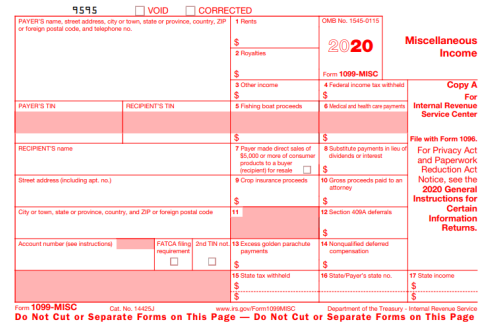


## INDEPENDENT CONTRACTOR OR EMPLOYEE:

Many small business owners seek to avoid classifying workers as employees because they correctly perceive that it is typically more expensive and frequently a bigger hassle. If a worker is correctly classified as an independent contractor, issuing a 1099 form in January is much less complex and painful than preparing quarterly and annual payroll returns and W-2 forms. However, a misstep at the outset may wind up costing you much more.



Form 1099-MISC 2020. The form is for reporting miscellaneous income. It includes fields for Payer's and Recipient's TIN, Recipient's name, address, and city/state/ZIP. It also has sections for various types of payments such as fishing boat proceeds, medical and health care payments, and nonqualified deferred compensation. The form is marked with 'VOID' and 'CORRECTED' in the top right corner.

**It isn't easy.** The question of whether a worker is an independent contractor or employee for federal income and employment tax purposes is a complex one. It is intensely factual, and the stakes can be very high. If a worker is an employee the company must withhold federal income and payroll taxes, pay the employer's share of FICA taxes on the wages plus FUTA tax, and often provide the worker with fringe benefits it makes available to other employees. These obligations don't apply for a worker who is an independent contractor. The business sends the independent contractor a Form 1099-MISC for the year showing what he or she was paid (if it amounts to \$600 or more), and that's it.

**Misclassification will be costly.** If it is determined that the employee was in fact misclassified, the IRS may require the employer to pay up to three years of the following:

- ✓ The employer's share of the FICA tax
- ✓ plus the employee's share of the FICA tax
- ✓ plus the employee's income tax
- ✓ plus the FUTA tax,
- ✓ plus a \$5,000 penalty for each employee that was misclassified
- ✓ plus the IRS can assess an additional penalty of 1.5% of the employee's wages
- ✓ plus another 40% penalty based on the amount of FICA tax that should have been withheld from the employee's pay
- ✓ plus 25% of the total tax deposit liability for failure to pay
- ✓ plus additional penalties if they determine the violation was intentional, including 20% of the amount of wages paid and penalty of another 100% of FICA
- ✓ plus penalties for worker benefit violations (overtime, meal, and rest breaks)
- ✓ plus interest on the tax assessments
- ✓ plus criminal penalties and imprisonment

This is significant because the employer is now having to pay 100% of the payroll tax associated with having an employee rather than splitting that cost with the employee,

as well as some of the IRS steepest compounding penalties. This is serious and the overall cost may actually exceed what was paid the worker in the first place. The penalties are transferable from the company to owners and other responsible parties. Yikes.

**Who is an "employee?"** There is no uniform definition of the term:

Under the **common-law rules** (so-called because they originate from court cases rather than from the tax code), an individual generally is an employee if the enterprise he works for has the right to control and direct him regarding the job he is to do and how he is to do it. Other determining factors include that of financial responsibility/risk (method of determining compensation, expense reimbursements and provision of tools or supplies) and nature of the relationship (benefits such as time off, insurance and pension, expected length of relationship, importance of the position to the business, etc.). Although a work contract is an important factor in determining status, the presence of a contract with a "contractor" is not the sole determining factor.

Some employers that have misclassified workers as independent contractors are relieved from employment tax liabilities under **Section 530** of the '78 Revenue Act (not the Internal Revenue Code). In brief, Section 530 protection applies only if the employer: filed all federal returns consistent with its treatment of a worker as an independent contractor; treated all similarly situated workers as independent contractors; and had a "reasonable basis" for not treating the worker as an employee. For example, a "reasonable basis" exists if a significant segment of the employer's industry has traditionally treated similar workers as independent contractors. Section 530 doesn't apply to certain types of technical services workers.



22222 VOID <input type="checkbox"/>		Employee's social security number		For Official Use Only OMB No. 1545-0008	
b Employer identification number (EIN)		1 Wages, tips, other compensation		2 Federal income tax withheld	
c Employer's name, address, and ZIP code		3 Social security wages		4 Social security tax withheld	
		5 Medicare wages and tips		6 Medicare tax withheld	
		7 Social security tips		8 Allocated tips	
d Control number		9		10 Dependent care benefits	
e Employee's first name and initial		Last name		Suff.	
f Employee's address and ZIP code		11 Nonqualified plans		12a See instructions for box 12	
		12a Statutory		12b	
		12b Retiree		12c	
		12c Other		12d	
15 State Employer's state ID number		16 State wages, tips, etc.		17 State income tax	
		18 Local wages, tips, etc.		19 Local income tax	
				20 Locality name	

**Form W-2 Wage and Tax Statement 2020**  
 Copy A - For Social Security Administration. Send this entire page with Form W-3 to the Social Security Administration; photocopies are not acceptable.  
 Department of the Treasury - Internal Revenue Service  
 For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions.  
 Cat. No. 10134D

Individuals who are **"statutory employees,"** (that is, specifically identified by the tax code as being employees) are treated as employees for social security tax purposes even if they aren't subject to an employer's direction and control (that is, even if the individuals wouldn't be treated as employees under the common-law rules). These individuals are agent drivers and commission drivers, life

insurance salespeople, home workers, and full-time traveling or city salespeople who meet a number of tests. Statutory employees may or may not be employees for non-FICA purposes. Corporate officers are statutory employees for all purposes.

Individuals who are **statutory independent contractors** (that is, specifically identified by the tax code as being non-employees) aren't employees for purposes of wage withholding, FICA or FUTA, and the income tax rules in general. These individuals are qualified real estate agents, certain direct sellers, certain delivery route workers, full-time life insurance agents and certain piece workers.

Some categories of individuals are subject to **special rules** because of their occupations or identities. For example, corporate directors aren't employees of a corporation in their capacity as directors, and partners of an enterprise organized as a partnership are treated as self-employed persons.

**Can it be fixed?** Sometimes. First, if a business suspects it has misclassified workers, correcting that classification sooner and prior to an issue with the IRS may result in an escape from all of those dire costs. Under certain circumstances, either prior to or after IRS notice of a potential violation, you can ask IRS (on Form SS-8) to rule on whether a worker is an independent contractor or employee. Additionally, if the proper procedures are followed, the IRS may abate some or all the penalties.



The misclassification of an employee is something you will want to avoid at all cost. Though it may be tempting to try and label someone as an independent contractor to avoid paying payroll taxes and benefits, the cost if you are determined to have misclassified workers can severely damage or destroy your business. The decision on how to pay a worker is not one that should be made flippantly with only a narrow consideration of what will save time, money and red tape in the short-term. If there is any doubt about the proper classification and the business wants to treat the worker as an independent contractor, **professional advice** should be obtained.



Contact us to assist us with any of these business tax matters. You may call us at 407-847-7466 or email us at [taxes@sbc-cpa.com](mailto:taxes@sbc-cpa.com).

Revised 01/18/2020  
by H. Edward McLeod, CPA

*NOTICE: Unless expressly stated otherwise, any accounting, business or tax advice contained in this communication is not intended as a thorough, in-depth analysis of specific issues, nor a substitute for a formal opinion, nor is it sufficient to avoid tax-related penalties.*