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ACCURATELY CLASSIFYING
WORKERS AND ITS
IMPORTANCE IN TODAY'S
BUSINESS WORLD

ACCURATELY CLASSIFYING WORKERS

Today's employers face the difficult task of properly classifying workers. This is an ongoing activity and critically important for accuracy. The multitude of buzz words being used by business and human resource professionals alike make it even more daunting: contingent workforce, temporary, contractor, independent contractor, employee, 1099. Anyone would be confused and mistakes can be costly. The following helps to identify and define the proper classifications with guidelines for your internal use and education.

There are several areas of the law where the proper classification of a worker is necessary.

- ◆ The first concern for most employers is **payroll taxes**. If the worker is an employee, the company is responsible for payroll taxes, including social security, Medicare, FUTA and SUTA. If the worker is an independent contractor, the company is not responsible for these taxes.
- ◆ Secondly, the **Fair Labor Standards Act (FLSA)**, which establishes the standards for minimum pay and overtime pay, does not apply to all classifications of workers, so it is necessary for a company to know the accurate classification of a worker to avoid violating workers' rights under the FLSA.
- ◆ The last area applies to **benefits and retirement plans**; employees are eligible to participate in the employer's group benefit plans and retirement plans while independent contractors are not.

A look at the buzzwords and how we use (or misuse them):

Contingent Workforce -- This is a catch-all phrase used by employers to label all of its non-permanent workers, including temporaries hired through an agency, independent contractors and even interns. This is not a legal classification of a worker's status.

Employee -- A person who is hired (permanently) by a company to perform services for wages or salary and whose work product, methods and schedule is under the company's control.



Temporary – This type of worker is brought on either through an agency or by the company directly for a limited period of time, and in most cases, is not eligible to participate in the company's benefit programs. If the worker is with an agency, the agency is responsible for paying payroll taxes for that worker. Seasonal workers would fall under this classification.

Independent Contractor – Loosely defined, an independent contractor is a worker who performs services for a company but is not an employee of the company. These workers are typically working under a written contract that stipulates the pay and the project they are hired to complete. In determining if a worker is an independent contractor, the IRS looks at who controls the work methods and results. If the company has the right to control only the *result* of the work and not the method, means or schedule of the worker, then the worker is an independent contractor. However, if the company is controlling how, what, and when the work will be done, the worker is an employee and not an independent contractor.

1099 – This is not a type of worker but the type of forms the company must submit to the IRS when it has paid an independent contractor more than \$600 in a calendar year. The company must also issue the independent contractor a Form 1099 so the independent contractor can properly report his earnings. This term is commonly used in place of independent contractor.

Contractor – This is typically used interchangeably with independent contractor which is the proper legal classification. Unfortunately, it is also frequently used synonymously with temporary. As we see in the above definitions, temporary and independent contractors are different classifications and employers must proceed with caution. The company controls more than the results of the work performed by a temporary worker so the worker does not meet the IRS rules to be classified as an independent contractor. If in fact the company only controls the results of the work, then the worker is an independent contractor.



ADDITIONAL CLASSIFICATION CATEGORIES

The government also classifies workers in categories other than we've detailed above. They classify workers as common-law employees, statutory employees and statutory nonemployees, again making the employer's task of classification even more arduous. We've covered independent contractors so let's look at the remaining categories.

A ***common-law employee***, as defined by the IRS under the common-law rules, is "anyone who performs services for you is your employee *if you can control what will be done and how it will be done*. This is so even when you give the employee freedom of action. What matters is that you have the right to control the details of how the services are performed."

A ***statutory employee*** is defined by the IRS as an independent contractor who "may nevertheless be treated as an employee by statute for certain employment tax purposes if they fall within any one of the following four categories and meet the three conditions described under ***Social Security and Medicare*** taxes."

1. A driver who distributes beverages (other than milk), meat, vegetable, fruit, or bakery products; or who picks up and delivers laundry or dry cleaning, if the driver is your agent or is paid on commission.
2. A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.
3. An individual who works at home on materials or goods that you supply and that must be returned to you or to a person you name, if you also furnish specifications for the work to be done.
4. A full-time traveling or city salesperson who works on your behalf and turns in orders to you from wholesalers, retailers, contractors; or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for you must be the salesperson's principal business activity.



An employer must withhold Social Security and Medicare taxes from the wages of statutory employees when the following criteria apply:

1. The service contract states or implies that substantially all the services are to be performed personally by them.
2. They do not have a substantial investment in the equipment and property used to perform the services (other than an investment in transportation facilities).
3. The services are performed on a continuing basis for the same payer.

Statutory nonemployees generally fall into two categories: direct sellers and licensed real estate agents. They are treated as self-employed for all federal tax purposes, including income and employment taxes, if:

- ◆ Substantially all payments for their services as direct sellers or real estate agents are directly related to sales or other output, rather than to the number of hours worked.
- ◆ Their services are performed under a written contract providing they will not be treated as employees for Federal tax purposes.

TYPES OF EMPLOYER CONTROLS TO ESTABLISH CLASSIFICATION

Employers can look at the following three areas of control to establish the proper classification of a worker. In general, the more control the employer has over the worker and the work product, the more likely it is that the worker is an employee rather than an independent contractor.

Behavioral Control: the IRS examines the specific facts that demonstrate whether the business has maintained the right to direct and control how a worker performs the task for which he or she is engaged. They specifically look at the type and degree of instruction and training.

- ◆ *Employees* are typically told how, when and where to work and are trained to complete the various duties of their job. The employer has the right to control the details of how the work is done.
- ◆ *Independent contractors* are generally experts in their field and are equipped with their own electronics and tools. They are also told by the employer what the desired results and deadlines are and are then allowed to work on their own schedule to meet those requirements.



Financial Control: the IRS examines the specific facts that show whether the employer has a right to control the financial and business aspects of the worker's job.

- ◆ *Employees* typically are paid on an hourly or salary basis and they are also reimbursed for business expenses. Employees typically work for just one employer at a time.
- ◆ *Independent contractors* are typically paid on a per project basis tied to a written contract and are not typically reimbursed for business expenses by the employer.
- ◆ *Independent contractors* are known to work for multiple employers at the same time.

Under financial control, the IRS will also look at the extent of the worker's investment and the extent to which the worker can realize a profit or incur a loss.

Type of Relationship: The IRS examines the nature of the parties' relationship:

- ◆ *Employees* typically do not work under a written contract; they are typically offered benefits like insurance and paid time off. Their relationship with the employer is considered permanent in nature and their duties are a key aspect of the employer's regular business.
- ◆ *Independent contractors* almost always operate under a strict written contract and are not eligible to participate in the employer's benefit offerings. The relationship between the employer and the independent contractor is not considered permanent and is limited to the duration of time stipulated in the written contract. Independent contractor work is not a key aspect of the employer's regular business but is part of a specific project or initiative.

Although the above areas of control all refer to the IRS definitions, they are generally recognized as acceptable by other governing bodies, and when applied properly, should ensure that the employer has accurately classified its worker and should be defensible against a lawsuit relating to misclassification.



IRS 20-FACTOR CONTROL TEST

Realizing that the various categories of classification are still difficult to analyze, the IRS issued a 20-Factor Control test in 1987. When your answer to any of the first 15 questions is 'Yes' then the worker is an employee. 'Yes' responses to the last 5 questions indicate your worker is an independent contractor. Eleven or more 'No' responses in the first 15 questions would mean your worker is an independent contractor.

	Factor	Y	N
1	Does the employer provide instruction about when and how to perform work?		
2	Does the employer train the worker?		
3	Is work performed essential to the employers business?		
4	Must the work be performed personally by the worker?		
5	Does the employer hire, supervise and pay assistants to the worker?		
6	Is there a continual relationship between employer and worker?		
7	Does the employer set the work hours and schedule?		
8	Does the worker devote full time to the business of the employer?		
9	Is the work performed on the employers premise?		
10	Does the employer set the order in which the work is to be completed?		
11	Is the worker required to submit reports to the employer?		
12	Is the worker paid by hour, week or month?		
13	Does the employer have the right to discharge worker at will?		
14	Can the worker terminate the relationship with the employer without liability to the employer?		



15	Does the employer pay business and/or travel expenses of the worker?		
16	Does the worker provide his own tools, materials and equipment?		
17	Does the worker have significant investment in facilities?		
18	Can the worker realize a profit or loss as a result of his or her services?		
19	Does the worker perform services for more than one employer at a time?		
20	Are the worker's services made available to the general public?		

In the event of an audit, which do occur even with small employers, the penalties can be harsh. Illegally misclassifying workers as independent contractors would deprive them of wages, benefits and expenses. A resulting law suit could find the employer liable to repay those losses and potentially pay more in damages to workers.

FedEx is currently entrenched in a class action suit of this nature. Thousands of drivers across 20 states are alleging that FedEx classified them as independent contractors thus disallowing them overtime pay, benefits and reimbursement for expenses. They claim that based on the IRS definitions they are employees that are entitled to overtime pay, group benefits, etc. Additionally, the IRS has tentatively determined that FedEx owes more than \$319 million in taxes and penalties for 2002 due to the misclassification of drivers as independent contractors. With the class action suit and audits of additional years, it is likely that FedEx will owe hundreds of millions of dollars more.

Let FedEx be an example for us all: classifying workers properly from the start will help ensure you are not infringing on any worker's rights and allow you to properly report any necessary taxes and wages to the appropriate Federal and State agencies. Keep in mind that taking the time to properly classify an employee *at the time of hire* will save you countless hours and dollars if audited or sued.



Additional resources may be found at:

www.irs.gov.

www.shrm.org

<http://www.dol.gov/compliance/laws/comp-flsa.htm>

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ABOUT THE AUTHOR

Amy Brenchley Arroyo joined Lakeshore in 2000 as a Staffing Manager and was promoted to Human Resources Manager in 2006. She is delighted to be able to contribute to Lakeshore's Newsletter and looks forward to future contributions.

ABOUT LAKESHORE

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