

**SECTION 1:
THE EMPLOYER-EMPLOYEE
RELATIONSHIP**



**THE EMPLOYER – EMPLOYEE
RELATIONSHIP**

- Employee vs. Independent Contractor
- Employer's Obligation
- Penalties For Misclassification



1.1 Importance of the Determination

Obligations of Employer – Must withhold...

- Federal Withholding Tax (FIT)
- Employee and Employer Social Security Tax
- Employee and Employer Medicare Tax
- Federal Unemployment Tax (FUTA)
- State Unemployment Tax (SUTA)
- Possible state withholding (SIT)
- Possible disability withholding (SDI)
- Company provided benefits



1.2 Employee vs Independent Contractor

Independent Contractor: Less Expensive

- Provides employer with a TIN (Taxpayer ID Number)
- Employer provides 1099 MISC at year end for services rendered (if the total is greater than \$600)
- **NO:**
 - Employee and Employer Social Security Tax
 - Employee and Employer Medicare Tax
 - Federal or State taxes, including unemployment and workers compensation
 - Cost for providing or administering employee benefits



1.2 Continued...

CAUTION!

New hire reporting requirements
have been expanded in several states
to include independent contractors.

If states require new hire reporting on IDC's then the accounts
payable department must be notified to ensure compliance.



1.2-1 Common Law Test

Right To Control Is Key

- Does the employer have the right to control what work
will be done and how that work will be done?
 - Yes - Employer – Employee Relationship exists and they are
a common law employee
 - No - Independent Contractor



1.2-1 Continued...

IT IS NOT THAT EASY...

- Does the employer have to exercise the "right to control" on a regular basis? – NO still an employee
- What happens when the individual is subject to control or direction of another only for the outcome and not for details of results? - IDC



Key Factors for indicating degree of control are:

Behavioral Control:

Right to direct and control the details and means by which the worker performs the work to be done

- Level of instructions the business gives the worker
- Level of training provided to the worker



Key Factors continued...

Financial Control:

Factors to consider when determining whether the business has the right to direct & control the economic aspects of the workers job:

- Unreimbursed Business Expenses – IDC's have more
- Substantial Investment – IDC's have more
- Services Available to the public? IDC offer this
- How is the worker paid? EE by hour/week and IDC by job
- Profit or Loss? Will the worker realize a profit or loss



Key Factors continued...

Type of Relationship:

Right to direct & control the manner and means of the workers activities

- Is there a written agreement? Helps determine the relationship.
- Are employee-type benefits provided? Vac, Sick etc.. EE
- Term of relationship? Continued ..EE or by time frame..IDC
- Are the worker's services an important aspect of the business's regular operations? If yes then EE



Key Factors continued...

IRS has deemed several factors unimportant in making a decision...

- Non essential factors include, part-time or full-time work, location and hours of work.
- Managers are employees too.
- Members of a Board of Director's are not considered employees for the work they perform as a director. (Voluntary, not compensated)
- Length of employment makes no difference.



Employee and Independent Contractor ?????

Can you have someone who is an independent contractor and employee at the same time?

YES

Each job performed by the by the individual will be examined separately.



1.2-2 Reasonable Basis Test

A worker may meet requirements under the common law test, but still be treated as independent contractor if...

■ REASONABLE BASIS: (determined by Section 530 (safe harbor) of the Revenue Act of 1978) May consist of one or more of the following:

- Court Decision, Published IRS Ruling, IRS Technical Advice, Private Letter ruling from IRS indicating worker is not an employee
- Past IRS Audit
- Longstanding recognized practice in significant segment of the employer's industry treating workers in similar situations as independent contractors



Section 530 Safe Harbor

Consistent treatment is a must!

- §530 Safe Harbor – must be consistent by the employer and the predecessor since 1978.
- You pass the reasonable basis test – clarified by Small Business Job Protection Act of 1996
- You treated the workers AND any similar workers as independent contractors.
- You filed 1099 MISC for each worker that earned at least \$600. §530 workers pay own Social Security and Medicare but not employer's share.



1.2-2 Continued...

Excluded from Reasonable Basis Test:

- Technical Services specialists working under a "three-party" arrangement involving worker, technical services firm & the firms client
 - Status is determined under the Common Law Test
- IRS role is strictly limited by law.



Pension Protection Act of 2006:

Pension Protection Act of 2006:

- Tax-exempt organizations may treat exam proctors as independent contractors under §530 beginning in 2007, if they are not common law employees.



Form SS-8

Form SS-8: Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding:

- Employer gets a definitive ruling as to the newly hired workers status
- Can take several weeks to 6 months
- While awaiting IRS ruling, employer should treat the worker as an employee (i.e. withholding all taxes) to help avoid penalties and interest.
- If ruled an independent contractor, NO refund of ANY employment taxes paid.



Form SS-8 continued...

- IRS answers to employers questions, phone forum in May, 2009.
 - www.americanpayroll.org/members/Forms-Pubs/
- Advice for reclassified employees
 - www.irs.gov/irs-pdf/n989.pdf
- Disputes can be heard by Tax Court
 - Must be an IRS Notice of Determination, employer is the only party that can seek a review by the Tax Court
 - The Court can decide amount of taxes, penalties due to misclassification of employees.



1.3 Employment Status Determined by Law

- Status of some employees determined by law, specifically by the Internal Revenue Code
 - Regardless of classification under the Common Law or Reasonable Basis Test
- Workers who would be considered independent contractors under one of the tests are statutory employees for certain purposes and workers who would be considered employees under these tests are treated as statutory nonemployees.



1.3-1 Statutory Employees

Workers that are not employees under common law but treated as employees for certain tax purposes

- Not subject to FIT withholding
- Are subject to:
 - Employee and Employer Social Security Tax
 - Employee and Employer Medicare Tax
 - In some instances FUTA



Statutory Employees continued...

Four Categories:

- HOMEWORKERS
- AGENT DRIVERS/COMMISSION DRIVERS
- LIFE INSURANCE SALES (F/T)
- TRAVEL OR CITY SALES PERSON

Remember.....HALT



Statutory Employees continued...

General Requirements:

- Agree w/employer all services are to be performed personally by the worker
- Must NOT make a substantial investment in equipment or facilities.
- Work must be part of a continuing relationship with the employer, not a single transaction.



1.3-2 Statutory Nonemployees

Employees who are treated as independent contractors for federal tax purposes even though they may qualify as employees under the common law test.

■ **NOT** subject to:

- Federal Income Tax
- Social Security Tax
- Medicare Tax
- FUTA



Statutory Nonemployees continued...

There are two categories of statutory nonemployees.

Read
Estate
Agents &
Direct Sales

REMEMBER.....READ



Statutory Nonemployees continued...

General Requirements must be met before their earnings are considered exempt deom taxes.

- Most compensation must be directly related to the sales/output and **NOT** the number of hours actually worked.
- Work performed **must** be under a written contract providing that the worker will not be treated as an employee for FIT, SS, Medicare, or FUTA purposes.



1.4 Temporary Help Agency Employees

- Used to meet short-term staffing needs
- Agency hires, screens, & trains the employees
 - Employees of the agency
 - Agency has the sole right to hire and fire
 - Clients obligation is to pay a fee for the worker's services
 - Have the contractual right to refuse a worker.
 - May request employee's preferred from past experience

CAUTION!!!

Ensure you are dealing with a financially secure & reputable agency.
If the agency fails, the client may become liable for unpaid withholding or payroll taxes.



1.5 Leased Employees

- Used to lower payroll & benefits expenses.
- Leasing company:
 - Hires, trains and qualifies workers for a client
 - Responsible for withholding taxes and administration and funding of benefits to employees
- Client:
 - Pays a fee to the lease company for the employees
 - The client may have the right to hire, fire, set wage levels and supervise however, the employees are still employees of the leasing company.



1.5 Lease Employees continued...

- Wage bases restart with leasing agreement:
 - If an employee quits the client company, goes to work for the lease company, then is retained through the lease company by the client company, all taxes start over at zero.
- Status issues lead to benefit plan relief from IRS:
 - Exclusive benefit rule noncompliance could cause plan disqualification
 - Relief from plan disqualification
 - Termination option
 - Conversion option
- Small companies benefit most



1.6-1 Federal Wage-Hour Law

Fair Labor Standards Act Regulates:

Child Labor
Overtime
Minimum Wage Rates
Equal Pay/Equal Work
Record Keeping

- The employer/employee relationship exists if the worker is "economically dependent" on the employer.



Federal Wage-Hour Law continued...

Determining Factors of economic dependence:

- How much control does the employer have over the work performed?
- Does the worker have the chance to make a profit or take a loss based on the work performed?
- Does the worker invest in tools & materials required to perform work or hire help?
- Does the work require special skill?
- How permanent is the working relationship?
- Is the work an integral part of the employer's business operation?



1.6-2 State Wage – Hour Laws

- FLSA employees generally satisfy state requirements, but check the state laws.

1.6-3 State Income Tax Withholding Laws

- Generally states that have withholding tax follow the common law test used by the IRS. Where nonresident employees exist, check the state laws for those with reciprocity agreements.
- Nonresident employees – most state taxes apply to residents and also nonresidents. To prevent double taxation, many states have reciprocity agreements that require employers to withhold only for their employee's state of residence.



1.6-4 State Unemployment Insurance Laws

- The aim of these laws is to provide a benefit to those who are unemployed through no fault of their own.
- Many states use the Common Law test, however, more than half use what is known as the ABC Test.



ABC Test

EE is independent contractor only if:

- **Absence of Control:** the worker is free from control or direction in performing the work both by agreement and in reality.
- **Business is unusual and /or away:** work is outside the usual course of the company's business or away from any of the employer's facilities.
- **Customarily independent contractor:** worker is customarily engaged in an independent trade, occupation or business.

This test is designed to make it tougher for a company to exclude workers from coverage.

If unsure, call the state!!



1.6-5 State Disability Insurance Laws

In the states that require ee withholding from ee wages to fund state disability insurance benefit payments status is determined by the same test as for SUI

- California, Hawaii, New Jersey, New York, Rhode Island, plus Puerto Rico



1.7 Worker Misclassification: Enforcement & Penalties

Misclassification of employees as nonemployees or independent contractors = substantial penalties
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They realized that they were losing billions due to misclassifications.



1.7-1 IRS Penalties

Internal Revenue Code provides special reduced tax assessments for unintentionally misclassifying an employee as an independent contractor:

- **If NO** FIT is withheld – 1.5% of wages paid
 - If no 1099 MISC is filed the penalty is doubled to 3%
- **If NO** Social Security or Medicare is withheld – 20% of the employees share is due.
 - If no 1099 MISC is filed the penalty is doubled to 40%
 - Employer's share must also be paid.



1.7-1 IRS Penalties continued...

Intentional misclassification of an employee as an independent contractor - your company pays:

- 100% of the FWT that should have been withheld
- 100% of the employee's *and* the employer's share of Social Security and Medicare Tax
- Plus, penalties for failing to file returns or pay tax

NOTE: States will collect back tax assessments and penalties as well.



1.7-2 IRS Enforcement Efforts

- 1099 Matching Program
- Forms W-2 with 1099 MISC from same employer
- IRS issued a training manual to avoid overzealous IRS agents
- Random tax audits for National Research Program
- IRS shares info with participating state agencies
- Note: Reclassification may mean retroactive benefits also: See pg. 1-24 1996 Microsoft case. Depends on the verbiage of the retirement plan eligibility rules.



1.7-3 FLSA Complaints Filed with the DOL

- Workers who believe they are being treated improperly as independent contractors and are not paid minimum wages or overtime may file a complaint with the U.S. Department of Labor's Wage and Hour Division. 75% of audits are from complaints.
- HUGE back pay and damage awards can result if the employer has no documented record of hours worked.
 - When lacking documented hours worked, the misclassified workers' recollection is used to determine hours worked.
- DOL may also file suit for equivalent of 2 years wages owed, 3 years + damages if misclassification was willful.
- FLSA violations carry substantial civil fines as well.



1.7-4 State Unemployment Agencies

What happens when an independent contractor stops work and files for unemployment benefits?

- This is often when misclassification is noticed because there were no eligible earnings and will often lead to a full-scale investigation of the employer's employment status determinations.
- This can lead to assessment of penalties for both failure to report wages and pay unemployment taxes owed.
- Also results in reduction of the credit an employer receives against the FUTA taxes owed for state taxes paid full and on time.



1.8 Proof of the Right to Work in the U.S.

The Immigration Reform and control Act of 1986 (IRCA) makes it illegal for an employer to hire an unauthorized worker.

- Employer must verify the identity and right to work of all employees hired after November 6, 1986.
- Employers protection:
 - Section 1 of Form I-9 Employment Eligibility Verification filled out by employees on 1st day of work.
 - Have employees provide original documentation within *three business days* of date of hire regarding both identity and authorization to work.
 - Completing employer section of I-9 Section 2 within 3 business days
 - Keeping forms for at least 3 years from date of hire or 1 year from date of term, whichever is longer



Proof of Right to Work Continued...

INS becomes... USCIS ... March 1, 2003

- Immigration and Naturalization Service
- United States Citizenship & Immigration Services
- USCIS is an agency that is part of Dept. of Homeland Security (DHS)
- Website is www.uscis.gov



Documents that prove identity or work authorization

List A: Prove *both* identity and work authorization.

1. U.S. Passport (expired/unexpired)
2. Permanent Resident Card or Alien Registration Receipt Card (green card) USCIS Form I-551, containing photograph, fingerprint & signature of bearer.
Caution: Old green cards (form I-151) are no longer valid!!
3. Unexpired foreign passport with temporary I-551 stamp or temporary I-551 printed notation on a machine readable immigrant visa



List A Documents continued...

4. Employment Authorization Document that contains photo, USCIS Form I-766
5. A Foreign passport with Form I-94 or I-94A with same name as passport & employment authorization stamp w/an unexpired endorsement of nonimmigrant status
6. Passport from Federated States of Micronesia (FSM) or Republic of the Marshall Islands (RMI) with form I-94 or I-94 A indicating nonimmigrant admission under the Compact of Free Assoc. between the US and the FSM or RMI



List B Documents

List B – Documents Proving Identity Only

1. Driver's license or ID card issued by the state or US possession with photo or identifying information including name, DOB, sex, height, eye color and address
2. ID card issued by federal, state or local govt. agency with photo or identifying info as above.
3. School ID card with photograph
4. Voter's registration card
5. U.S. Military card or draft record
6. Military dependent's ID card



List B Documents continued...

7. U.S. Coast Guard Mariner Card
8. Native American tribal document
9. Canadian driver's license
10. For persons under 18 who cannot present any of the above documents:
 - a. School Record or report card
 - b. Clinic, doctor, or hospital record
 - c. Day care or nursery school record



List C Documents

List C – Documents Proving Work Authorization Only!

1. U.S. social security card, if it does not say the card is not valid for employment
2. Certification of Birth issued by the State, Form FS-545, or Form DS-1350
3. Original or certified copy of a birth certificate w/an official seal issued by a state or local govt. agency
4. Native American tribal document



List C Documents continued...

5. U.S. Citizen ID card Form I-197
6. ID Card for Use of Resident Citizen in the US Form I-179
7. Unexpired authorization document issued by DHS (other than Form I-766)



Documents continued...

WARNINGS:

- Employers cannot demand specific documents! Employees may provide any documents on the list!
- Employers using E-Verify can only use List B documents that have a photograph
 - There are safe harbor procedures if you receive a no-match letter.
 - Receipts are temporary proof, the employee must present the replacement document within 90 days from date of hire.
 - Re-verifying employees must be done when an employee's work authorization expires.



Knowingly Hiring Unauthorized Aliens

Penalties

- Knowingly hiring an unauthorized alien and face civil penalties of \$539 - \$4,313 for each worker hired, for your 1st offense
 - \$4,313 - \$10,781 for a 2nd offense
 - \$6,469 - \$21,563 for more than two offenses
- Failure to comply w/the verification requirements - \$216 - \$2,156 for each person not verified.
- Engaging in a pattern of violating the hiring rules face up to \$3,000 and/or 6 months in jail



Electronic Forms I-9 & Recordkeeping only if:

- Form is legible, no changes to name, content, or sequence of the data elements.
- No additional data elements or language are inserted.
- Paper meets the standards for retention and production for inspection
- Electronic recordkeeping standards match those of the IRS.
- Employers can also download a fillable electronic I-9 at www.uscis.gov



Electronic Forms I-9 & Recordkeeping

Electronic signatures

- Must have a method of acknowledgement by person providing signature that he/she has read the document
- Attaches signature to or logically associates it with electronically completed I-9
- Affixes the signature at the time of the transaction
- Creates and preserves a record of verifying identity of employee
- Upon request can provide a printed confirmation of the transaction
- Can be accomplished using various technologies (signature pads, pins, click to accept, etc.)



Electronic Forms I-9 & Recordkeeping

Electronic creation & retention:

- Controls to ensure accuracy, integrity, and reliability.
- Prevent and detect manipulation of the data unintentional or otherwise (additions, deletions, alterations)
- Retrieval system with a search index
- Inspection and QA program
- Ability to reproduce legible hardcopies

Subject to Records Inspections

- Availability – must be able to retrieve data at time of inspection and provide them with resources to do so.



Electronic Forms I-9 & Recordkeeping

Documentation:

- Of business processes used for the electronic I-9 (creation, modification, storage, maintenance, authenticity, audit trails)

Security:

- Must have in place an effective security system and procedures to ensure only authorized personnel have access to this data, provides for backup and recovery, employees are trained to minimize risk, a secure and permanent record that establishes date of access, identity and action taken



Employment Verification Programs

E-Verify – internet accessible and driven, provides verification checks of SSA and DHS databases

- Voluntary and free to employers except some Federal entities and previous serious violators of the IRCA requirements.
- Extremely user-friendly with online training available
- Federal contractors and Subcontractors must use! See page 1-41 for specific guidelines.
- Includes US, Guam, Puerto Rico and US Virgin Islands. Does not apply to employment outside of US including embassies or bases in foreign countries



1.9 New Hire Reporting

Since 1997 payroll practitioners have been required to report information on newly hired employees to state agencies.

- Helps facilitate collection of child support
- Uncover fraud and abuse in unemployment compensation, workers comp, and public assistance

Federal New Hire Reporting Requirement

Under the Personal Responsibility & Work Opportunity Reconciliation Act of 1996

- Reporting requirement for each employee:
 - Employee's name, address & SSN
 - Employer's name, address and FEIN
 - The first date of employee performed services for pay



1.9 New Hire Reporting continued...

- Multistate employers that wish to file with one state must designate that state to the Secretary of Health and Human Services.
- Required to report within 20 calendar days of date of hire.
- Penalty of up to \$25 for failure to comply
- \$500 max if result is a conspiracy between employer & employee
- All states have laws mandating new hire reporting and the procedures to be followed. See table 1.2 pg. 1-46
- Federal government employers must report new hires to the National Directory of New Hires.
- Those employees rehired after lay off or returning to work after LOA need not be reported again if they were not removed from the payroll records.

