

INDEPEDENT CONTRACTOR OR EMPLOYEE?

The following information is from IRS publications and WA Department of Labor and Industries publications used to determine if a person is an employee or an independent contractor. This is a highly complex and unclear set of regulations. In many cases, while a person may be an independent contractor under federal IRS regulations, they may not be under state industrial insurance regulations. So while you may not be required to pay federal payroll taxes on them, you may be required to cover them with state industrial insurance. The criteria used for the state industrial insurance regulations can be found on page 6 of this publication. The IRS provides a form - SS-8 that employers can use to pre-determine if a person is an employee or independent contractor. You can find out more about that form on page 4 of this publication.

Federal IRS - Independent Contractor Information

1. Who Are Employees?

Before you can know how to treat payments you make for services, you must first know the business relationship that exists between you and the person performing the services. The person performing the services may be—

- An independent contractor.
- A common-law employee.
- A statutory employee.
- A statutory non-employee.

This discussion explains these four categories. A later discussion, **Employee or Independent Contractor?** (section 2), points out the differences between an independent contractor and an employee and gives examples from various types of occupations. If an individual who works for you is not an employee under the common-law rules (see section 2), you generally do not have to withhold Federal income tax from that individual's pay. However, in some cases you may be required to withhold under backup withholding requirements on these payments. See Circular E for information on backup withholding.

Independent Contractors

People such as lawyers, contractors, subcontractors, public stenographers, and auctioneers who follow an independent trade, business, or profession in which they offer their services to the public, are generally not employees. However, whether such people are employees or independent contractors depends on the facts in each case. The general rule is that an individual is an independent contractor if you, the payer, have the right to control or direct only the result of the work and not the means and methods of accomplishing the result.

Common-Law Employees

Under common-law rules, 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. For a discussion of facts that indicate whether an individual providing services is an independent contractor or employee, see **Employee or Independent Contractor?** (section 2). If you have an employer-employee relationship, it makes no difference how it is labeled. The *substance* of the relationship, *not the label*, governs the worker's status. Nor does it matter whether the individual is employed full time or part time.

For employment tax purposes, no distinction is made between classes of employees. Superintendents, managers, and other supervisory personnel are all employees. An *officer of a corporation* is generally an employee; however, an officer who performs no services or only minor services, and neither receives nor is entitled to receive any pay, is not considered an employee. A *director* of a corporation is not an employee. You generally have to withhold and pay income, social security, and Medicare taxes on wages you pay to common-law employees. However, the wages of certain employees may be exempt from one or more of these taxes. See **Employees of Exempt Organizations** (section 3) and **Religious Exemptions** (section 4).

Leased employees. Under certain circumstances, a corporation furnishing workers to various professional people and firms

is the employer of those workers for employment tax purposes. For example, a professional service corporation may provide the services of secretaries, nurses, and other similarly trained workers to its subscribers. The service corporation enters into contracts with the subscribers under which the subscribers specify the services to be provided and the fee to be paid to the service corporation for each individual furnished. The service corporation has the right to control and direct the worker's services for the subscriber, including the right to discharge or reassign the worker. The service corporation hires the workers, controls the payment of their wages, provides them with unemployment insurance and other benefits, and is the employer for employment tax purposes. For information on employee leasing as it relates to pension plan qualification requirements, see **Leased employees in Pub.560, Re-tirement Plans for Small Business (SEP, SIMPLE, and Keogh Plans)**.

Additional information. For more information about the treatment of special types of employment, the treatment of special types of payments, and similar subjects, get Circular E or Circular A (for agricultural employers).

Statutory Employees

Four categories of workers who are independent con-tractors under common law are treated by statute as employees.

- 1) A driver who distributes beverages (other than milk) or 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 an-nuity 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. See **Salesperson** in section 2.

Social security and Medicare taxes. Withhold social security and Medicare taxes from the wages of statutory employees if all three of the following conditions apply.

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

Federal unemployment (FUTA) tax. For FUTA tax, the term *employee* means the same as it does for social security and Medicare taxes, except that it does not include statutory employees in categories 2 and 3 above. Thus, any individual who is an employee under category 1 or 4 is also an employee for FUTA tax purposes and subject to FUTA tax.

Income tax. Do not withhold income tax from the wages of statutory employees.

Reporting payments to statutory employees. Furnish a Form W-2 to a statutory employee, and check "statutory employee" in box 15 (box 13 on the 2001 Form W-2). Show your payments to the employee as other compensation in box 1. Also, show social security wages in box 3, social security tax withheld in box 4, Medicare wages in box 5, and Medicare tax withheld in box 6. The statutory employee can deduct his or her trade or business expenses from the payments shown on Form W-2. He or she reports earnings as a statutory employee on line 1 of Schedule C or C-EZ (Form 1040). (A statutory employee's business expenses are deductible on Schedule C or C-EZ (Form 1040) and are not subject to the reduction by 2% of his or her adjusted gross income that applies to common-law employees.)

Statutory Nonemployees

There are two categories of statutory nonemployees: *direct sellers* and *licensed real estate agents*. They are treated as self-employed for all Federal tax purposes, including income and employment taxes, if:

- 1) 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 and
- 2) Their services are performed under a written contract providing that they will not be treated as employees for Federal tax purposes.

Direct sellers. Direct sellers include persons falling within any of the following three groups:

- 1) Persons engaged in selling (or soliciting the sale of) consumer products in the home or place of business other than in a permanent retail establishment.
- 2) Persons engaged in selling (or soliciting the sale of) consumer products to any buyer on a buy-sell basis prescribed by regulations, for resale in the home or at a place of business other than in a permanent retail establishment.
- 3) Persons engaged in the trade or business of delivering or distributing newspapers or shopping news(including any services directly related to such de-livry or distribution).

Direct selling includes activities of individuals who attempt to increase direct sales activities of their direct sellers and who earn income based on the productivity of their direct sellers. Such activities include providing motivation and encouragement; imparting skills, knowledge, or experience; and recruiting. For more information on direct sellers, see Pub.911,Direct Sellers.

Licensed real estate agents. This category includes individuals engaged in appraisal activities for real estate sales if they earn income based on sales or other out-put.

2.Employee or Independent Contractor?

An employer must generally withhold income taxes, withhold and pay social security and Medicare taxes, and pay unemployment tax on wages paid to an employee. An employer does not generally have to with-hold or pay any taxes on payments to independent contractors.

Common-Law Rules

To determine whether an individual is an employee or an independent contractor under the common law, the relationship of the worker and the business must be examined. All evidence of control and independence must be considered. In any employee-independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered. Facts that provide evidence of the degree of control and independence fall into three categories: behavioral control, financial control, and the type of relationship of the parties as shown below.

Behavioral control. Facts that show whether the business has a right to direct and control how the

worker does the task for which the worker is hired include

the type and degree of— *Instructions the business gives the worker.* An employee is generally subject to the business' instructions about when, where, and how to work. All of the following are examples of types of instructions about how to do work:

- When and where to do the work
- What tools or equipment to use
- What workers to hire or to assist with the work
- Where to purchase supplies and services
- What work must be performed by a specified individual
- What order or sequence to follow

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. The key

consideration is whether the business has retained the right to control the details of a worker's performance or instead has given up that right.

Training the business gives the worker. An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

Financial control. Facts that show whether the business has a right to control the business aspects of the worker's job include:

The extent to which the worker has unreimbursed business expenses. Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services they perform for their business.

The extent of the worker's investment. An independent contractor often has a significant investment in the facilities he or she uses in performing services for someone else. However, a significant investment is not necessary for independent contractor status.

The extent to which the worker makes services available to the relevant market. An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.

How the business pays the worker. An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is usually paid by a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.

The extent to which the worker can realize a profit or loss. An independent contractor can make a profit or loss.

Type of relationship. Facts that show the parties' type of relationship include:

Written contracts describing the relationship the parties intended to create.

Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.

The permanency of the relationship. If you engage a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that your intent was to create an employer-employee relationship.

The extent to which services performed by the worker are a key aspect of the regular business of

the company. If a worker provides services that are a key aspect of your regular business activity, it is more likely that you will have the right to direct and control his or her activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

IRS help. If you want the IRS to determine whether a worker is an employee, file Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, with the IRS.

Misclassification of Employees

Consequences of treating an employee as an independent contractor. If you classify an employee as an independent contractor and you have no reasonable basis for doing so, you may be held liable for employment taxes for that worker (the relief provisions, discussed below, will not apply). See Internal Revenue Code section 3509 for more information.

Relief provisions. If you have a reasonable basis for not treating a worker as an employee, you may be relieved from having to pay employment taxes for that worker. To get this relief, you must file all required Federal information returns on a basis consistent with your treatment of the worker. You (or your predecessor) must not have treated any worker holding a substantially similar position as an employee for any periods beginning after 1977.

Technical service specialists. This relief provision does not apply to a worker who provides services to another business (the client) as a technical service specialist under an arrangement between the business providing the worker, such as a technical services firm, and the client. A technical service specialist is an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work. This rule does not affect the determination of whether such workers are employees under the common-law rules. The common-law rules control whether the specialist is treated as an employee or an independent contractor. However, if you directly contract with a technical service specialist to provide services for your business rather than for another business, you may still be entitled to the relief provision. See **Employee or Independent Contractor?** below.

Industry Examples

The following examples may help you properly classify your workers.

Building and Construction Industry

Example 1. Jerry Jones has an agreement with Wilma White to supervise the remodeling of her house. She did not advance funds to help him carry on the work. She makes direct payments to the suppliers for all necessary materials. She carries liability and workers' compensation insurance covering Jerry and others he engaged to assist him. She pays them an hourly rate and exercises almost constant supervision over the work. Jerry is not free to transfer his assistants to other jobs. He may not work on other jobs while working for Wilma. He assumes no responsibility to complete the work and will incur no contractual liability if he fails to do so. He and his assistants perform personal services for hourly wages. They are employees of Wilma White.

Example 2. Milton Manning, an experienced tilesetter, orally agreed with a corporation to perform full-time services at construction sites. He uses his own tools and performs services in the order designated by the corporation and according to its specifications. The corporation supplies all materials, makes frequent inspections of his work, pays him on a piecework basis, and carries workers' compensation insurance on him. He does not have a place of business or hold himself out to perform similar services for others. Either party can end the services at any time. Milton Manning is an employee of the corporation.

Example 3. Wallace Black agreed with the Sawdust Co. to supply the construction labor for a group of houses. The company agreed to pay all construction costs. However, he supplies all the tools and equipment. He performs personal services as a carpenter and mechanic for an hourly wage. He also acts as superintendent and foreman and engages other individuals to assist him. The company has the right to select, approve, or discharge any helper. A company representative makes frequent inspections of the construction site. When a house is finished, Wallace is paid a certain percentage of its costs. He is not responsible for faults, defects of construction, or wasteful operation. At the end of each week, he presents the company with a statement of the amount he has spent, including the payroll. The company gives him a check for that amount from which he pays the assistants, although he is not personally liable for their wages. Wallace Black and his assistants are employees of the Sawdust Co.

Example 4. Bill Plum contracted with Elm Corporation to complete the roofing on a housing complex. A signed contract established a flat amount for the services rendered by Bill Plum. Bill is a licensed roofer and carries workers' compensation and liability insurance under the business name, Plum Roofing. He hires his own roofers who are treated as employees for Federal employment tax purposes. If there is a problem with the roofing work, Plum Roofing is responsible for paying for any repairs. Bill Plum, doing business as Plum Roofing, is an independent contractor.

Example 5. Vera Elm, an electrician, submitted a job estimate to a housing complex for electrical work at \$16 per hour for 400 hours. She is to receive \$1,280 every 2 weeks for the next 10 weeks. This is not considered payment by the hour. Even if she works more or less than 400 hours to complete the work, Vera Elm will receive \$6,400. She also performs additional electrical installations under contracts with other companies, which she obtained through advertisements. Vera is an independent contractor.

Trucking Industry

Example. Rose Trucking contracts to deliver material for Forest Inc. at \$140 per ton. Rose Trucking is not paid for any articles that are not delivered. At times, Jan Rose, who operates as Rose Trucking, may also lease another truck and engage a driver to complete the contract. All operating expenses, including insurance coverage, are paid by Jan Rose. All equipment is owned or rented by Jan, and she is responsible for all maintenance. None of the drivers are provided by Forest Inc. Jan Rose, operating as Rose Trucking, is an independent contractor.

Computer Industry

Example. Steve Smith, a computer programmer, is laid off when Megabyte Inc. downsizes. Megabyte agrees to pay Steve a flat amount to complete a one-time project to create a certain product. It is not clear how long it will take to complete the project, and Steve is not guaranteed any minimum payment for the hours spent on the program. Megabyte provides Steve with no instructions beyond the specifications for the product itself. Steve and Megabyte have a written contract, which provides that Steve is considered to be an independent contractor, is required to pay Federal and state taxes, and receives no benefits from Megabyte. Mega-byte will file a Form 1099-MISC. Steve does the work on a new high-end computer which cost him \$7,000. Steve works at home and is not expected or allowed to attend meetings of the software development group. Steve is an independent contractor.

Automobile Industry

Example 1. Donna Lee is a salesperson employed on a full-time basis by Bob Blue, an auto dealer. She works 6 days a week and is on duty in Bob's showroom on certain assigned days and times. She appraises trade-ins, but her appraisals are subject to the sales manager's approval. Lists of prospective customers belong to the dealer. She has to develop leads and report results to the sales manager. Because of her experience, she requires only minimal assistance in closing and financing sales and in other phases of her work. She is paid a commission and is eligible for prizes and bonuses offered by Bob. Bob also pays the cost of health insurance and group-term life insurance for Donna. Donna is an employee of Bob Blue.

Example 2. Sam Sparks performs auto repair services in the repair department of an auto sales com-pany. He works regular hours and is paid on a percentage basis. He has no investment in the repair department. The sales company supplies all facilities, repair parts, and supplies; issues instructions on the amounts to be charged, parts to be used, and the time for completion of each job; and checks all estimates and repair orders. Sam is an employee of the sales company.

Example 3. An auto sales agency furnishes space for Helen Bach to perform auto repair services. She provides her own tools, equipment, and supplies. She seeks out business from insurance adjusters and other individuals and does all the body and paint work that comes to the agency. She hires and discharges her own helpers, determines her own and her helpers' working hours, quotes prices for repair work, makes all necessary adjustments, assumes all losses from un-collectible accounts, and receives, as compensation for her services, a large percentage of the gross collections from the auto repair shop. Helen is an independent contractor and the helpers are her employees.

Attorney

Example. Donna Yuma is a sole practitioner who rents office space and pays for the following items: telephone, computer, on-line legal research linkup, fax machine, and photocopier. Donna buys office supplies and pays bar dues and membership dues for three other professional organizations. Donna has a part-time receptionist who also does the bookkeeping. She pays the receptionist, withholds and pays Federal and state employment taxes, and files a Form W-2 each year. For the past 2 years, Donna has had only three clients, corporations with which there have been longstanding relationships. Donna charges the corporations an hourly rate for her services, sending monthly bills de-tailing the work performed for the prior month. The bills include charges for long distance calls, on-line research time, fax charges, photocopies, postage, and travel, costs for which the corporations have agreed to reimburse her. Donna is an independent contractor.

Taxicab Driver

Example. Tom Spruce rents a cab from Taft Cab Co. for \$150 per day. He pays the costs of maintaining and operating the cab. Tom Spruce keeps all fares he receives from customers. Although he receives the benefit of Taft's two-way radio communication equip-ment, dispatcher, and advertising, these items benefit both Taft and Tom Spruce. Tom Spruce is an independent contractor.

Salesperson

To determine whether salespersons are employees under the usual common-law rules, you must evaluate each individual case. If a salesperson who works for you does not meet the tests for a common-law employee, discussed earlier, you do not have to withhold income tax from his or her pay (see **Statutory Employees** earlier). However, even if a salesperson is not an employee under the usual common-law rules, his or her pay may still be subject to social security, Medicare, and FUTA taxes. To determine whether a salesperson is an employee for social security, Medicare, and FUTA tax purposes, the salesperson must meet all eight elements of the statutory employee test. A salesperson is an employee for social security, Medicare, and FUTA tax purposes if he or she:

- 1) Works full time for one person or company except, possibly, for sideline sales activities on behalf of some other person,
- 2) Sells on behalf of, and turns his or her orders over to, the person or company for which he or she works,
- 3) Sells to wholesalers, retailers, contractors, or operators of hotels, restaurants, or similar establishments,
- 4) Sells merchandise for resale, or supplies for use in the customer's business,
- 5) Agrees to do substantially all of this work personally,
- 6) Has no substantial investment in the facilities used to do the work, other than in facilities for transportation,
- 7) Maintains a continuing relationship with the person or company for which he or she works, and
- 8) Is not an employee under common-law rules.

Washington State - Industrial Insurance Criteria for Independent Contractors

Definition of an employer

For purposes of industrial insurance coverage, an employer is defined within the law as follows:

Any person, body of persons, corporate or otherwise, and the legal representatives of a deceased employer, all while engaged in this state in any work covered by the provisions of this title, by way of trade or business, or who contracts with one or more workers, the essence of which is the personal labor of such worker or workers. (RCW 51.08.070)

A contractor in the building construction industry, registered under Chapter 18.27 RCW or licensed under Chapter 19.28 RCW is not considered to be an employer when:

- (1) Contracting with any other person, firm, or corporation currently engaging in a business which is registered under Chapter 18.27 RCW or licensed under Chapter 19.28 RCW;
- (2) The person, firm, or corporation works from a principal place of business that qualifies for a business deduction under Internal Revenue Service tax laws, other than that furnished by the prime contractor for which the person, firm or corporation has contracted to provide services;

[The person, firm, or corporation subcontracting work from another contractor must have his or her own principal place of business that qualifies as a business deduction under internal revenue tax rules. The principal place of business may not be the same as that of the contractor for whom the subcontract work is performed.]

- (3) The person, firm, or corporation maintains a separate set of books or records that reflect all items of income and expenses of the business; and

- (4) The work which the person, firm, or corporation has contracted to perform is:

(a) The work of a contractor as defined in RCW 18.27.010; or

(b) The work of installing wires or equipment to convey electric current or installing apparatus to be operated by such current as it pertains to the electrical industry as described in Chapter 19.28 RCW.

A contractor is however, considered to be the employer if he/she supervises the work of others or controls the means to accomplish the job. If you have specific questions, contact your local Labor and Industries office.

Definition of a worker

For purposes of industrial insurance coverage, a worker is defined within the law as follows:

Every person in this state who is engaged in the employment of an employer under this title, whether by way of manual labor or otherwise in the course of his or her employment; also every person in this state who is engaged in the employment of or who is working under an independent contract, the essence of which is his or her personal labor for an employer under this title, whether by way of manual labor or otherwise, in the course of his or her employment, or as a separate alternative, a person is not a worker if he or she meets the tests set forth in subsection (1) through (6) of RCW 51.08.195. Provided that a person is not a worker for the purpose of this title, with respect to his or her activities attendant to operating a truck he or she owns, and that is leased to a common or contract carrier. (RCW 51.08.180)

In the building construction industry, there is an exception to this law. Under revised law, any person, firm or corporation currently laboring for a business that is registered under Chapter 18.27 RCW, or licensed under Chapter 19.28 RCW, is not a worker when:

(1) Contracting to perform work for any contractor registered under Chapter 18.27 or licensed under Chapter 19.28 RCW;

(2) The person, firm, or corporation has a principal place of business that would be eligible for a business deduction for internal revenue tax purposes other than that furnished by the contractor for which the business has contracted to furnish services.

[The person, firm, or corporation subcontracting work from another contractor must have his or her own principal place of business that qualifies as a business deduction under internal revenue tax rules. The principal place of business may not be the same as that of the contractor for whom the subcontract work is performed.]

(3) The person, firm, or corporation maintains a separate set of books or records that reflect all items of income and expenses of the business; and

(4) The work that the person, firm, or corporation has contracted to perform is:

(a) The work of a contractor as defined in RCW 18.27.010; or

(b) The work of installing wires or equipment to convey electric current or installing apparatus to be operated by such current as it pertains to the electrical industry as described in Chapter 19.28 RCW.

However, a person who is registered under Chapter 18.27 RCW or 19.28 RCW performing work for any registered contractor *is* a worker when the contractor supervises or controls the means by which the result is accomplished or the manner in which the work is performed.

If you have questions about these definitions or specific employment arrangements, please contact your local Labor and Industries office.

Responsibility for independent contractors

If you enter into a contract with an independent contractor, you may be required to provide industrial insurance coverage during the period of the contract. You *must* cover the contractor *if* he or she is a worker as defined in the industrial insurance laws. That definition includes workers "... working under an independent contract, the essence of which is his or her personal labor."

The legal question of whether an independent contractor should be considered a worker employed by the contracting party, for industrial insurance purposes, has been the subject of a number of court cases. RCW 51.08.195, gives an employer an alternative six-part test to determine if an independent contractor is exempt from mandatory coverage. This law has been adopted for both L&I and Employment Security, giving an employer an advantage in that both L&I and Employment

Security will use the same six-part test to determine exemptions for independent contractors.

The new six-part test states that a person is exempt if:

1. He or she is free from control and direction over the performance of the services, AND
2. The service is outside the usual course of business OR outside all the places of business the employer OR the individual is responsible for the costs of the principle place of business from which the service is performed, AND
3. The individual is engaged in an independently established trade of the same nature as the contract, OR the individual has a principle place of business eligible for IRS business deduction, AND
4. The individual is responsible for filing a schedule of expense and income with the IRS for the business, AND
5. On the effective date of contract or within a reasonable period, has established required accounts with state agencies, AND
6. Individual maintains separate set of books and records that reflect items of income and expense for the business.

You can be severely penalized for not covering an independent contractor if, under the law, coverage is required.