

A misclassification hazard

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ABSTRACT

Worker classification has been a point of contention with the Internal Revenue Service (IRS) for a long time. After all, organizations that use the services of independent contractors save significant money by circumventing a myriad of state and local laws, payroll taxes, income tax withholdings and various fringe benefit programs. The IRS is very much aware of the tendency of businesses to wrongly classify workers as self-employed rather than as employees. In terms of tax consequences, employment status also makes a great deal of difference to the person performing the services. Failure to recognize the correct employee status can have serious repercussions for all parties involved.

The primary subject matter of this case involves the recognition of appropriate worker classification i.e. 'Employee' versus 'Self-employed' and the evaluation of this status for tax purposes. Zuni Outdoors, Ltd. is a multifaceted business that offers outdoor and indoor recreation services to the public. The case has a difficulty level of two or three, appropriate for introducing sophomore and junior business accounting students to both classifications and tax return evaluation. It is designed for a 50 minute class period and is expected to require approximately 1 hour of pre-class student preparation.

Keywords: worker classification, employee, self-employed, independent contractor, employee-employer relationship, tax consequences

CASE SYNOPSIS

Zuni Outdoors, Ltd. is a multifaceted small business operation that focuses on outdoor and indoor recreation services. Unlimited access to the facility is available through payment of a membership fee; however the general public can enjoy the offerings of the business through payment of daily entrance and administrative fees. The facility offers outdoor recreation activities such as: firearm courses and competitions, hiking and biking trails, paintball competition courses, and lake and pond fishing, as well as indoor activities which include: safety courses, yoga, fishing technique demonstrations and other sponsored events. Colt Steele is the sole proprietor of Zuni Outdoors, Ltd. and the grand opening this year has been a great success for the business. Two key members of the Zuni Outdoors personnel are Doc Remington, firearm safety instructor and Yolanda Nevada, administrative receptionist and yoga instructor. Both have employment agreements with Zuni Outdoors, Ltd. however, at year end some questions arise as to the proper employment status of these workers. Colt Steele must fully evaluate each agreement to determine whether Doc and Yolanda satisfy employee status or self-employed, independent contractor status.

NOTE: The case is a fictionalized version of a real-life organizational setting. Names and other identifying information were disguised to protect identities. The applicable fact situation is true to the real case.

CASE LEARNING OBJECTIVES

Objective 1: To help students comprehend the two worker classifications, employee and self-employed.

Objective 2: To improve students' analytical skills by allowing them to evaluate real-life organizational settings and choose the most appropriate alternative based on their analysis.

SPECIFIC TEACHING OBJECTIVES

Objective 1: Distinguish between employee and self-employed status.

Objective 2: Identify key attributes of employee status and self-employed status.

Objective 3: Analyze organizational relationships to determine correct status.

Objective 4: Evaluate the effects of worker status for tax purposes.

TARGET AUDIENCE AND COURSE

The case is designed to expose sophomore and junior accounting majors to the different worker classifications of employee and self-employed and the effects of that classification for tax purposes. Students enrolled in a taxation class will benefit from this case study.

Normally worker classification is introduced toward the beginning of the course after students receive an introduction to taxation and the individual tax model. Worker misclassification occurs when an employer, at hiring, improperly classifies a worker as an independent contractor (self-employed) rather than an employee. The distinction between "employee" and "self-employed" relates to the right of control; employers have the right to direct the means, methods and outcomes of their employee's work (Donahue et al, 2007). Independent

contractors are not employees but are in business for themselves. The impact of misclassification can be severe for all parties involved including the worker, the employer, and the government and taxpayers.

CASE STUDY

It's been a bitter-sweet ending to the first year of operations for Zuni Outdoors, Ltd. and Colt Steele, the sole proprietor. Zuni Outdoors has been a striking success. Colt Steele managed to achieve a smooth launch of his business and was able to make profit from the first year. Despite this glamorous outcome every businessman dreams of, there is a great deal of confusion and frustration about some unsettling decisions at year end. The potential for disenchantment is real if the situation is not properly handled.

Zuni Outdoors, Ltd. is an outdoor sports club and recreation facility located in the town of Revo, Pennsylvania. The facility is a haven for adventure-filled enthusiasts of all types including: paintball players who get to enjoy a state-of-the art tactical course; firearm fanatics that relish in the challenging shooting simulations; and anxious anglers that have access to the 4,000 acres of fully-stocked ponds and lakes. The sprawling 11,000 acre complex is nestled in the Appalachian mountain range offering a four season experience to guests year-round. There are over 100 miles of hiking and biking trails that twist and turn through the property, guiding visitors to numerous hidden springs and picnic areas. In addition to the natural scenery, Zuni Outdoors operates the Zuni Lodge, the center of operations for all events and activities held. According to Colt, the Zuni Lodge and the activities held there nurture the "inner life" of guests. For example, there are meditating yoga classes offered in the Mountain Room, a space that captures a Zen-like sensation of being one with nature with its floor-to-ceiling glass panels that provide an elevated, panoramic view of the mountain scenery. Other services include: firearm safety classes, fishing technique classes, and sponsored activities such as shooting, fishing and paintball competitions, community gatherings and charity events.

Unlimited access to the facilities and the sponsored events at Zuni Outdoors is either through membership or daily entrance fees plus additional user-fees e.g. equipment rental. Annual membership costs \$150.00. In addition, non-members are allowed to enjoy all that Zuni Outdoors has to offer by paying a daily entrance fee of \$10 per person, as well as rental equipment fees and event fees that are collected prior to admission. All members and non-members are required to complete a rules and safety contract before they are admitted into the complex or its sponsored events.

One of the main objectives of Zuni Outdoors, Ltd. is getting people involved with nature in a way that they can appreciate. Armed with a business degree, Colt decided to bring to life his dream and follow the pattern of successful business owners in the Steele family. Almost immediately, Colt began the conversion of the property into what is now Zuni Outdoors, Ltd. It took approximately three years to be ready for the grand opening. He has truly captured the essence of family tradition with this venture, and has been able to share his passion for the wilderness and all it offers. Fortunately for Colt, business has been extremely good in the opening year. Memberships sky-rocketed from just a mere 20 in the first two months to over 200 by the end of the year! Although many people attribute much of the success to Colt, he remains humble. He acknowledges that it would not have been possible without the help of his team of personnel.

Since Zuni Outdoors offers services that place visitors in potentially risky situations, Colt felt the need to ensure patrons are educated about safety issues and employ safe practices. Doc Remington, a long-time resident of Pennsylvania, has been an instructor at Zuni Outdoors since the grand opening. He was referred by another instructor at a training seminar Colt was attending in the northern part of Pennsylvania. Doc has been a long-time Firearm Safety Instructor with over 30 years of experience. He was a member of the United States Army. Thereafter, he worked for the Federal Bureau of Investigation (FBI) for 16 years, before taking up full-time firearm safety instruction. Doc took interest in becoming certified to provide training about firearm safety, and has since held over 1,500 classes all over the country to audiences such as state law enforcement officers, government officials, and the general public.

On receiving the reference, Colt decided to contact Doc to offer him the opportunity to conduct safety classes at Zuni Outdoors. After a long conversation, Doc agreed. As per an agreement signed between the two, Doc is required by Zuni Outdoors to maintain proper firearm instructor certification at all times and be in compliance with all relevant state laws. The provisional agreement gives Doc full control over the scheduling of the firearm safety classes so long as it does not interfere with sponsored events held at the Lodge. In order to conduct the classes, Doc is required to provide all necessary supplies e.g. pencils, paper, booklets, audio/video equipment, firearms. In return, Doc's compensation is to be based on a percentage of the fees the class attendees pay to enroll in the class. A 30-day written notice is required from either party for the termination of the agreement. The agreement specifically states that Zuni Outdoors, Ltd. maintains no health or retirement plans for Doc, and is not liable for any incidents resulting from the training classes.

Yolanda Nevada is the other key member of the team. She is primarily the administrative receptionist at Zuni Outdoors, Ltd. Her typical duties entail answering calls, scheduling events and collecting membership fees as well as any other applicable user fees. After a month in the administrative receptionist position, Colt approached Yolanda to ask if she would like to conduct yoga classes for Zuni Outdoors in addition to her receptionist responsibilities. In order to instruct the yoga classes in the Zuni Lodge, Yolanda has to furnish all the equipment and materials used in the classes – weights, yoga mats, towels, water and music. Although Yolanda absorbs these costs, part of the agreement is that Zuni Outdoors, Ltd. will provide a \$4,000 per year allowance for her expenses. Yolanda delightfully agreed and so she now also serves as the instructor for the yoga classes offered in the Zuni Lodge.

As the year ends, Colt is pleasantly overwhelmed with the level of success he and his team were able to accomplish. He has generated happy customers, satisfied employees and not to mention a healthy bottom line. On the surface things seem to be great, until Colt begins to collect, assemble and distribute year-end information for tax purposes. Colt knows he must send out wage information to both Doc and Yolanda reflecting the income they earned this year, however he is extremely bewildered as to which statement to issue them. Colt has appreciated the amount of good work and dedication the two members of his team have accomplished this year, and does not want to make a mistake that could cause them problems in completing their personal taxes. Even more so, Colt does not want any legal repercussions to affect Zuni Outdoors and the success it has achieved. Staying awake countless hours, reading through tax laws, Colt, tired and stressed, decides it might be best to seek some professional advice.

TEACHING NOTE

Case Summary

Zuni Outdoors, Ltd. is a multifaceted small business operation that focuses on outdoor and indoor recreation services. The facility offers both indoor and outdoor recreation activities. Colt Steele is the sole proprietor of Zuni Outdoors, Ltd. and the grand opening this year has been a great success for the business. Two key members of the Zuni Outdoors personnel are Doc Remington, firearm safety instructor and Yolanda Nevada, administrative receptionist and yoga instructor. Both have agreements with Zuni Outdoors, Ltd. however; at year end some questions arise as to the proper employment status of these workers. A full evaluation of each agreement is needed to determine whether Doc and Yolanda satisfy employee status or self-employed, independent contractor status.

Recommended Reading and Teaching Approach

It is recommended that the instructor utilize this case only after having given a lecture at the very least on the two worker status's, employee and self-employed. Depending on the level of instructor guidance desired, students may be directed to consider the discussion questions as they analyze the case. Students should be divided into groups of two or three individuals for prior analysis and subsequent in-class discussion purposes with the instructor serving as the facilitator. Students should be encouraged to participate in the discussion and respond to specific questions providing relevant reasoning. The instructor should also help students understand the main take away from the case, choose the most appropriate solution or decision alternative based on analysis and reasoning.

Prior to distributing the case, student reading should include relevant sections of I.R.S. Revenue Ruling 87-41. Also reading should include relevant sections of South-Western Federal Taxation 2014: Comprehensive, 37th Edition by Hoffman, Maloney, Raabe and Young (2014).

Suggested Discussion Questions and Answers:

Before presenting the students with the discussion questions, it is recommended to create the setting where the students play the role of Colt's accountant.

1. What would be the appropriate status classification for Doc; employee or independent contractor? Why?

The students may come to different conclusions to this question. It is however important to have students evaluate the list of factors in IRS Revenue Ruling 87-41.

He should be considered an independent contractor. He does have the option to file a Form SS-8 to have the IRS determine his employment status. If the IRS decides against him, Doc can appeal the ruling to the U.S. Tax Court.

To help determine whether Doc is an employee under the common law rules, the IRS identified 20 factors that may indicate whether the employer can exercise enough control to establish an employer-employee relationship (IRS). These factors, set forth in Revenue Ruling 87-41, were based on the circumstances that the courts recognized and relied upon to decide whether an employment relationship occurred. Not all the factors must exist to find an employee/employment relationship, but the factors are guides to use to assess the likelihood as to whether an individual is an employee or an independent contractor. This factor list is shortened

but gives a general approach by which you can guide students in their analysis. Please see the Appendix for the complete list of factors. In 1996, the IRS published a training manual for examiners, entitled “Independent Contractor or Employee? Training Materials” which grouped the common factors in three categories: (1) behavioral control; (2) financial control, and (3) relationship of the parties (Internal Revenue Service, 2014). Recently the IRS has addressed these three categories by focusing more on entrepreneur behavior and less on subjective financial control categories. Use these questions to address students’ attention to the categories (as indicated in Graphic 1 (Appendix)).

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? (IRS, 2014)

(1) Control over manner of accomplishing work. Doc controlled the manner in which he conducted the classes.

(2) Investment in work facilities and tools. The cost of conducting the class was an investment made by Doc. He provided all the materials needed with the exception of the facility (Zuni Lodge).

(3) Opportunity for profit or loss. Doc’s income depended on a percentage of the fees that were paid by class attendees. If such income exceeded his expenses (i.e., the cost of materials to conduct the class), he had a profit. If not, he had a loss.

(4) Termination of work relationship. Under the agreement, Doc had to give 30 days’ notice before termination.

(5) Participation in service integral to regular business. The firearm safety classes are an integral part of the business at Zuni Outdoors.

(6) Length of relationship. A one year period of performing services as an instructor may or may not be considered a continuing relationship.

(7) Intent of the parties. At least as far as Zuni Outdoors is concerned, Doc is regarded as independent contractor. Not only was he allowed to perform services for other parties, but he was not treated as an employee (e.g., no health or pension benefits, accrued vacation or sick leave). Likewise, his earnings should be reported using Form 1099 (rather than Form W-2).

Items (1), (2), (3), and (7) resolve in favor of the independent contractor status, while items (5) and (6) could reflect employee classification. Item (4) is resolved since immediate termination reflects an employment arrangement, while an advance notice requirement (the condition specified in the operating agreement) indicates independent contractor status.

2. Based on your classification of Doc in Question 1 above, discuss the tax advantages and disadvantages your classification choice imposes on both Doc and Zuni Outdoors, Ltd.

Doc should correctly be labeled as an independent contractor. Businesses are motivated to treat service providers as independent contractors for any of several reasons therefore the advantages attributed to Zuni Outdoors include:

- a. It reduces the cost of employee fringe benefits (e.g., health insurance, retirement plans). Because many of these benefits must be provided on a nondiscriminatory basis, they can be quite costly.
- b. It reduces the amount of payroll taxes (e.g., FICA, FUTA).
- c. It reduces the amount of vacation pay obligations, unemployment tax and workers' compensation requirements, and overtime and minimum wage restrictions.

The advantages/disadvantages for Doc being labeled an independent contractor could include:

- a. An independent contractor must pay the higher self-employment tax although; the benefit lies in the fact that the IRS allows you to claim a deduction as an adjustment to income for half of your payments. You have an obligation to pay your self-employment taxes, in addition to your income tax, every year. These taxes cover the same Social Security and Medicare taxes that employers withhold from their employees' paychecks. Calculating your self-employment tax liability requires you to prepare a Schedule SE.
- b. Doc may have limited options when it comes to benefits. Employer benefits represent part of the "hidden paycheck" for employees that independent contractors don't always enjoy.
- c. An employee does not have the same tax advantages as the self-employed for business expenses. While unreimbursed employee business expenses are limited in deductibility, the independent contractor can write off all reasonable and necessary business expenses on Schedule C.
- d. When you operate a business providing services as an independent contractor, you have the option of using the accrual method of accounting for your contractor earnings and expenses while reporting your personal income and deductions using the cash method. The tax benefit of the accrual method is that you claim deductions in the year you become liable for their payment, regardless of when you pay it. However, using the accrual method will require you to report income when you earn it, even if you receive payment in a future tax year. (Franco, 2010)

3. In drawing up the accounts of Zuni Outdoors, how would you characterize and evaluate Yolanda's correct employment status?

Direct students to consider that she is categorized as both employee and self-employed. When a taxpayer holds multiple jobs, it is possible to have dual status. She is an employee of Zuni Outdoors as a receptionist and is self-employed as a yoga instructor. Once again, direct students to the factors from Revenue Ruling 87-41 to analyze her employment situation.

4. How would you account for the allowances and expenses incurred on behalf of Yolanda?

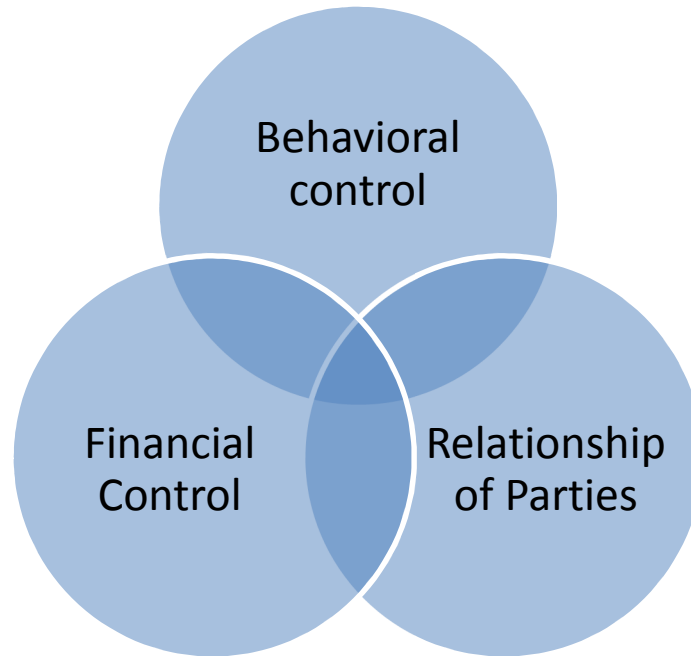
She should report the allowance and expenses directly on Schedule C. In this case, Yolanda will recognize a \$1,000 profit (\$4,000 - \$3,000), which will carry directly over to her 1040. She will also have to pay self-employment tax on this income in which a Schedule SE will need to be completed.

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APPENDIX:

Figure 1



The 20 factors identified by the IRS are as follows: (Joint Committee on Taxation, 2007). Please see graphic below descriptions.

1. **Instructions:** If the person for whom the services are performed has the right to require compliance with instructions, this indicates employee status.
2. **Training:** Worker training (e.g., by requiring attendance at training sessions) indicates that the person for whom services are performed wants the services performed in a particular manner (which indicates employee status).
3. **Integration:** Integration of the worker's services into the business operations of the person for whom services are performed is an indication of employee status.
4. **Services rendered personally:** If the services are required to be performed personally, this is an indication that the person for whom services are performed is interested in the methods used to accomplish the work (which indicates employee status).
5. **Hiring, supervision, and paying assistants:** If the person for whom services are performed hires, supervises or pays assistants, this generally indicates employee status. However, if the worker hires and supervises others under a contract pursuant to which the worker agrees to provide material and labor and is only responsible for the result, this indicates independent contractor status.
6. **Continuing relationship:** A continuing relationship between the worker and the person for whom the services are performed indicates employee status.
7. **Set hours of work:** The establishment of set hours for the worker indicates employee status.
8. **Full time required:** If the worker must devote substantially full time to the business

of the person for whom services are performed, this indicates employee status. An independent contractor is free to work when and for whom he or she chooses.

9. **Doing work on employer's premises:** If the work is performed on the premises of the person for whom the services are performed, this indicates employee status, especially if the work could be done elsewhere.

10. **Order or sequence test:** If a worker must perform services in the order or sequence set by the person for whom services are performed, that shows the worker is not free to follow his or her own pattern of work, and indicates employee status.

11. **Oral or written reports:** A requirement that the worker submit regular reports indicates employee status.

12. **Payment by the hour, week, or month:** Payment by the hour, week, or month generally points to employment status; payment by the job or a commission indicates independent contractor status.

13. **Payment of business and/or traveling expenses.** If the person for whom the services are performed pays expenses, this indicates employee status. An employer, to control expenses, generally retains the right to direct the worker.

14. **Furnishing tools and materials:** The provision of significant tools and materials to the worker indicates employee status.

15. **Significant investment:** Investment in facilities used by the worker indicates independent contractor status.

16. **Realization of profit or loss:** A worker who can realize a profit or suffer a loss as a result of the services (in addition to profit or loss ordinarily realized by employees) is generally an independent contractor.

17. **Working for more than one firm at a time:** If a worker performs more than de minimis services for multiple firms at the same time, that generally indicates independent contractor status.

18. **Making service available to the general public:** If a worker makes his or her services available to the public on a regular and consistent basis, that indicates independent contractor status.

19. **Right to discharge:** The right to discharge a worker is a factor indicating that the worker is an employee.

20. **Right to terminate:** If a worker has the right to terminate the relationship with the person for whom services are performed at any time he or she wishes without incurring liability, that indicates employee status.

Figure 2



A misclassification hazard