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IRS Looks Closely at Independent Contractors

Abstract
The IRS is using various tools to attack the status of various so-called "outside consultants" being used by hospitality firms. This article will provide some planning tips so that the hospitality firm can minimize its chances of having workers reclassified as employees.

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IRS Looks Closely at Independent Contractors

by

John M. Tarras

In an effort to cut costs in this difficult economic period, many hospitality firms are resorting to using independent contractors to do the work that in the past was handled by employees. The Internal Revenue Service has been keenly aware of this practice and has increased its search for contractors who are really employees.

A hospitality firm which classifies workers as independent contractors may need to seek professional guidance before the IRS examines business records. The following list is not exhaustive, but is offered merely to indicate potential trouble areas common to the hospitality industry:

• hiring a recent retired worker back as a consultant for the same type of job that he was doing before retirement

• requiring a shoeshine vendor to perform duties for the hotel as a requirement for maintaining his concession

• requiring babysitters to be available at certain times for the benefit of guests

• hiring any consultant (marketing, accountant, computer specialist, etc.) who works exclusively for the hospitality firm

• hiring a husband and wife team to run a small hotel for the owner

• setting hours for beauticians and manicurists

• requiring limousine drivers to be available for hotel guests on a regular basis

• hiring entertainers to work for the property on a regular basis
From a hospitality firm's point of view, the incentive for using independent contractors is to save money. For example, the firm is not responsible for income tax withholding, Social Security taxes, federal and state unemployment taxes, contributions to a pension plan, fringe benefits, and worker's compensation for someone properly classified as an independent contractor. In addition, there is generally more flexibility in retaining consultants since there is no expectation of continued employment after their assignment has been completed.

IRS Often Reclassifies Consultants

However, these advantages have often led hospitality firms to hire individuals as independent contractors only to have the IRS come in and reclassify them as employees. There are dire consequences to the IRS's reclassifying the workers as employees. First, the hospitality firm is liable for any taxes that should have been paid by the employer, including the employer’s share of Social Security tax (FICA), federal unemployment tax (FUTA), and state unemployment insurance taxes. Fringe benefits, such as pension contributions, profit sharing, life insurance and health insurance premiums, are just some of the additional expenses that may have to be paid retroactively to employees.

Also, worker's compensation is generally available to employees and not to independent contractors. Thus, injured workers may claim to be employees just to be covered under the firm's worker's compensation plan.

In addition to the employer's share of taxes, the hospitality firm would be required to pay 20 percent of the employee's share of Social Security tax (40 percent if the employer failed to file Form 1099, Miscellaneous Income, for each worker). Also, the employer is liable for 1.5 percent of the wages paid for income tax withholding (3 percent of wages if the employer did not file a Form 1099 for each worker). Furthermore, the hospitality firm is not allowed to recover from the employee any of the taxes paid by the employer on the employee's behalf.

The hospitality firm would likely be assessed penalties by the IRS for failure to file payroll tax returns and failure to make timely deposits. For tax purposes, penalties are a non-deductible expense for the hospitality firm. Also, interest will generally be charged on the taxes and penalties owed by the hospitality firm. Fortunately, interest expense is deductible for tax purposes.

There are collateral issues that might add thousands of extra dollars to the cost of reclassification—in addition to the issues raised above. For instance, workers reclassified as employees could be entitled to retroactive overtime pay. If the Department of Labor determines that the reclassification was willful, that department could fine the hospitality firm for failing to properly pay overtime.
IRS Uses Control to Determine Status

Like with many areas of tax law, there is no inclusive definition of employee. The Internal Revenue Code merely states that employees will include corporate officers, individuals who work at home performing services according to their employers' specifications, traveling salesmen engaged full time to solicit orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments for one employer, and other minor classifications not associated with the hospitality industry.

This narrow definition could not possibly include all workers hired by a hospitality firm. It is irrelevant how the worker is classified by the hospitality firm; the IRS uses a common law test of control to determine who is an employee. The basic test for determining whether the worker is an independent contractor or employee is if the employer has the right to direct the worker's output and evaluate his or her methods.

In an 1987 IRS revenue ruling, the IRS stated that technical service specialists (which would include engineers, designers, drafters, computer programmers, system analysts, or other skilled workers engaged in a similar line of work) will only be considered independent contractors if they pass the common law tests laid out in the revenue ruling. Presumably, this test would apply to other workers engaged by the hospitality firm where there is a question as to status.

The following is a summary of the 20 common law factors:

- **Instructions**: If the worker is only responsible for getting the desired outcome, then he or she is likely to be considered an independent contractor. An employee would be required to follow instructions on how to accomplish a job. Control exists when the worker is compelled to follow instructions.

- **Training**: Sufficient control is usually found if the employer requires the worker to work with certain other employees of the firm or to attend training sessions. An independent contractor will choose which method he or she desires to use to obtain the result desired by the hospitality firm.

- **Integration**: This is an overall test that looks at how the work being performed fits into the whole scheme of the enterprise. For instance, the more necessary the work is for the day-to-day survival of the hospitality firm, the more control is inferred. This is so because it appears that management has a desire to control the work for the firm's survival.

- **Personal services rendered**: The more customer oriented in nature the service rendered, the more interested the firm should be in controlling the work method. For instance, a hotel that supplies names of babysitters for the convenience of the guest may assert sufficient control over the babysitters to qualify them as employees.
• **Hiring, supervising, and paying assistants**: Any assistants supplied by the firm would indicate control, and thus employee status. However, the presence of assistants who are the financial responsibility of the person contracted with would indicate independent contractor status.

• ** Continuing relationship**: If the relationship between the worker and firm is of a continuous nature, then employee/employer status is likely to be found.

• **Set hours of work**: Control—and thus employee relationship—is indicated if the hospitality firm sets work hours. An independent contractor is only responsible for the end result and thus establishes his or her own hours.

• **Full time required**: If a worker is required to spend the entire workday at one job, then he or she will be considered an employee. Someone who offers his or her services to the general public and actually does different jobs is more likely to be found to be an independent contractor.

• ** Doing work on employer's premises**: If the worker is required to spend his or her time at the hospitality firm or at designated properties, control can be inferred and the worker may be considered an employee. Independent contractors work on location where they deem it necessary and may spend some time at one location but would not be required to do all their work there.

• **Set order of sequence**: If the work must be done in a certain order, even though there may be other acceptable alternative ways of doing it, the worker will be deemed under the control of the firm and thus considered an employee.

• **Oral or written reports**: If the worker must report frequently in writing or orally as to his actions taken to date, this may mean that the employer is exerting control over the project in such a manner to constitute an employer/employee relationship.

• **Payment by hour, week, month**: If the worker receives a regular receipt of payment on a regular basis, then this indicates an employer/employee relationship. On the other hand, a payment that is based on straight commission or an agreed-to payment for each job to be performed would indicate independent contractor status.

• **Payment of business and/or travel expenses**: An independent contractor usually takes care of his or her own expenses unless specified differently in the contract. An employer/employee status is usually found where the firm pays expenses in accordance with company policy.
• **Furnishing of tools and materials**: An independent contractor will provide his or her own tools and equipment. An employee will usually receive tools and equipment from the employer.

• **Significant investment**: An extremely important test is whether the worker has an investment in his or her own establishment. If the firm provides the work facilities and controls the investments in the business, then it is almost certain the IRS will determine that an employer/employee relationship exists. For instance, if the hospitality firm owns the equipment used by the worker on the job, the firm is considered to have control over the worker.

• **Realization of profit and loss**: Is the risk of profit or loss with the firm or with the worker? If the worker does not risk losing money on the project, then he or she is generally considered to be an employee.

• **Working for more than one firm at a time**: An independent contractor will work for more than one firm at a time or else offer himself out for the possibility of working for more than one firm. The more firms a worker is engaged with, the more it shows that no one firm exerts control over the worker.

• **Making services available to the general public**: An independent contractor makes his or her services available to the general public. The IRS looks for such as items as advertising, phone listings, etc., to determine availability to the public.

• **Right to discharge**: If a worker can be discharged at will, an employer/employee status exists. Generally, an independent contractor’s rights and obligations are spelled out in a contract and thus a hospitality firm would not have any right to discharge the worker unless specified within the contract.

• **Right to terminate**: The independent contractor who fails to finish a project is liable to the firm for the work not finished. An employee, on the other hand, is not liable for any work not finished at the time of termination.

The above criteria are used by the IRS to determine the status of the worker in relation to the firm. The factors are weighted, depending on the individual circumstances, and as such can only be used as guidelines in determining whether an employee/employer relationship exists. However, it is clear that the more control the IRS determines the firm has over the worker, the more likely it is that an employer/employee status will be found.
Supervision Is a Key Issue

The following example demonstrates how important the issue of control is in determining whether a worker is an independent contractor or an employee. The facts are similar in both examples except for one important element—supervision.

In a revenue ruling, the IRS determined from the following facts that workers for a catering company were really employees and not independent contractors. Frequently, the catering company often hired from a list of individuals for specific catering work. These workers were free to work for other catering companies if they so desired. The workers were required to bring their own uniforms and any equipment that would be needed for the job.

However, the catering company supervisor was in charge of the workers while they were at the contracted-for engagement and he directed the workers as to how the guests were to be served. The IRS believed that the directions given to the workers by the company supervisor were sufficient enough to exercise control over the workers and therefore constituted employee status.

In a case brought before the Court of Claims, the IRS attempted to reclassify workers as employees. The taxpayer was a catering firm that supplied workers to catering jobs as needed when requested by their clients. The workers were free to work for other catering firms. As in the ruling above, they were also required to supply their uniforms and equipment. However, the catering company provided no supervisory personnel for any of the engagements.

The court found that the catering company did not have control over the workers as to performance of their duties. It was further determined that the workers were only provided as a convenience to the clients. Thus, the workers were found to be independent of control in each engagement and were therefore independent contractors.

Safe Harbor Rules May Apply

It is important to note that there are certain safe harbor rules that may apply to the hospitality firm for workers other than "technical service specialists" which must use the 20-step control test presented above. For IRS purposes, technical service specialists include computer programmers, system analysts, engineers, designers, drafters, and other similar type workers. If a worker is not classified as a technical service specialist, then the following "safe harbor" rules will prevent that worker from being classified as an employee:

- Independent contract status has been established by court cases or by IRS-published rulings directly relating to the hospitality firm.
- A past audit was conducted by the IRS on the independent contractor issue and there was no assessment of employment tax with respect to individuals performing services substantially similar to those reviewed in the audit.
There is a long-standing, recognized practice of treating similar workers as independent contractors in the business in which the contractors operated.

The hospitality firm can follow several practical steps to minimize the chances of having workers classified as employees:

- The most important step is to have never treated the worker as an employee in the past.
- There should be a written document in which the parties specifically agree that the worker is to be an independent contractor and not an employee.
- Form 1099s should be issued to report the income of independent contractors to the IRS.
- Employees presently do not do a similar type of work that they have done in the past.
- There should be a definite ending term to the work without unlimited renewal.
- The company should not exert excessive control over the individual as enumerated in the 20 common law tests.

The IRS is cracking down on firms that incorrectly classify workers as independent contractors. The stakes are high because the employer can be liable for income tax withholding and Social Security taxes of the employee without any right to recover these taxes from the employees. In addition to collecting the taxes, the IRS is likely to impose severe penalties on the firm for failing to file payroll tax returns and failure to make timely deposits. Interest will also be charged on the penalties and past due taxes.

It does not matter what you label the worker. The IRS will apply the control test to determine the status of the workers in question. The IRS will provide a hospitality firm with Form SS-8 which contains a questionnaire on the 20-item control test. It is a good idea to use this form and to review your independent contractor status before the IRS does.

References

1Rev. Rul. 87-41, 1987-1 CB 296.

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