

Guide to **Independent Contractors**

How to Determine a Worker's
Classification



Dear NFIB Member:

Every business that hires workers must determine whether a worker is an employee or an independent contractor. This may seem like an easy determination to make. After all, employees work for you—but then again, so do independent contractors. Needless to say, correctly classifying your workers can be a challenge.

More importantly, misclassifying your workers can result in an avalanche of expensive legal and tax problems with federal agencies such as the IRS, the Department of Labor and the National Labor Relations Board, just to name a few. That's why we compiled *The NFIB Guide to Independent Contractors: How to Determine a Worker's Classification*.

The NFIB Guide to Independent Contractors: How to Determine a Worker's Classification

Inside you'll find the answers to your most basic questions, such as how the two categories of workers are defined and the three most common tests used by government agencies for determining who is an independent contractor. The guide also explores more complex issues, including legal and financial obligations based on classification and liability associated with worker status. Finally, we'll give you tips on avoiding misclassification problems.

Developed by the NFIB Small Business Legal Center, *The NFIB Guide to Independent Contractors: How to Determine a Worker's Classification* will help you stay on the right side of employment law. The NFIB Small Business Legal Center is the voice for small business in the nation's courts and the legal resource for small business owners nationwide.

This guide is just one of the many compliance guides developed by our Legal Center to make your job just a little bit easier. To find out about all of the guides available in this series, call 1-800-NFIB-NOW or visit www.NFIB.com/legal.

A handwritten signature in black ink that reads "Karen R. Harned". The signature is fluid and cursive.

Karen Harned
Executive Director

CONTENTS

one	Defining the Two Categories of Workers3
two	The Risks of Misclassification4
three	Distinguishing Between Employees and Independent Contractors6 <ul style="list-style-type: none">» The Common Law Test» The Economic Reality Test» The ABC Test
four	Special IRS Classifications7 <ul style="list-style-type: none">» Statutory Employees» Statutory Non-employees
five	Avoiding Misclassification Problems.....15
six	Conclusion16
Appendix one	
Application of the Tests16	
Appendix two	
Sample Independent Contractor Agreement.....17	



ABOUT NFIB GUIDE TO INDEPENDENT CONTRACTORS

Welcome to another edition of the Small Business Guides, our exclusive series of publications providing practical solutions to the challenges faced by small business owners. The *NFIB Guide to Independent Contractors* has been compiled to assist you in determining whether your workers should be considered employees or independent contractors. Covering the risks of misclassification, the three most common tests used by government agencies in determining worker status, special IRS classifications and more, this guidebook will help ensure your workers are correctly classified.

ABOUT NFIB

The National Federation of Independent Business is the leading small business association representing the consensus views of its members in Washington and all 50 state capitals. NFIB's mission is to promote and protect the right of our members to own, operate and grow their businesses. NFIB gives members access to many business products and services at discounted costs and provides timely information designed to help small businesses succeed.

ABOUT NFIB SMALL BUSINESS LEGAL CENTER

The NFIB Small Business Legal Center is the voice for small business in the nation's courts and the legal resource for small business owners nationwide. A 501(c)(3) public interest law firm, the center litigates and educates for small businesses. Founded in 2000, the Legal Center has become a critical component of NFIB's influence.

DEFINING THE TWO CATEGORIES OF WORKERS

Is a worker an employee or an independent contractor? This question has long caused headaches for businesses. Proper classification of a worker as an independent contractor can help a business save time and money. Conversely, if that worker is an employee who is misclassified as an independent contractor, then the consequences to your business can be severe.

This guide helps explain the differences between employees and independent contractors, offers some guidance on how to ensure proper classification, and informs you of the impact that misclassification can have on your business. Though the federal government and the individual states may vary in their methods of classification, as a business owner, you will need to make sure you have all of your bases covered on both the federal and state levels. By systematically adopting a step-by-step method to classify your workers under all the applicable federal and state tests, you can prevent some future administrative headaches and save your business money in the long run.



UNDER UNITED STATES LAW, a worker is either an employee or an independent contractor. Each worker must be given only one classification; there can be no ambiguity as to which category you have selected. The main thing to consider throughout the process of determining whether to classify a worker as an employee or an independent contractor is control. Generally, employees are subject to the control of their employers, while independent contractors retain a great deal of control over the services they provide to the businesses that hire them. You may refer to the following descriptions for a more detailed explanation of the two classifications.

Employee

An employee is defined as a person hired for a regular, continuous period to perform work for an employer who maintains control over both the service details and the final product.

Independent Contractor

The term independent contractor generally refers to a worker who performs services for others, usually under contract, while at the same time retaining economic independence and complete control over both the method by which the work is performed and the final product.

The essential theme to both descriptions is the emphasis on the level of control a business exerts over the worker. The more control that you exert over a worker, the more likely it is that an employer-employee relationship exists. On the contrary, the absence of control over a worker can suggest the existence of an independent contractor relationship.


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THE RISKS OF MISCLASSIFICATION

THERE ARE MANY REASONS THAT A BUSINESS might be tempted to assign the wrong classification to workers. Businesses might save money by classifying a worker as an independent contractor because a business does not have to provide benefits, insurance or pay certain taxes for non-employees. The potential for savings provides an incentive for some businesses to make the mistake of misclassifying workers. As tempting as it may be for a business to assign independent-contractor status to all new hires, you should beware of the legal pitfalls associated with improper classification.

A business that incorrectly classifies an employee as an independent contractor may find itself embroiled in a number of legal and tax problems. For example, the Internal Revenue Service (IRS)

actively pursues companies that intentionally misclassify workers. However, not all misclassifications are intentional. Though many businesses have difficulty in making decisions about a worker's status, government agencies may be willing to work with businesses that do attempt to comply with the classification regulations.

In making the decision to classify a worker as an employee or independent contractor, it is important to carefully weigh the risks and benefits associated with each classification. When in doubt, classifying a worker as an employee instead of an independent contractor may ultimately be the safer choice and may save a business time and money in the long run.

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LEGAL AND FINANCIAL OBLIGATIONS

GOVERNMENT

Whether a worker is an employee or independent contractor has several implications for all businesses due to the oversight exercised by various levels of the government. The issue dictates your obligations under federal and state income tax laws, federal and state wage and hour laws, state unemployment and workers' compensation laws, and federal equal employment and labor laws. Charges and other penalties can be assessed against your business on the federal level, the state level, or both if your business fails to comply with the applicable classification obligations. The following state and federal agencies have an interest in how your workers are classified.

Internal Revenue Service

The IRS is the federal agency most likely to review the classification of your workers through audits or other means. They want to ensure that the business is making proper payments of payroll taxes for each employee. If the IRS finds that a business improperly classified an employee as an independent contractor, it can levy against an employer any unpaid payroll taxes due plus interest and penalties. In addition, individual owners or officials of a business may be personally liable for the taxes not withheld and paid to the IRS if the IRS views the failure to withhold and pay as willful. Further, when the IRS chooses to penalize an employer, it often sends a red flag to other agencies to investigate and impose their own penalties.

EMPLOYEES: For each employee, employers must withhold and remit federal payroll taxes to the IRS. These withholdings are reported to the employees through a Form W-2 provided by the employer. Federal payroll taxes are based on wages paid to the employee and include the following:

- Federal Income Tax Withholding (FIT)
- Social Security and Medicare Tax (FICA)
- Federal Unemployment Tax (FUTA)

INDEPENDENT CONTRACTORS: Independent contractors, on the other hand, pay their own income taxes and self-employment taxes directly to the IRS. The self-employment tax is equal to the employer and the employee's portion of FICA taxes. Businesses do not have to withhold or pay any taxes on the payments they make to independent contractors. A business owner's only obligation on behalf of independent contractors is to complete a Form 1099-MISC at the end of every year if the independent contractor was paid \$600 or more during that year.

United States Department of Labor (DOL)

If a worker is classified as an employee instead of an independent contractor, that employee is entitled to various DOL legal statutory protections. The Fair Labor Standards Act (FLSA) includes minimum wage and overtime pay requirements for employees. The Occupational Safety and Health Act (OSHA) requires an employer to maintain a safe and healthy workplace and prohibits the discharge of employees in reprisal for exercising their right to complain about safety conditions. In addition, the Employee Retirement Income Security Act (ERISA) requires that a company make its 401(k) and retirement benefits available to all employees on the same basis. But if a worker qualifies as an independent contractor, he or she cannot be covered by the employee benefit plan. Retirement plans can lose their tax qualification if they cover a non-employee.

National Labor Relations Board (NLRB)

The National Labor Relations Act (NLRA) gives employees the right to organize into unions for the purpose of bargaining collectively. However, the NLRA's definition of "employee" excludes independent contractors. Thus, independent contractors have no rights to organize and a business is permitted to discharge (or cancel a contract with) a worker if he/she tries to organize.

Federal and State Equal Employment Opportunity Agencies

Various federal and state civil rights statutes, such as the Age Discrimination in Employment Act (ADEA), the Americans with Disabilities Act (ADA) and Title VII of the Civil Rights Act of 1964, as amended, protect employees and not independent contractors. Independent contractors are not counted when determining whether a business meets the threshold for coverage under the statutes, nor can independent contractors pursue the remedies under these statutes. Independent contractors do have some legal protection under 42 U.S.C. § 1981, which prohibits racial discrimination in contracting.



BASED ON CLASSIFICATION

U.S. Citizenship and Immigration Services

The Immigration Reform and Control Act requires businesses to complete I-9 forms verifying that employees are authorized to work in the United States. A business is not required to go through this process for independent contractors.

State Departments of Taxation

State Income Taxes. In states that impose an income tax, employers are responsible for withholding state income taxes on wages paid to employees. Businesses do not have to withhold taxes for independent contractors.



State Workers' Compensation Agencies

Workers' Compensation Insurance. Businesses are responsible for providing workers' compensation coverage for employees but not for independent contractors. This can result in substantial savings; however, unlike employees who are covered by workers' compensation, independent contractors can sue you for work-related injuries.

State Unemployment Compensation Agencies¹

Unemployment Insurance. Businesses must pay an unemployment tax on the wages of employees, but not on the wages of independent contractors. In the event of loss of job, only those classified as employees are eligible to obtain unemployment compensation benefits.



INTELLECTUAL PROPERTY

It is important to determine the proper worker status in order to handle any intellectual property disputes between you and your workers. Intellectual property covers the various legal entitlements that attach to the tangible products created by the human mind. These legal rights are determined by the status of the worker who created the product in question. Independent contractors generally have greater ownership rights over the intellectual property they create for their hiring company, while employees usually sacrifice any claims to the intellectual property created for the company that employs them.

LITIGATION

Misclassification of a worker's status can lead to costly litigation for the business. Employees misclassified as independent contractors have successfully sued for unemployment insurance, stock options, overtime pay, retirement benefits, profit sharing, disability payments, workers' compensation and more, in so-called "permatemps" (workers who are classified as long-term temporary workers) and related lawsuits. These types of lawsuits can cost a business valuable time and resources in addition to any civil monetary awards that may have to be paid to the misclassified workers.



¹ To find contact information for your state's unemployment insurance tax agency go to www.workforcesecurity.doleta.gov/unemploy/agencies.asp.

ADMINISTRATIVE BURDENS

Along with the financial and legal obligations associated with worker classification, businesses must also consider the administrative tasks associated with each category of worker.

EMPLOYEES

- **Tasks:** Employers control the details of an employee's daily assigned work tasks.
- **Pay:** Employees are paid a salary or hourly wages, generally in periodic set intervals such as biweekly or bimonthly.
- **Pay Rate:** The rate paid to an employee is often less than the higher rate charged by independent contractors for the same work.
- **Benefits:** Employers often provide benefits such as health insurance, retirement plans, sick leave and paid vacations for their employees.
- **Liability:** Employees are limited to workers' compensation benefits when injured on the job and may not sue the employer for negligence.
- **Training:** A new employee may lack the requisite skill necessary to perform the job, leaving the employer to provide training.
- **Facilities:** Employers must usually furnish employees with work space and tools to perform their duties.
- **Termination:** Various state laws regulate the termination of employees without an employment contract. Generally, an employee is terminable at will.



INDEPENDENT CONTRACTORS

- **Tasks:** Independent contractors generally control the details of the tasks they are contracted to perform.
- **Pay:** Independent contractors are paid by the job, at intervals determined by the contract.
- **Pay Rate:** The rate charged by an independent contractor is often higher than the rate at which an employee could be paid for the same work.
- **Benefits:** By hiring an independent contractor, a business is able to save on fringe benefits such as health insurance, retirement plans, sick leave and paid vacations.

- **Liability:** Independent contractors are not covered by workers' compensation, but they can sue the business for negligence if there is a work-related injury.
- **Training:** Businesses do not have to provide training to independent contractors for general skills. The independent contractor is usually hired for his/her prior knowledge or skill required for the position.
- **Facilities:** Businesses generally do not provide work space/offices or the tools necessary for independent contractors.
- **Termination:** If a business is unsatisfied with the independent contractor's work, it can terminate the relationship, subject to the agreement with the contractor.

The administrative burden associated with employees is typically higher and more long-term than it is with independent contractors. However, there are several risks associated with hiring an independent contractor. Which of these burdens and risks your business is ready to take on should help you in deciding which category of worker to hire.

Liability Associated With Worker Status

Whether a business will be liable for the wrongful actions of a worker depends on the classification of that worker. Employers may be held liable for the negligent acts of employees, since the employer was presumably controlling the actions of the employee. There is much less risk of liability for a business regarding the actions of independent contractors. Businesses generally are not liable for the negligence of independent contractors except in certain situations. For example, if the activity is ultra-hazardous, non-delegable or the business holds the contractor out to be an employee, then the independent contractor will likely be considered an employee for liability purposes.

Whether or not your business is ready to assume liability for the actions of your workers should also inform your decision on how to classify them. The principal concept is that liability, like other financial obligations, will depend on the business establishing clear and separate categories of workers, as either employees or independent contractors.



DISTINGUISHING BETWEEN EMPLOYEES AND INDEPENDENT CONTRACTORS

THERE ARE THREE TESTS THAT ARE COMMONLY USED by government agencies in determining worker status: the Common Law Test, the Economic Reality Test and the ABC Test. The most important test is the Common Law Test. It is a 20-factor test used primarily by the IRS to establish whether an individual is an employee for federal employment tax purposes. Businesses should pay particular attention to this test because the IRS is the federal agency most likely to investigate a classification problem. A failure to correctly classify a worker under the IRS test often draws the attention of other government agencies that may begin their own investigations and impose their own penalties for any misclassification. Therefore, every business must first examine whether the classification system they are using satisfies the federal requirements under the Common Law Test.

Unfortunately, you cannot presume that a worker who satisfies the Common Law Test for independent contractor status

will be automatically considered an independent contractor for all other governmental purposes. A thorough federal analysis should also include the Economic Reality Test in order to satisfy the obligations imposed by DOL. After the federal analysis, a business owner should then consider whether the individual state where the business is located may utilize either of the additional tests or use state-specific criteria in the classification process. For example, determining obligations under state workers' compensation and state unemployment tax programs may require the use of a different test. It is common for the states to use the Economic Reality Test, the ABC Test, or some other state-specific test. It is strongly recommended that employers using workers they intend to classify as independent contractors make sure that both the Common Law Test and Economic Reality Test are met. Contact the appropriate state authority, your attorney or accountant to see which test applies in your case.

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The Common Law Test

USED BY: The IRS², some state unemployment compensation insurance agencies and some state workers' compensation agencies.

CRUX OF THE TEST—CONTROL VS. INDEPENDENCE: An *employer-employee* relationship exists when the business controls or has the right to control the worker performing the services, the result of the work, and also the means by which the result is accomplished. A *business-independent* contractor relationship exists when the worker independently performs services outside of the business control.

FACTORS: The Common Law Test consists of twenty factors. Not all of the factors need to be present in every case in order to make a determination about classification. The test merely weighs the existence of factors indicating a level of control against those factors showing independence.

1. INSTRUCTIONS

- a. Employee: provided with instructions from the business regarding when, where and how to perform the work.
- b. Independent Contractor: decides when, where and how to accomplish the services he or she is providing.

2. TRAINING

- a. Employee: receives training directly from the employer, demonstrating that the business wants the services performed in a particular manner.
- b. Independent Contractor: receives little or no training from the business, but rather, hiring is based on pre-existing proficiency or expertise in a particular line of work.

3. SERVICES RENDERED BY THE WORKER PERSONALLY

- a. Employee: personally performs any assigned duties.
- b. Independent Contractor: free to hire employees or subcontract tasks.

4. SET HOURS OF WORK

- a. Employee: works hours established by the employer.
- b. Independent Contractor: retains the ability to set own hours.

5. REALIZATION OF PROFIT OR LOSS

- a. Employee: receives pay for time and labor only without realizing any additional gain or sharing in the risk of loss realized by the company based on the worker's services.
- b. Independent Contractor: personally stands to gain or to lose economically based on performance of his/her services.

6. TIME REQUIRED

- a. Employee: usually devotes his/her employment to the business; full-time employment could prevent the worker from engaging in other gainful employment.
- b. Independent Contractor: does not necessarily work solely for one business and remains free to pursue other projects.

7. DOING WORK ON EMPLOYER'S PREMISES

- a. Employee: performs services on the premises of the employer to the extent which the nature of the services requires the work to be done on the employer's premises. If the business has the right to compel the worker to perform services at an alternative specified location, then the level of control remains the same.
- b. Independent Contractor: chooses where to perform the services.

8. ORDER OR SEQUENCE OF THE WORK

- a. Employee: required to perform services in the order set by the employer.
- b. Independent Contractor: retains the option of deciding the sequence in which the work is performed.

² In 2006, the IRS issued a revised test that consolidated the 20 factors into 11 factors, divided into three groups: (1) behavioral control, (2) financial control, and (3) the type of relationship between the parties. Functionally, this new test is very similar to the 20-factor test. IRS Publication 15-A lists the factors and is available at www.irs.gov/publications/p15a/ar02.html#d0e346.

9. CONTINUING RELATIONSHIP

- a. Employee: a continuing, non-sporadic relationship exists between the business and the worker.
- b. Independent Contractor: free to perform a service and then move on to other projects.

10. HIRING, SUPERVISING AND PAYING ASSISTANTS

- a. Employee: may hire assistants only under the direction of the employer.
- b. Independent Contractor: free to hire, supervise and pay additional assistants or subcontractors as necessary.

11. INTEGRATION OF THE WORKER'S SERVICES

- a. Employee: services are integrated into the daily success and operation of the business.
- b. Independent Contractor: services provided do not substantially affect the overall success of the business.

12. ORAL OR WRITTEN REPORTS

- a. Employee: submits regular reports to the employer for whom the services are being performed.
- b. Independent Contractor: accountable for end results only and not necessarily required to provide regular reports.

13. PAYMENT METHOD

- a. Employee: paid by the hour, week or month.
- b. Independent Contractor: paid by the project or on a straight commission.

14. PAYMENT OF BUSINESS EXPENSES

- a. Employee: the business usually pays expenses for the worker.
- b. Independent Contractor: pays for own business and traveling expenses.

15. FURNISHING OF TOOLS AND MATERIAL

- a. Employee: receives tools and equipment from the employer.
- b. Independent Contractor: provides tools, equipment and materials.

16. SIGNIFICANT INVESTMENT

- a. Employee: depends on the continued success of the business without taking on any investment in the working facilities or equipment.
- b. Independent Contractor: invests in facilities or equipment used to perform any services, showing that the worker is in business for himself/herself.

17. WORKING FOR MORE THAN ONE BUSINESS

- a. Employee: restricted, either explicitly or effectively, from providing services to several businesses at once.
- b. Independent Contractor: free to provide services to multiple, unrelated businesses at the same time.

18. AVAILABILITY OF SERVICE TO THE GENERAL PUBLIC

- a. Employee: provides services to only one business.
- b. Independent Contractor: offers services openly to the general public.

19. RIGHT TO FIRE THE WORKER

- a. Employee: employer maintains the discretion to discharge a worker.
- b. Independent Contractor: may not be terminated as long as the performance proceeds according to the agreed-upon terms.

20. WORKER'S RIGHT TO QUIT

- a. Employee: generally has the right to terminate the relationship with the business at any time.
- b. Independent Contractor: must fulfill any contractual obligations or else risk liability for breach.

Qualifying as an independent contractor under the safe harbor does not guarantee that another agency, such as the state workers' compensation board, will come to the same conclusion.

IRS SAFE HARBOR

In the event that the IRS determines that a worker has been inappropriately classified as an independent contractor despite the business's conscientious application of the IRS Common Law Test, there is a safe harbor that can prevent penalties from being imposed. This safe harbor, Section 530, essentially excuses a business for its misclassification of a worker if the business has a "reasonable basis" for its classification. A reasonable basis may arise from one of the following:

1. **Judicial Precedent:** sufficient similarity between a court case or revenue ruling to classification used by the business.
2. **Prior IRS Audit:** when the IRS has previously reviewed the business's treatment of similar workers and did not challenge the decision nor assess a tax.
3. **Industry Standard:** where there is a long-standing, widespread industry practice of labeling a certain type of worker as an independent contractor.
4. **Reliance Upon Advice:** where the business reasonably relied upon the advice of a business lawyer or accountant who knew the facts about the business.

One of the most important aspects of the safe harbor is the notion of similar circumstances. A business must treat all similarly situated workers alike as inconsistencies will preclude safe harbor protections. So long as the business is classifying all of its workers the same way, then there may be room for the safe harbor to protect the business from IRS penalties.

However, businesses should keep in mind that the IRS extends this safe harbor protection only to cover penalties for employment tax purposes. Qualifying as an independent contractor under the safe harbor does not guarantee that another agency, such as the state workers' compensation board, will come to the same conclusion.

The Economic Reality Test

USED BY: DOL and various state agencies.

CRUX OF THE TEST: There is an employer-employee relationship when a worker is economically dependent on the business for which services are rendered.

FACTORS: The Economic Reality Test is made up of five factors. All of the factors are examined in this analysis, with no one factor being completely determinative. The existence of any factors will be considered along with the strength of the particular factor in the working relationship when making a determination on worker status.

1. DEGREE OF CONTROL

- a. **Employee:** The business may control the worker.
- b. **Independent Contractor:** The business may not control the worker.

2. OPPORTUNITIES FOR PROFIT OR LOSS

- a. **Employee:** Workers have no opportunity to profit from the gains or losses of the business.
- b. **Independent Contractor:** Workers gain or lose financially along with the successes and failures of the business.

3. INVESTMENT IN FACILITIES

- a. **Employee:** Workers do not invest in the business's facilities, tools or equipment.
- b. **Independent Contractor:** Workers invest in the business's facilities, tools or equipment.

4. PERMANENCY OF THE RELATIONSHIP

- a. **Employee:** An ongoing relationship of indefinite duration exists.
- b. **Independent Contractor:** Intervals of employment are periodic and sporadic.

5. SKILL AND INITIATIVE ARE REQUIRED TO PERFORM THE SERVICES

- a. **Employee:** The worker's skills are being used to further the activities of a single employer.
- b. **Independent Contractor:** The worker's skills are being used to generate business opportunities in an open market independent of the financial success of the particular business.



The ABC Test

USED BY: Two-thirds of the states.

CRUX OF THE TEST: This test is a straightforward statutory test, primarily used to determine worker status for unemployment compensation purposes at the state level.

FACTORS: Under the ABC Test, a worker is an independent contractor if he or she satisfies each of the following three factors:

1. The business does not control the worker's performance of the service;
2. The worker is operating an independent enterprise or business; and
3. The work is outside the usual course of the business operations or the worker is free to exercise discretion as to where the service will be performed.

Because these tests do not contain hard and fast rules, they may appear to leave some room for ambiguity when classifying worker status. Every situation is different and the government has shown a willingness not to excessively restrict the business of either employers or independent contractors with overly rigid enforcement. Rather, the tests serve as broad guidelines that attempt to allow both businesses and agencies to consider the whole picture of a working relationship when making a classification. As balancing tests, the existence of a factor indicating employee status at your business could be overwhelmed by offsetting factors indicating independent contractor status.

However, the underlying principle should always focus on measuring the degree of control businesses have over employees, versus the degree of independence that independent contractors have from businesses. All information that provides evidence of the degree of control and independence should be considered at some point in any test that is applied.

SPECIAL IRS CLASSIFICATIONS

There are situations where the federal government has predetermined by statute that the type of worker in question is to be classified as an employee or an independent contractor regardless of what determination would otherwise be reached under the previously stated tests.

STATUTORY EMPLOYEES

By statute, even when workers are independent contractors under the common law rules, some workers may nevertheless be treated as employees for certain employment tax purposes if they:

- (1) Fall within any one of the following four categories and
- (2) Meet all three of the conditions described below.

According to the IRS, there are four categories of statutory employees that are used for federal tax purposes. The categories are:

1. Drivers who distribute food, beverages (other than milk) or deliver laundry.
2. Full-time traveling salespeople whose principal business activity is to remit orders from wholesalers and other retailers to the employer. The goods sold must be supplies used for the buyer's business or merchandise for resale.
3. Full-time insurance agents whose principal business activity must be selling life insurance or annuity contracts.
4. Individuals who work at home with materials provided by the employer and that must be returned to the employer.

If the worker falls within one of the above categories, then the worker must still meet three threshold requirements to be considered a statutory employee:

1. The employee must personally do a substantial amount of the work.
2. The employee must make no significant investment in carrying out the project.
3. There must be a continuing relationship between the employer and employee.



If a worker falls within the four categories and satisfies all three conditions, then the worker will be considered an employee regardless of any other factors that may indicate otherwise.

STATUTORY NON-EMPLOYEES

The IRS has listed three categories of statutory independent contractors or non-employees. These types of workers are treated as self-employed for all federal tax purposes. They are:

1. Direct Sellers: door-to-door salespeople who are engaged in the sale of consumer goods or newspapers to people in their homes or places of business other than a permanent retail store.
2. Licensed real estate agents.
3. Companion Sitters: those who provide attendance or household care services to children, elderly or disabled individuals.

Similar to the test for a statutory employee, in order to qualify as statutory non-employees, workers falling within these categories must also satisfy additional requirements to qualify under the statutory non-employee classification:

1. For real estate agents and direct sellers only, substantially all of their payments must be directly related to sales or other output, rather than to the number of hours worked.
2. The worker's services must be performed under a written contract providing that they will not be treated as employees for federal tax purposes.

AVOIDING MISCLASSIFICATION PROBLEMS

WHEN MAKING THE DECISION TO LABEL A WORKER as an employee or an independent contractor, the main focus should always be control. Aside from making sure to stay within the boundaries of the applicable tests, which are discussed in Appendix One, pp. 14-15, there are several steps a business can take to improve the likelihood that its decision will be upheld by the examining agency. Though not guaranteed, taking the following steps will often signify to a reviewing government entity that a worker should be given independent contractor status.

- **Require the Independent Contractor to Incorporate:** By incorporating, the worker will be considered an employee of his or her own corporation, and not the employee of the business that hired the worker. The independent contractor's corporation should bill the business and the business in turn should pay the corporation, not the worker personally.
- **Sign a Contract:** A clear agreement with the worker that the employment status will be that of an independent contractor should also outline the jobs and positions of both parties, in-

dicating form of payment (preferably a flat fee, rather than an hourly wage) and, if possible, stating that the worker will carry his or her own insurance. A sample Independent Contractor Agreement is included in this handbook.

- **Clear Communication:** Explain to the independent contractor that he or she is free to provide services to the general public, not just to your business.
- **Keep Finances Separate:** Require that the independent contractor keep his or her own accounts on materials and equipment needed to perform the services.
- **Treat Independent Contractors Differently From Employees:** Do not provide employee benefits to the independent contractor, such as paid vacation days or insurance.
- **Treat All Independent Contractors Alike:** In the event of an audit, equal treatment of similarly situated workers shows that the decision to classify a worker as an independent contractor is a substantial one.

Another option is to make a request to the IRS for a determination regarding a worker's status by filing a Form SS-8. The IRS will issue a private letter ruling on the matter, which will bind the IRS to that determination in the future under those specific circumstances. However, this option should be considered a last resort because the IRS has a strong bias in favor of finding employee status and will almost always take the opportunity to declare the type of worker an employee, which would bind your business to that classification. Other than taking the risk of an IRS ruling against your business interests, you should focus instead on the various tests which the government will use to evaluate the classifications that you assign to your workers.



CONCLUSION

THE QUESTION OF WHETHER A WORKER IS AN EMPLOYEE or an independent contractor has no simple answer. Despite the many considerations that must enter into a business classification of its workers, your business should focus primarily on the key competing principles of control and independence when making your determination. Even if the classification proves to be incorrect, your diligence could demonstrate your good faith in the matter. A systematic approach to your classification process should help your business to maneuver through the basic steps used to distinguish employees from independent contractors.

1. Assess the needs of your business and decide whether hiring employees or independent contractors would be the most appropriate. Take whatever steps seem necessary to help solidify the classification you have selected.

2. Step back and look objectively at your classification. Work through the Common Law Test and Economic Reality Test to make sure you have satisfied the federal standard for your chosen classification.
3. Review any state requirements, which will most likely follow the ABC Test, and make sure that the classification continues to hold up against scrutiny on the state level.

By taking some preliminary steps to ensure that each of your workers is properly classified, your business can function without fear of government sanctions and you can save your money and headache medicine for other business problems.

APPLICATION OF THE TESTS

Independent Contractors

EXAMPLE #1: Mary runs a housecleaning service out of her basement. She owns a truck, vacuums, mops, buckets and cleaning supplies. She advertises to generate business through local mailings and in newspapers. Mary has a schedule of charges based on how many rooms are to be cleaned, square footage, and how much time is required for cleaning. If Mary needs help, she enlists her daughter's services and pays her out of her earnings. Mary is an independent contractor.



- **Common Law Test:** This fact pattern is characterized by a lack of control by looking at the strong presence of independent contractor factors #3, #6, #10, #13, #14, #15, #17 and #18. Weighed against the weak presence of the remaining factors, the lack of control leads to the determination that a business that hires Mary would be able to classify her as an independent contractor.
- **Economic Reality Test:** Factors #3 and #5 indicate independence in this business relationship. Without any further information showing any level of economic dependency on her business clients, Mary may be classified as an independent contractor under this test as well.
- **ABC Test:** Though the performance of the service (#3) must necessarily take place at the business, the other two factors (#1 and #2) both indicate an independent contractor relationship.

EXAMPLE #2: Joe is a freelance photographer. He has a dark room in his house where he maintains his own camera and developing equipment. He contracts work from several different magazines and gets paid per picture. Joe has full artistic control over his photographs. Joe is able to take off from photography several months out of the year whenever he chooses. Joe is an independent contractor.



- **Common Law Test:** Factors #2, #4, #6, #7, #9, #11, #13, #15, #17 and #18 under the independent contractor characteristics appear to be present in Joe's business, and none of the remaining factors strongly indicate an employee relationship. Therefore, this balancing test weighs heavily in favor of classifying Joe as an independent contractor.

- **Economic Reality Test:** The fact pattern does not describe Joe's relationship with the magazines as one of economic dependence: the magazines cannot control when Joe takes time off; Joe has invested time and money in his dark room at home and not in any of the magazines; Joe is paid by the picture rather than on an ongoing basis; and Joe is hired specifically for his skills as a photographer that he markets to the competing magazines. Under this analysis, Joe would also be classified as an independent contractor.
- **ABC Test:** Though unclear as to the level of direction Joe receives from the magazine, the fact that Joe has full artistic control over his products shows that Joe's business exhibits all three of the requirements under this test, making an independent contractor classification appropriate.

EXAMPLE #3: Matt runs a roof repair business. He has invested in tools and equipment, and purchases the materials as needed for each job. Matt has hired three assistants to help him and he pays them himself. Matt's roof repair business profits greatly after storm season, when many homes are in need of roof repair. However, during mild years, Matt's business has difficulty covering its expenses. Matt is an independent contractor.



- **Common Law Test:** Matt runs a business that falls within the independent contractor factors #3, #5, #9, #10, #13, #14, #15, #17 and #18. Because there are no strong factors that could be used to establish an employee relationship, Matt should be classified as an independent contractor.
- **Economic Reality Test:** Matt is not economically dependent on any of his clients, and so could not be considered one of their employees. Matt's economic prosperity is more closely aligned to the season of the year than to his employer, making Matt an independent contractor.
- **ABC Test:** This business clearly satisfies factor #2, and there is no reason to believe that factors #1 and #3 would indicate anything other than the independent contractor relationship shown by the other two tests.

Please refer to Chapter 3 for detailed information on the factors.

Employees

EXAMPLE #1: Lee is a head chef employed on a full-time basis by Bob's restaurant. Lee works six days a week, and he is on duty in the kitchen on certain assigned days and times. Lee gets a yearly salary. Although Lee created most of the menu and provides the creative inspiration for almost all the recipes, the final menu must be approved by Bob. Bob has hired six other cooks to help with the food production and provides all the utensils and food with which to cook. Lee is an employee.



- **Common Law Test:** When looking at the factors, the employee characteristics are apparent in factors #1, #4, #5, #6, #7, #9, #10, #11, #13 and #15. Some of the remaining factors could arguably be characterized as indicating an employee relationship as well, which far outbalances any possible classification of Lee as an independent contractor. Lee is an employee.
- **Economic Reality Test:** Lee has a permanent relationship with Bob's restaurant in which the ultimate control of the menu is outside of Lee's power. Lee's skills are being put to use to generate business for the restaurant and not for Lee personally, making Lee dependent on the success of the restaurant in order to continue as head chef. Under this test, Lee should be classified as an employee.
- **ABC Test:** None of the independent contractor factors are present in this case. Lee's cooking is controlled by the approval of Bob with no indication of independence or discretion on Lee's part. Lee is an employee under this test.

EXAMPLE #2: Bill is a computer technician. Three days a week for 10 hours a day, Bill provides computer services at Jones & Smith, a law firm. Bill has his own office at Jones & Smith. Bill submits weekly reports to his supervisor, and is paid hourly. Although Bill is free to provide his services to other companies the other days of the week, he remains on call for Jones & Smith. Bill is an employee.



- **Common Law Test:** Factors #1, #4, #5, #7, #9, #11, #12, #13 and #15 indicate an employer-employee relationship exists between Bill and Jones & Smith. Though Bill may provide services to other companies (#17), which would be indicative of an independent contractor, this test is a balancing test, and the weight of the factors would place Bill in the employee category.

- **Economic Reality Test:** Within the services he provides, Bill is controlled by Jones & Smith. He does not share in the legal accomplishments of the firm, has not invested his own money into the office and equipment that he works on, and he is engaged in a consistent, ongoing employment relationship even though only on a part-time basis. This analysis establishes that Bill is an employee.
- **ABC Test:** No factors showing Bill's independence as a worker are evident from the fact pattern. During the three days of the week Bill is employed by Jones & Smith, Bill exercises no control, no independence, and no discretion in his work activities. Therefore, Bill should be classified as an employee.

EXAMPLE #3: Diane delivers flowers for Fiona's Flower Shop. The shop provides Diane with a truck and uniform, both emblazoned with the words "Fiona's Flower Shop." The shop also trained Diane in regard to proper etiquette when making home deliveries and maintains specific instructions regarding what to do when a customer is not home. Each day, the shop gives Diane a list of deliveries to make, but she is free to do them in whichever order she deems best. The shop is held liable for any automobile accidents that Diane is involved in while performing deliveries. Diane is an employee of Fiona's Flower Shop.



- **Common Law Test:** The following employee factors are evident: #1, #3, #4, #7, #9, #11, #15 and #18. Even though Diane is free to select the sequence in which she performs her services (#8), this would be more a practical consideration based on the geographical location of the deliveries as opposed to an indicator of independence. Diane should be classified as an employee.
- **Economic Reality Test:** Diane exhibits complete economic dependence on Fiona's Flower Shop. Though exhibiting a marginal level of control over her delivery route, Diane's skills are being put to use in a permanent position with the shop. The economic reality of this situation is that Diane is in an employer-employee relationship.
- **ABC Test:** This straightforward test for independent contractor status is clearly not satisfied. The flower shop controls Diane's deliveries, Diane is not otherwise engaged in any kind of delivery business outside of her tasks at the flower shop, and Diane performs her deliveries at the locations given to her by the flower shop. Because Diane does not qualify as an independent contractor, she must be classified as an employee.

SAMPLE

INDEPENDENT CONTRACTOR AGREEMENT

This Independent Contractor Agreement (“Agreement”) is made this ____ day of _____, 20____, by and between _____, a _____ corporation (“Company”), and _____, an independent contractor (“Contractor”). In consideration of the mutual promises made here, Company and Contractor agree to the following:

1. SERVICES

The Contractor will render services to the Company according to the schedule as described in Exhibit A of this Agreement. The Company may request that plans, progress reports and final results be provided by the Contractor on a monthly basis or at any other reasonable interval.

In accordance with the Company’s objectives, the Contractor will determine the method, details and means of performing the services required by this Agreement. The Company shall have no right to, and shall not, control the manner or determine the method of performing the Contractor’s services. The Contractor shall provide the services for which Contractor is engaged to the reasonable satisfaction of the Company.

2. COMPENSATION

In full consideration for the performance of the Services rendered by the Contractor, and for any rights granted or relinquished by the Contractor under this Agreement, the Company shall pay the Contractor according to the terms as set forth in Exhibit B of this Agreement. The Company will regularly report amounts paid to the Contractor by filing Form 1099-MISC with the Internal Revenue Service as required by law.

3. INDEPENDENT CONTRACTOR RELATIONSHIP

The Contractor agrees to perform the Services contained in this Agreement solely as an independent contractor. The parties to this Agreement recognize that this Agreement does not create any actual or apparent agency, partnership, franchise or relationship of employer and employee between the parties. The Contractor is not authorized to enter into or commit the Company to any agreements, and the Contractor shall not represent himself/herself as the agent or legal representative of the Company. The Contractor recognizes that this Agreement is not exclusive and that the Company reserves the right to contract with other parties for similar services during the term of this Agreement. Further, it is understood that the Contractor is free to contract for services to be performed for other organizations or clients without providing notice to the Company.

A. Company Benefits

It is understood that because the Contractor is engaged in the Contractor’s own independently established business that the Contractor is not eligible for and shall not participate in, any employee health, retirement or other fringe benefit plans of the Company. The Contractor shall make no claim against the Company for sick leave, vacation, Social Security, unemployment benefits, health or other fringe benefit plans of the Company. The Contractor shall not be entitled to any remuneration, benefits or expenses other than as specifically provided for in this Agreement.

B. Liability

The Company shall not be liable for paying contributions, taxes or assessments on payroll or other charges under any applicable federal, state or local laws on behalf of the Contractor or any other person consulted or employed by the Contractor in performing the services under this Agreement, including but not limited to FICA, federal, state and local income tax and wage taxes, unemployment and/or workers’ compensation. All such costs shall be the Contractor’s responsibility. The Contractor shall not represent himself/herself to federal, state or municipal agencies, to be other than an independent contractor of the Company. The Contractor shall comply with all federal, state and local laws and regulations regarding compensation, hours of work or other conditions of employment for any employee working for the Contractor, including, but not limited to, all laws and regulations regarding minimum compensation, overtime pay and equal employment opportunities.

4. CONFIDENTIALITY

In connection with the performance of the Services contained in this Agreement, the Contractor may be exposed to confidential and proprietary information of the Company, whether or not so identified. All such information shall be subject to the terms and conditions of the Non-Disclosure Agreement as set forth in Exhibit C.

5. WARRANTIES

A. The Contractor

- i) The Contractor represents and warrants that the Services will be performed in accordance with and not violate applicable laws, rules or regulations, and standards prevailing in the industry. The Contractor shall be solely responsible for obtaining all permits, permissions or licenses required to comply with such laws, rules or regulations.
- ii) The Contractor has full power and authority to enter into and perform its obligations under this Agreement. The Agreement is a legal, valid and binding obligation of the Contractor. The Contractor represents that this Agreement does not violate the terms of any agreement between the Contractor and a third party. So long as the Contractor shall devote as much productive time and energy as is necessary to perform the required Services under this Agreement, the Contractor is expressly free to perform services for other parties while performing services for the Company.

B. The Company

- i) The Company represents that it has full power and authority to enter into and perform its obligations under this Agreement. The Agreement is a legal, valid and binding obligation of the Company.
- ii) The Company shall not be liable for injury or death occurring to the Contractor's employees or other assistants in the course of performing.

6. TERMINATION

This Agreement may be terminated by either party if the other party breaches or is in default on any obligation contained in this Agreement. The party terminating the Agreement shall provide 15 days' written notice to the other party. Upon termination by either party, Contractor shall provide to Company a final invoice and return to Company any materials or other tangible items provided by the Company to Contractor in connection with this Agreement. Unless otherwise terminated, this Agreement will continue in force until the Services have been fully and completely performed.

7. GENERAL TERMS

A. Choice of Law

This Agreement will be governed and construed in accordance with the laws of the State of _____ that are applicable to contracts made and performed therein. Both parties submit to the jurisdiction of the federal and state courts in the named state for purposes of any suit or proceeding arising from this Agreement.

B. Entire Understanding

This document and any exhibit attached constitute the entire understanding and agreement between the parties. This Agreement supersedes any and all agreements, either oral or in writing, between the parties not embodied herein.

C. Partial Invalidity

If any provision of this Agreement is held by a court of competent jurisdiction to be invalid, void or unenforceable, then the remaining provisions will continue in full force without being impaired in any way

The undersigned parties execute this Agreement

[COMPANY NAME]

[CONTRACTOR]

By: _____

By: _____

EXHIBIT A
EXHIBIT B
EXHIBIT C