

## **Employee or independent contractor? An instructional case dilemma with income tax implications<sup>1</sup>**

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### **ABSTRACT**

This instructional case has been crafted to provide students with an experiential learning tool to help develop and exercise analytical and critical thinking skills while addressing issues involving an individual's employment status and potential income tax liability. Worker misclassification continues to be of grave concern to the Internal Revenue Service (IRS) since such misclassifications may have significant income taxation implications, including significant losses to the U. S. Department of the Treasury and programs like Medicare and Social Security. The case involves John McCloud, a current graduate student and aspiring certified public accountant (CPA). He works as a government accountant by day, and to earn extra money to prepare and sit for the CPA exam, works as a janitor in the early morning. John is hired as an independent contractor to provide light janitorial services for a small commercial office building owned by Todd Langham, a novice investor in real property who has no property management experience. Although the written agreement entered into by John and Todd explicitly states the terms of the agreement, actual events and behavior involved in its execution appear to blur the employer-independent contractor relationship and make that relationship suspect. And, such a suspect status could have profound income taxation implications and/or consequences for John and Todd.

Keywords: independent contractor, fissured workplace, worker misclassification, income tax

Note: This is a fictitious instructional case.

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## **WORKER MISCLASSIFICATION**

Worker misclassification has been of significant concern to the federal government for many years and, in recent years, has garnered the urgent attention of the Internal Revenue Service and United States Department of Labor (Brown, 2015). Worker misclassification results from an employment relationship in which an employer mislabels an employee an independent contractor. Some employers in certain industries (e.g. construction, home health care, and janitorial services) have been known to intentionally engage in business practices (fissured workplace) that misclassify employees (“The 2016 Federal Budget,” 2015) in an effort to avoid paying income taxes and other employment benefits. Whether intentional or inadvertent, worker misclassification has significant implications (e.g. penalties) for employers. Furthermore, it has significant implications (e.g. losses) for government agencies such as the U.S. Department of the Treasury as well as government programs like Social Security and Medicare.

## **THE CASE**

### **Key Players**

John McCloud is a 21 years old recent college graduate, current Master of Accountancy graduate student at a local public university, and aspiring CPA. He works as an accountant for his state’s department of transportation during the day and as a janitor for a small commercial office building in the early morning. John does business as McCloud Janitorial Services, and this is his first business. John uses the income from the business to help prepare (exam review materials) for the CPA exam and pay for exam fees to be able sit for the exam.

Todd Langham is a 52 years old civil engineer for his state’s department of transportation. He is also a novice investor in real property. He recently acquired a small commercial office building comprising approximately 3,000 square feet and housing two tenants, a nonprofit organization and a local CPA firm. After getting advice from his peers, Todd, who is inexperienced at managing property, decides to provide property management services for his property instead of outsourcing that function. Hiring a janitor is one of his first priorities.

### **Background**

John and Todd work at the same state department of transportation. After Todd speaks with his peers about how to manage his newly acquired commercial office building, one of his departmental unit colleagues by the name of Peter Klass suggests John as a possible hire for janitor. Peter and John currently work together on a long-term department project in which John provides grant management services for a transportation project that Peter oversees. The regular meetings that John and Peter have regarding the project’s progress have allowed them to get to know one another personally. This has allowed Peter to learn of John’s desire to earn extra money so he can prepare and sit for the CPA exam. Peter informs John of a possible opportunity to earn that extra money by working for Todd. John expresses interest, and Peter informs Todd.

Todd contacts John shortly after learning of John from Peter, and he arranges to meet with him the next day at a local bookstore to discuss the janitorial opportunity. After meeting and discussing the opportunity and wanting to help John after hearing his passion for becoming a CPA, Todd offers the janitorial position, an independent contractor position, to John. John

accepts, and the two agree to meet again in a couple of days to discuss and formally agree to the terms of the janitorial agreement. The couple of days provide John with time to obtain a business license from the city and Todd with time to draw up a written agreement.

### **The Agreement**

After a couple of days, John and Todd meet to discuss the terms of an agreement for John's provision of janitorial services. The relevant terms of the agreement are as follows:

- Beginning January 3<sup>rd</sup>, and on a month-to-month basis, McCloud Janitorial Services will engage in the following:
  - Provide light janitorial services to have the offices clean Monday – Friday. The services are as follows:
    - Emptying office wastebaskets;
    - Dusting each individual office in the building;
    - Vacuuming, sweeping, and mopping appropriate areas; and,
    - Cleaning the office building's men's and women's restrooms.
  - Provide services at a time outside of normal office hours of 8AM – 5PM.
  - Supply its own equipment and supplies.
  - Be paid \$2,250 in arrears per month.
  - Have the option to terminate the agreement at any time, but must pay liquidating damages of \$75 per day remaining under contract at the time of termination.
  - Be evaluated at the end of each month to determine whether to renew the business arrangement by signing a new agreement for the new month. The evaluation is based upon a cleaning satisfaction survey completed by the building's tenants.

John agrees to the terms and signs the agreement. And, Todd gives John keys to the building.

### **The Scenario**

John began providing janitorial services as scheduled on January 3<sup>rd</sup>. He voluntarily chose to clean in the early morning from 5:00 a.m. to 7:00 a.m., Monday through Friday. He found cleaning the building easy and lucrative, and decides to market his business to the public in hopes of securing another cleaning contract. Additionally, for the first two months of the year, the business relationship between John and Todd goes as planned and contracted.

Shortly after obtaining a contract renewal for the month of March, John is approached by Todd who voices concerns from tenants of the CPA firm. Todd informs John that those tenants have approached him regarding times they came into the office early (prior to 7:00 a.m.) to work on income tax season projects, and John was there cleaning. Todd informs John that the tenants found his cleaning loud (vacuum) and disruptive during those times and have asked Todd to resolve the matter since their arriving in the office early during tax season is somewhat normal.

To resolve the matter, Todd asks John if he can clean the building from 4:00 a.m. to 6:00 a.m. instead of the usual 5:00 a.m. to 7:00 a.m. Working that schedule, John is highly likely not to be on site cleaning if the CPA firm tenants decide to work prior to normal office hours. John agrees to the change in his cleaning hours. Also, with that agreement, Todd also provides John

with a new, very quiet, yet expensive, vacuum cleaner to use in case a tenant from the CPA firm comes into the office during John's new cleaning hours.

John continues the provision of his janitorial services at the new cleaning hours and with the new vacuum cleaner through the end of the December.

### **Discussion Questions**

1. Identify any issue(s) with the written agreement which may make the employer-independent contractor relationship questionable.
2. Do you believe the agreement is sound? Explain.
3. Identify any issue(s) with the behavior/activities of Todd and John which make the employer-independent contractor relationship questionable.
4. Do you believe John is an independent contractor during the first two months? Explain.
5. Do you believe John is an independent contractor after completing one year? Explain.
6. What income tax issues or implications are there for John and Todd at the end of the year?

### **REFERENCES**

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