

Employee or Independent Contractor - You Decide?

The distinction between whether a worker is an employee or an independent contractor has important tax consequences. Worker classification affects how you pay your Federal income tax, social security and Medicare taxes, and how you file your tax return. The classification also affects your eligibility for employer and social security benefits. Those who should be classified as employees, but aren't, may lose out on social security benefits, workers' compensation, unemployment benefits, and, in many cases, group insurance (including life and health), and retirement benefits.

Generally, a worker is either an independent contractor or an employee. Certain workers are considered employees by statute for purposes of the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), or for Federal income tax withholding from wages.

Where there is no controlling statute, a worker's status is determined by applying the common law test, which applies for purposes of FICA, FUTA, Federal income tax withholding, and the Railroad Retirement Tax Act. A worker's status under the common law test is determined by applying relevant facts that fall into three main categories: behavioral control, financial control, and the type of relationship itself. 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 may be 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 to help with the work, and 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.
 - Training -- if the business provides you with training about required procedures and methods, this suggests that the business wants the work done in a certain way, and 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, this is an indication that you are 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 if it is difficult, if not impossible, to determine status based on other facts.

If you are not sure whether you are an independent contractor or an employee, complete Form SS-8, Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding. Publication 1779, Employee Independent Contractor Brochure, and Publication 15-A, Employer's Supplemental Tax Guide, also can provide additional information on independent contractor or employee status. For information on the tax responsibilities of self-employed persons, refer to Publication 505, Tax Withholding and Estimated Tax, and Publication 533, Self-Employment Tax.

Editor's note: The information presented herein follows accepted IRS guidelines and is offered for informative purposes only. Worker's compensation insurance issues such as these however are ultimately governed by the states. And while many states will follow some form of this common law test in making their evaluation—they are not obligated to simply stop there. When you have a workplace injury and no obvious insurance recourse the courts or labor boards may become more inclined to find a "defacto employer-employee" relationship to have existed. In that case coverage could be found to exist even though the insurer received no premium for that unreported payroll. That's one big reason why insurers ask their insured's to maintain proof of insurance (in the form of an ACORD Certificate of Insurance) for their IC's. And why insurers instruct their premium auditors to report payroll and ultimately charge premiums on uninsured subs where no valid proof of insurance is on file at the time of audit.

IRS References:

- Publication 15-A, Employer's Supplemental Tax Guide
- Publication 505, Tax Withholding and Estimated Tax
- Publication 533, Self-Employment Tax
- Publication 1779, Employee Independent Contractor Brochure
- Form SS-8, Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding
- Tax Topic 762, Independent contractor vs. employee

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