

SPECIAL REPORT

TESTS TO DETERMINE INDEPENDENT CONTRACTOR STATUS

(12-18-2014)

This Special Report was written by Kenneth R. Hale, J.D., CPCU, AAI, LIC of Marsh & McLennan Agency LLC. Mr. Ken Hale can be contacted at 734-525-2412 or khale@mma-mi.com. More Special Reports are available at www.mma-mi.com.

A. Under the Michigan Workers' Compensation Act, a person is an employee rather than an independent contractor if the person:

1. does not maintain a separate business;
2. does not hold him or herself out to and render service to the public; or
3. is not an employer subject to the Workers' Compensation Act.

If the worker fails any one of these tests, that person will be excluded from employment status and will be treated as an independent contractor.

B. Under the Michigan No-Fault Auto Statute the courts have held:

“An independent contractor is one who, carrying on an independent business, contracts to do work without being subject to the right of control by the employer as to the method of work but only as to the result to be accomplished.”

“To be an employee, there must be an actual employment relationship. We apply the economic reality test to determine whether an employment relationship exists under the No-Fault Act.”

“The economic-reality test considers four basic factors:

1. control of a worker's duties;
2. payment of wages;
3. right to hire, fire, and discipline; and

4. performance of the duties as an integral part of the employer's business toward the accomplishment of a common goal.”

“However, this list of factors is non-exclusive. Other relevant factors to consider include:

1. whether the individual furnishes his own equipment;
2. whether the individual holds himself out to be public for hire; and
3. whether independent contractors customarily perform the undertaking.”

“Weight should be given to those factors that most favorably effectuate the objectives of the statute in question.”

“For example, we have noted that, in commercial situations, it was the Legislature's intent to place the burden of providing no-fault benefits on the insurers of those motor vehicles, such as those vehicles owned by or registered to an employer.”

C. Under the Federal law for Federal Tax purposes the IRS in its publication indicates:

1. WORKER CLASSIFICATION RULES

In General

Significant tax consequences result from the classification of a worker as an employee or independent contractor. These consequences relate to withholding and employment tax requirements, as well as the ability to exclude certain types of compensation from income or take tax deductions for certain expenses.

Some consequences favor employee status, while others favor independent status. For example, an employee may exclude from gross income employer-provided benefits such as pension, health, and group-term life insurance benefits.

On the other hand, an independent contractor can establish his or her own pension plan and deduct contributions to the plan. An independent contractor also has greater ability to deduct work-related expenses.

Under present law, the determination of whether a worker is an employee or an independent contractor is generally made under a facts and circumstances test that seeks to determine whether the worker is subject to the control of the service recipient, not only as to the nature of the work performed, but the circumstances under which it is performed.

Under a special safe harbor rule (sec. 530 of the Revenue Act of 1978), a service recipient may treat a worker as an independent contractor for employment tax purposes even though the worker is in fact an employee if the service recipient has a reasonable basis for treating the worker as an independent contractor and certain other requirements are met.

In some cases, the treatment of a worker as an employee or independent contractor is specified by statute.

Significant tax consequences also result if a worker was misclassified and is subsequently reclassified, e.g., as a result of an audit. For the service recipient, such consequences may include liability for withholding taxes for a number of years, interest and penalties, and potential disqualification of employee benefit plans. For the worker, such consequences may include liability for self-employment taxes and denial of certain business-related deductions.

Common-law Test

In general, the determination of whether an employer-employee relationship exists for Federal tax purposes is made under a common-law test that has been incorporated into specific provisions of the Internal Revenue Code (the “Code”) or that is required to be used pursuant to Treasury regulations or case law.

For example, section 3121(d)(2)¹ (which defines terms for purposes of the Social Security taxes that apply to wages paid to an employee) generally defines the term “employee” to include any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.

¹ Except as otherwise indicated, all references to sections are to sections of the Code.

By contrast, section 3401 (which defines terms for purposes of an employer's Federal income tax withholding obligation with respect to wages paid to an employee) does not define the term "employee." However, regulations issued under section 3401 incorporate the common-law test.

The regulations provide that an employer-employee relationship generally exists if the person contracting for services has the right to control not only the result of the services, but also the means by which that result is accomplished.

In other words, an employer-employee relationship generally exists if the person providing the services "is subject to the will and control of the employer not only as to what shall be done but how it shall be done."²

Under the regulations, it is not necessary that the employer actually control the manner in which the services are performed, rather it is sufficient that the employer have a right to control³ Whether the requisite control exists is determined based on all the relevant facts and circumstances.

Over the years, courts have identified on a case-by-case basis various facts or factors that are relevant in determining whether an employer-employee relationship exists.

In 1987, based on an examination of cases and rulings, the Internal Revenue Service ("IRS") developed a list of 20 factors that may be examined in determining whether an employer-employee relationship exists.⁴

The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed; factors other than the listed 20 factors may also be relevant.

The 20 factors identified by the IRS are as follows:

1. Instructions: If the person for whom the services are performed as the right to require compliance with instructions, this indicates employee status.

² Treas. Reg. sec. 31.3401(c)-(1)(b).

³ *Id.* See also, *Gierek v. Commissioner*, 66 T.C.M. 1866 (1993) (involving the classification of a stockbroker and stating that the key inquiry is whether the brokerage firm had a right to control the worker regardless of the extent to which such control was actually exercised). See also, IRS Publication 1779 (Rev. 1-2005).

⁴ Rev. Rul. 87-41, 1987-1 C.B. 296 (providing guidance with respect to section 530 of the Revenue Act of 1978).

2. Training: Worker training (e.g., by requiring attendance at training sessions) indicates that the person for whom services are performed want the services performed in a particular manner (which indicates employee status).
3. Integration: Integration of the worker's services into the business operations of the person for whom services are performed is an indication of employee status.
4. Services rendered personally: If the services are required to be performed personally, this is an indication that the person for whom services are performed is interested in the methods used to accomplish the work (which indicates employee status).
5. Hiring, supervision, and paying assistants: If the person for whom services are performed hires, supervises or pays assistants, this generally indicates employee status. However, if the worker hires and supervises others under a contract pursuant to which the worker agrees to provide material and labor and is only responsible for the result, this indicates independent contractor status.
6. Continuing relationship: A continuing relationship between the worker and the person for whom the services are performed indicates employee status.
7. Set hours of work: The establishment of set hours for the worker indicates employee status.
8. Full time required: If the worker must devote substantially full time to the business of the person for whom services are performed, this indicates employee status. An independent contractor is free to work when and for whom he or she chooses.
9. Doing work on employer's premises: If the work is performed on the premises of the person for whom the services are performed, this indicates employee status, especially if the work could be done elsewhere.

10. Order or sequence test: If a worker must perform services in the order or sequence set by the person for whom services are performed, that shows the worker is not free to follow his or her own pattern of work, and indicates employee status.
11. Oral or written reports: A requirement that the worker submit regular reports indicates employee status.
12. Payment by the hour, week, or month: Payment by the hour, week, or month generally points to employment status; payment by the job or a commission indicates independent contractor status.
13. Payment of business and/or traveling expenses: If the person for whom the services are performed pays expenses, this indicates employee status. An employer, to control expenses, generally retains the right to direct the worker.
14. Furnishing tools and materials: The provision of significant tools and materials to the worker indicates employee status.
15. Significant investment: Investment in facilities used by the worker indicates independent contractor status.
16. Realization of profit or loss: A worker who can realize a profit or suffer a loss as a result of the services (in addition to profit or loss ordinarily realized by employees) is generally an independent contractor.
17. Working for more than one firm at a time: If a worker performs more than the minimal services for multiple firms at the same time, that generally indicates independent contractor status.
18. Making service available to the general public: If a worker makes his or her services available to the public on a regular and consistent basis, that indicates independent contractor status.
19. Right to discharge: The right to discharge a worker is a factor indicating that the worker is an employee.

20. Right to terminate: If a worker has the right to terminate the relationship with the person for whom services are performed at any time he or she wishes without incurring liability, that indicates employee status.

More recently, the IRS has identified three categories of evidence that may be relevant in determining whether the requisite control exists under the common-law test and has grouped illustrative factors under these three categories:

1. behavioral control;
2. financial control; and
3. relationship of the parties.

The IRS emphasizes that factors in addition to the 20 factors identified in 1987 may be relevant, that the weight of the factors may vary based on the circumstances, that relevant factors may change over time, and that all facts must be examined.

Generally, individuals who follow an independent trade, business, or profession in which they offer services to the public are not employees. Courts have recognized that a highly educated or skilled worker does not require close supervision; therefore, the degree of day-to-day control over the worker's performance of services is not particularly helpful in determining the worker's status.

Courts have considered other factors in these cases, tending to focus on the individual's ability to realize a profit or suffer a loss as evidenced by business investments and expenses.

This document is not intended to be taken as advice regarding any individual situation and should not be relied upon as such. Marsh & McLennan Agency LLC shall have no obligation to update this publication and shall have no liability to you or any other party arising out of this publication or any matter contained herein. Any statements concerning actuarial, tax, accounting or legal matters are based solely on our experience as consultants and are not to be relied upon as actuarial, accounting, tax or legal advice, for which you should consult your own professional advisors. Any modeling analytics or projections are subject to inherent uncertainty and the analysis could be materially affective if any underlying assumptions, conditions, information or factors are inaccurate or incomplete or should change.