

Employee or Independent Contractor?

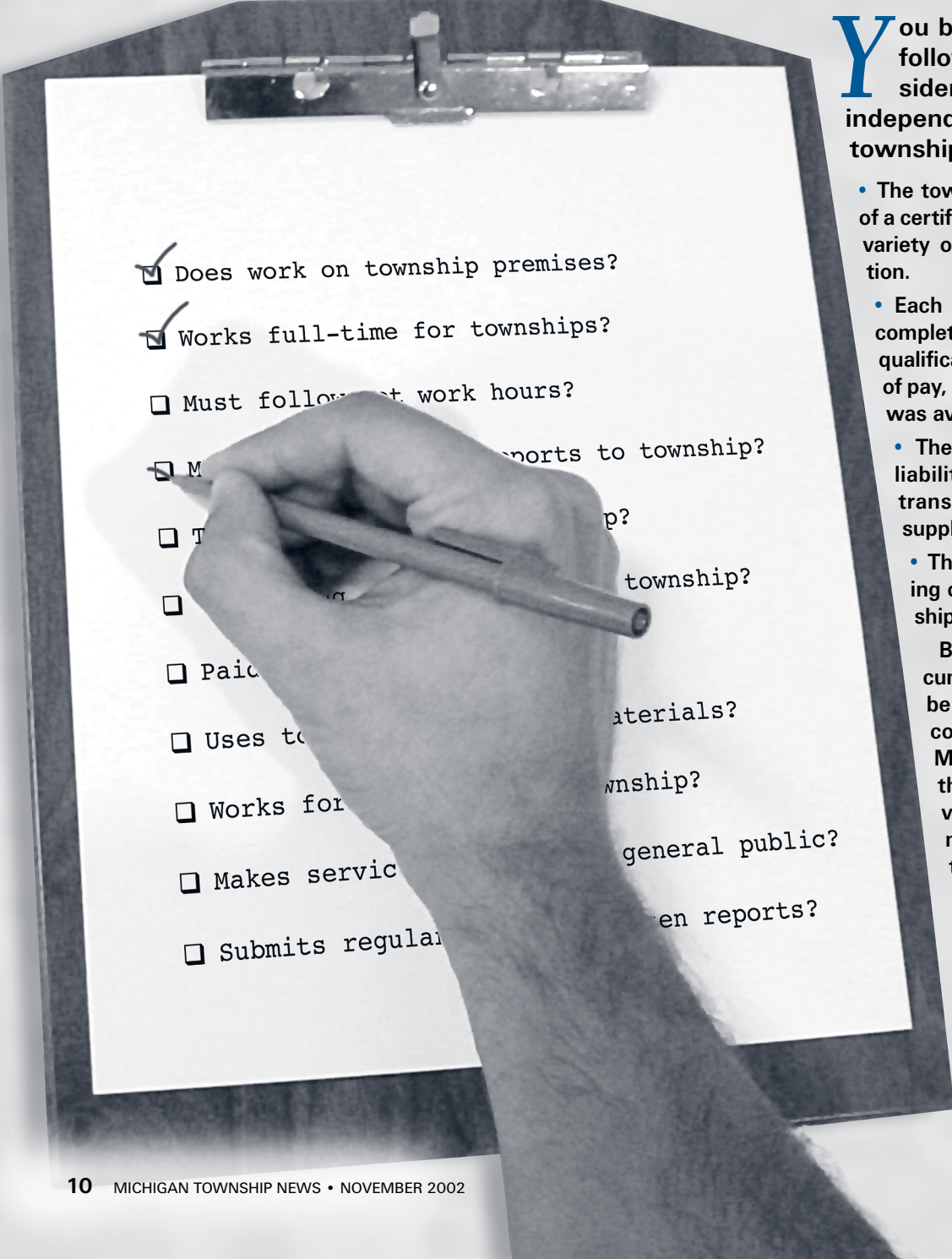
Determining the Difference

By Patrick Hanes, Attorney,
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You be the judge. Would the following assessor be considered an employee or an independent contractor by the township?

- The township obtained the services of a certified assessor who works for a variety of clients through a corporation.
- Each applicant to the corporation completed a card listing his or her qualifications, requested hourly rate of pay, and days and hours he or she was available for work.
- The assessor provides his own liability insurance and his own transportation, equipment and supplies.
- The assessor receives no training or instruction from the township.

Based on the described circumstances, this person should be considered an independent contractor by the township. MCL 41.61 gives townships the right to contract with private assessment firms, and many townships do just that—hire seasonal or part-time workers, or skilled workers for specific projects. One question often arises: when is a worker considered a township employee, and when are they considered an independent contractor?

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- Does work on township premises?
 - Works full-time for townships?
 - Must follow set work hours?
 - Must submit reports to township?
 - Transportation provided by township?
 - Provides own transportation to township?
 - Paid by township?
 - Uses township materials?
 - Works for township?
 - Makes services available to general public?
 - Submits regular reports?

Employee Classification

According to Section 104.6 of the IRS Tax Professional's Corner Handbook, the term "employee" includes any individual who, under the usual common law rules for determining the employer/employee relationship, has the status of an employee. With certain exceptions, the imposition of employment taxes—FICA, FUTA and income tax withholding—always involves the employer/employee relationship issue and requires the application of the common law rules to the specific facts and circumstances of each employer. This is the basis for determining the employment status of an individual worker or a group of workers.

In the most general of terms, under the common law, a worker is an employee when the person for whom the services are performed has the right to control and direct the individual who performs the services. This control reaches not only the result to be accomplished, but also the details and means by which that result is to be accomplished. In other words, an employee is subject to the will and control of the employer not only as to specific duties, but how those duties are accomplished.

It is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if the employer has the right to do so. Note also that the courts have held that the degree of supervision necessary to demonstrate control is only "such supervision as the nature of the work requires."

Why is Employee Classification Important?

Tens of thousands of workers are reclassified each year from independent contractor status to employees by the IRS. At one point in the early 1990s, the IRS estimated that misclassification costs the government approximately \$1.56 billion in taxes annually. In the late 1990s, reclassification of employees resulted in more than \$100 million of additional taxes and penalties to the IRS.

With penalties of 100 percent of the tax liability assessed by the IRS, the cost of misclassifying a worker can be catastrophic and therefore requires the prudent employer to take all reasonable steps to avoid reclassification. But taxes and penalties may only be the tip of the iceberg. Misclassification of workers can result in employee benefit problems as well as a myriad of issues relative to compliance, workers' compensation and unemployment insurance.

If a township misclassifies an employee as an independent contractor, the mistake can be costly. The township could be hit with both the employer's and employee's portion of FICA, federal and state employment taxes, and may have to pay the employee's federal and state income tax, which should have been withheld from his or her pay. If an employer fails to deduct and withhold the correct amount from an employee's wage because the employee was not treated as an employee, the employer is liable for 1.5 percent of wages paid to the employee, and 20 percent of the FICA taxes.

There are also a variety of statutes that require townships, as employers, to fulfill obligations on behalf of their employees. If a township uses an independent contractor, the following obligations are some of the responsibilities of the independent contractor, *not* the township:

- **Fair Labor Standards Act**—requires employers to pay nonexempt employees the minimum wage and overtime compensation.
- **Michigan Employment Security Act**—requires employers to make tax contributions to a trust fund from which employees receive benefits when they are involuntarily unemployed.
- **The Elliott-Larsen Civil Rights Act**—prohibits employers from discriminating against employees on the basis of age, race, sex, etc.
- **The Workers' Disability Compensation Act**—requires employers to provide workers' compensation insurance for employees.

Other statutes that affect employers are: the Age Discrimination in Employment Act; National Labor Relations Act; Employee Retirement Income Security Act; Family and Medical Leave Act, and Work Adjustment and Retraining Notification Act.

Determining the Difference

There are numerous tests a township can use to determine if a worker is an independent contractor or an employee. The "economic reality" test looks at the totality of the circumstances surrounding the relationship between the parties. Under the economic reality test, the following factors are used to determine if an individual is an employee or an independent contractor:

- What liability, if any, does the township incur if the individual is terminated at-will?
- Is the work being performed an integral part of the township's business, which contributes to the accomplishment of a common objective?
- Is the position or job of such a nature that the individual primarily depends on the income of the township for payment of living expenses?
- Does the individual furnish his or her own equipment and materials?
- Does the individual hold himself/herself out to the public as one ready and able to perform tasks of a given nature?
- Is the work or undertaking in question customarily performed by an independent contractor?
- Does the township have the right to control the means by which the individual achieves the end result?

The Michigan Supreme Court recently determined that the economic reality test is not a matter of terminology, oral or written, but of the realities of the work performed. The court said that control is a factor, as is payment of wages, hiring and firing, and the responsibility for the maintenance of discipline, but the test of economic reality views these elements as a whole, assigning primacy to no single one.

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As if this is not confusing enough, there is also the question of independent contractor status for tort purposes, such as personal injury and wrongful conduct claims. The *Kidder vs. Miller Davis* court case discussed the control theory as being the traditional common-law test used to delineate the master-servant relationship. If one is examining the responsibility of an employer for the acts of its worker, the courts will look at the control test being whether the employer has the right to control the actions of the worker. If not, the employer is typically not responsible for the acts of the worker since the worker is an independent contractor.

Taking the 20-point Test

The IRS has developed a 20-point checklist to assist an employer in determining whether a worker is an employee or an independent contractor. The list is only a guide, and the importance of each factor depends on the facts and circumstances of a particular case.

1. Instructions. A worker who is required to comply with another person's instructions about when, where, and how he or she is to work is ordinarily an employee.

2. Training. Training a worker indicates that the person(s) for whom the services are performed want the services performed in a particular method or manner.

3. Integration. Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control.

4. Services rendered personally. If the services must be rendered personally, presumably the person(s) for whom the services are performed are interested in the methods used to accomplish the work as well as the results.

5. Hiring, supervising and paying assistants. If the person(s) for whom the services are performed hire, supervise and pay assistants, that factor generally shows control over the workers. However, if one worker hires, supervises and pays the other assistants pursuant to a

A worker is an employee when the person for whom the services are performed has the right to control and direct the individual who performs the services.

contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor status.

6. Continuing relationship. A continuing relationship between the worker and the person(s) for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring, although irregular, intervals.

7. Set hours of work.

The establishment of set hours of work by the person(s) for whom the services are performed is a factor indicating control.

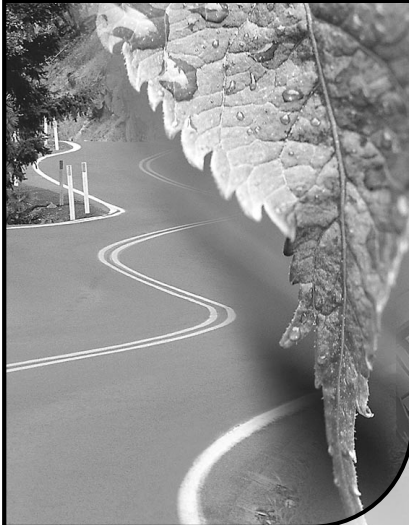
8. Full time required.

If the worker must devote substantially full time to the business of the person(s) for whom the services are performed, such person(s) have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor, on the other hand, 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(s) for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere. Work done off the premises of the person(s) receiving the services, such as at the office of the worker, indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee.

10. Order or sequence set. If a worker must perform services in the order or sequence set by the person(s) for whom this services are performed, this factor shows that the worker is not free to follow his or her own pattern of work but must follow the established routines and schedules of the person(s) for whom the services are performed.

11. Oral or written reports. A requirement that the worker submit regular or written reports to the person(s) for whom the services are performed indicates a degree of control.



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12. Payment by hour, week, month. Payment by the hour, week or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor.

13. Payment of business and/or traveling expenses. If the person(s) for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities.

14. Furnishing of tools and materials. The fact that the person(s) for whom the services are performed furnish significant tools, materials and other equipment tends to show the existence of an employer-employee relationship.

15. Significant investment. If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (i.e. a rented office), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person(s) for whom the services are performed for such facilities and, accordingly, the existence of an employer-employee relationship.

16. Realization of profit or loss. A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but the worker who cannot is an employee.

For example, if the worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates the worker is an independent contractor. The risk that a worker will not receive payment for his or her services,

however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.

17. Working for more than one firm at a time. If a worker performs more than *de minimis* services for a multiple of unrelated persons or firms at the same time, this factor generally indicates that the worker is an independent contractor. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.

18. Making service available to general public. The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship.

19. Right to discharge. The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications.

20. Right to terminate. If the worker has the right to end his or her relationship with the person(s) for whom the services are performed at any time he or she wishes without incurring liability,

that factor indicates an employer-employee relationship.

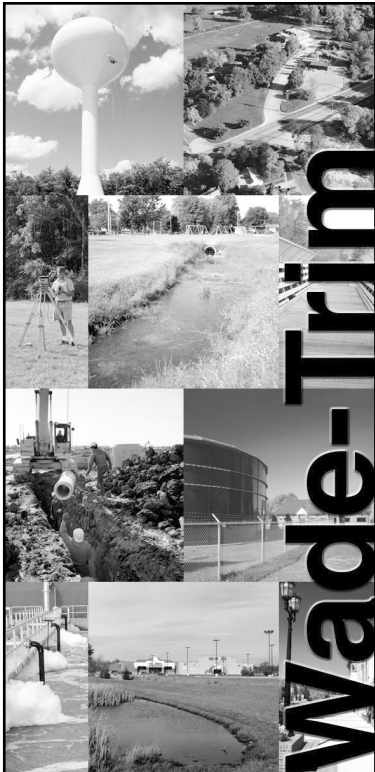
Each case is decided on its own individual facts, and there is no hard and fast rule as to how many of the 20 points it takes to have a worker be deemed an employee. In some cases, it may be as few as one point, and others may require six or seven. And, of course, many of these 20 points do not apply to all work situations.

Sailing the Safe Harbor

There is also a concept in the law called a "safe harbor" provision, which provides employers with some protection in certain situations. The safe harbor only applies to income tax liability.

According to Section 530 of the Revenue Act of 1978, to qualify for "safe harbor" from liability, the following conditions must be met:

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- The taxpayer does not treat the worker as an employee for any time period.
- All of the employer's federal tax returns must have consistently treated the worker as an independent contractor.
- The employer must not have treated any individual holding a substantially similar position as an employee after 1977.
- The employer must demonstrate a "reasonable basis" for treating the worker as an independent contractor. Reasonable basis includes judicial precedent, published ruling, technical advice or letter ruling; a past IRS audit of the employer in which no employment tax on substantially similar workers was assessed, or long-standing recognized practice of a significant segment of the industry in question.
- The taxpayer must have filed a Form 1099 for the worker in question.

Interestingly enough, when Congress enacted the safe harbor provisions, the

IRS was specifically barred from issuing any regulations or revenue rulings pertaining to worker classification.

Taking Care of Business

Although the use of independent contractors can be very beneficial to a township, an incredible amount of care must be used in making the determination that a worker is an independent contractor. Some tips for helping to strengthen the position of correctly classifying a worker as an independent contractor are:

- Use a written contract
- Require worker to have a federal ID number (not a social security number)
- Worker must have liability and workers' compensation insurance
- Keep a copy of the worker's business card
- Keep a copy of the worker's assumed name certificate
- Keep a copy of worker's advertisements

- Keep a list of worker's assistants
- Don't pay on an hourly, daily or weekly basis
- Don't set hours or order of work

By doing your homework, you can ensure correct employee classification and a proper working relationship with all township workers. ■

Portions of this article were excerpted from "Employee vs. Independent Contractor—Be Careful Out There," presented by Steve Schultz, attorney, Foster, Swift, Collins & Smith, P.C., Lansing.



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Sample Agreement Between Township & Independent Contractor

Note: This simple form is for illustrative purposes only. It has not been prepared with any specific factual situation in mind, and it may not be suitable for your use. No warranty is made as to its fitness for any particular purpose or use. No other warranty is given or implied.

WHEREAS, _____ ("the Township") intends to contract with _____ (independent contractor—"IC") for the performance of certain tasks;

WHEREAS, IC's principal place of business is located at the following address:
_____.

WHEREAS, the Township's office is located at the following address:
_____.

WHEREAS, IC declares that IC is engaged in an independent business and has complied with all federal, state and local laws regarding business permits and licenses of any kind that may be required to carry out the said business and the tasks to be performed under this agreement;

WHEREAS, IC declares that IC is engaged in the same or similar activities for other townships and that the Township is not IC's sole and only client or customer.

THEREFORE, IN CONSIDERATION OF THE FOREGOING REPRESENTATIONS AND THE FOLLOWING TERMS AND CONDITIONS, THE PARTIES AGREE:

1. SERVICES TO BE PERFORMED. The Township engages IC to perform the following tasks or services: _____

2. TERMS OF PAYMENT. The Township shall pay IC according to the following terms and conditions [set forth here commission or fee arrangement, and the time for payment, etc.]: _____

3. INSTRUMENTALITIES. IC shall supply all equipment, tools, materials and supplies to accomplish the designated tasks except as follows: _____

4. GENERAL SUPERVISION. IC retains the sole right to control or direct the manner in which the services described herein are to be performed. Subject to the foregoing, the Township retains the right to inspect, to stop work, to prescribe alterations and generally to supervise the work to insure its conformity with that specified herein.

5. NO PAYROLL OR EMPLOYMENT TAXES. No payroll or employment taxes of any kind shall be withheld or paid with respect to payments to IC. The payroll or employment taxes that are the subject of this paragraph include but are not limited to FICA, federal personal income tax, state personal income tax, state disability insurance tax, and state unemployment insurance tax.

6. NO WORKERS' COMPENSATION. No workers' compensation insurance has been or will be obtained by the Township on account of IC or IC's employees.

7. TERMINATION. This agreement shall end on _____ and may not be terminated earlier (except for cause) without _____ days prior written notice from one party to the other.

AGREED to this day _____ of _____, 20____, at _____, State of Michigan.

TOWNSHIP:
By: _____
[Name and Title]

INDEPENDENT CONTRACTOR:
By: _____
[Name and Title]