

How To Classify Workers and Avoid Crippling IRS Penalties

"Independent Contractor" vs. "Employee"

NIGHTMARE SCENARIO: Consider the following possibility. The IRS audits a small business and then determines that it owes over \$28,000 in back taxes plus over \$10,000 in penalties. They give the business 10 days to pay. They did this because the business had for several years retained a person to perform services and had chosen to treat the person as an independent contractor rather than as an employee (with the business thus being able to avoid paying its one-half share of the worker's FICA taxes and dumping the entire burden for paying those taxes upon the "self-employed" worker). In reaching its determination the IRS disregarded how the business classified the person and, instead, made an independent determination that the person was really an employee.

WHAT THE IRS CAN MAKE YOU DO: When the IRS determines that an individual is really an employee and not an independent contractor they can make the business pay all of the unpaid payroll taxes going back to the date that the worker was first retained. They can also assess penalties. A business with an "employee" must pay one half of the medicare, social security, and unemployment taxes (FICA) owed for that person and must withhold the other half from the employee's paycheck and deposit it with the IRS. Upon reclassification the IRS will also send a notice to "employee" notifying him or her of the reclassification and stating that proof must be submitted that he or she paid taxes based upon being an "employee" and not as an "independent contractor". If this cannot be proven to the satisfaction of the IRS the "employee" may have to also pay the back taxes plus penalties.

The "Common Law Rule" Applied by the IRS in determining Status

The IRS applies what it considers to be the "common law" in determining the classification of workers. IRS Revenue Ruling 87-41 spells out twenty common law factors that are to be considered ([CLICK HERE](#) to view the 20 factors). The IRS published these so that employers could correctly classify workers as employees or independent contractors and also to help independent contractors determine if they've been correctly classified or not.

To determine whether an individual is an employee or an independent contractor under the common law, the relationship of the worker and the business must be examined. All evidence of control and independence must be considered. In any employee-independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered. **Facts that provide evidence of the degree of control and independence fall into three categories:**

- behavioral control
- financial control, and
- the type of relationship

Behavioral control: Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of--

- **Instructions the business gives the worker.** An employee is generally subject to the business' instructions about when, where, and how to work. All of the following are examples of types of instructions about how to do work:
 - When and where to do the 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 a specified individual
 - What order or sequence to follow
- **The amount of instruction needed varies among different jobs.** Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. A business may lack the knowledge to instruct some highly specialized professionals; in other cases, the task may require little or no instruction. The key consideration is whether the business has retained the right to control the details of a worker's performance or instead has given up that right.
- **Training the business gives the worker.** An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

Financial control: Facts that show whether the business has a right to control the business aspects of the worker's job include:

- **The extent to which the worker has unreimbursed business expenses.** Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services they perform for their business.
- **The extent of the worker's investment.** An independent contractor often has a significant investment in the facilities he or she uses in performing services for someone else. However, a significant investment is not necessary for independent contractor status.
- **The extent to which the worker makes services available to the relevant market.** An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.
- **How the business pays the worker.** An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is usually paid by a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.
- **The extent to which the worker can realize a profit or loss.** An independent contractor can make a profit or loss.

Type of relationship: Facts that show the parties' type of relationship include:

- Written contracts describing the relationship the parties intended to create.
- Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.
- The permanency of the relationship. If you engage a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that your intent was to create an employer-employee relationship.
- The extent to which services performed by the worker are a key aspect of the regular business of the company. If a worker provides services that are a key aspect of your regular business activity, it is more likely that you will have the right to direct and control his or her activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

IRS help. If you want the IRS to determine whether a worker is an employee, file Form SS-8, Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding, with the IRS. [Click Here to go to the IRS's download page](#). *Hint: to open the link in a new (full) window, click your mouse's right hand button on the link and choose the appropriate choice.*

The IRS's 20 "Common Law" Factors For Determining if a Worker is an "Employee"

To help determine whether a worker is an employee under the common law rules, the IRS has identified 20 factors that may indicate whether the employer can exercise enough control to establish an employer-employee relationship. These factors, set forth in **Revenue Ruling 87-41**, were based on the circumstances that the courts identified and relied upon to decide whether an employment relationship existed. Not all the factors must be present to find an employee/employment relationship, but the factors are guides to use to assess the likelihood as to whether an individual is an employee or an independent contractor.

1. INSTRUCTIONS

A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed have the RIGHT to require compliance with instructions. See, for example, Rev. Rul. 68-598, 1968-2 C.B. 464, and Rev. Rul. 66-381, 1966-2 C.B. 449.

2. TRAINING

Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular

method or manner. See Rev. Rul. 70-630, 1970-2 C.B. 229.

3. INTEGRATION

Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must necessarily be subject to a certain amount of control by the owner of the business. See *United States v. Silk*, 331 U.S. 704 (1947), 1947-2 C.B. 167.

4. SERVICES RENDERED PERSONALLY

If the Services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results. See Rev. Rul. 55-695, 1955-2 C.B. 410.

5. HIRING, SUPERVISING, AND PAYING ASSISTANTS

If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor status. Compare Rev. Rul. 63-115, 1963-1 C.B. 178, with Rev. Rul. 55-593 1955-2 C.B. 610.

6. CONTINUING RELATIONSHIP

A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals. See *United States v. Silk*.

7. SET HOURS OF WORK

The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control. See Rev. Rul. 73-591, 1973-2 C.B. 337.

8. FULL TIME REQUIRED

If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor on the other hand, is free to work when and for whom he or she chooses. See Rev. Rul. 56-694, 1956-2 C.B. 694.

9. DOING WORK ON EMPLOYER'S PREMISES

If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere. Rev. Rul.

56-660, 1956-2 C.B. 693. Work done off the premises of the person or persons receiving the services, such as at the office of the worker, indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee. The importance of this factor depends on the nature of the service involved and the extent to which an employer generally would require that employees perform such services on the employer's premises. Control over the place of work is indicated when the person or persons for whom the services are performed have the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required. See Rev. Rul. 56-694.

10. ORDER OR SEQUENCE SET

If a worker must perform services in the order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker's own pattern of work but must follow the established routines and schedules of the person or persons for whom the services are performed. Often, because of the nature of an occupation, the person or persons for whom the services are performed do not set the order of the services or set the order infrequently. It is sufficient to show control, however, if such person or persons retain the right to do so. See Rev. Rul. 56-694.

11. ORAL OR WRITTEN REPORTS

A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control. See Rev. Rul. 70-309, 1970-1 C.B. 199, and Rev. Rul. 68-248, 1968-1 C.B. 431.

12. PAYMENT BY HOUR, WEEK, MONTH

Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor. See Rev. Rul. 74-389, 1974-2 C.B. 330.

13. PAYMENT OF BUSINESS AND/OR TRAVELING EXPENSES

If the person or persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities. See Rev. Rul. 55-144, 1955-1 C.B. 483.

14. FURNISHING OF TOOLS AND MATERIALS

The fact that the person or persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employer-employee relationship. See Rev. Rul. 71-524, 1971-2 C.B. 346.

15. SIGNIFICANT INVESTMENT

If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated

party), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed for such facilities and, accordingly, the existence of an employer-employee relationship. See Rev. Rul. 71-524. Special scrutiny is required with respect to certain types of facilities, such as home offices.

16. REALIZATION OF PROFIT OR LOSS

A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but the worker who cannot is an employee. See Rev. Rul. 70-309. For example, if the worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.

17. WORKING FOR MORE THAN ONE FIRM AT A TIME

If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. See Rev. Rul. 70-572, 1970-2 C.B. 221. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.

18. MAKING SERVICE AVAILABLE TO GENERAL PUBLIC

The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship. See Rev. Rul. 56-660.

19. RIGHT TO DISCHARGE

The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications. Rev. Rul. 75-41, 1975-1 C.B. 323.

20. RIGHT TO TERMINATE

If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship. See Rev. Rul. 70-309.