

# THE EVOLVING LANDSCAPE OF WORKER CLASSIFICATION



**JOHN A MITCHELL, LLB, MST,  
EA, NTPI FELLOW®**

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NATIONAL ASSOCIATION OF ENROLLED AGENTS (NAEA)

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# The presenter:

## John A Mitchell, LLB, MST, EA, NTPI Fellow®



- John has over 30 years' experience in taxation, having started by preparing 1989 tax returns “by hand” in the 1990 filing season.
  - John currently specializes in tax controversy with the Internal Revenue Service (IRS) working with examinations, collections, appeals, and Chief Counsel. He holds a law degree as well as a Master of Science in Taxation.
  - John speaks Spanish at a “Native Speaker” level of proficiency. He is a husband, father of two, stepfather of two and grandfather of two. In his down time, he enjoys music, books, movies and spending time with family.
- **Bar Admissions/Licensing:**
    - Mexico – Attorney at Law
    - USA - Enrolled Agent
    - Passed CA Bar 07/2023 (Final admission pending)
  - **Organizations:**
    - National Association of Tax Professionals (NATP)
    - National Association of Enrolled Agents (NAEA)
    - Texas Society of Enrolled Agents (TXSEA) (Board of Directors)
    - American Institute of Certified Public Accountants (AICPA)
    - American Bar Association (ABA) Tax Section
  - **Publications:**
    - Tax Pro Journal
    - EA Journal
  - **Media Appearances:**
    - NowMedia Network – BizTalk Program – On-air contributor as a subject-matter expert in tax
    - NowMedia Network – Vision Empresarial (Spanish) – On-air contributor as a subject-matter expert in tax
    - NowMedia Network – Legal Talk with John Mitchell – Television Talk Show Host
    - Tax Pro Podcast – A tax-focused podcast for Circular 230 tax professionals – Coming Summer 2024!

Tel:  
832-469-6010

Email:  
attorneymitchell@pm.me



# Disclaimer



- The information provided on this presentation does not, and is not intended to, constitute legal or tax advice; instead, all information, content, and materials included in this presentation are for general informational purposes only. No attorney-client relationship is established.

A red, rectangular stamp with rounded corners and a thick border, containing the word "DISCLAIMER" in bold, uppercase, sans-serif font. The stamp is tilted slightly upwards to the right.

**DISCLAIMER**

# Course Description



- In this course we will explore the dynamic and evolving landscape of worker classification, focusing on the latest legal developments and practical application for tax professionals.
- This course will equip Enrolled Agents with the knowledge and tools needed to accurately classify workers and navigate the complexities of compliance.



**DESCRIPTION**

# Learning Objectives



- 1. Understand the key differences between employees and independent contractors under current IRS guidelines.
- 2. Analyze recent legal cases and legislative changes impacting worker classification.
- 3. Apply the IRS' 20-factor test and other relevant criteria to real-world scenarios.
- 4. Identify common pitfalls and best practices for ensuring proper worker classification.
- 5. Advise clients on compliance strategies and risk management related to worker classification.



*Learning Objectives*

# Overview of Worker Classification



- **Definition and Importance**

- Worker classification determines whether a worker is an employee or an independent contractor.
- Affects payroll taxes, benefits eligibility, and labor law compliance.

- **Historical Context and Evolution**

- Shift in workforce dynamics over decades.
- Increasing prevalence of gig economy and freelance work.



# Why Proper Classification Matters



- **Implications for Taxes, Benefits, and Legal Compliance**
  - Employee classifications require withholding of income taxes and contributions to Social Security and Medicare.
  - Contractors are responsible for their own taxes; different tax deductions apply.
- **Common Consequences of Misclassification**
  - Fines and penalties for non-compliance.
  - Potential back payment of wages and benefits.
  - Risk of lawsuits and reputational damage.



# Understanding IRS Guidelines



- **Employee vs. Independent Contractor: Key Distinctions**
  - Employees are subject to control over how, when, and where to work.
  - Independent contractors have the freedom to determine their work methods.
- **Overview of IRS Form SS-8**
  - Used by workers and firms to request IRS determination of a worker's status.
  - Helps clarify ambiguous classification situations.



# When You Are an Employee



- Your employer must withhold income tax and your portion of social security and Medicare taxes.
- Also, your employer is responsible for paying social security, Medicare, and unemployment (FUTA) taxes on your wages.
- Your employer must give you a Form W-2, Wage and Tax Statement, showing the amount of taxes withheld from your pay.



# When You Are an Independent Contractor



- The business may be required to give you Form 1099-MISC, Miscellaneous Income, to report what it has paid to you.
- You are responsible for paying your own income tax and self-employment tax. The business does not withhold taxes from your pay. You may need to make estimated tax payments during the year to cover your tax liabilities.
- You may deduct business expenses on Schedule C of your income tax return.

VOID CORRECTED

PAYER'S name, street address, city or town, state or province, country, ZIP, or foreign postal code, and telephone no.

1 Rents

2 Royalties

3 Other income

4 Fedl

5 Fishing boat proceeds

6 Mi

7 Nonemployee compensation

8 Payer made direct sales of \$1,000 or more of consumable goods to a buyer

1099

PAYER'S TIN

RECIPIENT'S TIN

20

Form 1099-MISC

# Significant Court Cases



- **Olson v. State of California (9<sup>th</sup> Circuit No. 21-55757)**
  - Upholds CA “ABC” test adopted in *Dynamex Operations W., Inc. v. Superior Ct.*, 416 P.3d 1 (Cal. 2018)
- **Dynamex Operations West, Inc. v. Superior Court (California, 2018)**
  - Established the "ABC Test" for determining independent contractor status.
  - Shifted the burden of proof to employers to justify independent contractor status.
- **Vazquez v. Jan-Pro Franchising International, Inc. (California, 2021)**
  - Reinforced retroactive application of the ABC Test.
  - Implications for ongoing and past worker classification cases.
- **Implications for Worker Classification**
  - Nationwide ripple effects influencing how states adopt worker classification criteria.
  - Increasing scrutiny and compliance requirements for employers.



# Legislative Changes



- **Overview of New Laws and Regulations**
- **California Assembly Bill 5 (AB5)**
  - Codified the ABC Test, affecting various industries, including ride-sharing and delivery services.
- **The PRO Act (Protecting the Right to Organize Act)**
  - Aims to expand employee rights and redefine worker classification on a federal level.
- **Impact on Federal and State Levels**
  - Divergence between states adopting stricter classification rules and those maintaining traditional standards.
  - Federal vs. state jurisdictional challenges and their implications for businesses.



# Regulatory & Administrative Changes



- Overview of new regulations
  - ✦ US Department of Labor Regulation Change 29 CFR Parts 780, 788 & 795
- Impact on federal and state levels
  - ✦ Greater likelihood of workers classified as Employees



# The 20-Factor Test



- **Level of instruction.** If the company directs when, where, and how work is done, this control indicates a possible employment relationship.
- **Amount of training.** Requesting workers to undergo company-provided training suggests an employment relationship since the company is directing the methods by which work is accomplished.
- **Degree of business integration.** Workers whose services are integrated into business operations or significantly affect business success are likely to be considered employees.
- **Extent of personal services.** Companies that insist on a particular person performing the work assert a degree of control that suggests an employment relationship. In contrast, independent contractors typically are free to assign work to anyone.
- **Control of assistants.** If a company hires, supervises, and pays a worker's assistants, this control indicates a possible employment relationship. If the worker retains control over hiring, supervising, and paying helpers, this arrangement suggests an independent contractor relationship.

# The 20-Factor Test



- **Continuity of relationship.** A continuous relationship between a company and a worker indicates a possible employment relationship. However, an independent contractor arrangement can involve an ongoing relationship for multiple, sequential projects.
- **Flexibility of schedule.** People whose hours or days of work are dictated by a company are apt to qualify as its employees.
- **Demands for full-time work.** Full-time work gives a company control over most of a person's time, which supports a finding of an employment relationship.
- **Need for on-site services.** Requiring someone to work on company premises—particularly if the work can be performed elsewhere—indicates a possible employment relationship.
- **Sequence of work.** If a company requires work to be performed in specific order or sequence, this control suggests an employment relationship.

# The 20-Factor Test



- **Method of payment.** Hourly, weekly, or monthly pay schedules are characteristic of employment relationships, unless the payments simply are a convenient way of distributing a lump-sum fee. Payment on commission or project completion is more characteristic of independent contractor relationships.
- **Payment of business or travel expenses.** Independent contractors typically bear the cost of travel or business expenses, and most contractors set their fees high enough to cover these costs. Direct reimbursement of travel and other business costs by a company suggests an employment relationship.
- **Provision of tools and materials.** Workers who perform most of their work using company-provided equipment, tools, and materials are more likely to be considered employees. Work largely done using independently obtained supplies or tools supports an independent contractor finding.
- **Investment in facilities.** Independent contractors typically invest in and maintain their own work facilities. In contrast, most employees rely on their employer to provide work facilities.
- **Realization of profit or loss.** Workers who receive predetermined earnings and have little chance to realize significant profit or loss through their work generally are employees.

# The 20-Factor Test



- **Work for multiple companies.** People who simultaneously provide services for several unrelated companies are likely to qualify as independent contractors.
- **Availability to public.** If a worker regularly makes services available to the general public, this supports an independent contractor determination.
- **Control over discharge.** A company's unilateral right to discharge a worker suggests an employment relationship. In contrast, a company's ability to terminate independent contractor relationships generally depends on contract terms.
- **Right of termination.** Most employees unilaterally can terminate their work for a company without liability. Independent contractors cannot terminate services without liability, except as allowed under their contracts.
- **Requirements for reports.** If a worker regularly must provide written or oral reports on the status of a project, this arrangement indicates a possible employment relationship.

# The 20-Factor Test Summarized



- **Detailed Review of Factors**
  - **Behavioral control:** Instructions, training, and evaluation.
  - **Financial control:** Investment, expenses, and opportunity for profit or loss.
  - **Type of relationship:** Contracts, benefits, and permanency.
- **Application to Various Scenarios**
  - Assessing different types of work arrangements.
  - Practical examples of how factors affect classification.

# Case Study 1 - Background



- The worker submitted a request to determine his worker status after receiving a Form 1099 for his labor services in 2022 and 2023, believing he was incorrectly classified as an independent contractor and filed Form SS-8 to contest this.
- The payer, a construction business, classified the worker as an independent contractor, claiming he set his own hours, used his own tools, and worked without a written agreement, though the payer provided work assignments and instructions.
- Disputes existed over the level of control: the worker claimed the payer gave specific verbal instructions and required personal service performance, while the payer said the worker could resolve issues and hire substitutes.
- The payer supplied some equipment and paid the worker an hourly rate, but did not cover workers' compensation or allow for economic risk, while the worker did not incur expenses or lease equipment for services.
- The work relationship could be terminated by either party without liability; the worker did not perform similar services for others, and the relationship ended when the payer dismissed him. The payer claimed the worker was represented as a contractor, while the worker stated he was represented as a laborer.

# Case Study 1 - Analysis



- The employer-employee relationship is established when the employer has the right to control and direct the worker, not only in terms of what work is done but also how it is performed, regardless of whether the employer actually exercises that control.
- Regulations specify that if an employer-employee relationship exists, any designation of the worker as an independent contractor or similar role is irrelevant for federal tax purposes; the actual working relationship takes precedence over any contractual terms.
- Integration of the worker's services into the business and the payer's responsibility for assigning work and problem resolution suggest the payer retained the right to direct and control the worker, indicative of an employer-employee relationship.
- Payment methods, such as hourly wages, suggest an employer-employee relationship, especially when the worker does not invest capital or assume business risks. The worker's inability to realize a profit or incur a loss further supports this classification.
- The worker's services were integral to the payer's business, and the relationship could be terminated by either party without liability. There was no evidence of the worker performing similar services for others, indicating that the worker was a common law employee, not an independent contractor.

# Case Study 1 – Result



- The IRS determined that the individual in question was an **EMPLOYEE**.



# Case Study 2 - Background



- The firm is a limited liability company that provides roof replacement for their customers. The worker also has a business with his own EIN that provides roof replacement to his customers. The worker got the job in question from the firm listed on his Form SS-8.
- The worker's advertises his business using his personal name and contact information. The worker stated the firm trained him how to perform his services. However, the worker's website states he has 5 years of experience. The worker bases is workmanship upon his past years of experience.
- The worker's business has the same address as his personal residence. The worker's website under his business name states he has 5 years of past experience in providing these services to his customers. The worker has built his reputation on these past 5 years of experience.
- The worker also gives a 10-year workmanship warranty with all of the roofs he repairs. There were several pictures of the jobs the worker has performed in the past on his site. The worker advertises to contact them for a free estimate.

# Case Study 2 – Analysis



- As is the case in almost all worker classification cases, some facts point to an employment relationship while other facts indicate independent contractor status. The determination of the worker's status, then, rests on the weight given to the factors, keeping in mind that no one factor rules.
- The degree of importance of each factor varies depending on the occupation and the circumstances. The information provided by both parties and discovered by our investigation shows the worker does operate his own business as being self employed.
- The worker holds himself out to the general public as being self-employed. The worker advertises his business both on Facebook and on his own personal website. There was an article in a local paper that listed his business, the services he provided, the history of his business and the variation of the services he provided as being self-employed. This article was signed by the worker in the instant case.

# Case Study 2 - Result



- Based on the information that was found in our investigation and the above analysis, we conclude that the is an independent contractor operating a trade or business.



# Case Study 3 - Background



- The firm is seeking a determination of worker classification for workers performing stitching and design development services between January 2017 and December 2020, prompted by a state unemployment audit, and claims these workers are independent contractors based on factors such as owning their own business, filing business tax returns, and controlling their work schedules.
- Workers reported they performed piecework stitching services at their own locations and on their own schedules, reinforcing their status as independent contractors, as outlined in an Independent Contractor Agreement provided by the firm.
- The firm provided patterns and instructions but did not assign specific work, allowing workers to choose when to pick up work. Workers decided on the methods and locations for their duties, hired their own helpers, and were not required to attend meetings or submit reports.
- The firm supplied materials such as hardware, thread, and patterns, while workers supplied their own equipment and covered their expenses, including insurance. Workers were paid on a piecework basis, set their own service prices, and were liable for any losses.
- The work relationship was flexible, allowing either party to terminate it without penalty. Workers could perform services for other firms, advertise publicly, and were considered independent contractors, typically ending the relationship when a job was completed.

# Case Study 3 – Analysis



- An employer-employee relationship exists when the employer has the right to control and direct the worker's tasks and methods, even if this control is not actively exercised. The key factor is the right to control.
- According to Section 31.3121(d)-1(a)(3), if an employer-employee relationship exists, any other designation, such as independent contractor, is irrelevant for federal tax purposes. The actual working relationship overrides contractual terms.
- A claim of independent contractor status based on written or verbal agreements is insufficient. The determination of an employment relationship is based on factual circumstances and is not negotiable between the parties.
- In this case, workers were not required to personally perform services, could resolve their own work problems, set their own schedules, and worked at their own locations without reporting requirements. This indicates a lack of employer control necessary to establish an employer-employee relationship.
- Workers were paid on a piecework basis, could negotiate their pay, and assumed business risks by investing capital and carrying insurance. This, along with the ability to terminate the relationship without liability and providing similar services to others, supports their classification as independent contractors.

# Case Study 3 - Result



- Based on the above analysis, we conclude that the firm did not have the right to exercise direction and control over the worker to the degree necessary to establish that the workers were common law employees, and the workers were independent contractors operating a trade or business.



# The “ABC” Test



- AB5, enacted in 2020 in California, changed the law as to how workers would be classified as contractors or employees. While courts previously considered a number of factors to answer that question, AB5 presumed that all workers were employees unless the relationship met a strict test, called the “ABC” test:
- **Autonomy:** The worker is free from the control and direction of the hiring entity in performing the work
- **Scope of Work:** The worker performs tasks outside the usual course of the hiring entity’s business.
- **Independent Trade:** The worker is engaged in an independently established trade, occupation, or business similar to the work performed.
- **Workers must meet all three criteria to be classified as independent contractors.** This shift has resulted in many previously considered independent contractors now being classified as employees.

# The “ABC” Test & The Recent Decision



- AB5 has undergone a number of court challenges which have upheld the legality of the new law.
- At issue before the Ninth Circuit was whether the law could exempt certain professions from its requirements.
- By ruling that the Legislature could do so without violating constitutional principles, certain professions, such as lawyers, veterinarians, real estate agents, and hair stylists, keep their exemption and are not subject to the “ABC” test.
- The potential for an appeal to the U.S. Supreme Court remains uncertain, but it appears AB5 has survived the latest court challenge.

# The Borello Test



- The California Supreme Court established the Borello test in *S.G. Borello & Sons, Inc. v. Dept. of Industrial Relations* (1989) 48 Cal.3d 341. The test relies upon multiple factors to make that determination, including whether the potential employer has all necessary control over the manner and means of accomplishing the result desired, although such control need not be direct, actually exercised, or detailed.

# The Borello Test



- This factor, which is not dispositive, must be considered along with other factors, which include:
- Whether the worker performing services holds themselves out as being engaged in an occupation or business distinct from that of the employer;
- Whether the work is a regular or integral part of the employer's business;
- Whether the employer or the worker supplies the instrumentalities, tools, and the place for the worker doing the work;
- Whether the worker has invested in the business, such as in the equipment or materials required by their task;
- Whether the service provided requires a special skill;
- The kind of occupation, and whether the work is usually done under the direction of the employer or by a specialist without supervision;
- The worker's opportunity for profit or loss depending on their managerial skill;
- The length of time for which the services are to be performed;
- The degree of permanence of the working relationship;
- The method of payment, whether by time or by the job;
- Whether the worker hires their own employees;
- Whether the employer has a right to fire at will or whether a termination gives rise to an action for breach of contract; and
- Whether or not the worker and the potential employer believe they are creating an employer-employee relationship (this may be relevant, but the legal determination of employment status is not based on whether the parties believe they have an employer-employee relationship).

# The Borello Test



- Borello is referred to as a “multifactor” test because it requires consideration of all potentially relevant facts – no single factor controls the determination. Courts have emphasized different factors in the multifactor test depending on the circumstances. For example, where the employer does not control the work details, an employer-employee relationship may be found if (1) the employer retains control over the operation as a whole, (2) the worker's duties are an integral part of the operation, and (3) the nature of the work makes detailed control unnecessary. (Yellow Cab Cooperative v. Workers Compensation Appeals Board (1991) 226 Cal.App.3d 1288.)

# DOL Multifactor “Economic Reality” Test



- **Opportunity for Profit or Loss:** This factor examines whether the worker can earn more by exercising personal initiative, managerial skills, or business acumen. For instance, a freelance graphic designer who actively markets their services and negotiates contracts has a higher opportunity for profit or loss compared to a worker assigned tasks with no say in the business operations.
- **Degree of Control Over Work:** This looks at the extent of the employer's influence on the work process. For example, an IT consultant who sets their own schedule and chooses their methodology demonstrates a lower degree of control by the employer, indicating independent contractor status.
- **Investment in Facilities and Equipment:** Consideration is given to the investment in tools, equipment, or facilities needed to perform the work. A carpenter who owns their tools and workshop is more likely to be an independent contractor, unlike a worker who uses the employer's tools and facilities.

# DOL Multifactor “Economic Reality” Test



- **Permanence of the Relationship:** This factor assesses whether the work relationship is temporary or indefinite. A marketing specialist hired for a specific short-term project may be seen as an independent contractor, unlike a long-term, ongoing administrative assistant.
- **Integration into the Business:** This involves evaluating how integral the worker's services are to the business's core operations. A baker in a bakery is more integral and likely an employee, whereas a plumber fixing a leak in the bakery is less integral and more likely an independent contractor.
- **Level of Skill and Initiative Required:** This factor looks at the level of skill and the extent of the initiative the worker uses to market their services, manage time, and decide on the order and sequence of the work. A software developer creating a product independently and selling it to various clients demonstrates a high level of skill and initiative, leaning towards independent contractor status.

# Resources



- Publication 15 – Employer’s Tax Guide
- Publication 1779 – Independent Contractor or Employee Brochure
- Publication 1976 – Section 530 Relief
- IRS Form SS-8 and Instructions
- <https://www.irs.gov/newsroom/worker-classification-101-employee-or-independent-contractor>
- <https://www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee>
- <https://www.irs.gov/newsroom/irs-reminds-business-owners-to-correctly-identify-workers-as-employees-or-independent-contractors>
- <https://www.irs.gov/government-entities/worker-reclassification-section-530-relief>
- <https://www.irs.gov/businesses/ss-8-determinations-of-worker-classification>
- <https://www.irs.gov/newsroom/what-employers-need-to-know-when-classifying-workers-as-employees-or-independent-contractors>

Thank You!

