the hour. Even if he works more or less than 400 hours to complete the work, Ben will receive \$6400. He also performs additional electrical installations under contracts with other companies that he obtained through advertisements. Ben is an **independent contractor**.

Trucking Industry

Example. Ben Trucking Co. contracts to deliver material for Big Pond Inc. At \$140 per ton. Ben Trucking is not paid for any articles that are not delivered. At times, Ben, who operates as Ben Trucking Co., may also lease another truck and engage a driver to complete the contract. All operating expenses, including insurance coverage, are paid by Ben. All equipment is owned or rented by Ben and he is responsible for all maintenance. None of the drivers are provided by Big Pond Inc. Ben, operating as Ben Trucking Co., is an **independent contractor**.

Computer Industry

Example. Joe, a computer programmer, is laid off when Megabyte Inc., downsizes. Megabyte agrees to pay Joe a flat amount to complete a one-time project to create a certain product. It is not clear how long that it will take to complete the project, and Joe is not guaranteed any minimum payment for the hours spent on the program. Megabyte provides Joe with no instructions beyond the specifications for the product itself. Joe and Megabyte have a written contract, which provides that Joe is considered to be an independent contractor, is required to pay Federal and state taxes, and receives no benefits from Megabyte. Megabyte will file a Form 1099-MISC. Joe does the work on a new high end computer that cost him \$7000.00. Joe works at home and is not expected or allowed to attend meetings of the software development group. Joe is an **independent contractor**.

Automobile Industry

Example 1. Lisa is a salesperson employed on full-time basis by Paul, an auto dealer. She works six days a week and is on duty in Paul's showroom on certain assigned days and times. She appraises trade-ins, but her appraisals are subject to the sales manager's approval. Lists of prospective customers belong to the dealer. She is required to develop leads and report results to the sales manager. Because of her experience, she requires only minimal assistance in closing and financing sales and in other phases of her work. She is paid a commission and is eligible for prizes and bonuses offered by Paul. Paul also pays the cost of health insurance and group-term life insurance for Lisa. Lisa is an **employee** of Paul.

Example 2. Karl performs auto repair services in the repair department of an auto sales company. He works regular hours and is paid on a percentage basis. He has no investment in the repair department. The sales company supplies; issues instructions on the amounts to be charged, parts to be used, and the time for completion of each job; and checks all estimates and repair orders. Karl is an **employee** of the sales company.

Example 3. An auto sales agency furnishes space for Patrick to perform auto repair services. He provides his own tools, equipment, and supplies. He seeks out business from insurance adjusters and other individuals and does all of the body and paint work that comes to the agency. He hires and discharges his own helpers, determines his own helpers working hours, quotes prices for repair work, makes all necessary adjustments, assumes all losses from uncollectible accounts, and receives compensation for his services, a large percentage of the gross collections for the auto repair shop. Patrick is an **independent contractor** and the helpers are his **employees**.

Salesperson

To determine whether the salespersons are employees under the usual common-law rules, you must evaluate each individual case. If a salesperson who works for you does not meet the tests for common law employee, discussed earlier, you do not have to withhold income tax from his or her pay. However even if a salesperson is not an employee under the usual common-law rules, his or her may still be subject to social security, Medicare, and FUTA taxes.

To determine whether a salesperson is an employee for social security, Medicare, and FUTA tax purposes, the salesperson must meet all eight elements of the statutory employee test. A salesperson is a statutory employee for social security, Medicare, and FUTA tax purposes if he or she:

- 1) Works full time for one person or company except, possibly, for sideline sales activities on behalf of the other person,
- 2) Sells on behalf of, and turns his or hers orders over to, the person or company for which he or she works,
- 3) Sell to wholesalers, retailers, contractors, or operators of hotels, restaurants, or similar establishments,
- 4) Sells merchandise for resale, or supplies for us in customer's business,
- 5) Agrees to do substantially all of this work personally,
- 6) Has no substantial investment in the facilities used to do the work, other than in facilities for transportation,
- 7) Maintains a continuing relationship with the person or company for which he or she works, and
- 8) Is not an employee under common law rules.

SOME OF THE LEGAL IMPLICATIONS

Employees are agents of their employers-principals. Agency is the relationship arises when one person (the principal) manifests an intention that another person (the agent) shall act on his behalf.

An agency must have the consent of both the employer and the employee; yet no consideration is required and generally a writing is not required.¹

Liabilities

Once an agency is established, you should consider who the parties to a contract are, and what and liabilities are under their contract. Generally, if the employee has authority, the employer is liable to the third party. Whether an employer can be held liable on a contract the employee enters into on behalf of the employer depends on whether the employer was disclosed, partially disclosed, or undisclosed.²

¹. There are several complex categories of agency which this paper will not address. If you would like additional information on this issue please contact the author.

². This too is an area of law which is too complex to detail in this paper.

An employer may be liable to third parties for torts³ committed by his employees under the doctrine of respondeat superior. Here, there are two elements: (1) there must have been an employer-employee relationship between the party whose act caused the injury and the person sought to be held liable therefore; and (2) the employee's wrongful conduct must have been committed within the course and scope of the employment relationship. The liability of the employer is joint and several inasmuch as the victim may recover in full from **either** the employer or the employee.

The employer is not liable for the torts of his employee **unless** the tort occurred within the course and scope of the employee's employment. In other words, was the employee about the employer's business? Three tests generally are used:

1. Whether the conduct was of the same general nature as, or incident to, that which the employee to perform;
2. Whether the conduct was substantially removed from the authorized time and space limits of the employment [frolic & detour]; and
3. Whether the conduct was actuated at least in part by a purpose to serve the employer.

Who Are Employees?

Before you (the business owner) can know how to treat payments that you make for services, you must first know the business relationship that exists between you and the person performing the services. The person performing the services may be:

- \$ An independent contractor
- \$ A common-law employee
- \$ Leased Employees
- \$ A statutory employee
- \$ A statutory non-employee

Independent Contractors

People such as lawyers, contractors subcontractors, public stenographers, and auctioneers who follow an independent trade, business, or profession in which they offer their services to the public, are generally not employees. However, whether such people are employees or independent contractors depends on the facts in each case, the general rule is that an individual is an independent contractor. If you, the person for whom the services are performed, have the

³. A tort is a private or civil wrong or injury, other than a breach of contract, for which the courts will provide a remedy in the form of an action for damages.

right to control or direct only the result of the work and not the means and methods of accomplishing the result.

Common-Law Employees

Under common-law rules, anyone who performs services for you is your employee if you can control what will be done and how it will be done. This is so even when you give the employee freedom of action. What matters is that you have the right to **control** the details of how the services are performed.

If you have an employer-employee relationship, it makes no difference how it is labeled. The substance of the relationship, not the label, governs the worker's status. Nor does it matter whether the individual is employed full time or part time.

For employment tax purposes, no distinction is made between classes of employees. Superintendents, managers, and other supervisory personnel are all employees. An officer of a corporation is generally an employee; however, an officer who performs no services or only minor services, and neither receives nor is entitled to receive any pay is not an employee with respect to the services performed as a director.

You generally have to withhold any pay income, social security, and Medicare taxes on wages that you pay to common-law employees. However, the wages to certain employees may exempt from one or more of these taxes.

Leased employees.

Under certain circumstances, a corporation furnishing workers to various professional people and firms is the employer of those workers for employment tax purposes. For example, a professional service corporation may provide the services of secretaries, nurses, and other similarly trained workers to its subscribers. The service corporation enters into contracts with the subscribers under which the subscribers specify the services to be provided and the fee to be paid to the service corporation for each individual furnished. The service corporation has the right to control and direct the worker's service for the subscriber, including the right to discharge or reassign the worker. The service corporation hires workers, controls the payment of their wages, provides them with unemployment insurance and other benefits, and is the employer for employment tax purposes.

Statutory Employees

If workers are independent contractors under the common law rules, such workers may nevertheless be treated as employees by statute ("statutory employees") for certain employment tax purposes if they fall within any one of the following four categories and meet the three

conditions described under Social Security and Medicare taxes below.

- 1) A driver who distributes beverages (other than milk) or meat, vegetable, fruit, or bakery products; or who picks up and delivers laundry or dry cleaning, if the driver is your agent or is paid on commission.
- 2) A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.
- 3) An individual who works at home on materials or goods that you supply and that must be returned to you or to a person you name, if you also furnish specifications for the work to be done.
- 4) A full-time traveling or city salesperson who works on your behalf and turns in orders to you from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for you must be the salesperson's principal business activity.

Statutory Nonemployees

There are two categories of statutory nonemployees: direct sellers and licensed real estate agents. They are treated as self-employed for all Federal tax purposes, including income and employment taxes, if:

1. Substantially all payments for their services as direct sellers or real estate agents are directly related to sales or other output. Rather than to the number of hours worked; and
2. Their services are performed under a written contract providing that they will not be treated as employees for Federal Tax purposes.

Direct Sellers. Direct sellers include persons falling within any of the following three groups:

- 1) Persons engaged in selling (or soliciting the sale of) consumer products in the home or place of business rather than in a permanent retail establishment.
- 2) Persons engaged in selling (or soliciting the sale of) consumer products to any buyer on a buy-sell basis, a deposit-commission basis, or any similar basis prescribed by regulations, for resale in the home or at a place of business other than in a permanent retail establishment.
- 3) Persons engaged in the trade or business of delivering or distributing newspapers or shopping news (including any services directly related to such delivery or distribution).

Licensed real estate agents. This category includes individuals engaged in appraisal activities for real estate sales if they earn income based on sales or other output.

Miss-classification of Employees

Consequences of treating an employee as Independent contractor. If you classify an employee as an independent contractor and you have no reasonable basis for doing so, you may be held liable for employment taxes for that worker.

Relief provisions. If you have a reasonable basis for not treating a worker as an employee, you may be relieved from having to pay employment taxes for that worker. To get this relief, you must file all required Federal information returns on a basis consistent with your treatment of the worker. You (or your predecessor) must not have treated any worker holding a substantially similar position as an employee for any periods beginning after 1977.

Technical service specialists. This relief provision does not apply to the worker who provides services to another business (the client) as a technical service specialist under an arrangement between the business providing the worker, such as a technical services firm, and the client. A technical service specialist is an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.

This rule does not affect the determination of whether such workers are employees under the common-law rules. The common-law rules control whether the specialist is treated as an employee or an independent contractor. However, if you directly contract with a technical service specialist to provide services for your business rather than for another business, you may still be entitled to the relief provision.

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Note: All statements contained in this paper regarding tax implications must be confirmed with the reader's certified public accountant.