

Silver Advantage **Tax Alert**

What Distinguishes an Employee from an Independent Contractor?

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January 2014 -- In the current, fast changing and uncertain business environment, employers have found an increasing need to hire workers for short-term projects or workers with specific unique skills. Determining whether these individuals should be classified as employees or as independent contractors can be difficult. The determination, however, is an important one, because companies that fail to properly classify their workers could face significant cost increases for additional taxes, penalties, and interest.

The characteristics that differentiate an employee from an independent contractor typically revolve around the relationship between the worker and the company, and the level of control each one has. The determination of worker classification depends on multiple factors. The IRS has a "20 Factor Test" that it uses to evaluate worker status. Classification under the test depends upon the preponderance of factors toward one conclusion or the other. These factors have been condensed into three general categories:

Behavioral Control

These factors refer to whether an employer has a right to direct or control how a worker performs the services. This includes the type of instruction given, degree of instruction, the evaluation process, and training. When a company hires an independent contractor with a certain expertise, or to perform a specific skill, the company specifies the desired result. The independent contractor's method of accomplishing the result is at his/her discretion, and that individual maintains control over his/her work schedule. The contractor is expected to have the required skills without additional training. In an employer-employee relationship, the company establishes guidelines, and may provide training in order to accomplish the desired results. The employee follows the employer's guidelines as directed as well as the work schedule outlined by the employer.

Financial Control

These factors consider whether or not the employer has the right to control the economic aspects of the worker. An independent contractor maintains the risk of making a profit or incurring a loss from the services provided, while an employee does not. An independent contractor usually incurs unreimbursed business expenses and may have invested in a separate place of business and/or own business assets, such as office equipment and computers, in order to perform services. Employees are typically reimbursed for out-of-pocket business expenses, and will normally use the employer's facilities and equipment to perform their duties.

Employees are generally paid a wage based on an hourly rate or annual salary. Workers who are paid by commission can also be considered employees. The IRS guidelines state that an independent contractor should be paid a flat fee for the work performed; however, an independent contractor can be paid on an hourly basis as long as other factors are present to indicate that the individual should be classified as an independent contractor.

Type of Relationship

Determining whether an individual is an employee or independent contractor is also dependent upon how the company and individual perceive their relationship. While a written contract might specify the classification, the IRS may determine that other factors require the employer to reclassify an individual. Generally, employees are

entitled to employer-paid benefits, such as health insurance, pension plans, and/or paid vacation. Independent contractors would not be entitled to these benefits. Employees are hired on a permanent basis while independent contractors are not. However, the mere fact that a worker is temporary or is paid hourly is not conclusive evidence that the worker is an independent contractor. The IRS is more likely to classify a worker as an employee if he/she provides services that are a key aspect of the business.

The Illinois Department of Unemployment Security (IDES) has an even more narrow definition of an independent contractor than the IRS. Under their regulations, the default position is that every worker is an employee unless all of the following three criteria are met:

- The individual is free of control or direction over performance of services,
- The service provided is performed outside the usual course of business of the employer, and
- The individual is engaged in an independently established trade, occupation, or profession.

It is the responsibility of the company to evaluate its relationships with workers and to determine proper classifications. If audited by the IRS or IDES, the company must be able to support a worker's classification as an independent contractor. Having a written contract with the worker can provide that needed support as long as it clearly states an independent arrangement, but it is not conclusive on its own. Issuing a timely filed Form 1099 reporting income paid for services provided also provides support. Workers with their own company serving multiple clients are more likely to be considered independent contractors as long as the arrangement is with that company.

Voluntary Classification Settlement Program

The IRS has a program that allows employers, at minimal cost, to correct a worker's classification from independent contractor to employee, when appropriate. The program provides significant partial relief from federal employment taxes. To participate in this program, an employer must apply to the IRS and enter into a closing agreement with the IRS.

Using independent contractors can be a cost effective way of getting work done without the additional costs incurred when adding employees. The cost of misclassifying employees often far exceeds the cost of proper compliance. However, the classification rules can be complicated and difficult to navigate. Should you have any questions concerning worker classification, you should work with both your attorney and tax advisor. Michael Silver & Company CPAs can provide expertise and guidance in determining worker classifications in this current regulatory environment.

***Janell Wilson** has over seventeen years of experience in public accounting, assurance and tax services. She is responsible for audit engagement management, supervision, reporting, and other operational matters. Janell's specific experience is across a wide range of companies within the private and middle market sector, and within industries including manufacturing, automobile dealerships, retail, religious and charitable organizations, trade associations, and leasing companies. She also has experience with employee benefit plan audits. **Roxanne Edralin** is a Staff Accountant on the Accounting and Audit team. **Judy Mason** has over 20 years of tax, accounting, business consulting, and compliance experience, serving closely-held and start-up businesses, entrepreneurial and family-owned companies, their owners and families. Her expertise is in federal, state, local, and employment taxation, guiding clients through the complexities of conducting business, particularly as it relates to income and payroll taxes including employee classification issues. She has successfully defended a broad range of federal income and payroll tax audits.*