



## 3 tests, few answers: The not-so-simple world of worker classification

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### Will the IRS, DOL and states deem your worker a contractor or employee?

We know that the middle market is a strong driver of job growth. Determining the best time to add new workers is complicated—do you hire long or add workers alongside demand? And are those workers full-time employees or independent contractors? The use of independent contractors has grown in recent years as businesses and workers embraced the flexibility these arrangements may provide. A gap in wage reporting and taxation was an unintended consequence and as a result the IRS, U.S. Department of Labor (DOL) and states are taking a harder look at how companies classify workers.

Are your workers properly classified? There are three tests to help determine the proper classification of a worker:

- The common law test
- The ABC test
- The economic realities test

In some situations, you may need to consider all three tests to determine a worker's classification and there are few bright lines between them.

## The common law test

The common law test is typically considered the standard bearer for worker classification. Using the common law test, the IRS, and many state agencies, looks at three general factors to determine the degree of direction and control you have over the worker in question.

The three factors are:

Behavioral control	Financial control	Relationship of parties
Does the company control or have the right to control what the worker does and how the worker does his or her job?	Are the business aspects of the worker's job controlled by the payer? <ul style="list-style-type: none"><li>▪ How is the worker paid?</li><li>▪ Are expenses reimbursed?</li><li>▪ Who provides supplies?</li></ul>	Are there written contracts or employee-type benefits?  Will the relationship continue, and is the work performed a key aspect of the business?
<b>An independent contractor</b> is typically judged by the end result or completed work.	<b>An independent contractor</b> tends to have significant investment in his or her own business, and is not reimbursed for expenses related to performing that service.	<b>An independent contractor</b> typically has a written contract that is specific to the services provided, not simply claiming independent contractor status.

Relevant evidence in all three categories described above must be weighed and evaluated within the context of the business. Some factors may indicate that the worker is an independent contractor, while others may suggest an employee classification. No single factor or set number of factors determine the classification of the worker and some factors may be relevant in one situation, but not in another. The key in making a determination is to consider the entire relationship and the extent of the right to direct and control the services provided by the worker.

The common law test is specifically applied in relation to income tax withholding, federal unemployment tax, state unemployment tax and FICA tax, among others.

So, if the common law test covers federal and state income and unemployment, why are there two more tests? Some state employment tax agencies wanted a more stringent tool to assess worker classification and so they created what is commonly referred to as the ABC test.

## The ABC test

The ABC test more clearly distinguishes between a worker who is personally performing services for your business versus a worker who is doing the work of his or her own business for the benefit of your business. What does that mean?

If you have a worker on-site, providing similar services to those provided by your employees or services aligned with your business, you likely have an employee, not an independent contractor.

The ABC test looks at up to three factors:

A	B	C
The worker is free from control or direction of the performance of his work, both under contract of service and in fact.	The service is either outside the usual course of the business for which such service is performed, or it is performed outside of all the places of business of the enterprise for which such service is performed.	The worker is customarily engaged in an independently established trade, occupation, profession or business.

Under the ABC test, if you have an information technology (IT) business and a contractor provides IT installation services to your clients, that worker would not pass the B factor. However, if you have a contractor providing regular building maintenance for your IT business, that would pass the B factor. And yet, if that building maintenance person provides maintenance solely for your IT company and no others, that same worker would not pass the C factor.

The ABC test is used by the majority of states and applies to state income tax withholding and state unemployment tax withholding.

### The economic realities test

The economic realities test focuses on whether the worker is economically dependent on the employer or is actually in business for him or herself.

The economic realities test looks at:

- The extent to which the work performed is an integral part of the employer's business
- The worker's opportunity for profit or loss, depending on his or her managerial skill
- The extent of the relative investment of the employer and worker
- Whether the work performed requires special skills and initiative
- The permanency of the relationship
- The degree of control exercised or retained by the employer

As with the common law and ABC tests, there is no single determining factor; each factor is analyzed in relation to the others. The DOL applies the economic realities test broadly to ensure that individuals are protected as employees under several federal employment acts including Title VII of the Civil Rights Act, the Age Discrimination in Employment Act, the Americans with Disabilities Act and the Fair Labor Standards Act.

Depending on the facts and circumstance of each worker, you may get different results from each test. Thus, you may wish to evaluate all three tests collectively, where applicable, to determine the proper classification of a worker. This approach will provide greater protection in the event of a worker classification audit.

### Getting it right

Proper worker classification is important to you, to your workers and to the government. Growing businesses need to be certain that new workers are treated appropriately under the law. The consequences can range from administrative hassles to significant penalties.

If you believe you have improperly classified workers, voluntary disclosure programs may be available to help you correct past errors and minimize penalties.

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