



WAGE EMPLOYMENT VS. SELF-EMPLOYMENT

JIM HUSTON AND LUCY MILLER

Introduction

It is not uncommon for Benefits Specialists to encounter individuals who receive some form of income, but who are unclear about whether or not this income counts as “wages” for Social Security purposes. Furthermore, in some instances, it is difficult to determine if the income a person gets is from wage employment (i.e.: an employer-employee relationship exists) or if the person is actually self-employed. This is further complicated by the fact that some businesses pay workers as if they were self-employed (i.e.: independent contractors), when, based on U.S. Department of Labor wage and hour laws, they actually meet the definition of employees.

Determinations about whether income is “earned” as opposed to “unearned” and subsequent decisions about whether earned income represents “wages” or should be counted as “net earnings from self-employment” can get very complicated. To make matters worse, these issues are not simply under the jurisdiction of the Social Security Administration. Both the U. S. Department of Labor (DOL) and the Internal Revenue Service (IRS) have a stake in these matters and often have overlapping laws and regulations. These determinations are critically important, since the DI/SSI programs treat various forms of income in drastically different ways. There can also be legal ramifications for beneficiaries and their employers if the Federal tax and wage & hour laws are not complied with. If Benefits Specialists are not clear about what a form of income is and how it is treated by SSA, incorrect advice will be provided which may cause the beneficiary to make a series of poor choices about work.

The purpose of this document is NOT to make Benefits Specialists experts in determinations of wage employment or self-employment. There are literally hundreds of POMS citations covering this topic and the issues involve complex legal interpretations. This document was written to provide a general understanding of how wage employment and self-employment differ, and how SSA decides which situation applies to a beneficiary with earned income.

Employer-Employee Relationship

When SSA personnel look at income a beneficiary receives the first decision to be made is whether the income is “earned” or “unearned”. Basically, if an employer-employee relationship exists, or the individual meets the definition of being self-employed, the income will be counted as earned. There are four basic types of employment relationship that may exist and each has specific criteria. Individuals with earned income may be classified as being: 1.) Employees; 2.) Independent contractors (a specific type of self-employment); 3.) Statutory employees; or 4.) Statutory non-employees. With only minor exceptions, these classifications virtually are the same across the SSA, IRS and DOL.



1. Employees

The general law governing employer-employee relationships is deceptively simple:

“In general, under the common-law rules an individual is an employee if he is subject to the right of direction and control by the person for whom his services are performed as to the details and means by which the result is accomplished.”
(POMS RS 02101.005)

In other words, in wage employment situations, the employer has the right to determine how, where, and when the employee performs the assigned work. In addition, when an employer-employee relationship exists, the employer is subject to DOL wage and hour laws and is required to withhold taxes and FICA contributions from employees' wages per IRS and SSA rules. At the end of each year, the employer provides an IRS W-2 form to each employee to document wages paid and wages withheld. If wages are paid which are below minimum wage, the services must be in food service or the employer must have an approved sub-minimum wage waiver.

To help Claims Representatives make decisions about when a beneficiary is an employee, Social Security provides a list of the principle indicators of wage employment in POMS RS 02101.149 – RS 02101.252. These factors vary from profession to profession, but the main indicators are as follows:

- ◆ Integration of the services into another business
- ◆ A restriction against working for others in competition with the employer
- ◆ A continuing relationship
- ◆ Payment for the services on a time basis
- ◆ Control over the beneficiary's order of services
- ◆ A restriction against hiring helpers or substitutes
- ◆ No opportunity for profit or risk of loss on the part of the beneficiary
- ◆ The right of either party to end the relationship at any time

Social Security has identified a number of additional criteria to help determine when an employer-employee relationship exists in circumstances where it is not readily apparent. To develop this situation further, the Claims Representative will ask the beneficiary if the following characteristics apply:

1. You are required to comply with where, when and how to work.
2. You have been given training by the employer on how to do the job.



3. Your services are integrated into the normal operation of the business.
4. You have to personally perform the services (no substitutes allowed).
5. The employer hires assistants or coworkers.
6. The arrangement is for continuing or ongoing work, even if the work is sporadic.
7. The employer determines the hours of work.
8. The work is full time. Full time in this case does not mean 40 hours. It means that the person is restricted from doing other gainful work because of the hours or agreement.
9. The work is required by the employer to be done on site if it could be done elsewhere.
10. The employer specifies in what order the tasks are to be done.
11. You give regular oral or written reports are required by the employer.
12. You receive regular (weekly, bi-weekly, monthly) payments for services or guaranteed minimum salary or draw account.
13. The employer pays your travel and business expenses.
14. You do not have an investment in necessary tools, facilities or equipment.
15. You do not have a loss potential.
16. You do not have the capability of working for multiple employers.
17. Your services are not available to the public.
18. The employer has the right to fire you at any time.
19. You have the right to quit at any time.

Not all of these criteria need to apply in order for SSA to determine that a beneficiary meets the test of an employee. However, simply meeting one of these criteria would generally not be sufficient to determine that an employer-employee relationship exists. The weight to be given these factors is not always constant. Their degree of importance may vary somewhat depending on the occupation being considered and the reasons for their existence. Some of the factors listed above would not apply at all to particular occupations. SSA personnel must use judgment and discretion when applying these guides.

Special Rules for Officers and Directors of Corporations

Generally, SSA considers an officer of a corporation to be an employee of the corporation. A corporate officer is deemed to be in “employment” even if he/she performs no services for the corporation, as long as remuneration is received for holding corporate office. However, an officer of a corporation who as such does not perform any services, or performs only minor services, and who neither receives nor is entitled to receive, directly or indirectly, any remuneration for serving as an officer is not considered to be an employee of the corporation.

Although a corporate officer is generally an employee, payments made to the officer do not constitute “wages” unless such payments are made for performing services for the corporation or for holding corporate office. Payments by a corporation to an officer for reasons other than the holding of a corporate office are not wages. Examples of such payments would include payment of dividends, repayment of loans, or fees for services performed in other capacities of a non-employment nature. Corporations often make payments of this type to “honorary” or inactive corporate officers.

The board of directors is the governing body of the corporation and therefore is not subject to control by the corporation. Therefore, a director who attends and participates in board meetings



would not meet the common law test for an employee, but would be deemed to be in self-employment. A director who does work for the corporation, other than attending and participating in the meetings of the board of directors, may be an employee with respect to such work if it is non-directorial in nature.

Benefits Specialists need to recognize that beneficiaries who are “officers” of relatively small companies that have been incorporated may think they are self-employed when, in fact, SSA considers them to be employees! It is a good practice to check with the local field office whenever dealing with a beneficiary who is a corporate officer to verify employment status before offering advice. Remember that the difference between being an employee and being self-employed can have a significant impact on how benefits are affected – particularly in the SSI program.

2. Independent Contractors

Independent contractors are not employees, but rather constitute a specific type of self-employment. In determining whether an individual is an employee or an independent contractor under the common law rule, all evidence of control and independence must be considered. The facts fall into three main categories:

- ◆ does the entity have the right to direct and control how the worker performs the specific task for which the worker is hired;
- ◆ does the entity have the right to direct and control the business and financial aspects of the worker’s activities; and
- ◆ the relationship of the parties. A written contract is a very important piece of evidence showing the type of relationship the parties intended to create. A written agreement describing the worker as an independent contractor is evidence of the parties’ intent. The substance of the relationship, not the label, governs the worker’s status. The facts and circumstances under which a worker performs services are determinative. The substance of the relationship, not the label, governs the worker’s status.

It is not uncommon for employers to incorrectly treat workers as independent contractors when they actually meet the test for being classified as “employees”. This mis-classification is sometimes done out of ignorance of the DOL laws, but is occasionally willful in nature. Employees are sometimes treated as independent contracts to avoid paying minimum wage or avoid paying the employer taxes associated with employees. If IRS determines that an employer has incorrectly treated a worker as an independent contractor rather than an employee, it can assess the employer for all unpaid taxes, with respect to that worker and other workers performing similar services.

3. Statutory Employees

A statutory employee is a special class of worker which actually meets all the tests for an independent contractor, but may be treated as an employee for Social Security withholding purposes (FICA and Medicare taxes). Some workers, who would be otherwise be considered



independent contractors (i.e., self-employed) under the common-law rules for determining employer-employee relationships, are specifically defined as employees in section 210 of the Social Security Act. There are only four categories of “statutory employees” as this is a very limited class of worker.

- ◆ A driver who distributes beverages (other than milk) or meat, vegetable, fruit, or bakery products; or who picks up and delivers laundry or dry cleaning, if the driver is your agent or is paid on commission.
- ◆ A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.
- ◆ An individual who works at home on materials or goods that you supply and that must be returned to you or to a person you name, if you also furnish specifications for the work to be done.
- ◆ A full-time traveling or city salesperson that works on your behalf and turns in orders to you from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for you must be the salesperson's principal business activity.

Statutory employees are provided a W-2 from the employer with the amount of Social Security wages in box 3. If an individual is considered a statutory employee, the employer should check the “statutory employee” block on the W-2 to indicate his or her status. When filing tax returns, the statutory employee may be able to deduct trade or business expenses from the wages shown on the W-2 by filing a Schedule C or C-EZ. However, SSA uses the Social Security wages (reported on the W-2) as the gross income for SGA purposes for DI beneficiaries.

4. Statutory Non-Employees

There are two categories of statutory non-employees: *direct sellers* and *licensed real estate agents*. They are treated as self-employed for all Federal tax purposes, including income and employment taxes, if:

- ◆ Substantially all payments for their services as direct sellers or real estate agents are directly related to sales or other output, rather than to the number of hours worked, and
- ◆ Their services are performed under a written contract providing that they will not be treated as employees for Federal tax purposes.

Self-Employment Determinations



In order to be covered by Social Security, a self-employed individual must be engaged in a trade or business and have net earnings from self-employment (NESE). Net Earnings from Self-Employment (NESE) is the gross income derived by an individual from any trade or business carried on by that individual less the allowable deductions which are attributable to that trade or business. Effective with taxable years beginning after 12/31/89, a new deduction of 7.65% is required when computing NESE.

Net earnings from self-employment (NESE) must be at least \$400 for a taxable year before it will be taxable and creditable as self-employment income (SEI). If NESE is less than \$400 for the taxable year, there is:

- ◆ no self-employment income (SEI)
- ◆ no self-employment tax payable for that year and, and,
- ◆ no earnings credited to the earnings record.

Normally, Social Security considers an individual to be self-employed when an employer-employee relationship is not in evidence, and the person in question is determined to be engaging in “trade or business”. Section 211(c) of the Social Security Act provides that the phrase “trade or business” shall have the same meaning as when used in section 162 of the Internal Revenue Code (IRC). Although the IRC does not specifically define the term “trade or business” in detail, certain criteria have been set forth in court decisions and IRS rulings for determining whether a trade or business exists.

Factors Indicating the Existence of a Business or Trade

Social Security’s general policy is to consider the following issues when determining the existence of a trade or business:

- ◆ Is there a good faith intention of making a profit or producing income?
- ◆ Is there continuity of operations, repetition of transactions, or regularity of activities?
- ◆ Are the functions being performed a regular occupation or profession?
- ◆ Is the individual holding him/herself out to others as being engaged in the selling of goods or services?

SSA typically considers an individual to be engaged in a trade or business as a self-employed person when he/she is regularly engaged in an occupation or profession for the purpose of deriving a livelihood, whether in whole or in part. The factors of continuity of work and profit motive indicate the existence of a trade or business even though there may be no “holding out” of the goods or services as available to the general public. Some other factors that come into play when considering the existence of a trade or business include:



1. Personal Services - The fact that an individual derives his/her income from a trade or business is the controlling issue - not the nature or extent of the services.
2. Seasonal - Although length of time is usually an important factor, certain activities that are considered to be a trade or business are seasonal (e.g. selling ice cream during the summer months, plowing snow during the winter).
3. Illegality – Even though an activity is illegal, it may still constitute a trade or business. Individuals engaged in such activities are required by SSA to report their income and pay self employment taxes.
4. Multiple Enterprises - An individual may have more than one trade or business at the same time. On the other hand, an individual may have more than one business enterprise, but one or more may be excluded from the definition of “trade or business”.
5. Hobbies - The buying and selling involved with a hobby is generally done for the purpose of improving or otherwise furthering the hobby. In these cases, the activities do not constitute a trade or business.

Development of a Questionable Trade or Business

Self-employed individuals generally report net earnings from self-employment (NESE) and self employment income (SEI) on their Federal income tax returns. When this is the case, there is typically no need for SSA to question the existence of the trade or business as it is obvious. In some instances, however, the individual has NOT reported income to the IRS and it is not clear how the income should be treated. If the IRS has issued a ruling to the individual regarding the existence of a trade or business and the ruling can be verified as bone fide, SSA will accept it without question. When no such ruling is available, the following list of questions is used by SSA personnel to gather the information necessary to determine whether or not a trade or business is in evidence. Again – not all of these questions need to be answered in the affirmative in order to determine that a trade or business exists, nor is a single affirmative answer generally sufficient to make such a determination.

- ◆ What documents has the individual executed? (e.g., SS-4, tax reports or returns, etc.)
- ◆ Does the individual feel the activities constitute a trade or business – why or why not?
- ◆ Is the individual associating with other individuals in the performance of the activities in question? If so, in what capacity? (i.e. partner, helper etc.)
- ◆ What business firms or other organizations does the individual deal with?
- ◆ Was income reported on a tax return? If so, how was it reported?
- ◆ Are there business licenses, permits, registrations in place?



- ◆ Is there a regular place of business?
- ◆ Are there indications of availability to others for transacting business?
- ◆ Is the individual a member of a business or trade association?

Self-employment determinations can be extremely complex. When in doubt about whether a beneficiary is in wage employment or self-employment, or how a type of income should be counted, refer the beneficiary to the local SSA field office for a formal determination. In some cases, it is a good idea to refer the beneficiary to a competent tax advisor before reporting the income to the SSA. It is critically important for Benefits Specialists to have a basic understanding of the differences between wage employment and self-employment since the income derived from these activities affect DI/SSI benefits in different ways. However, Benefits Specialists are not authorized to make determinations of what is or is not self-employment income, but must defer to SSA personnel on these matters.



Venture Mentors, LLC

JIM HUSTON, CPA

President

708 Cherokee Woods Rd. Louisville, KY 40206

phone (502) 930-2079 fax (502) 896-6876

e-mail jim@venturementors.biz