

Employee vs. Independent Contractor

The question of whether a worker is an independent contractor or an employee for federal income and employment tax purposes is a complex one. It is intensely factual, and the stakes can be very high. It's critical for an enterprise periodically to review the status of its workers and see if they are properly classified. 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.

1099 Requirements: If you are operating a trust or business you are required to send the independent contractor a Form 1099-NEC if the amount paid is \$600 or more in the calendar year. In addition, the State of California Employment Development Department (EDD) requires any payer of services provided by an independent contractor to file a Form DE 542 with the EDD within 20 days of either making payments totaling \$600 or more or entering into a contract for \$600 or more in any calendar year, whichever is earlier. Rental properties owned by individuals claiming they are a trade or business for purposes of QBI must issue 1099s, as is also required by those claiming the real estate professional designation. Some of the other most commonly issued 1099s by businesses include 1099-INT for interest earned and 1099-DIV for dividends earned.

Who is an "employee"? There is no uniform definition of the term: California Assembly Bill 5 (AB 5) is a state statute that became law in 2019. It expands a landmark Supreme Court of California case, *Dynamex Operations West, Inc. v. Superior Court*. In that case, the court held that most workers are employees, ought to be classified as such, and the burden of proof for classifying individuals as independent contractors belongs to the hiring entity. The law refers to the ABC test to determine if the worker is an independent contractor: (A) the individual is free from direction and control applicable both under the contract for the performance of service and in fact; (B) the service is performed outside the usual course of business of the employer; and (C) the individual is customarily engaged in an independently established trade, occupation, profession, or business of the same nature as that involved in the service performed.

Previously, the courts relied on the "common law" tests developed over time by the courts; similar to the new part (A) of the ABC test. A worker generally is an employee for federal tax purposes if the employer has the right to control and direct the worker regarding the job they are doing and how they are doing it. The employer doesn't have to actually direct or control how the services are performed; it's enough if the employer has the right to do so. The IRS and California still apply the following factors to see if the employer has the right to direct and control the worker:

Instructions. A worker who must comply with instructions about when, where, and how they are to work is ordinarily an employee. This control factor is present if the business has the right to make the worker follow instructions. However, instructions regarding government standards are given little weight, as is the absence of instructions for professionals such as attorneys, who must follow the rules of their profession.

Training. By teaming an experienced employee with the worker, by corresponding with the worker, by requiring them to attend meetings, or by using other methods, indicate the business wants the services performed in a particular method or manner. Periodic or ongoing training is a particularly strong sign of an employer-employee relationship, but orientation/information programs on company policies are not.

Integration of the worker's services into the business operations generally shows the worker is subject to direction and control.

If the **services must be rendered personally**, the business probably is interested in the methods used to accomplish the work as well as in the results.

A business that hires, supervises, and pays assistants for a worker is exhibiting **employer-like control** over the worker on a job. Conversely, an independent contractor relationship is indicated if a worker is contractually obligated to hire, supervise, and pay assistants.

A continuing relationship between the worker and the business indicates an employer-employee relationship exists. A continuing relationship may exist where the worker is called in at frequently recurring, although irregular, intervals.

The fact that a business requires **work to be performed on its premises** suggests control over the worker (if the work could be done elsewhere). Work done off the premises, such as at the worker's office, indicates some freedom from control. The importance of this factor depends on the type of services involved and whether an employer generally would require employees to do similar work on its 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.

The establishment of **set hours** of work by the person for whom the services are performed is a factor indicating control.

A business exhibits control over a worker if it requires them to **perform services in a specific order** or sequence.

A business's requirement that the worker **submit regular or written reports** indicates a degree of control over 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.

Businesses generally do not grant employee benefits like insurance, pension plans, paid vacation, sick days and disability insurance to independent contractors. However, the lack of these types of benefits does not necessarily mean the worker is an independent contractor.

A business exhibits characteristics of an employer if it **supplies a worker with significant tools**, materials, and other equipment, or ordinarily pays the worker's business and/or traveling expenses.

A worker exhibits independent contractor status if he or she **invests in facilities** that aren't typically maintained by employees (e.g., renting their own office). By contrast, an employee usually relies on the employer to provide the facilities needed to do the job. Special scrutiny is required with respect to certain types of facilities, such as home offices.

A worker who can **realize a profit or suffer a loss** as a result of his or her services generally is an independent contractor, but a worker who cannot is an employee. The risk that a worker will not be paid is not factored in.

A worker who performs more than minimal services for a number of **unrelated businesses** at the same time generally is an independent contractor. However, a person who works for more than one business may be an employee of each such business, especially where the businesses are part of the same service arrangement.

An independent contractor is generally **free to seek out business opportunities**. Independent contractors advertise, maintain a visible business location, and are available to work in the relevant market.

If a worker must **devote substantially full time** to the business at 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 restricts the worker from doing other gainful work. An independent contractor on the other hand, is free to work when and for whom they choose.

The **right to fire** a worker is a factor indicating that they are an employee. An independent contractor on the other hand, cannot be fired as long as they produce the work that was contracted for.

Although a contract may state that the worker is an employee or an independent contractor, this is not sufficient to determine the worker's status. The IRS is not required to follow a contract stating that the worker is an independent contractor. How the parties work together determines whether the worker is an employee or an independent contractor.

There is no litmus test for exactly how many of these factors must be satisfied, nor are these factors uniformly applied. Please contact us if you have any questions.