

Ohio State University Fact Sheet

Community Development

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Small Business Series

Employee or Independent Contractor

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Issue of Correct Classification

A person working for a business as an employee or independent contractor is an important distinction. The **first question** is who determines if a person performing work for a business is an employee or an independent contractor? Answer: the IRS. The **second question** is how will a business who misclassifies an employee as an independent contractor get caught? Answer: IRS audit of the business, unemployment claim filed by a former worker, or a claim filed for worker's compensation benefits filed by a worker, a former contractor filing a Form SS-8 (Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income tax Withholding) to mention a few. The **third question** is what are the consequences of being caught and having an independent contractor reclassified as an employee? Answer: the employer becomes responsible for both the employers and employees FICA (15.3% of gross wages), FUTA (currently \$56 per year per employee), as well as the federal income tax (20% of gross wages). The IRS may also bring in the state and as a result, the employer may also become liable for the state income tax, as well as state unemployment and worker's compensation. Employer's may also face a penalty equal to the amount of the back taxes owed. Likewise, the employer will owe interest on all back taxes from the due dates. And, the business may be required to support the injured person for the rest of their life.

Common Law Rules

The following are a list of 20 questions the IRS uses to determine if a worker is an independent contractor or employee. The answer of yes to any one of the questions (except #16) may mean the worker is an employee.

1. Is the worker required to comply with instructions about when, where and how the work is done?

2. Is the worker provided training that would enable him/her to perform a job in a particular method or manner?
3. Are the services provided by the worker an integral part of the business' operations?
4. Must the services be rendered personally?
5. Does the business hire, supervise, or pay assistants to help the worker on the job?
6. Is there a continuing relationship between the worker and the person for whom the services are performed?
7. Does the recipient of the services set the work schedule?
8. Is the worker required to devote his/her full time to the person he/she performs services for?
9. Is the work performed at the place of business of the company or at specific places set by the company?
10. Does the recipient of the services direct the sequence in which the work must be done?
11. Are regular oral or written reports required to be submitted by the worker?
12. Is the method of payment hourly, weekly, monthly (as opposed to commission or by the job?)
13. Are business and/or traveling expenses reimbursed?
14. Does the company furnish tools and materials used by the worker?
15. Has the worker failed to invest in equipment or facilities used to provide the services?
16. Does the arrangement put the person in a position of realizing either a profit or loss on the work?
17. Does the worker perform services exclusively for the company rather than working for a number of companies at the same time?
18. Does the worker in fact make his/her services regularly available to the general public?
19. Is the worker subject to dismissal for reasons other than non-performance of the contract specifications?
20. Can the worker terminate his/her relationship without incurring a liability for failure to complete the job?

Non-Employee Requirements

To qualify a person as an independent contractor under Section 503 of the 1978 Revenue Act, the following three (3) requirements must be met:

1. You must file 1099 miscellaneous income forms (if over \$600)
2. Similar workers must be treated alike (not treated as employees)
3. There must be a good reason for the contractor status
 - a) Precedent: court cases and revenue rulings
 - b) Practice: long standing in the industry
 - c) IRS previous audit

IRS Interpretations

The IRS uses the 20 factors (listed previously) to determine if a worker is an employee or an independent contractor. However, it is their interpretation (although it could be challenged). Not all factors apply in each case or carry the same weight.

According to the IRS, workers are employees if they must comply with the employer's instructions about their work, receive training or direction from the employer, provide services that integrate into the employer's business, render their services personally (can't subcontract), have a continuing working relationship with the employer, must follow set hours of work, work full-time for the employer, perform the work at the employer's site, regularly report to the employer, are paid regularly (e.g. weekly), are paid for business expenses, use the employer's tools, materials, etc. lack a major investment in facilities used to perform services, cannot make a profit or suffer a loss from their services, work for one employer at a time, do not offer services to the public, can be fired, may quit work at any time and not incur a liability. Thus, to qualify as an independent contractor, the opposite of all of these would be true. But remember, the IRS selects the questions and grades the answers.

Statutory Employees and Statutory Non-Employees

The Federal code list the following four occupational groups as not being employees under the Common Law Rules (20 questions), but are employees under the Statutory Rules:

1. Agent Drivers or Commission Drivers: Must be licensed, paid on a commission basis, and a contract must exist stating the agent will not be an employee for federal tax purposes.
2. Full-time Life Insurance Salesperson (one company)
3. Homemakers: Work at home for one employer making clothing, needlecrafts, bedspreads, buttons, quilts, gloves, etc.
4. Traveling or City Salesperson: Sells for one principal employer.

The following are Statutory Non-Employees according to the Federal code. According to the Federal Code, the following are considered not to be employees, but are independent contractors under statutory rules.

1. Qualified Real Estate Agent: Must be licensed, paid on a commission basis, and a contract must exist stating the agent will not be an employee for federal tax purposes.
2. Direct Seller: Sells consumer products outside a permanent retail establishment, is paid on a commission basis, and a contract must exist stating the salesperson will not be an employee for federal tax purposes.

Strategies for Business Owners

If there is some question as to whether or not a person is an independent contractor or employee, the following may help convince the IRS the person is truly an independent contractor.

- The business should have the person sign a written agreement attesting to the fact that he/she is an independent contractor.
- The person should actually bill the business for the services rendered.
- The person should be required to have their own worker's compensation coverage.
- As much independence as possible should be given in areas such as hours worked, where the job is to be performed, etc.
- The person should provide his/her own tools, supplies training, transportation, etc.

The ultimate safeguard is to complete a Form SS-8 which asks the IRS for a determination if the person is an employee.

For more information, see IRS Publication 937.

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