

EMPLOYEE VERSUS INDEPENDENT CONTRACTOR STATUS: A TEACHING CASE FOR USE IN A TAX ACCOUNTING OR FINANCIAL PLANNING CLASS

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ABSTRACT

Whether a worker is properly classified as an employee or an independent contractor has been controversial over time. The Tax Cuts and Jobs Act of 2017 made a number of changes that affect this determination: Unreimbursed employee business expenses are no longer deductible, the corporate tax rate is a flat 21 percent, and many independent contractors now receive a new deduction, called the qualified business income deduction, of up to 20 percent of business income. This paper is an early draft of a teaching case to have students analyze the worker classification and involves the relevant recent tax law changes.

Keywords: Worker classification, qualified business income, fringe benefit, pre-tax benefits, post-tax benefits.

INTRODUCTION

The issue of whether a worker should be classified as an employee or an independent contractor has always been a significant issue. After all, employees pay one-half of the Social Security and Medicare taxes, are covered by federal and state unemployment and workers' compensation while independent contractors are self-employed and pay the entire Social Security and Medicare taxes and are not covered unemployment of workers' compensation. For employees, the fringe benefits are excludable from gross income.

Add to these the treatment of medical insurance and retirement contributions. Medical insurance premiums paid by an employer are excludable from gross income and those paid by one who is self-employed are deductible in arriving at adjusted gross income. Similarly, employer and employee contributions to a traditional retirement account are excluded from gross income while contributions to a traditional retirement account by a self-employed individual are deductible for adjusted gross income

Recent developments increase the significance of this classification. The Tax Cuts and Jobs Act of 2017 [4, 5] instituted the qualified business income deduction that allows self-employed individuals a new deduction of up to 20% of their net business income. This deduction may be phased-out for some higher income individuals. While this deduction allows some self-employed individuals pay tax on as little as 80 percent of their income, employees' compensation does not qualify and they are taxed on 100 percent of their compensation.

Recent developments in California, specifically, *Dynamex Operations West, Inc. v. Superior Court of Los Angeles* [2] and Assembly Bill 5 [1] substantially increase the likelihood that workers will be classified as employees in the state.

THE TEACHING CASE

Below is an early draft of a case that requires students to quantify the after-tax cash flow effects of worker classification. Given specific amounts for employee compensation and net income for self-employed, students are asked to estimate the after-tax cash flow in each case and assess the risks and benefits.

The case design has the student assigned reading for key variables that the student has not covered in course work. Then the student is asked to analyze relative cash flow in somewhat comparable employee and independent contractor situations. This is followed by subjective questions evolving from the reading and the cash flow analysis.

Reading

Please read the materials presented here before moving on to the numerical assignment and discussion questions.

Social Security and Medicare Taxes

Employees

Social Security tax	12.4%	Limited to the wage base of \$132,900 for 2019
Employer pays	6.2%	
Employee pays	6.2%	
Medicare tax	2.90%	
Employer pays	1.45%	
Employee pays	1.45%	

Self-employeds

Social Security tax	12.4%	Limited to the wage base of \$132,900 for 2019
Medicare tax	2.90%	

Deduct one-half in arriving at SETax base and in arriving at AG or the income taxI

Calculation of Self-employment tax

Self-employment income	\$135,000	
Multiply by 0.9235	0.9235	
Base	\$124,673	
Social Security tax	\$15,459	12.4% of the base or \$132,900, whichever is less
Medicare tax	\$3,616	2.9% of the base
	\$19,075	

Medical Insurance

Self-employed individuals can deduct their medical insurance for themselves and certain family members as a deduction for adjusted gross income. If they have employees, the coverage must also be provided for the employees.

Employees can generally exclude employer contributions to medical and disability insurance from gross income.

Retirement Plan Contributions

Self-employed individuals can deduct their contributions to traditional retirement plans, including contributions to Solo(k) plans. Of course, if the account is a Roth account, the contribution is not deductible.

Employees can generally exclude employer contributions to traditional retirement accounts from gross income, with the exception Roth contributions. An employer's matching contributions, or any other contributions, to a traditional plan are excludable from gross income.

Unemployment and Workers' Compensation and Other Excludable Benefits

Employees may also exclude the employer's payments for social security, Medicare, workers' compensation and unemployment.

Qualified Business Income Deduction

Independent contractors and other self-employer business owners, including owners of partnerships and S corporations, may qualify for a 20 percent artificial deduction called the qualified business income deduction. Qualified business income includes income from a trade or business as well as income from rentals.

Internal Revenue Code (IRC) [4] §199A(c)(3)(A) "qualified items of income, gain, deduction, and loss" means items of income, gain, deduction, and loss to the extent such items are—

- (i) effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "qualified trade or business (within the meaning of section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears), and
- (ii) included or allowed in determining taxable income for the taxable year.

IRC [4] § 864(c) Effectively connected income, etc.

(1) General rule. For purposes of this title—

(A) In the case of a nonresident alien individual or a foreign corporation engaged in trade or business within the United States during the taxable year, the rules set forth in paragraphs (2), (3), (4), (6), (7), and (8) shall apply in determining the income, gain, or loss which shall be treated as effectively connected with the conduct of a trade or business within the United States.

(B) Except as provided in paragraph (6) [1] (7), or (8) or in section 871(d) or sections 882(d) and (e), in the case of a nonresident alien individual or a foreign corporation not engaged in trade or

business within the United States during the taxable year, no income, gain, or loss shall be treated as effectively connected with the conduct of a trade or business within the United States.

(2) Periodical, etc., income from sources within United States—factors in determining whether income from sources within the United States of the types described in section 871(a)(1), section 871(h), section 881(a), or section 881(c), or whether gain or loss from sources within the United States from the sale or exchange of capital assets, is effectively connected with the conduct of a trade or business within the United States, the factors taken into account shall include whether—

- (A) the income, gain, or loss is derived from assets used in or held for use in the conduct of such trade or business, or
- (B) the activities of such trade or business were a material factor in the realization of the income, gain, or loss.

In determining whether an asset is used in or held for use in the conduct of such trade or business or whether the activities of such trade or business were a material factor in realizing an item of income, gain, or loss, due regard shall be given to whether or not such asset or such income, gain, or loss was accounted for through such trade or business.

(3) Other income from sources within United States. All income, gain, or loss from sources within the **United States** (other than income, gain, or loss to which paragraph (2) applies) shall be treated as effectively connected with the conduct of a trade or business within the United States.

However, QBI does not include salaries and wages from any source or guaranteed payments from partnerships. Salaries and wages include those from a business owned, in whole or in part, by the taxpayer and from those owned by unrelated employers.

Guaranteed payments are generally payments to a partner that are a specified amount or are based on something other than the net income of the partnership. For example, if a partner receives a management fee or compensation (often referred to as partner salaries) for managing partnership assets in her role as a partner, the amount paid would be considered a guaranteed payment.

New IRC [4] §199A creates a tension between compensatory payments to owners and the amount of pass-through income which is available for application of the QBI Deduction. Accordingly, partnership and S corporation owners must now re-think their compensation arrangements. Not only do partnership guaranteed payments and S corporation shareholder-employee salaries reduce the QBI Deduction, such payments are generally subject to self-employment tax and payroll tax, respectively.

The 20 percent QBI Deduction is further limited to 20 percent of taxable income before the QBI Deduction.

General Considerations in Classification

Read and study FS-2017-09 [3] for factors to be considered in worker classification:
<https://www.irs.gov/newsroom/understanding-employee-vs-contractor-designation>

THE NUMERIC PART OF THE CASE

Estefania has income and deductions as a consultant for 2019 that are summarized as follows:

Gross income from sole proprietorship	\$146,500
Cash operating expenses for sole proprietorship	22,250

Estefania pays for her own medical insurance coverage (for herself and her immediate family) at \$950 per month and places \$1,000 per month in a personal retirement account.

Estefania's primary client, Cheng Ltd., has offered her a job with a salary of \$94,000. The company will provide equivalent medical coverage, cover all business expenses, and match Estefania's contributions to a § 401(k) plan up to \$500 per month.

Estimate the value of unemployment coverage and workers' compensation coverage. If in doubt, use 4% and 6%, respectively, of salary.

Complete an analysis of Estefania's take home currently, and assuming she sees no substantial differential risks, advise her as to whether she should accept the offer.

DISCUSSION QUESTIONS

Question 1

Estefania as an employee is able to exclude a number of fringe benefits. Would these be considered pre-tax benefits or post-tax benefits? What would be the pre-tax value assuming Estefania's marginal tax bracket is 33 percent?

Question 2

Estefania is allowed to deduct business expenses for adjusted gross income as an independent contractor. As an employee, the expenses are disallowed unless they are reimbursed. Explain.

Question 3

One might say that an employee who must incur business expenses would be better off taking a cut in pay and having the expenses reimbursed, rather than not having them reimbursed. True or false? Explain.

Question 4

Workers' compensation insurance might be described as a tax-preferred fringe benefit. Describe workers' compensation insurance and explain.

Question 5

Estefania's employer, if she is an employee, might offer nonqualified stock options. Explain the treatment of nonqualified stock options.

More Questions to be Provided.

These questions are intended to get the students to write, some where the question is not clear. Their writing and ability to deal with uncertainty can be observed.

POST-COMPLETION DISCUSSION IDEAS

Planning to Affect the Classification

After discussing the calculations, one might take the opportunity to discuss how to plan to make sure that workers cannot be reclassified by the government. Workers and employers should negotiate relationships that are clear.

REFERENCES

- [1] California Assembly Bill 5 (September 18, 2019).
- [2] *Dynamex Operations West, Inc. v. Superior Court of Los Angeles* (2018) 4 Cal.5th 903 (Dynamex).
- [3] FS-2017-09 [July 20, 2017] -- factors to be considered in worker classification:
<https://www.irs.gov/newsroom/understanding-employee-vs-contractor-designation>
- [4] *Internal Revenue Code of 1986*, Title 26, United States Code.
- [5] *Tax Cuts and Jobs Act of 2017*, P.L. 115-97 (November 2, 2017).

PRELIMINARY NUMERICAL CALCULATIONS

Employee	\$105,500
SS	\$6,541
MHI	\$1,530
Med coverage	\$-
Retirement	\$6,000
Unemployment	\$4,220
Workers' compensation	\$6,330
Subject to IT	\$99,500
Cash flow after tax	\$93,539
I.C.	\$124,250
SS	\$14,228
MHI	\$3,328
Med coverage	\$11,400
Retirement	\$12,000
QBI Deduction	\$24,850
Subject to IT	\$67,222
Cash flow after tax	\$83,294
IT difference	-\$11,297
	\$94,591