

You Say Potato, the IRS Says...

The IRS Guide to Distinguishing Employees from Independent Contractors

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The IRS recently released a fact sheet (FS-2015-21) informing employers on how to correctly determine whether its workers are employees or independent contractors. Whether workers are classified as employees or independent contractors affects the employer's federal employment tax obligations. Employers must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to employees, but do not have any such obligations on payments made to independent contractors. Although the fact sheet does not provide any new guidance on worker classification issues, the information contained in the fact sheet is a useful reminder to employers of the importance of worker classification and the various procedures in place to ensure that workers are properly classified.

The classification of a particular worker depends on the degree of control the employer holds over the worker or the amount of independence the worker has in performing his or her duties. Generally, the greater the amount of control the employer holds over the worker, the more likely it is that the IRS will determine that the worker is an employee. As stated in the fact sheet, the IRS looks to three categories of evidence when determining the classification of a particular worker:

Behavioral Control – Whether the business owner controls or has the right to control not only the worker's tasks but how the tasks are performed.

Financial Control – Whether the business owner controls the business aspects of the worker's job, such as the way the worker is paid, whether the worker's expenses are reimbursed, and whether the owner provides the necessary tools/supplies for the job.

Type of Relationship – Whether the relationship between the parties more closely resembles an employment relationship or an independent contractor relationship as evidenced by written contracts, employee benefits, the permanency of the relationship, and whether the work performed is a key aspect of the business.

If, after reviewing the three categories described above, an employer is unsure as to whether a worker is more appropriately classified as an employee or independent contractor, it may File Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding with the IRS. There is no fee for requesting a determination from the IRS.

An employer who misclassifies workers as independent contractors without any reasonable basis for doing so, may be held liable for unpaid employment taxes, interest and penalties. However, an employer who has a reasonable basis for treating its workers as independent contractors may be entitled to relief under Section 530 of the Revenue Act of 1978 if it treated similar workers consistently and filed all required federal tax returns consistent with each worker being an independent contractor.

The IRS also operates the Voluntary Classification Settlement Program, which gives eligible businesses the opportunity to reclassify workers as employees for future tax periods and provides partial relief from federal employment taxes for businesses that agree to treat workers as employees going forward.

It is important to note that the information contained in the IRS fact sheet only addresses worker classification for purposes of federal employment taxes. Other federal and state agencies utilize different worker classification tests. The IRS often shares information obtained in employment tax audits with the other agencies, and the agencies have been known to do the same with the IRS. Accordingly, employers are strongly advised to review their current practices to ensure workers are being classified properly and to take action necessary to avoid potentially costly liabilities.

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