

Lesson 1 – Independent Contractor vs. Employee

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Welcome to this presentation.

I've a few announcements before we get started.

The information contained in this presentation's current as of the day it was presented, and shouldn't be considered official guidance.

Any stories, names, characters, and incidents portrayed in this production are fictitious. No identification with actual persons (living or deceased), places, buildings, and products is intended or should be inferred.

This program will be maintained in accordance with federal recordkeeping laws.

Now let's get started.

This is the first of 12 lessons on payroll taxes.

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In this lesson, you'll learn to identify a worker as either an independent contractor or an employee.

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IRS Publication 15, the Employer's Tax Guide, explains your responsibilities as an employer. The IRS updates this publication annually. You should download a current version at the beginning of each year and review "What's New" for any changes.

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In this presentation, you'll learn to identify a worker as either an independent contractor or an employee. You'll also learn about the categories of evidence you must consider in determining whether an employer/employee relationship exists.

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Independent contractors and employees are treated differently in several ways, including:

- Independent contractors complete Form W-9, while employees complete Form W-4.
- Independent contractors may be issued Form 1099-MISC, while employees receive a W-2.
- No withholding is required from an independent contractor, but employees have income and FICA taxes withheld.

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In addition, independent contractors are responsible for paying their own income and self-employment taxes. Often independent contractors must make quarterly estimated tax payments to cover these taxes.

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Here is Form W-9, Request for Taxpayer Identification Number. Independent contractors use this form to provide their name, address, and identification number. Failure to provide this information may result in backup withholding.

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Here's Form W-4, Employees Withholding Allowance Certificate. Employees must complete the W-4 form to provide their name, address, and social security number, as well as information about marital status and withholding allowances.

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This is Form 1099-MISC. This form is used to report payments to independent contractors.

Beginning with the 2016 calendar year, the due date for all Forms 1099-MISC that report payments of non-employee compensation in Box 7 is Jan. 31 of the following year. This is true whether the forms are filed electronically or using paper.

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This slide contains Form W-2, Wage and Tax Statement. It's used to report wage payments to employees.

Again, beginning with the 2016 calendar year, the due date for all W-2 forms is Jan. 31 of the following year. This is true whether the forms are filed electronically or using paper.

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Why's proper worker classification important?

Worker classification affects how a worker pays his federal income tax, social security and Medicare taxes – and how he files his tax return.

Misclassifying an employee as an independent contractor can have significant tax consequences.

If the IRS reclassifies an independent contractor to an employee during an examination, it can collect the income and FICA taxes attributable to payments reclassified as wages from the employer.

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You can find general information about who's an employee in IRS Publication 15, Employer's Tax Guide – commonly referred to as Circular E.

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Publication 15-A, Employer's Supplemental Tax Guide, contains detailed employment tax information supplementing what's provided in Pub. 15. It contains a section on the proper classification of a worker as an independent contractor or an employee.

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Publication 1779, Independent Contractor or Employee, discusses the tax implications related to worker classification and offers a condensed explanation of the factors used to distinguish between an independent contractor and an employee.

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Publication 4268, Employment Tax for Indian Tribal Governments, also includes a chapter explaining this difference.

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Most employees fall into the broad category of common law employees.

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The common law rules focus on three key areas to determine how much control the payer has over the worker.

These areas are:

- Behavioral control
- Financial control
- Relationship of the parties

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Behavioral control considers whether the payer has the legal right to direct and control not just what must be done, but how it must be done. The more control that exists, the more likely the worker's an employee.

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Factors we consider when looking at behavioral control include the type and degree of instruction given, the presence of a formal and regular evaluation process, and the type and amount of training provided.

Precise instructions, formal evaluations and regular training are standard tools used to exercise control over not just the end product, but also the process involved in achieving that product.

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An employee's subject to instructions about when, where, and how to work. Workers subject to greater, more detailed instructions are likely employees.

Independent contractors are generally subject to minimal instructions.

The amount of instruction needed varies among different jobs. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved.

A business may lack the knowledge to instruct some highly specialized professionals. In other cases, the task may require little or no instruction.

Employers may also give experienced employees greater freedom in how they complete their work. The key consideration's whether the business has retained the legal right to control the details of a worker's performance even if it chooses not to exercise it.

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Here are some examples of instructions a company provides workers. These instructions demonstrate a desire to control the manner the worker must do a task.

- Is the worker told when and where to do the work?
- Does the worker provide his own tools or are they provided for him?
- Is there a dress code the worker must follow?
- Is the worker told where to purchase supplies?
- Is certain work required to be completed by a specific individual?
- Can the worker hire others to assist with the work?
- Does the worker have to follow a particular sequence to complete a task?

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Evaluations are common for both employees and independent contractors. The more the evaluation measures how the tasks are completed, the stronger the indication the worker's an employee. However, if it only measures the result, it could be an indication of either an employee or a contractor.

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If the business provides the worker training on how to do the job, this indicates the business wants the job done in a particular way. This is strong evidence the worker's an employee.

Periodic or ongoing training about procedures and methods is even stronger evidence of an employer/employee relationship. Independent contractors, on the other hand, ordinarily use their own methods and have the necessary training to perform the assigned work.

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Financial control is the second factor. This considers whether the business has the right to control the economic aspects of the worker's job.

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Let's discuss some factors to help determine whether a company has financial control over the worker.

The six categories are:

1. Significant investment
2. Expense reimbursement
3. Opportunity for profit or loss
4. Services available to the market
5. Method of payment
6. Responsibility for fixing problems

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Independent contractors often have significant investment in materials, equipment, etc., they use in working for someone else. However, in many occupations, such as construction, workers spend thousands of dollars on the tools and equipment and may be employees.

There's no precise dollar limit a worker must meet to have a significant investment. Furthermore, a significant investment isn't necessary for independent contractor status, as some types of work don't require large expenditures.

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How about expense reimbursement? Independent contractors are more likely to have unreimbursed expenses than employees. They incur fixed, ongoing costs regardless of whether work's being performed.

However, employees may also incur unreimbursed expenses regarding the services they perform for their business. Teachers, for example, often spend their own money on classroom supplies – money that isn't reimbursed.

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The opportunity to make a profit or loss is another important factor.

An employee's risk of incurring a loss is very small.

If a worker has a significant investment in the materials, tools and equipment used – and has unreimbursed expenses – he has a greater opportunity to lose money (that is, the expenses will exceed the income from the work). A worker with an increased risk of incurring a loss is more likely an independent contractor.

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Independent contractors can seek out other work opportunities. They often advertise, maintain a visible business location, and are available to work in the relevant market.

An employee provides his or her services to one business.

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An employee is guaranteed a regular wage amount for an hourly, weekly, or other rate. This is true even when the employer supplements the wage or salary by a commission.

An independent contractor usually receives a flat fee for the job. However, it's common in some professions, such as law, to pay independent contractors hourly.

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Independent contractors must make necessary repairs and often bear the legal and financial responsibility to cover damages. This can also tie into the opportunity to make a profit or loss.

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The third key factor's the relationship of the parties. This factor tries to determine what the parties intended and how they perceived their relationship.

How did the worker obtain the job (bid, application, employment agency, or other)?

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Determining the relationship of the parties involves consideration of the following categories:

- Written contracts
- Employee type benefits (such as a pension plan, insurance, and vacation pay)
- Permanency of relationship
- Ability to be terminated
- Degree to which the work performed is a key aspect of the business

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The IRS must give the existence of a written contract and the terms of that contract consideration. Although a contract may state the worker's an employee or an independent contractor, this isn't sufficient to determine his status.

The IRS isn't required to follow a contract stating the worker's an independent contractor, responsible for paying his or her own self-employment tax. Great weight's given to how the parties work together to

determine whether the worker's an employee or an independent contractor.

The courts have ruled that contracts, however skillfully devised, shouldn't be permitted to shift tax liability as definitely fixed by the statutes. In other words, the courts, and the IRS, don't allow the terms of a contract to overrule the requirements set by law.

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Employees often receive a variety of benefits from their employers including, but not limited to:

- Retirement
- Insurance
- Vacation

Businesses don't grant these types of benefits to independent contractors. However, the lack of these types of benefits doesn't mean the worker's an independent contractor.

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If you hire a worker with the expectation the relationship will continue indefinitely, rather than for a specific project or period, the IRS considers the intent was to create an employer-employee relationship. Examples of exceptions include seasonal and intermittent employment.

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A company can't fire independent contractors if they produce a result that meets the terms of their contract. In addition, independent contractors are required to satisfactorily complete a job or they're legally obligated to make good.

An employer may fire an employee and the employee can quit at any time.

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If a worker provides services that are a key aspect of your regular business activity, it's more likely you'll have the right to direct and control his or her activities.

For example, if a law firm hires an attorney, it'll present the attorney's work as its own and has the right to control or direct that work. This would indicate an employer-employee relationship.

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You can't rely on a single factor to determine whether a worker's an independent contractor or an employee. You must consider all facts and circumstances in each case to correctly determine whether a worker is an employee or contractor.

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The IRS can determine whether a worker's an employee or an independent contractor. Just send it a completed Form SS-8, Determination of Worker status for Purposes of Federal Employment Taxes and Income Tax Withholding. There's no fee for this determination.

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The SS-8 addresses the same three factors we just discussed:

- Behavioral control
- Financial control
- Relationship of the worker and firm

A worker or employer can file Form SS-8 and receive a determination from the IRS. When the IRS receives the request, it'll begin research but may come back to the firm and worker for further information. At the end of the process, which could take six months, the IRS will:

- Issue a determination letter, which is binding on the IRS

- Issue an informational letter, which is advisory but not binding

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You'll use these forms when making payments to workers: Forms W-9 and 1099-MISC for payments to an independent contractor, and Forms W-4 and W-2 for payments to an employee.

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These four publications include information about employees and independent contractors. We also talked about using Form SS-8 to request a determination from the IRS concerning a worker's proper status.

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This is the end of Lesson 1. You should be able to distinguish between an independent contractor and an employee. You also should understand and be able to apply the categories of evidence.

Thank you.