

BUSINESS OWNERS: WHO IS AN EMPLOYEE VS. WHO IS AN INDEPENDENT CONTRACTOR?

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The question of whether a worker is an independent contractor or employee for federal income and employment tax purposes is a complex one. It is based on individual facts & circumstances and the stakes can be very high. If a worker is an employee, the company must withhold federal income and payroll taxes, pay the employer's share of FICA taxes on the wages plus FUTA tax, and often provide the worker with fringe benefits it makes available to other employees. There may be state tax obligations as well. These obligations don't apply for a worker who is an independent contractor. The business sends the independent contractor a Form 1099-MISC for the year showing the amount paid to the contractor (if the amount is \$600 or more), and that's it.

So, who is an "employee?" There is no uniform definition of the term.

Under the common-law rules (so-called because they originate from court cases rather than from a statute), individuals are generally employees if the enterprise they work for has the right to control and direct them regarding the job they are to do and how they are to do it. Otherwise, the individuals are independent contractors.

Some employers that have misclassified workers as independent contractors can be relieved from employment tax liabilities under Section 530 of the 1978 Revenue Act (not the Internal Revenue Code). In brief, Section 530 protection applies only if the employer: 1) filed all federal returns consistent with its treatment of a worker as an independent contractor; 2) treated all similarly situated workers as independent contractors; and 3) had a "reasonable basis" for not treating the worker as an employee. For example, a "reasonable basis" exists if a significant segment of the employer's industry has traditionally treated similar workers as independent contractors. Note that section 530 doesn't apply to certain types of technical services workers.

Individuals who are "statutory employees," (specifically identified by the Internal Revenue Code as being employees) are treated as employees for social security tax purposes even if they aren't subject to an employer's direction and control (even if the individuals wouldn't be treated as employees under the common-law rules). These individuals are agent drivers and commission drivers, life insurance salespeople, home workers, and full-time traveling or city salespeople who meet a number of tests. Statutory employees may or may not be employees for non-FICA purposes. Corporate officers are statutory employees for all purposes.

Individuals who are statutory independent contractors (specifically identified by the Internal Revenue Code as being non-employees) aren't employees for purposes of wage withholding, FICA, or FUTA and the income tax rules in general. Qualified real estate agents and certain direct sellers are statutory independent contractors.

Some categories of individuals are subject to special rules because of their occupations or identities. For example, corporate directors aren't employees of a corporation in their capacity as directors, and partners of an enterprise organized as a partnership are treated as self-employed persons.

Under certain circumstances, you can ask IRS (on Form SS-8) to rule on whether a worker is an independent contractor or employee, and I can help you prepare this request.

If you'd like to discuss how these complex rules apply to your business to make sure that none of your workers are misclassified, please Rusk & Company to arrange for an appointment.