



Independent Contractor or Misclassified Employee?

An Express Employment Professionals White Paper

Executive Summary

As the business world continues to change, the way employers staff their companies is evolving. Many are turning to independent contractors to complete projects when their core staff can't meet demands. In the U.S., millions of workers are classified as 1099 contractors and don't receive the same benefits as employees, such as reduced taxes, employer-paid taxes, insurance, social security, or workers' compensation. Properly classified 1099 contractors can be a win-win solution for both the utilizing company and the workers, but misclassified contractors can lead to trouble for the employer. Incorrectly classifying

an employee as a contractor affects the amount of tax funds government agencies receive, so it is not a mistake that is taken lightly by government officials. If the U.S. Internal Revenue Service (IRS) finds contractors who don't match up to their two classification tests, employers are faced with paying back taxes, as well as interest and penalties on what they owe. With the increased attention being placed on the classification of workers, it is the employer's job to ensure contractors and employees are properly classified to prevent placing their business at risk.

Introduction

As the economy continues to fluctuate, companies are relying on alternative means to keep production up and overhead down. One such method is recruiting self-employed independent contractors. Contractors offer companies expertise in a specific trade, profession, or business for special projects. But the businesses paying for their services only have the rights to control the final results, not the process. Since contractors are not considered employees, businesses do not have to pay federal, state, or local taxes, social security, Medicare taxes, unemployment insurance, workers' compensation, or overtime. The projects get done with a savings of as much as 30% of the usual employee payroll and tax expenses.

Contract workers are often referred to as 1099 workers because a company that pays them more than \$600.00 a year must issue them a 1099 IRS form. In 2009, the U.S. Census Bureau reported there were 10.3 million independent contractors in the U.S., accounting for 7.4% of the entire U.S. workforce.¹

10.3 million independent contractors in the U.S.

Pitfalls of Misclassification

While it is not known how many contractors are misclassified nationwide, studies show it is a common, far-reaching problem. A recent federal study reported that up to 30% of companies misclassify employees. Ohio's attorney general estimates that the states' 92,500 misclassified workers have cost the state up to \$35 million a year in unemployment insurance taxes, up to \$103 million in workers' compensation, and as much as \$223 million in income tax revenue. And studies from Harvard and Cornell found that 4.5% of Massachusetts workers and 10% of New York private sector workers were misclassified.²

If those numbers are true nationwide, it could mean millions of misclassified workers are not receiving the employer benefits guaranteed them by law and the federal and state governments are missing out on billions of dollars. And, with the tax shortages facing federal, state, and local agencies, correct contractor classification is now under the microscope. The IRS places the burden of proper classification on the employer's shoulders, so it is your responsibility to ensure your contractors are classified correctly.

Protect Yourself with General Documentation

If your classification practices are audited, you must be able to show documentation that your contractors are separate business entities, and that their intent from the beginning of their contract was to serve as an independent contractor. So, keep a folder for each contractor that includes such pieces as:

- Advertisements
- Business cards and stationery
- White Pages business listings
- Insurance certificates
- Billing invoices
- Lease information
- 1099s issued from other companies
- Copies of prior tax returns
- W-9 forms

You should also include a signed independent contractor agreement. This is not an employee application or an employee contract. It should be a specific contract stating the services the contractor will provide, including the specific project, due date, location, expected results, and the compensation you will provide in return. Also, do not furnish contractors with W-4 forms since you won't be withholding any taxes. Maintaining W-4s indicates an employer-employee relationship.

IRS Classification Tests

IRS examiners have two tests to help determine if someone is an employee or an independent contractor. One is the 20-factor test. The 20 factors are a reflection of the SS-8 form, which you can use internally to distinguish the classification for yourself or you can complete the form and send it off to the IRS for an official classification. Go online to find the SS-8 form and make sure your company is on track.³ Some of the most critical factors are:

- Instructions
 - A worker is probably not a contractor if required to follow instructions on when, where, and how work is to be done.
- Job training
 - Providing or arranging training of any kind is a sign you expect work to be performed a certain way, thus implying an employer-employee relationship.
- Worker's ability to make a profit or suffer a loss
 - An employee will always get paid, while a contractor has a financial stake in the enterprise and can make a profit or suffer a loss.

The other test is called the reasonable basis test. This is based on how similar workers in your industry have been classified by the legal courts and the IRS. If you can show reasonable basis for classifying someone as a contractor, then the IRS cannot reclassify them as an employee. Some of the conditions of reasonable basis are:

- A court ruling
- A previous ruling by the IRS
- An IRS Technical Advice memorandum or private ruling letter issued to your company
- Past IRS audits that did not find fault with your classifications
- A longstanding, widely recognized industry practice



The Consequences

Hiring independent contractors has its risks. By utilizing contractors you automatically increase the likelihood that your business will be audited by the IRS, Employment Development Department, and other government agencies. If during an audit it is determined that you unintentionally misclassified employees as 1099 contractors, you will be required to pay a portion of the back taxes. If you did not file a 1099 form for a worker, then you will be required to pay a bigger portion of the taxes. It is also up to the agency to determine if you will have to pay penalties as well. If it is found that you intentionally misclassified workers, you could be forced to pay the full amount of taxes that should have been withheld and face even more interest and penalties.

Misclassification of employees as contractors has come into the spotlight over the past few years. Microsoft settled a suit at the cost of \$97 million. UPS paid \$27 million to settle a suit with 203 misclassified workers. And federal, state, and local agencies now have this issue on their radars. Beginning in February of 2010, the IRS launched an examination of 6,000 random companies to be conducted over the course of three years, and one of their main focuses is worker classification.

States are getting involved as attorneys general and legislators are beginning to pursue independent contractor abuses. In June 2009, eight state attorneys general combined forces to bring FedEx Ground in line with state classification laws. State legislators are forming task forces and even passing laws to deal with classification issues. Maryland passed the Workplace Fraud Act of 2009, creating a presumption of employee status for workers in the construction or landscaping industries, authorization for information-sharing between state agencies, and stipulations for penalties. Delaware is considering a similar law, while New York passed another industry-specific law establishing very clear rules on when cab drivers are employees and when they're contractors.⁴ And, in a February 1, 2010, report, New York's governor announced their task force has identified over 31,000 misclassifications and collected \$11 million in unpaid unemployment taxes and \$14.5 million in unpaid wages.²

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The Benefits

Despite all the risks associated with independent contractors, they can be a real asset to your business. They enable you to have short-term projects completed by job-specific experts without going through the expenses of hiring and firing. You obtain access to specialized skills and experiences not readily available within your core staff. You save money on overhead administrative and benefits costs, while enjoying the benefits of having an as-needed worker pool.

These same benefits can also be the result of turning to a staffing firm for short-term contractors and project professionals. You still enjoy all the same advantages, but without the hassle of research, interviewing, and paperwork.

Conclusions

With federal, state, and local governments looking for new ways to increase tax revenues, independent contractor relationships are coming under closer scrutiny. While the benefits of utilizing independent contractors are many, the risks of improperly classifying statutory employees as contract workers are significant. Let Express Employment Professionals take the worry away by providing quality workers that stay on our payroll. Talk with your Express representative today to find out how we can be your staffing solution.

Action Steps

- Review your current contractors' information.
- Gather documentation to support contractor status.
- Ensure contractors have a 1099 and W-9 on file.
- Have contractors sign a contract agreement if none is on file.
- Use the IRS's two tests to ensure correct classification.
- Contact your local Express office about simplifying your contracting process.

Sources

1. U.S. Census Bureau. 2009. Statistical abstract of the U.S., Table 588.
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4. National Employment Law Project. (2009, July) Summary of independent contractor reforms – new state activity. Retrieved from <http://www.nelp.org/page/-/Justice/SummaryIndependentContractorReformsJuly2009.pdf>