

# The Employee VS. The Independent Contractor

Presented by:

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# The Employee

- Employee classification
  - Requires an employer to...
    - Deal with withholding taxes
    - Pay one-half of the mandated Social Security & Medicare Tax
    - Pay of Federal & state unemployment insurance
    - Pay workers compensation premiums
    - Other (Sick pay, Family Leave Act, others)

# The Independent Contractor

- Independent contractor (IC) classification may save the company money in the areas of...
  - Benefits
  - Social Security
  - Unemployment insurance
  - Workers' compensation insurance premiums
  - Other (no sick pay, limited ADA, no Family Leave Act issues)

# Does the End

## Justify the Means?

- There are obvious financial benefits of classifying your employee as an independent contractor, but the risks associated with misclassification can be costly!

# How Should an Employer

## Classify?

- To arrive at a determination as to how to classify individuals providing services as either employees or independent contractors (IC), the business relationship that exists between the company and the person performing the services, needs to be known.
- The degree of **control** and **independence** must be determined.
- When deciding whether a worker is an employee or IC, there are two separate tests that need to be considered:
  - The Common Law Test
  - The Reasonable Basis Test

# The Common Law Test

- The “20-factor”
  - Test used by the IRS to determine how much control the company has over the worker
  - Employer or the worker files an SS-8 IRS form
  - Once the form is filed, the IRS will review all of the facts and circumstances to determine the status of the worker
- The IRS estimates that at least 85% of filed SS-8 forms are from workers contesting their treatment

# Weighing the Employee and the Independent Contractor

- The issue of **control** is not clear cut in every worker/employer relationship, therefore the IRS will add more weight and de-emphasize, certain components of the 20-factors to aid in their decision
- According to the IRS, the 3 most important factors are:
  - Instructions to workers
  - Job Training
  - Worker's ability to make a profit or suffer a loss

# Important Factors

- Factor 1: Instructions to workers
  - The worker is more than likely an employee if the employer requires him or her to follow instructions on when, where, and how work is to be done
- Factor 2: Job training
  - If the company provides or arranges for training of any kind for the worker, this is a sign of control and, therefore, a sign of an employee/employer relationship
- Factor 3: Worker's ability to make a profit or suffer a loss
  - This is obvious, only an IC can realize a profit or incur a loss from his or her work. This is the risk factor; an IC must assume all the risks associated with the relationship.
  - Whereas an employee can be rewarded with a bonus or can be disciplined or fired but an IC cannot.



# Court Ideals

- There are three categories of **control** that the courts have consistently considered in deciding on a worker's role
  - Behavioral control:
    - Facts that show whether the business has the right to direct and control; instructions and training are two areas that are looked at and evaluated.
  - Financial control:
    - Facts that show whether the business has a right to control business aspects of the worker's job. These factors include, reimbursement of expenses and whether or not the worker can realize a profit.
  - Type of relationship:
    - Written contracts, any benefits provided to worker, the permanency of the relationship and how integral the services are to the principal activity.

# The Reasonable Basis Test

- Considered a “safe-harbor” if a company can show that it had a reasonable basis for treating a worker as an IC
- A reasonable basis exists if...
  - A previous court, or IRS ruling in favor of treating workers in similar circumstances
  - An IRS advice directly to the company so advising
  - Past IRS audit where such treatment was accepted
  - Longstanding policy within the industry

# The Best Offense is a Good Defense...

- Never assume that it is accurate to classify a worker as an IC because:
  - The worker asked or wanted to be treated as such
  - The worker has a signed contract
  - The worker is retained sporadically, or is on call
  - The worker is paid on commission only
  - The worker works for other companies

# DEPARTMENT OF LABOR

- In an attempt to “give America a raise”, on July 15, 2015 the Department of Labor (DOL) issued an “administrative interpretation”
  - Redefined an IC more narrowly for many workers previously classified as an IC to now be eligible to be classified as an employee

# Interpreting the

## “Interpretation”

- The interpretation diminishes the importance of the control factor and focuses on the economic realities test
- The economic realities test looks at whether the worker is economically dependent on the employer or the business

# The Economic Realities Test

- Six factors to consider
  - The extent to which the work performed is an integral part of the company's business.
  - The worker's opportunity for profit or loss is dependent on his or her skill.
  - The extent of the relative investments of the company and the worker.
  - Whether the work requires special skills and initiative.
  - The permanency of the relationship.
  - The degree of control exercised or retained by the company.

# The Primaries of the DOL Interpretation

- The DOL believes most work should be performed by employees; IC should be used sparingly.
- Hiring a business entity or drafting an IC agreement, will **not** protect the company from the Fair Labor Standards Act (FSLA) and, therefore, the new overtime and minimum wage rules will be enforced.
- Careful thought should be employed when determining the type and scope of work and engaging the services of any nonemployee.
- Appropriate indemnification agreements need to be obtained to protect the company from the wage and hourly claims under the FSLA.

# In Conclusion

- The interpretation allows for a very subjective analysis and each factor is examined and analyzed in relation to one another; no single factor is determinable.
- The **control** factor should not be given undue weight.
- DOL administrative interpretation is merely guidance, it does not carry the enforcement weight of a regulation.
- The courts will eventually issue guidance on this matter but a company will need to be aware of the potential risk involved.



# Penalties

- The penalties imposed, should a determination of misclassification arise, would depend on whether or not the company provided the required 1099-MISC form to the IC and filed it to the IRS with the 1096 transmittal.
- Generally a 1099-MISC is required for all non-employee compensation (or other income) if the amount paid to the IC is \$600 or more.

# IRS Rules the Worker Should

## Have Been Classified an Employee...

- 1099-MISC was provided
  - Income tax withholding penalty is computed at a rate of 1.5% of “wages” (1099-MISC amount).
  - The penalty for the employer’s (so determined) liability for social security and Medicare is computed at the rate of 20% of the employee’s share.

Employer’s share of SS and Medicare	7.65%
20% of the employee’s share (20% x 7.65%)	1.53%
Income tax withholding (1.5% of wages)	<u>1.50%</u>
<b>Total Penalty</b>	<b>10.68%</b>

# IRS Rules the Worker Should

## Have Been Classified an Employee...

- 1099-MISC was not provided
  - The penalty rates would double and the total would be 13.71%.
  - Since 2013, an employee earning in excess of \$200,000 is responsible for an additional .9% Medicare tax, an additional penalty of .36% of wages over \$200,000 would be added to the penalty.
  - There will also be penalties assessed by the various states and also the Federal and state unemployment insurance penalties that will need to be considered.
  - The effects on the benefits that the company provides to its employees would also have to be calculated in the overall cost of failure to properly classify a worker.



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# For More Information...



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