

Avoiding Misclassification of Workers: Independent Contractor or Employee



Article By
[Angelique M. Neal](#)
[Varnum LLP](#)
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If you are a business owner, the proper identification of worker status is critical. The IRS and the Department of Labor routinely investigate to determine whether businesses are properly classifying their workers as independent contractors. State authorities are also targeting businesses that misclassify their workers. On April 22, Michigan Attorney General Dana Nessel announced that she is establishing a [Payroll Fraud Enforcement Unit](#) to investigate misclassification of workers, wage theft and non-payment of overtime.

While some employers misclassify their workers as independent contractors in error, some have misclassified their workers in an attempt to reduce labor costs and to avoid the payment of state and federal taxes. Generally, a business owner must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee. Alternatively, a business owner does not generally have to withhold or pay any taxes on payments made to independent contractors. The classification of a worker as an independent contractor may sound appealing; however, if that worker has been misclassified as an independent contractor and should be considered an employee, the employer is not only liable for the additional taxes that result, there are also substantial penalties that can apply. Knowing how your workers should be classified can help you avoid these consequences.

Internal Revenue Service Factors

The IRS focuses on the employer's control or right to control the details of how the worker performs his/her services. Three categories are considered in order to determine the employer's control over the worker: behavioral control, financial control and the relationship of the parties.

Behavioral Control: this category determines whether the business has the right to direct and control the work performed by the worker, even if that right is not exercised by the business. These factors are considered:

- Type of instructions given – e.g., when and where to work, what tools to use or where to purchase supplies and services.
- Degree of instruction given – e.g., detailed instructions may indicate that the worker is an employee.
- Evaluation systems to measure the services performed – e.g., whether the evaluation system is based on how the work is done or on the end result.
- Training offered to a worker on how to do the job – e.g., periodic vs. ongoing training about procedures and methods used to provide the services.

Financial Control: this category determines whether the business has a right to direct or control the financial and business aspects of the worker's job. These factors are considered:

- Significant investment in the equipment the worker uses in providing his/her services.
- Are expenses of the worker being reimbursed?
- Does the worker have an opportunity for profit or loss?
- Are the services of the worker available to others? Does the worker seek out business opportunities?
- Method of payment – e.g., whether the worker is guaranteed a regular wage amount on an hourly, weekly or other period of time basis vs. whether the worker is paid a set amount for the job.

Relationship: the type of relationship depends upon how the worker and business perceive their interaction with one another. This includes:

- Written contracts which describe the relationship the parties intend to create. The fact that there is a contract between the parties is not sufficient to determine the worker's status on its own.
- Benefits provided play a factor. Is the business providing employee benefits such as insurance, pension plan, vacation pay or sick pay?
- Permanency of the relationship is important. Is there an expectation that the relationship will continue indefinitely rather than for a specific project or period?

- Services provided which are a key activity of the business. Consider the extent to which services performed by the worker are seen as a key aspect of the regular business of the company.

Businesses should consider the three categories above and weigh all the factors when determining whether a worker is an employee or independent contractor. Some factors may indicate that the worker is an employee, while other factors indicate that the worker is an independent contractor. The key is to look at the entire relationship and consider the degree of control, or extent of the right to direct and control the worker providing services.

There can be significant consequences for treating an employee as an independent contractor. If you have no reasonable basis for misclassifying the worker, you may be held liable for employment taxes for that worker as well as related penalties. If, however, there is reasonable basis for the classification of the worker, there are relief provisions that may be available to the employer. In addition, the employer may be able to participate in the Voluntary Classification Settlement Program.

If you have concerns about whether your workers are properly classified as independent contractors, or if the IRS has notified you that they are conducting a worker classification examination, you need an experienced tax attorney to represent you in your dealings with the IRS on the issue.

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