

1099

EMPLOYEE VS. INDEPENDENT CONTRACTOR



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The Employee vs. Independent Contractor Issue

Business owners often may not understand when to classify an individual as an employee versus an independent contractor. Proper classification of a worker as an independent contractor may save a company money and benefits, such as group health and workers' compensation insurance, as well as social security and unemployment insurance taxes. In most cases, the only tax form employers have to complete is a Form 1099-MISC at the end of the tax year for workers classified as independent contractors. It is important to ensure that workers are classified correctly. Misclassification can result in significant liability.

Classifying workers as employees, on the other hand, requires that the company: withhold federal, state, and local income taxes; pay half of the tax mandated under the Federal Insurance Contributions Act (for social security and Medicare); pay the full tax required under the Federal Unemployment Tax Act and any state unemployment insurance tax laws; pay for workers' compensation; file a number of returns during the course of the year with the various tax authorities; and provide W-2s by January 31. The employee may also have rights to any employee benefits offered, such as health insurance, vacations, holidays, or retirement plans.

Employee or Independent Contractor?

The IRS has given guidelines to its agents to help determine worker status. In the past, a list of 20 factors compiled by the IRS had been used in court decisions to determine worker status.

The list, sometimes called the 20-factor test, is still used as an analytical tool, although some of the factors are no longer as relevant as they once were. More recently, agents are directed to focus on the overall situation rather than to emphasize one or two of the 20 factors.

The determination of whether a worker is an employee or an independent contractor is based on common-law rules, which look at the relationship of the worker and the business, taking into consideration all evidence of control and independence.



The determination of worker status depends primarily on the extent to which the person receiving the services has the right to direct and control the service provider on what is to be done and how it is to be done. An employer generally has the right to control how an employee performs a service. In contrast, independent contractors determine for themselves how the work is to be performed.

Courts consider many factors in determining worker status. These factors fall into three main categories: behavioral control, financial control, and relationship of the parties. These factors are used in connection with IRS audits concerning worker status. Not all factors need to be present in any given situation, and no single factor is controlling.

BEHAVIORAL CONTROL

Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of:

- *Instructions the business gives the worker.* An employee is generally subject to the business's instructions about when, where, and how to work. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved.
- *Training the business gives the worker.* An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

FINANCIAL CONTROL

Facts that show whether the business has a right to control the business aspects of the worker's job include, but are not limited to:

- *The extent to which the worker has unreimbursed business expenses.* Independent contractors are more likely to have unreimbursed expenses than employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services they perform where they work.
- *The extent of the worker's investment.* An independent contractor often has a significant investment in the facilities or equipment he or she uses in performing services for someone else. However, a significant investment is not required.

- *The extent to which the worker can realize a profit or incur a loss. An independent contractor can make a profit or loss.*

TYPE OF RELATIONSHIP

Facts that show the type of relationship between parties include, but are not limited to:

- *Written contracts describing the relationship the parties intended to create.*
- *Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.*

Risks When You Misclassify Employees

Intentionally misclassifying employees as independent contractors may result in penalties plus interest. The exposure for unintentional misclassification of an employee is serious, but not as serious as the risk for an intentional misclassification. Here is what's at stake:

If the employer filed a Form 1099, unintentionally misclassifying an employee, the employer's liability for federal income tax withholding is limited to 1.5% of the employee's wages. The employer's liability for FICA taxes would be 20% of the employee's share, plus the entire amount owed by the employer. And, the employer would have no rights to recover from the employee what is due to the IRS. If an employer has not filed any information returns that were required, such as the Form 1099, the percentage amounts are doubled. The employer must pay 3% for federal income tax withholding and 40% of the employee's portion of FICA in addition to the employer's share of FICA.

Additionally, the employer would still be liable for unemployment taxes. Interest and penalties could be assessed by the IRS, but only on the amount of the employer's liability. The employer's liability includes the percentage of tax that should have been withheld. For example, interest for failure to collect FICA would be based on the employer's share of FICA plus the 20% of the tax that should have been withheld from the employee.

Intentionally misclassifying an employee could result in the following employer liabilities: the full amount of income tax that should have been withheld (with an

adjustment if the employee has paid or does pay part of the tax); the full amount of both the employer and employee shares for FICA (but might receive an offset if the employee paid FICA self-employment taxes); and interest and penalties, computed on far larger amounts than in the case of an unintentional misclassification. In addition to the back taxes, criminal and civil penalties may be issued.

Playing It Safe

When in doubt about how to classify a worker, the most conservative approach would be to classify him or her as an employee. It is always advisable to seek professional advice from your accountant or attorney. The hiring firm has the burden of proving a worker is an independent contractor. When a former worker files an unemployment insurance claim, an investigation is automatically triggered to determine the status of the worker.

The IRS uses the guidelines indicated in this publication and the 20-factor test to determine proper classification, but will also look to a written contract for independent contractor classification. Any such contract would generally set forth the terms of the relationship between the employer and the individual, and may include:

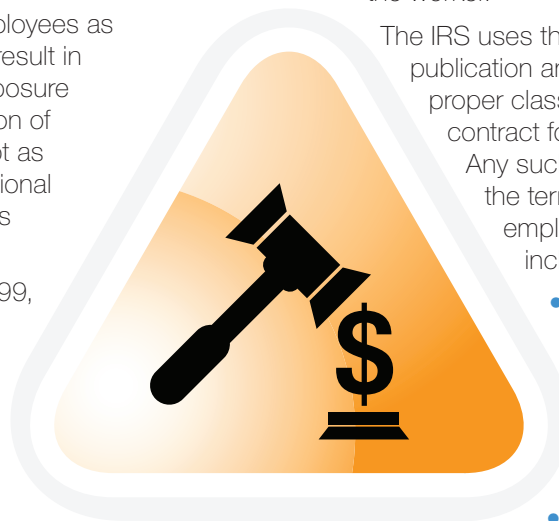
- A statement that the independent contractor is not entitled to employee benefits programs;
- A joint severability clause stating that if part of the contract is struck down, the rest of it survives;
- Acknowledgment that the independent contractor is free to work elsewhere at any time.

A contract between the employer and the worker may be immaterial, however, depending on the facts and circumstances of the case.

Assumptions to Avoid in Classifying Workers

A hiring firm should not assume it is safe to classify a worker as an independent contractor simply because:

- The worker wanted, or asked, to be treated as an independent contractor.
- The worker signed a contract.
- The worker does assignments sporadically, inconsistently, or is on call.



- The worker is paid commission only.
- The worker does assignments for more than one company.

IRS Form SS-8 can be used to request a determination of the status of a particular individual. The IRS will use the information provided on the form, as well as any other information that can be obtained from the parties involved, to determine whether an individual is covered under the payroll tax laws. Although a taxpayer may seek worker classification guidance by submitting Form SS-8, such guidance is taxpayer-specific and is not intended as guidance for other members of the industry involved. The IRS determination does not necessarily indicate worker classification under other employment-related laws.



Safe Harbors — §530 of the Revenue Act of 1978

An employer will not owe employment taxes for misclassified workers if that employer meets all three of the following requirements described in section 530 of the Revenue Act of 1978, as amended:

1. The employer must have had a reasonable basis for not treating the workers as employees. An employer will be considered to have a reasonable basis if the treatment of such worker resulted from reliance on any of the following:
 - Judicial precedent, published rulings, or technical advice with respect to the taxpayer;
 - A past IRS audit in which there was no employment tax assessment attributable to the treatment of the individuals holding positions substantially similar; or
2. The employer (and any predecessor business) must have treated the workers, and any similar workers, as independent contractors for all applicable periods beginning after December 31, 1977.
3. The employer must have filed Form 1099 MISC (Miscellaneous Income) for each worker, if such form was required.

An employer may be denied the protection of a safe harbor if that employer inconsistently classified workers who are doing the same tasks, or if it has not filed the appropriate tax forms consistent with the treatment of a worker as an independent contractor. Therefore, an employer is encouraged to treat all individuals considered to be “independent contractors” consistently, and to file federal tax forms as required. Check with your accountant or attorney for professional advice on this subject.

Classification Settlement Program

The IRS Classification Settlement Program (CSP) lets employers under audit that have partially met the section 530 requirements on misclassified workers receive reduced assessments in exchange for prospective reclassification. The CSP is designed, according to the IRS, to resolve worker-classification cases as quickly as possible and thus reduce employer burden.

To be eligible for the CSP, the employer must at least have fulfilled the reporting consistency requirement under section 530.

Conclusion

It is important for businesses to understand the employee vs. independent contractor distinction. Correctly classifying workers before they perform services can save a business confusion, difficulties, and possible fines down the road.

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