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EXCLUSIVE TAX ISSUE Vol. 3, Issue 2, November 2010

Employee or Independent Contractor: Recent Tax Court Case is a "Close Call"!

by David Herzog, Associate

Pop Quiz!!

You own a spa. You have cosmetologists, nail technicians and massage therapists ("service providers") coming to your spa to provide services for your customers.

Do you characterize the service providers as independent contractors or employees?

You decide to call them . . . independent contractor! Why? Well, you'd say (when the IRS asked you) that you called them independent contractors because that's really what they were.

Your *real* reason is that, as independent contractors, it's up to the service provider (not you) to pay the employment tax, called the self-employment tax. Otherwise, if you treat them as an employee, then you'd be paying the employment tax. In other words, you pay one-half, and you withhold (and send to the IRS) the other half that the employee should be paying. So when the employee receives a check, the employee's liability is taken care of. Additionally, from a non-tax perspective, you can also avoid such things as paying into the unemployment kitty or having to carry worker's compensation insurance.

Nice!

What's at Stake? (This part is boring, but you have to read it.)

From a tax perspective, your business must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to employees.

Exactly how much is this? 15.3%. The rate consists of two parts: 12.4% for social security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance). (Though only the first $106,800 of the taxpayer's combined wages, tips, and net earnings is subject to any combination of the 12.4% social security part of SE tax or social security tax.) Employers also pay FUTA (Federal Unemployment Tax Act) which, though almost negligible for a small business, can add up.

By contrast, you don't have to withhold or pay any taxes on payments to independent contractors. Just give them their hourly; that's the extent of your obligation (unless your contract with them is more complicated than that). Employers are more likely to withhold and submit taxes than independent contractors are to voluntarily pay their tax liabilities. So that's why the IRS is always trying to construe service providers as employees (so does the California Franchise Tax Board and the Employment Development Department!).

And the penalties: in this particular case, if the IRS wins, you pay, on a $20,473 tax liability, almost $6,000 in penalties. Ouch!!

So, with that background, we go back to your life as the spa entrepreneur . . .

The Facts

Any review of an independent contractor/employee case is typically fact intensive. So, bear with me while I go through the facts here (the more you know, the more likely it is you'll get the right answer!).

> Your service providers receive no set salary or wages and no fringe benefits. As a general rule, your spa charges each service provider weekly "booth rent" equal to the greater of approximately $80 "base rent" or 25% of the gross revenues the service provider generates that week. The service providers set their own hours. Some of them work full time; others were part-time workers who were students or had jobs elsewhere.
>
> Your spa posts prices for various spa services on brochures and on its Internet site. But the service providers aren't required to charge these posted prices; they often charge less and occasionally provide free services for repeat customers, family, and friends.
>
> Clients pay for services at a central point as they leave the spa. The spa accepts payment by cash, check, gift certificate, or credit card. Cash payments are kept in a wicker basket beneath the receptionist's desk. When low on funds, a service provider sometimes takes money from the basket and leaves a handwritten note.
>
> Service providers generally provide their own supplies. Each service provider purchases his or her own work clothing, which generally consisted of shirts with the spa logo and either khaki, black, or white slacks or shorts.
>
> Each week you prepare payout sheets for the service providers. These payout sheets list each service provider's clients and the total amount that each client paid for services rendered. From these amounts the spa deducts booth rent, expenses for products the service providers might have purchased from the spa, and any amount that the service provider might have taken from the basket money.
>
> One of your massage therapists incorporated her business.

Have you figured out yet if characterizing them as independent contractors is correct?

Well, how about some law on the subject:

Direction and Control

For purposes of employment taxes, the term "employee" includes "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee." (Code Sec. 3121(d)(2)) Under common law rules, the most important consideration in determining an employer-employee relationship is generally whether the person for whom the services are performed has the right to direct and control the method and manner in which the work is to be done.

The IRS has identified these 20 factors for determining the existence of an employment relationship in various tax law contexts. In other words, if this element exists, it leads the IRS to characterize the worker as an employee:

1. The putative employer's right to require compliance with instructions;
2. Training by the putative employer;
3. Integration of the worker's services into business operations;
4. A requirement that the worker's services be rendered personally;
5. the putative employer's hiring, supervising, and paying assistants;
6. A continuing relationship;
7. Set hours of work;
8. A requirement that the worker devote substantially full time for the putative employer rather than being free to work when and for whom he or she chooses;
9. Doing work on the putative employer's premises;
10. Requiring the worker to perform services in the order or sequence set by the putative employer;
11. Requiring the worker to submit oral or written reports;
12. Paying by the hour, week, or month, rather than by the job or on a straight commission;
13. Paying business and travel expenses;
14. Furnishing tools and materials;
15. A lack of significant investment by the worker;
16. An absence of ability by the worker to realize a profit or suffer a loss;
17. Working for no more than one firm at a time;
18. The worker's not making his or her services available to the general public on a regular and consistent basis;
19. A right to discharge the worker; and
20. A right by the worker to terminate the relationship without incurring liability.

Figure it out?

In a recent case with these facts and circumstances, the Tax Court held . . . (drum roll please): The service providers were not its employees but rather were independent contractors. Accordingly, the spa did not owe employment taxes *and penalties* as the IRS had contended.

The following factors supported the spa's contention that the service providers were not employees:

- The spa generally did charge, and the service providers did generally pay, weekly rent of at least $80.
- The service providers were compensated on a straight commission basis, with no minimum guaranteed level of payment.
- The spa did not pay service providers' business or travel expenses.
- Many of the massage therapists made significant investments in outfitting and decorating their massage rooms. Thus, the service providers bore the risk of suffering net losses.
- Several service providers believed that they had a nonemployee relationship with the spa; and
- The spa did not tell the service providers how to provide their services to the clients. The service providers were all licensed professionals, possessing skills as required by their licensing. They set their own hours. Although the spa posted prices for various services, the service providers were free to charge less and sometimes provided services for free.

On the IRS's side, these factors supported employment status for the service providers:

- Their services were integrated into the spa's operations;
- They provided their services mostly on the spa's premises;
- The spa provided at least some informal training to new service providers;
- There was no showing that the service providers made their services available to the general public (other than by working at the spa) regularly and consistently;

- They were assisted in booking appointments and in receiving payments by receptionists that the spa employed and supervised;
- Clients paid the spa rather than the service providers; and
- The spa kept the payments until it distributed the service providers' weekly checks.

Bottom Line

The Tax Court acknowledged that it was confronted with a close case. But weighing all the evidence, it concluded that factors indicating the service providers' autonomy predominated over those indicating the spa's control over them. Accordingly, it held that the service providers were independent contractors rather than employees.

Whether you're a business owner or a contractor, it's important to know the rules. Every case is different. It always helps to have a written agreement in place that defines the lack of direction and control, and incorporates these other elements. Independent contractors who have their own businesses (maybe by incorporation) and business licenses strongly indicate an intention to act independently.

Consult with your business or tax advisor before characterizing a "close call" as an independent contractor.

Need More?

Want to know more about this case? Click here.

This article is intended as a general guideline. The rules are complex, and changing continually. Please consult your tax advisor.

If you have any questions or suggestions for article topics, please feel free to email me at dherzog@pinnaclelawgroup.com.

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