

# Get Smart with Agent 1099

**H**ere at Friedman, Kannenberg & Co., we considered hiring Don Adams from the 1965 hit television show "Get Smart" to figure out what's on the minds of music retailers. However, we decided instead to conduct an annual survey of our music retail clientele, asking what issues or problems concern them most.

"Inventory Management" had perennially ranked No. 1, until last year when "Employee Compensation and Retention" became the issue of most concern to American music dealers. It remained at the top of the list in this year's survey. Although finding and retaining the right people is difficult, the rising costs of labor and employment are adding to the employee compensation dilemma.

Many business owners think that hiring independent contractors can be one way to control the cost of labor. It lets them compensate workers without the burden of payroll taxes and employee benefits. We see this most often in those stores that provide music lessons and repair services, as music teachers and repair technicians are often hired as independent contractors—as opposed to employees—in order to help reduce and control payroll costs.

However, many business owners don't understand the various effects of classifying an individual as an employee or an independent contractor. This article will help shed some light on the benefits, shortfalls and even financial dangers associated with these two opposing ways to hire and pay someone.

## Classified Kaos

Classifying a worker as an independent contractor can save a company money and benefits, such as payroll taxes, unemployment insurance taxes, pension contributions, group health insurance and workers' compensation insurance to name a few. In most cases, the only tax form

employers have to complete at the end of the tax year is a Federal Form 1099-MISC for those workers classified as independent contractors.

On the other hand, classifying a worker as an employee requires that the company (a) withhold federal, state and local income taxes;



(b) pay the employer-matched half of the social security and Medicare tax (mandated under the Federal Insurance Contributions Act); (c) pay the full tax required under the Federal Unemployment Tax Act and any state unemployment tax laws; (d) pay workers' compensation insurance as required by law; (e) file a number of payroll tax returns with the various tax authorities during the course of the year; and (f) provide all employees Federal Wage Statements Form W-2 by Jan. 31 of the following year.

Since employers cannot discriminate with employment benefits, the employee may also have rights to employee benefits, such as health insurance, vacations, holidays and/or retirement plans.

Accordingly, many business owners—both small and large—prefer to treat their workers as independent contractors. The savings in tax and benefits can be substantial for employers who operate on thin profit margins, engage a large number of workers or have a large payroll. Unfortunately, the government is aware that most employers would like to avoid paying these taxes. Moreover, because these taxes are imposed to promote the welfare of employees, the government frowns upon employers who classify true employees as independent contractors in order to escape these taxes.

## The Man from Uncle (Sam)

In an effort to protect workers, the IRS established back in 1987 a set of stringent rules to help determine worker status. These rules were imposed to strictly limit an employer's ability to treat workers as independent contractors. They had the intended effect of requiring employers to treat most workers as employees and, in turn, pay payroll taxes on their behalf.

These rules consisted of a list of 20 factors and were used by the IRS in court decisions to determine worker status (see pages 22-23). Sometimes called the "20 Factor Test," the list is still used as an analytical tool, although some of the factors are no longer as relevant as they once were.

Accordingly, in 1996, the IRS released new guidelines to its agents in order to help determine worker status. These new guidelines direct agents to focus on the overall set of circumstances and "big employment picture" rather than emphasize one or two of the 20 factors.

## Maxwell Not-So Smart

Why do employers need to be careful when treating workers as independent contractors? The short answer, again, is money. If the gov-



ernment determines that an employer has been erroneously treating workers as independent contractors, rather than employees, it can require the employer to pay all back payroll taxes plus penalties and interest. The government can also void an employer's fringe-benefit plan by claiming that, by not covering all employees, the plan violates nondiscrimination rules.

Employers should never call workers "employees" if these workers are truly independent contractors. However, simply calling a worker an "independent contractor" doesn't automatically convince the government of a worker's status. Essentially, independent contractors are people who operate their own businesses, while employees do not operate their own businesses. If you keep this distinction in mind, you may be better able to understand the myriad of factors discussed herein.

As previously mentioned, the IRS uses the "20 Common Law Factors" (IRS Revenue Ruling 87-14) as a guideline when determining if there is sufficient "control" to establish an employer-employee relationship. The degree of each factor's importance varies, depending on the occupation and the scope of work being performed. Under the common-law test, an employer-employee relationship is present when the person for whom services are performed has the right to control and direct the individual who performs the services as to (1) the result to be accomplished by the work and (2) the details and methods used in achieving the end result. It is not necessary that the employer overtly directs or controls the means and methods by which a result is accomplished—all that is required is that they have the right to do so.

## Agent 86 & His 20-Factor Test

We all know that music retailers have a tendency to quickly assign the status of "independent contractor" to music teachers, repair technicians and piano tuners, to name a few. Accordingly, pages 22 and 23 contain the now famous 20 Factors that need to be considered when determining whether a worker truly is an independent contractor or just an employee in disguise.

By the way, these 20 factors are not an exhaustive list. The IRS and tax courts consider many additional factors, and no one factor is conclusive. Instead, in reaching a decision, the IRS and the courts weigh all the pertinent factors in each particular case. The factors supporting a determination that a worker is an independent contractor go on one side, while the factors supporting a determination that a worker is an employee go on the other side. Here are some of the most important factors.

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## EMPLOYEE vs. INDEPENDENT CONTRACTOR

FACTOR	ISSUES TO CONSIDER	EMPLOYEE	INDEPENDENT CONTRACTOR
<b>1. Instructions</b>	A worker who must comply with instructions about when, where and how he/she is to work indicates an employer-employee relationship exists.	Must follow mandatory instructions as to where, when and/or how to perform work.	Performs work based upon independently established procedures or industry specs.
<b>2. Training</b>	Training a worker to complete the task at hand, training a worker in specific methods or requiring a worker to attend meetings and receive direction are factors indicative of an employer-employee relationship.	Receives and/or is required to receive training.	Skilled professional requiring no training to adequately perform services.
<b>3. Integration of Services</b>	When the success of a particular project is dependent upon the performance of certain services which become an integral part of the business, the worker performing these services is usually subject to a certain amount of direction and control, which deems them to be an employee.	Provides essential services which meld into overall business operation.	Work performed is not an "integral part"—it is a "unique" service.
<b>4. Services Rendered Personally</b>	By requiring a worker to personally perform contracted services, the employer is interested in the means and methods used to accomplish the work in addition to the results, and deems the worker to be an employee.	Required to render services personally.	Has assistants or employees while retaining the right to hire others to perform the required work.
<b>5. Hiring, Supervising and Paying Assistants</b>	A worker (as opposed to the employer) who hires, supervises and pays assistants and is responsible only for the attainment of the result is usually deemed to be an independent contractor.	Does not supervise or hire others.	Hires assistants at his/her expense to perform all or part of project.
<b>6. Regular and Continuous Relationship</b>	A continuing relationship not based on projects indicates an employer-employee relationship exists.	Services are part of a continuing relationship.	Provides services and contracts for separate and distinct projects, not on continuing basis.
<b>7. Set Hours of Work</b>	Requiring the work to be performed at set hours indicates control over the worker and is indicative of an employer-employee relationship.	Required to work set hours.	Retains right to complete work at any time.
<b>8. Full Time Required</b>	If the worker must devote substantially full time to the business and is not working on a project basis, the worker may be limited from performing services elsewhere, is being controlled and is deemed to be an employee.	Required to devote full-time to a job on a non-project basis.	Contract specifies what is to be accomplished by what date; free to choose to work for other clients
<b>9. Doing Work on Employer's Premises</b>	If the worker is required to work on-site when the work could be done elsewhere, this factor suggests control and indicates an employer-employee relationship exists.	Required to work on-site, when alternatives exist.	Rents or leases location where work is performed.
<b>10. Order or Sequence Set</b>	If a worker must perform services in a set order or sequence, this factor indicates control as the worker is not free to follow their own pattern of work. The adherence to an established industry or technical standard is generally not regarded as control.	Required to perform task in a set manner, routine or schedule.	Has full discretion over routine or manner in which to perform services.



# EMPLOYEE vs. INDEPENDENT CONTRACTOR

FACTOR	ISSUES TO CONSIDER	EMPLOYEE	INDEPENDENT CONTRACTOR
<b>11. Oral or Written Reports</b>	Requiring the worker to submit regular oral or written reports indicates a degree of control. Quality assurance checks with no evaluation system does not necessarily indicate an employer-employee relationship.	Required to submit regular oral and/or written work reports where work is evaluated.	Has few or no obligations to file regular written or oral reports.
<b>12. Payment by Hour, Week, Month</b>	Payment by the hour, week or month (as opposed to contract structured payment made by the job or on a fixed fee basis) generally points to an employer-employee relationship.	A person paid at regular intervals.	Compensation determined separately by project or based on fixed fee.
<b>13. Payment of Business or Training Expenses</b>	As employees are ordinarily reimbursed for business, travel or training related expenses, the ability to control these expenses by regulating the worker's business activities indicates that an employer-employee relationship exists.	Business or training expenses are paid or reimbursed.	No reimbursement for business or training expenses.
<b>14. Furnish Tools or Equipment</b>	The furnishing of significant tools, materials and other equipment tends to reduce the workers risk of loss and suggests an employer-employee relationship.	Tools and materials are furnished.	Furnishes own tools and materials.
<b>15. Significant Investment</b>	A worker who personally invests in equipment and facilities used in performing services indicates the worker is an independent contractor, particularly if the investment requires ongoing overhead or maintenance costs.	Does not invest in facilities and/or equipment used to perform work.	Possesses and invests in facilities and equipment to perform services.
<b>16. Realization of Profit or Loss</b>	A worker who can realize a profit or risks suffering a financial loss as a result of performing the contracted services is generally an independent contractor.	Compensated for services at fixed rate regardless of profitability.	Shoulders the possibility of incurring a loss and realizing a profit.
<b>17. Major Source of Income (working for one firm at a time)</b>	Training a worker, requiring a worker to attend meetings, directing a worker and other activities that require the worker to devote all their time to one project or deriving income from one client indicates an employer-employee relationship.	Performs services for only one firm at a time, on a non project basis.	Has numerous concurrent clients and is not financially dependent on any one.
<b>18. Services Available to General Public</b>	A worker who makes his/her services available to the general public lends itself to independent contractor status.	Services are not offered to general public and points toward control.	Offers services to public.
<b>19. Right to Discharge</b>	The threat of dismissal, which to some degree can cause the worker to comply with an employer's instructions, indicates control and an employer-employee relationship. An independent contractor cannot be fired so long as he or she produces a result that meets the contract specifications.	Can be discharged at any time with no liquidated damages.	Cannot be discharged other than for failure to perform contracted service.
<b>20. Right to Terminate</b>	A worker's right to end his/her work relationship at will and without liability indicates an employer-employee relationship.	May terminate relationship at any time.	May terminate work relationship only upon completion of contract or breach by other party.

**1. Control.** One key factor is whether the worker or the employer controls the manner and details by which the end result of a job is achieved. If the employer controls the manner and details, then the worker may be an employee. If the worker controls the manner and details, then the worker may be an independent contractor.

**2. At-Will Relationship.** An employment relationship with no fixed duration and with an employer's right to terminate workers at will—that is, without prior notice and for any or no reason—is a strong indication that the workers may be employees. Conversely, a relationship with a fixed term—for example, a six-month period—coupled with a right to terminate workers before the term expires only for cause or upon significant notice—such as 30 days or more—indicates that the workers may be independent contractors.

**3. Operating Their Own Business.**

Remember, the essential feature of independent contractors is that they operate their own businesses, while employees do not. Independent contractors often **do business** as a corporation or under a trade name; hire others to assist in the work; perform or seek to perform services for more than one employer; provide their own tools and transportation, pay their own expenses and are paid by the job, rather than through wages or a salary.

**Final Thoughts from the Chief**

Structuring a relationship with workers so the IRS will view them as independent contractors is not cut and dried. Employers will often be faced with competing choices.

On the one hand, they may want to retain as much control over workers as possible, along with the greatest flexibility to change or terminate the relationship. However, retaining too much control may cause workers to become employees.

To best assure a favorable outcome in the event of IRS or labor department scrutiny, employers should have an attorney assist them in structuring written contracts or arrangements with workers. Attorney Jim Goldberg has frequently assisted NAMM and other music retailing organizations in doing so, and serves as a great resource for these and other legal issues. You can reach him by phone at 202-628-2929 or via e-mail: jimcounsel@aol.com.

Do your homework by preparing or reviewing employee contracts, labor agreements and contractor arrangements so your store's labor remains a labor of love instead of 20 ways to screw your lover.



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