

Employee or Contractor?

The Internal Revenue Service has identified the misclassification of workers as one area creating the "tax gap." When an individual is misclassified as an independent contractor the employer does not pay the required taxes on the wages and income often goes un-reported or under-reported.

This is not a new issue. The IRS has been auditing for misclassification for more than a decade, however proposed legislation would add increased penalties and step up audit and enforcement activities significantly. Congress is now looking at proposed new legislation [HR 5107 or SB 3254] to tighten up the classification of workers as employees or independent contractors, to increase the reporting requirements, and to add stiff penalties for misclassifying workers.

If enacted, the new legislation would amend the Fair Labor Standards Act. Proposed legislation includes a requirement that the employer provide written notification to all individuals of their classification as either an employee or a contractor, and gives the individual the right to challenge that classification. It would also make employers responsible for maintaining records of the hours worked and amounts paid to independent contractors, comparable to those maintained for employees.

Misclassification of employees would be considered a "prohibited act" triggering penalties (of up to \$1,100 per misclassified employee or up to \$5,000 per misclassified employee for repeated or willful violations) in addition to trust tax obligations. Penalties for failure to provide notification apply even if employees are properly classified.

Behavioral Control

1. Who provided the instructions to the workers?
2. Does the payor provide training to the worker?
3. Is the worker integrated into the business operations?
4. Must the services be rendered personally?
5. Who hires, supervises, and pays assistants?
6. Who sets work hours?
7. Is the worker required to work full-time?
8. Does the worker perform his or her duties on the employer's premises?
9. Who sets the order or sequence of the work?
10. Is there a requirement of oral or written reports?



The Internal Revenue Service looks at three broad areas in determining the classification of workers:

1. Behavioral Control - when, where and how work is to be performed,
2. Financial Control - how are they being paid, who is providing materials and equipment, and
3. Relationship - right to terminate services, service to multiple organizations, etc.

Twenty specific factors are considered (see inserts). Not one of the factors considers a written contract between the parties to be a factor, much less

determinative in deciding how a worker should be classified, nor are there a set number of factors that "make" the worker an employee or an independent contractor.

Financial Control

11. Is the worker paid by the hour, week, or month?
12. Does the payor pay for the worker's business or traveling expenses?
13. Does the payor furnish the worker with tools and materials?
14. Is the worker making an investment in maintaining their own work facilities?
15. Does the worker realize a profit or loss?

If an individual is an employee, wages should be paid, taxes withheld and FICA, Medicare and FUTA taxes should be paid, and Form W-2 should be issued at year end. If an individual is an independent contractor then the employer pays the contractor a fee and issues Form 1099 MISC if the fees paid are in excess of \$600 for the calendar year. The contractor is obligated to report the income and pay their own self-employment taxes.

To add teeth to the enforcement, the DOL has budgetary authorization of \$25 million to hire 90 investigators and 10 attorneys to focus on employee misclassification. The IRS has already begun the Employment

Tax Audit Initiative, a plan to audit 6,000 US companies over the next 3 years specifically to address employment tax compliance in addition to the normal 60,000 employment tax audits that generally occur. One of the five areas they will be focusing on will be employee classification.



In addition to stepped-up enforcement at the federal level, the proposed legislation mandates that state unemployment agencies conduct similar audits. Oregon's definition of an independent contractor differs from the federal definition.

Information about Oregon's rule can be found at

www.OregonIndependentContractors.com.

The contractor versus employee issue has been around for a long time. Given the employment tax burden placed on employers, there is significant incentive to attempt to classify people hired to perform services as contractors rather than employees. Occasionally it is the service provider that desires the contractor classification to escape withholding taxes. Regardless of which party drives the classification, it is the employer that will suffer the consequences of any misclassification. Those consequences become even harsher with the proposed legislation. Employers are well advised to review the twenty factors and document the facts whenever making a decision as to how to classify a service provider.

Employers would also do well to conduct their own compliance reviews to evaluate potential employment tax audit issues, assess exposure, and proactively make sure the rules are being complied with.

Relationship

16. Does the worker provide services to more than one business at a time?
17. Is the worker available to the general public?
18. What are the payor's rights to discharge the worker?
19. What are the worker's rights to terminate the relationship?
20. Is the relationship continuous or permanent?

