VOLUME 22 , ISSUE 8

LAGOS WEALTH ADVISORS
BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

ADVISOR'S BULLETIN

WHAT'S IN THIS MONTH'S NEWSLETTER

What Every Financial Professional Needs to Know About Employees vs Contractors

Michael W. Lagos, CFP®
President

Jane M. Roberts
Director of Client Services

Justin P. Boren , PHD
Chief Compliance Officer

Samuel Escobar
Financial Advisor

A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Running a business is tricky. Most new entrepreneurs will tell you that they had much to learn as they got started. Business owners have to become experts—or hire knowledgeable professionals—with regard to administrative details such as employment, contracts, websites, and taxes.

For financial professionals, working with business owners can be emotionally satisfying and financially rewarding. It can also be frustrating, as those clients juggle business-related issues while they could be pursuing long-term financial goals.

Those of us who work with entrepreneurs have to learn a great deal about their business operations in order to do an effective job of serving them. Often, the more we understand about the company's details—especially details about the business's workers—the more refined our help can be.

Having said all that, why is it relevant for an advisor to understand why a business owner might hire an independent contractor instead of an employee?

The IRS and other government agencies have a vested interest in making sure businesses treat their employees fairly. All kinds of tax and labor rules are designed to pursue the goal of protecting employed workers.

Independent contractors, on the other hand, generally do not get the same protections employees do. The government treats contractors as business owners in their own right and assumes, rightly or wrongly, that they can take care of themselves.

Our entrepreneur clients may be tempted for administrative or financial reasons to try to classify people who should be employees as independent contractors. The Service knows this and has been involved with developing a body of regulations and case law to properly identify which contractors should be classified as employees.

An employer who has mistakenly made an employee a contractor may be on the hook for substantial financial penalties. We need to be able to warn them about their potential liabilities. On the other hand, those businesses who legitimately have contractors may be candidates for financial solutions not available if the workers were employees.

In this issue, we will discuss the differences between employees and contractors from a business owner's perspective. We will review some of the information from the IRS and from case law that can help an entrepreneur tell the difference between the two. And finally, we will discuss the pitfalls and opportunities produced where a business has independent contractors.

Regards,
Michael W. Lagos, CFP®

The Advisor's Bulletin is provided by Lagos Wealth Advisors and Lagos Financial & Insurance Services, Inc. It is intended to serve as a resource for the advisors which we are associated with. Recent developments in estate, business, and insurance planning are outlined for your reference. Should you wish to receive additional information related to financial planning, estate planning, insurance planning, or investment management, please do

1320 VALLEY VISTA DRIVE, SUITE 202
DIAMOND BAR, CA 91765
866.444.4964
WWW.LAGOSADVISORS.COM

What Every Financial Professional Needs to Know About Employees vs Contractors

BACKGROUND

Why does the IRS care about the proper classification of someone as either an employee or independent contractor? As you might expect, it's about taxes.

Employer Motivations

When an employer pays an employee, both parties must pay FICA taxes.

FICA taxes apply to earnings generated by a taxpayer in any given year. According to Federal Regulations Section 404.429, earnings include

> the sum of your wages for services rendered in a taxable year, plus your net earnings from self-employment for the taxable year, minus any net loss from self-employment for the same taxable year.

Employers are obligated to collect the employees' portion of FICA taxes from the employees' paychecks and turn over the money to the federal government. Employers are also obligated to pay their portion of FICA, which is also based on employees' wages.

FICA rules require an employer to withhold three separate taxes from the wages paid to employees.

1. 6.2 percent Social Security (OASDI) tax
2. 1.45 percent regular Medicare tax
3. 0.9 percent Medicare surtax on high wage earners

The law also requires an employer to contribute to two of those taxes.

1. 6.2 percent Social Security tax (OASDI)
2. 1.45 percent regular Medicare tax

For most workers the total amount of FICA tax collected is 15.3 percent of wages—7.65 percent OASDI plus Medicare for the employee and a matching amount paid by the employer.

Self-employed taxpayers pay both the employer and employee portion of FICA on net earnings from self-employment. To calculate the total FICA tax, first net earnings from self-employment are determined. Then the self-employed taxpayer will multiply net self-employment income by 92.35% (.9235) to get the taxable net earnings from self-employment. This fraction has the effect of giving the taxpayer a deduction from income for one-half of the FICA taxes to reflect the fact that employees don't have to pay FICA tax on the portion of FICA their employers pay them.

Finally, the result is multiplied by 15.3 percent for most self-employed taxpayers to determine the FICA liability.

If an employer hires and pays a contractor instead of an employee, the employer

- Does not have to collect the employee's portion of FICA taxes to send to the federal government, nor
- Does the employer have to make a contribution of 7.65 percent of the contractor's compensation of its own.

Employee Motivations

From an employee's perspective, being classified as a contractor rather than an employee creates a at least two perceived advantages:

1. Since the employer is not deducting an employee's 7.65 percent share of FICA taxes from the contractor's compensation, the contractor feels like she is getting paid more.
2. The contractor who has significant business-related expenses may be able to deduct those from compensation before figuring net self-employment wages that are subject to FICA.

The first listed plus of being a contractor is an illusion. Most contractors, unlike employees, are considered to be self-employed. As such, they are on the hook to calculate and pay their own 15.3 percent FICA taxes on self -employment earnings. They must also file IRS Schedule C along with their regular income tax returns to properly report their self-employment income.

The obligations to fully report self-employment income and pay both the employer and employee FICA taxes are a surprise to many people who have been employees in the past but have a contractor relationship with a new company.

IRS Website Guidance

The Service has provided guidance on the IRS website to help an employer decide whether someone is an employee or independent contractor. The guidance looks to how much control an employer exercises on the person in question. In general, the more control the employer exercises, the more likely the person is an employee.

Facts that provide evidence of the degree of control and independence fall into three categories:

1. Behavioral: Does the company control or have the right to control what the worker does and how the worker does his or her job?
2. Financial: Are the business aspects of the worker's job controlled by the payer? (these include things like how worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)
3. Type of Relationship: Are there written contracts or employee type benefits (i.e. pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?

Businesses must weigh all these 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. There is no "magic" or set number of factors that "makes" the worker an employee or an independent contractor and no one factor stands alone in making this determination. Also, factors which are relevant in one situation may not be relevant in another.

The keys are to look at the entire relationship and consider the extent of the right to direct and control the worker.

Those business owners who would like the IRS's input in advance on a specific employee versus contractor issue can consider filing Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding. The Service cautions those who ask for its help to expect it to take six months or more to get an answer.

CASES AND PUBLISHED GUIDANCE

There have been many court cases and some published guidance covering whether a person may be treated as an employee or independent contractor. We have included a small sample below.

***Atig Rahman*, T.C. Summary Opinion 2014-35**

In March 2010 Atig Rahman began working for Ever Care. Ever Care is a business that provides home and other care services to adults with disabilities. During 2010 Ever Care owned three homes and acquired a fourth. Ever Care hires both floor staff and group home managers. The company paid Atig $9,075 for his services in 2010.

The group home Atig managed was staffed with approximately six full-time workers, and the home always had at least one staff member present. He worked approximately 40 hours per week and was paid an hourly rate every two weeks. When Atig was not working, he was on call as the first point of contact should a problem arise at the home.

When Ever Care hired Atig, Ever Care specifically enumerated his duties and responsibilities, many of which were required by the State of Florida to maintain an adult care facility. Ever Care specified not only Atig's particular job duties but also when and where to perform them.

Atig's duties included:

- preparing a monthly forecast of finances;
- purchasing groceries for the home;
- meeting with officials from the Florida licensing agency;
- maintaining the home and making repairs; and scheduling, hiring, and
- firing staff.

Atig's duties also included assisting residents with personal grooming and facilitating transportation for them.

Ever Care paid for the weekly groceries for the residents as well as for upkeep and repairs to the home. Atig did not incur any out-of-pocket expenses related to his work at Ever Care.

In or around early 2011 Ever Care relieved Atig Rahman of his duties.

Ever Care considered Atig to be an independent contractor and provided him with a Form 1099-MISC, Miscellaneous Income, for 2010. Atig hired a CPA to prepare his 2010 Federal income tax return. He did not report either unemployment compensation or compensation from Ever Care, nor did he report liability for self-employment tax on the return.

The IRS mailed a notice of deficiency for 2010, determining a deficiency of $7,038 and an accuracy-related penalty of $1,115. In the notice the Service asserted that Atig was an independent contractor of Ever Care and therefore liable for self-employment tax.

The Tax Court ultimately decided that under the circumstances Atig was an employee of Ever Care and not liable for self-employment tax. The decision was based on the control that Ever Care had over Atig's duties.

The case is silent on whether the Service ever sought to collect self-employment taxes related to the situation from Ever Care.

Vizcaino v. Microsoft Corp., 97 F.3d 1187 (9th Cir. 1996)

Microsoft Corporation supplemented its core staff of employees with a pool of other professionals. In the 1980s and 1990s, it classified these individuals as independent contractors.

These people were engaged when Microsoft needed to expand its workforce to meet the demands of new product schedules. The company did not provide them with any of the employee benefits regular employees received.

During the time these individuals worked with Microsoft, they performed services as software testers, production editors, proofreaders, formatters, and indexers. Microsoft fully integrated them into its workforce: they often worked on teams along with regular employees, sharing the same supervisors, performing identical functions, and working the same hours. Because Microsoft required that they work on-site, they received admittance card keys as well as office equipment and supplies from the company.

In 1989 and 1990, the IRS examined Microsoft's employment records to determine whether the company was in compliance with tax laws. It concluded that Microsoft's freelancers were not independent contractors but employees for withholding and employment tax purposes.

As a result of the Service's audit, Microsoft agreed to pay overdue employer withholding taxes and issue retroactive W-2 forms to allow the independent freelancers to recover Microsoft's share of FICA taxes. It apparently also agreed to pay freelancers retroactively for any overtime they may have worked.

The freelancers subsequently sued Microsoft, seeking to get retroactive credit for certain retirement benefits available for employees. The federal Ninth Circuit Court of Appeals ultimately decided that the former independent contractors were entitled to those benefits, as Microsoft had misclassified them as contractors earlier.

Keller v. Commissioner, T.C. Memo. 2012-62

John and David Keller were the equal owners of Action Auto Body, an auto body repair shop. Each of seven auto body workers had his own space on AAB's premises to perform their work for the company. They did not pay any rent. David Keller paid all of AAB's auto workers weekly by check; the amount varied depending on commissions and the type of work they performed.

Another person started out by cleaning the shop and assisting other workers at AAB and moved up to writing estimates for repairs. He received on-the-job training from David and the other on-site workers. This person was also paid weekly by check.

Two others performed secretarial duties for AAB such as serving as a receptionist, answering the phones, and filing. They were paid weekly by check as well.

David Keller did not withhold any payroll tax from the amounts paid to any of the workers at AAB and did not issue Forms W-2, Wage and Tax Statement, or Forms 1099-MISC, Miscellaneous Income.

The Tax Court decided that the three workers who did not perform repairs should have been classified as employees. The court also decided that the repair workers were properly classified as independent contractors.

David Keller and AAB were thus liable for the employment taxes related to those three employees. The court also imposed penalties for the failure to make the required deposits, file the correct forms, and timely pay tax for the three employees.

Rev. Proc. 2022-13

Earlier this year, the IRS issued Rev. Proc. 2022-13. In that publication, the Service clarified the circumstances under which its determination that a contractor should have been classified as an employee would be subject to review by the Tax Court.

DYNAMEX OPERATIONS WEST, INC. V. THE SUPERIOR COURT OF LOS ANGELES COUNTY, 230 CAL.APP.4TH 718 (2014)

Dynamex Operations West, Inc. (Dynamex), a nationwide courier and delivery service, used its drivers to make deliveries of packages, letters, and parcels to Dynamex customers. Prior to 2004 Dynamex had classified its California drivers as employees and compensated them subject to this state's wage and hour laws.

In 2004 Dynamex converted the status of all drivers from employee to independent contractor. Two of the drivers filed suit in 2005 alleging that, as a practical matter, they continued to perform the same tasks as they had when classified as employees with no substantive changes to their work.

Thus, they claimed, they and all of the Dynamex drivers in California were improperly classified as independent contractors in violation of California law. They sought to pursue a class-action lawsuit on behalf of all Dynamex drivers.

The court applied a more stringent test than the one imposed by the IRS under California law for a worker to be classified as an independent contractor rather than an employee. It decided that for the employer to meet its burden, it must establish each of three factors:

> (A) that the worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact; and
>
> (B) that the worker performs work that is outside the usual course of the hiring entity's business; and
>
> (C) that the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed.

The court concluded that Dynamex's drivers performed work within the employer's core business—package delivery—and thus were employees rather than contractors. The class was certified and the lawsuit was allowed to proceed.

Since the *Dynamex* decision, the California legislature succeeded in its efforts to codify most of the court's analysis. There has been significant political pressure by certain companies—Lyft, Uber, and Doordash among them—to change the California law and prevent the philosophy from spreading more widely.

While *Dynamex* is a California state court decision, if a state requires a person to be classified as an employee, the classification of that person as an employee would also likely subject the company to FICA and related requirements related to the employment.

WHEN IT MATTERS FOR LIFE INSURANCE PROFESSIONALS

It will be important for life insurance and financial professionals to understand something about employee and independent contracts classifications when working with

- a business owner who has one or more workers that the owner considers to be contractors and
- a person who has been classified as an independent contractor.

At a minimum, there would be an opportunity to educate the client about the potential issues associated with improper classification and also to discuss the tax and reporting requirements connected with being a contractor.

There are also some special possible problems and opportunities when working with an employer who has contractors.

Deferred Compensation

Life insurance professionals are often involved with helping business owners implement a certain kind of nonqualified deferred compensation arrangement known as the supplemental executive retirement program (SERP).

There are two main tax features of SERPs:

1. While the key employee generally does not recognize income on the SERP benefit until it is paid, the employer does not get a tax deduction for amounts it sets aside now to pay deferred benefits later.
2. The employer is generally able to deduct SERP benefits when they are paid. The employee likewise usually pays income tax on SERP benefits when received.

Employers and employees must navigate some highly technical potential pitfalls in a successful SERP implementation.

- Constructive receipt issues (Section 451)
- Substantial risk of forfeiture issues (Section 83)
- Section 409A issues

Failure to abide by the technical rules may accelerate the income tax result for the employee, or, in the situation where Section 409A has been violated, a significant penalty tax may be imposed.

Where an employer has a valid independent contractor relationship with an individual or a company, the parties may enter into a deferred compensation-like agreement without being directly subject to the employment-specific SERP provisions of the Tax Code.

As a practical matter, that means a business and contractor have more creativity over how to design a compensation plan that pays the contractor later than if the parties had an employment relationship.

Pension

Pension-related restrictions and opportunities may arise from the ambiguity between employer and contractor relationships.

EMPLOYER PERSPECTIVE

If an employer has a contractor relationship with a worker, that person would not be included in any pension or welfare benefit plan it provides on a nondiscriminatory basis to its employees. Thus, if an employer is seeking to provide a pension for only a select group or just the owners, the business's owners may try to make as many workers as possible contractors.

Of course, the more workers that are contractors in a business, the more risk the employer runs of misclassifying some.

CONTRACTOR PERSPECTIVE

If a worker is properly classified as an independent contractor, the person will generally receive compensation from the business that will show up on the worker's individual income tax return—Schedule C. The worker will be treated as a sole proprietor from the IRS's perspective.

Sole proprietors are eligible to implement qualified plans—including SEPs, SIMPLEs, or Section 401K plans—based on their net self-employment income. Their decision to do so is not limited in any way by what the bigger business does—or does not do—for its employees unless the proprietor also has a significant ownership interest in the bigger business.

CONCLUSION

There may be a significant financial incentive for owners of some closely held businesses to mis-classify their employees as independent contractors. When financial and insurance professionals run into those situations, it will be prudent to bring the potential problems to the attention of the business owners and their tax professionals. The IRS and some other regulating entities have the power to impose significant penalties on those businesses that get it wrong.

For our business-owning clients who have legitimate independent contractor relationships, we have the ability to be more creative in the kinds of compensation arrangements we suggest they enter.

Finally, for those who have been classified as independent contractors, we should recognize that they are also business owners. Our conversations with them should cover the same ground we would explore with any other entrepreneur—including retirement planning, protecting against business risks, and perhaps succession planning.

LAGOS
WEALTH ADVISORS
BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

1320 VALLEY VISTA, SUITE 202
DIAMOND BAR, CA 91765
Phone: 866-444-4964, Fax: 714-940-0889

IN THIS ISSUE OF ADVISOR'S BULLETIN

What Every Financial Professional Needs to Know About Employees vs Contractors

Building Protecting and Perpetuating Family Wealth

LWA strives to develop and maintain sound financial plans designed to achieve our client's wealth accumulation, preservation and transfer objectives, with the goal of preserving their wealth for multiple generations. We provide these services in a confidential and consultative manner, building life-long relationships based upon education, trust, communication and service.