

HR INSIGHTS

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Employee or Independent Contractor?

Hiring an independent contractor offers employers many advantages. Unlike for traditional employees, employers do not pay taxes on independent contractors' wages, and are not expected to provide benefits. Employers often save 30 to 40 percent on labor costs by using independent contractors. In addition, as independent contractors are generally hired for a specific period or project, employers have no obligation to rehire them after each contract period or project is complete.

However, employers should be cautious when classifying individuals as independent contractors. Misclassifying an employee as an independent contractor can have serious financial and legal consequences.

At the end of each year, the Internal Revenue Service (IRS) requires employers to issue Form 1099 to every contractor to whom they paid \$600 or more during the tax year and file Form 1096 with the IRS to report payments the employer made to contractors.

The IRS, the U.S. Department of Labor and various state agencies constantly monitor compliance with employee and independent contractor classification using a variety of criteria. Using the Employment Tax Examination Program (ETE), special IRS teams investigate misclassification of workers through audits. Employers that file Form 1099 are subject to audits, as are employers in industries that tend to abuse the privilege of hiring independent contractors.

If a company is found in violation, the IRS may impose the following penalties in addition to attorney and tax advisor's fees:

- Retroactive payment of back taxes for the individual
- Interest calculated from the time when payments were due
- Penalty fines of up to 100 percent of the amount due

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- Retroactive contributions to the individual's Medicare and Social Security, federal and state unemployment taxes, and workers' compensation benefits

Who is an Independent Contractor?

As a general rule, the more an employer controls the work of an individual, the more likely that individual is the employer's employee. For this reason, it is generally accepted that employers can control or direct the result of the work done by independent contractors, but not the means and methods by which contractors choose to accomplish each assignment.

In addition, employers do not supervise a contractor's work as they would monitor an employee's performance, nor do they usually provide the supplies or tools the contractor needs to complete its tasks.

In contrast, employers can exercise a higher degree of control on their employees. This includes not only the jobs employees perform but also the processes and tools they must use to complete them.

There are also compensation differences between the employer-contractor relationship and the employer-employee relationship. A contractor's claim for compensation is tied to its ability to meet the expectations of its contract. It is possible for an employer to refuse compensation to a contractor that fails to deliver the services it was hired to provide. On the other hand, an employer's ability to refuse paying employee wages is limited and often illegal.

Nevertheless, there are some exceptions to the general rule regarding degree of control.

Statutory Employees

Statutory employees are workers who, by statute, must be classified as employees, even when their work relationship with an employer looks more like that of an independent contractor. For FICA and FUTA purposes, a worker is classified as an employee if he or she belongs to one of the categories below and meets the [criteria for withholding Social Security and Medicare taxes](#):

- Drivers who distribute beverages (other than milk), meat, vegetables, fruits or bakery products, or who pick up and deliver laundry or dry cleaning, and who are either employer agents or are paid on commission
- Full-time life insurance sales agents whose principal business activity is selling life insurance, annuity contracts or both, primarily for one life insurance company
- Individuals who work at home on materials or goods that are supplied and must be returned to an employer (or its designated entity) when the employer also provides the specifications for the work to be done

- Full-time traveling or city salespersons who work on behalf of an employer and turn in orders to that employer from wholesalers, retailers, contractors or operators of hotels, restaurants and other similar establishments. The goods sold must be merchandise for resale or supplies for use in a buyer's business operation. The work performed for the employer must be the salesperson's principal business activity.

Statutory Non-employees:

There are three categories of statutory non-employees: *direct sellers*, *licensed real estate agents* and *certain companion sitters*. These individuals are treated as self-employed for federal tax purposes if:

- Substantially all payments for their services as direct sellers or real estate agents are directly dependent on their sales or other output, rather than the number of hours they work; and
- Their services are performed under a written contract stating that they will not be treated as employees for federal tax purposes.

Advantages of Hiring Independent Contractors

- *Labor cost reduction* - Companies can get the same or better services for less money because there are no employment add-on costs.
- *Supplies and office space cost reduction* - Independent contractors provide their own equipment, materials and office space.
- *Liability reduction* - Employers are not automatically responsible for any injuries independent contractors may sustain while providing their services or for wrongful termination, job discrimination or sexual harassment lawsuits. However, because many of these areas are highly regulated by state and federal law, employers may still be liable under certain circumstances. Contact legal counsel for more information.

Disadvantages of Hiring Independent Contractors

Misclassifying employees as independent contractors is potentially a serious liability for employers. Typically, misclassifying an employee can expose employers to federal sanctions and investigations, state audits and penalties, and unexpected unemployment and workers' compensation lawsuits.

Determining Classification: Common Law Control Test

The IRS uses a version of the common law control test to determine whether an individual is an employee or an independent contractor. If the majority of the factors in the control test favor the existence of an employer-employee relationship, then the individual should be classified as an employee (or vice versa).

Determining Classification: Categories of Evidence

Since common law factors change, the courts and the IRS have grouped the preceding questions into three main categories, known as the “categories of evidence.” These categories are behavioral control, financial control and type of relationship.

Behavioral control - Individuals should be classified as employees if the employer assumes control over their instruction and training:

- Instruction - an employee is generally told:
 - When, where and how to work
 - What tools or equipment to use
 - What workers to hire or to assist with the work
 - Where to purchase supplies and services
 - What work must be performed by each individual
 - What order or sequence to follow
- Training - an employee may be trained to perform services in a particular manner.

Financial control - The extent to which the individual carries the following financial burdens or privileges can dictate whether he or she is an employee or an independent contractor:

- Cost of work expenses and reimbursements
- Contributions and significant company investments
- Offering services to the general public
- Manner of compensation and payment
- The possibility for making a profit or sustaining a loss after the work is complete

Type of relationship - The following can also be used to classify an individual:

- Written contracts describing the intended relationship;
- Whether the worker receives employee benefits;
- The permanency or length of the relationship; and
- How integral the services are to the company’s principal activity.

IRS Factors Used to Determine Control

Beginning on 2015, the IRS adopted a simplified 11-point test that looks at the 11 factors outlined by the categories of evidence described above.

Other government agencies, including state agencies, have developed their own systems to determine an individual's status within a company. Employers should contact these agencies directly for specific information.

Determining Classification: Retirement Issues

The Supreme Court has ruled that the common law test also determines whether an individual is considered an employee for the purpose of the Employee Retirement Income Security Act of 1974 (ERISA), stating that it would consider the following in determining if someone is eligible for retirement benefits:

- Employer rights to control how and with what resources tasks are completed
- Skills necessary to complete the task
- Materials used to complete the task
- Locations at which the work is done
- Length of the relationship between the company and the individual
- Employer ability to assign additional tasks to the individual
- Amount of discretion concerning when and for how long an individual will work
- Payment methods
- Employer involvement in hiring and paying assistants
- Whether tasks are considered part of the individual's regular business
- Whether the individual provides services as part of his or her own business
- Whether employee benefits are allocated to the individual
- Whether the employer pays taxes on behalf of the individual

Determining Classification: Wage and Hour Issues

Under the Fair Labor Standards Act (FLSA), the federal courts apply a six-point test to determine whether an individual is considered an employee or an independent contractor. This test also focuses on how much control an employer has over an individual. Under the FLSA, federal courts consider the following:

1. Nature and degree of control the employer has over the individual
2. The individual's opportunity for profit and loss

3. The individual's investment in the business
4. The length of the relationship between the company and the individual
5. The skills needed to perform the task
6. The amount in which the individual's work affects the company's business

Determining Classification: Labor Relations

The National Labor Relations Act (NLRA) specifically excludes contracted persons as employees. As a result the National Labor Relations Board (NLRB) also developed several determinants to decide whether an individual is considered an employee or an independent contractor. The NLRB's determinants focus on whether the employer has the right to control and provide direction for the work completed by asking:


- How integral is the task to the business (part of continuous product or specialized assistance)?
- How is the individual compensated (wages versus contracted amount)?
- Does the employer have the right to discipline the individual?
- To what extent can the employer supervise the work?
- What is the nature of the skill required to complete the tasks? Is this skill specialized and not commonplace within the company?
- Does the individual work for other clients or advertise his or her services as a business?
- Can the individual profit from completing the task?

Protection against Misclassification:

Companies wishing to hire an independent contractor should be aware of common mistakes in order to avoid potential penalties. An independent contractor agreement is a good first step. This document should contain a description of the services the individual will perform, how long the task should take and how the person will be paid. This agreement can serve as evidence of the person's intended status with the employer should an investigation ever arise.

It is also wise to screen independent contractors before hiring them to complete a project. It's best to develop a formal interview questionnaire to obtain the information needed to prove the person's status. Here are some good questions to ask:

1. Do you have a legal entity established for your business?
2. Have you filed a fictitious business name (doing business as...)?
3. What is the address and telephone number of your business?

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4. How many employees do you have?
 5. What professional licenses do you hold?
 6. How do you market yourself to obtain new business?
 7. What type of equipment and supplies do you currently own to complete work?
 8. What additional equipment and materials will you need to complete the task and how do you plan to obtain said materials?
 9. What type of insurance coverage do you possess to cover your business?
 10. Can you provide professional references?

While hiring an independent contractor provides many advantages to companies, it imperative that employers document and update records that can prove an individual's status as an independent contractor. The pivotal detail to remember is that as the employer's control increases, the likelihood that the individual can be classified as an independent contractor decreases. For this reason, it pays to be highly scrupulous when deciding to hire someone as an independent contractor.

