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Dealing With TWC: Independent Contractors, Tax Audits, and the Texas Payday Law

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Independent Contractors / Contract Labor

Independent contractors are self-employed, independent business entities in a position to make a profit or loss based upon how they manage their own independent enterprise – an employer of such an individual is merely one of the clients or customers of that contractor. Most states and IRS use similar tests to determine whether given workers are employees or independent contractors. Whether the test applied is the common-law direction and control test,² the ABC test,³ the economic realities test,⁴ or the IRS test,⁵ the issues are basically the same – all the tests boil down to whether the employer exercises direction and control over the performance of the services of the worker. An employee's work is directly integrated into the primary service offered by the employer, while an independent contractor performs work that is outside the usual scope of the employer's business. All the laws presume that a worker performing services for pay is an employee – if an employer thinks otherwise, it has the burden of proof in almost any possible legal situation.⁶

"Contract labor" may be the most widely used misnomer in business today. The issue is really whether a given worker is an employee or an independent contractor. In basic terms, an employee is someone over whose work an employer exercises direction or control and for whom there is extensive wage reporting and tax responsibility. An independent contractor is self-employed, bears responsibility for his or her own taxes and expenses, and is not subject to an employer's direction and control. The distinction depends upon much more than what the parties call themselves.

Some may ask why this issue is important. For one thing, employers must report, and pay employment taxes on, the wages of employees; for independent contractors, the only report of earnings that Texas employers make is the Form 1099. For another, almost all employment laws apply only to employees; independent contractors are generally covered only by statutes limited to discrimination on the basis of race, color, national

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² *Critical Health Connection, Inc. v. Texas Workforce Com'n*, 338 S.W.3d 758 (Tex. App.--Austin 2011).

³ *Fleece on Earth v. Department of Employment and Training*, 181 Vt. 458, 923 A.2d 594 (Vt. 2007).

⁴ *Brock v. Mr. W Fireworks, Inc.*, 814 F.2d 1042 (5th Cir. 1987).

⁵ *U.S. v. Porter*, 569 F.Supp.2d 862 (S.D. Iowa 2008).

⁶ Texas Labor Code, § 201.041.

origin, or citizenship. In addition, company benefits are limited to employees. Finally, properly classifying workers will help an employer avoid audits, unnecessary claims and appeals, back taxes, interest, and penalties.

The Texas Unemployment Compensation Act does not directly define "independent contractor". Instead, it sets forth a broadly inclusive test, known as the "direction or control" or "common law" test, for who is an employee: "'employment' means a service, including service in interstate commerce, performed by an individual for wages or under an express or implied contract of hire, unless it is shown to the satisfaction of the Commission that the individual's performance of the service has been and will continue to be free from control or direction under the contract and in fact". By implication, an "independent contractor" would be a person whose services do not meet the above test. To aid in application of the common-law test, TWC has adapted the old IRS twenty-factor test for use by the agency (online at www.texasworkforce.org/ui/tax/forms/c8.pdf).

It is important to note that it does not matter that one or both parties may call their arrangement "contract labor". The above definition makes clear that the important consideration is the underlying nature of the work relationship. The law creates a presumption of employment and places the burden for proving otherwise on the employer. It sets forth the primary factor in an independent contractor relationship, namely, the absence of direction and control over the work.

No less an authority than the United States Supreme Court has established a widely-accepted five-part test, known as the "economic reality" test, that helps establish whether a person is an employee or an independent contractor. Dealing with the issue whether an employer owed Social Security taxes on certain workers, the Supreme Court found the following factors important:

- (1) the degree of control exercised by the alleged employer;
- (2) the extent of the relative investments of the [alleged] employee and employer;
- (3) the degree to which the "employee's" opportunity for profit and loss is determined by the "employer";
- (4) the skill and initiative required in performing the job; and
- (5) the permanency of the relationship.⁷

(quoted from *Brock, supra*). *Brock*, one of the leading cases from the Fifth Circuit explaining independent contractor/employee issues, goes on to state that the "focus is whether the employees as a matter of economic reality are dependent upon the business to which they render service".⁸ The same case notes further that "it is *dependence* that indicates employee status...the final and determinative question must be whether the total

⁷ *United States v. Silk*, 331 U.S. 704 (1947).

⁸ *Brock*, at 1043.

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