

Worker classification – making the call



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Is the person you are hiring your employee or an independent contractor? In many cases, the answer is obvious, but sometimes it is not. Worker classification continues to be a headache for businesses of all sizes — and an area of scrutiny by the IRS.

Why does it matter?

The distinction is important for employment tax reasons. With an employee, the business and the employee share the responsibility for Social Security and Medicare (FICA) taxes on the employee's earnings. The business also must pay unemployment taxes for the worker. With an independent contractor, the contractor is fully liable for his or her own self-employment taxes. FICA taxes do not apply, and unemployment taxes are not required to be paid.

Benefits are another consideration. A company's health and retirement plans must cover an employee after the employee meets plan eligibility requirements. An independent contractor typically does not receive benefits.

How to decide

To answer the worker classification question for federal tax purposes, a company should analyze its entire relationship with the worker, focusing on the degree of direction and control the company exercises. The more control, the more likely it is that a worker is an employee. Three elements come into play:

- > **Behavioral control** over what work is done and how it is done (sequence of work tasks, detailed instructions regarding how to perform the job, etc.)
- > **Financial control** over the business aspects of the job (who provides tools/supplies, how the worker is paid, whether expenses are reimbursed, etc.)
- > **Type of relationship** (whether it is ongoing, written contracts, provision of benefits, etc.)

Businesses that would like the IRS to determine a worker's status for purposes of federal employment taxes and income tax withholding can request a determination by filing Form SS-8. The IRS advises that it could take as long as six months to get a determination.

Legal classifications

Federal law specifically classifies certain workers as employees for FICA purposes, even if they are not subject to an employer's control. These include certain agent and commission drivers, a life insurance company's full-time sales agents, home workers, and full-time traveling or local salespeople. Similarly, two categories of workers are considered statutory nonemployees (i.e., self-employed): direct sellers and licensed real estate agents.

Possible relief

In some situations, the IRS may relieve a business from having to pay employment taxes for a wrongly classified worker. The business must have a reasonable basis for not treating the worker as an employee, must have been consistent in its treatment, and there must be a long-standing practice in the industry of treating the worker as an independent contractor. Obviously, relief is not a foregone conclusion. We encourage you to review the facts regarding any current or prospective use of employment contractors or contract employees to ensure that any such classification will withstand IRS scrutiny. An adverse determination by the IRS can have significant financial implications that can include payment of back taxes, along with penalties and interest.

Upcoming audits

The IRS is preparing to launch a new audit program focusing on federal employment tax returns. Although all lines on the return will be scrutinized, the IRS will primarily concentrate on fringe benefits, reimbursed expenses, officer compensation, and worker classification.

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