Independent Contractors and Unemployment Tax Issues

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Internet Resources

- TWC Tax Department home page:  
  http://www.twc.state.tx.us/customers/bemp/bempsub3.html
- TWC Tax Manuals online:  
  http://www.twc.state.tx.us/ui/tax/manuals/taxmanuals.html
- Rule 13 information:  
  http://www.twc.state.tx.us/ui/sphrgs/commrule13.html
- Detailed paper:  
  www.twc.state.tx.us/news/efte/ics_contract_labor.html
Why is IC Status Important?

• Most employment laws apply only to employees, not to independent contractors
  Title VII         ADA         ADEA
  FLSA             Texas Payday Law

• However, some laws apply even to ICs, e.g.,
• Payroll taxes do not apply to ICs!
Classify Workers Correctly

- Law presumes that a worker is an employee
- Burden is on the employer to prove otherwise
- Back taxes, interest, and penalties can result from misclassification of workers
- “Contract labor” usually means temporary staff obtained from a temporary staffing firm, or workers supplied by a labor agent
- Reality: Independent contractors exist, but all the legal presumptions are against employers who want to classify workers as such
Independent Contractors – Main Ideas

• An independent contractor is effectively a self-employed independent business entity who is in a position to make a profit or loss based upon how he or she manages their own independent enterprise while fulfilling the contract.
Different Tests for Different Laws

- TWC: direction and control test
- IRS: eleven-factor test based on behavioral / financial control and type of relationship
- DOL / SSA: economic reality test
- Other states: “ABC” test
- Common threads and most important factors are direction and control, profit / loss, and integration of services
TWC Test

• TWC uses the common law “direction and control” test
• all work and services are presumed to be in “employment”, unless the employer proves that the work is free from the employer’s direction and control, both under the contract of hire and in fact
• TWC’s 20-factor test is adapted from the old IRS 20-factor test: http://www.texasworkforce.org/ui/tax/forms/c8.pdf
DOL and SSA use what is known as the “economic realities” test:

1. the degree of control exercised by the alleged employer;
2. the extent of the relative investments of the alleged employee and employer;
3. the degree to which the employee's opportunity for profit and loss is determined by the "employer";
4. the skill and initiative required in performing the job; and
5. the permanency of the relationship.
the focus is on “whether the employees as a matter of economic reality are dependent upon the business to which they render service”

an employee is economically dependent upon the job for a livelihood

IC is not dependent upon any one employer, but rather has a customer base to fall back upon
“ABC” Test

About two-thirds of other states use the so-called "ABC" test, which has the following factors:

A. The worker is free from control or direction in the performance of the work.
B. The work is done outside the usual course of the company's business and may be done off the premises of the business.
C. The worker is customarily engaged in an independent trade, occupation, profession, or business.

This test is not very different from the DOL's “economic realities” test.
IRS Tests

• IRS formerly used the “Twenty Factors” test
• New eleven-factor test – three categories:
  – behavioral control
  – financial control
  – type of relationship between parties
• Six of one, half a dozen of the other
Behavioral Control

Facts that show whether the business has a right to direct and control the worker include the type and degree of:

- Instructions the business gives the worker
  - 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

- Training the business gives the worker
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
• The extent of the worker's investment
• The extent to which the worker makes services available to the relevant market
• How the business pays the worker
• The extent to which the worker can realize 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
- The permanency of the relationship
- The extent to which services performed by the worker are a key aspect of the regular business of the company
Records for an Audit

- All cancelled checks
- Time cards
- Cash vouchers
- Cash disbursement journal
- Petty cash
- Individual earnings records
- Check register
- Payroll journal
- TWC tax reports
- IRS Forms 940, W-3, and W-2
- General ledger
- IRS Forms 1099, 1096, W-9
- Master vendor files
- Chart of accounts
- Profit and loss statement
- Corporate minutes
- Corporate charter
- Federal tax return (1040, 1120, 1120S, etc...)
- Any other records that may reflect services
What It Boils Down To

- Employer seeks the contractor out, not vice versa
- Employer has to negotiate terms with the contractor
- Training is not an issue – contractors are experts and should not need training
- Employer is buying a finished project or completed service
- Integration of services = presumption of control
- Non-competition agreement → no
- Non-solicitation agreement → maybe
- Non-disclosure agreement → usually OK, but be careful
Seeking Agency Input

• In a questionable situation, before anyone is hired, ask TWC or IRS for advice
• Usually, they’ll give informal opinions if you are ♥ nice ♫ to them
• Agencies will give letter rulings in selected cases, but only after the worker is hired
• Forms to request rulings: C-12 for TWC; SS-8 for IRS
How Audits Get Started

- Unemployment claim – TWC finds no wages reported and disallows the claim – claimant appeals – this is the highest priority Tax Department investigation – TWC may end up notifying IRS
- “Tattle-tale” letter from employees or competitors
- Random audit – 1% of all employers each year
- Stratified or program audit – targeted industries or regions – example: hair salon industry in the late 1980s; landscape and construction firms in past decade
Dealing with Audits

• Don’t panic!
• Read the audit notice carefully
• Organize your records – get them all located and ready to show
• Determine who can speak for the employer
• If there’s a time conflict, notify agency immediately and get it rescheduled
• Call 1-800-832-9394 (TWC help line for employers)
• Consider hiring legal counsel with appropriate expertise if the case is more involved
• File appeal under Rule 13 (40 TAC § 815.113)
During the audit itself:

- Answer only the questions asked
- Show only the documentation requested
- Do not initiate “chatting”
- Do not volunteer information that has not been requested
- Practice the four "Cs": comply with requests, be calm and civil, and control any urges to do the examiner's job
Red Flags

- Terms such as “1099 employees” or “contract labor”
- Having contractors fill out job applications
- Having contractors wear company badges or uniforms, or carry company business cards, indicating their affiliation with the company
- Giving contractors a company e-mail address
- Inviting contractors to company parties and other events using the same invitation that goes to regular employees
- Giving contractors company benefits or wage advances
- Having contractors sign company policy handbooks
- Non-competition agreements
Do You Have These To Show?

- Contractors’ business cards
- Contractors’ invoices to your company on their own stationery
- Copies or printouts of any advertisements or website pages they use for their own businesses
- Written contracts for provision of services or performance of a project
- E-mails, letters, or other documentation relating to negotiating the parameters of the work
Rule 13 Case Study - Bookkeeper

- Hourly rate of pay
- Worked continuously for two years
- Full-time hours at company offices
- Did not work for other companies
- Used company equipment
- Kept track of the company’s accounts
- No out-of-pocket expenses
- Supervised by company managers
- Could quit or be fired without liability
• **Decision:** the bookkeeper was in employment. Main reasons:
  • Her work was directly integrated into the company’s operations
  • She had no potential for profit or loss
  • She did not conduct herself in any way as an independent business entity
Case Study – Outside CPA

- Hourly rate of pay specified by the CPA herself
- Written contract called for monthly audits of the company’s books
- Scheduled her work at her own office or at company offices
- Had several other clients
- Used her own equipment
- Company did not train or supervise her
- Paid her own expenses (license, CPE, office costs)
- Sent monthly invoices
- Contractual liability for premature end of an audit
Case Study – Outside CPA - cont…

• **Decision:** the outside CPA was not in employment. Main reasons:
  • Her work was not directly integrated into the company’s operations
  • She was a licensed outside professional
  • She had a real potential for profit or loss
  • She had her own client base, just like any real business would
  • She conducted herself as an independent business entity
Typical Rule 13 Decisions

Employees:
- Any clerical staff
- Temporary staff
- Drivers of company vehicles / equipment
- Sales staff
- General laborers
- Helpers of all types
- Nurses and medical aides
- Caregivers

Independent contractors:
- Outside professionals
- Owner-operator truck drivers
- Business owners with their own clients and paid helpers
Independent Contractor Court Case

- Nurse staffing company – providers/nurses were treated as independent contractors
- Their work was directly integrated into the only service provided by the employer → presumption of control
- Also, they could not delegate the work, and they had no investment in a business beyond their own time
- Court held that direction and control can be delegated by a staffing company / registry to its clients
- Court even agreed with TWC that the staffing company was a “temporary help firm”
Avoiding Other Problems

• Report wages and pay all taxes on time – deadlines can be extended for good cause shown (Rules 815.107(b)(3) and 815.109(f)) – set up a payment plan if necessary

• Section 204.083 – mandatory transfer of compensation experience in case of shared ownership or management between the predecessor and successor

• Section 204.084 - 204.085 – partial transfer of compensation experience is possible (one-year deadline – Rule 815.111)

• Section 204.086 – successor entity is liable for the UI tax debt of its predecessor

• Section 205.002 – reimbursing ER election must be timely and is effective for two years
Thanks!

Thanks for your attendance and Good Luck!

Remember the toll-free hotline for employers:
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