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## **Subject: Employee or 1099 – Be Careful!**

Since the dawn of withholding and the requirement that employers match Social Security and Medicare taxes, there has been a struggle between employers and the IRS over whether a worker should be considered an employee or an independent contractor. In the past various tests have been cobbled together by the courts and the IRS. These would often function as checklists (the so called “20 factor test”) and IRS audit guidelines, guiding employers on how to categorize their workers. But the tests have grown more complex and confusing. An effort to simplify the decision-making process, the IRS changed how it will analyze the classification of workers to a “3 behavior test” – **“behavioral control”, “financial control”, and the “type of relationship” of the parties. Let’s look at each one in turn.**

### **Behavioral Control**

Factors 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 and training the business gives the worker. Examples of types of instructions include:

- When and where to do the work
- What tools or equipment to use
- What workers to hire or to assist with the work
- Where to purchase supplies and services
- What work must be performed by a specified individual
- What order or sequence to follow

**The key consideration here, according to the IRS, is “whether the business has retained the right to control the details of a worker’s performance or instead has given up that right.”**

### **Financial Control**

**Six major factors to consider when looking at financial control are:**

1. The extent to which the worker has unreimbursed business expenses. Independent contractors are more likely to have them than are employees.

2. The extent of the worker's investment. Independent contractors often have a significant investment in the facilities they use to perform services for someone else.
3. The extent to which the worker makes service available in the open market. An independent contractor is usually free to seek out other business opportunities.
4. How the business pays the worker. An employee is usually guaranteed a regular wage while an independent contractor is usually paid a flat fee for a particular job performed.
5. The extent to which a worker can realize a profit or loss. An independent contractor can realize a loss.
6. The extent to which services performed by the worker are a key aspect of the regular business of the company. Independent contractors seldom are involved in the "core business" of the company.

### **Type of Relationship/Intent of the Parties**

Here are factors that will be considered:

- Written contracts. It helps to describe the relationship the parties are intending to create.
- Whether the business provides the worker with employee-type benefits such as insurance, pension, vacation pay, etc.
- The permanency of the relationship. If the worker is engaged with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, that is evidence that there was intent to create an employer-employee relationship.

### **What if I "1099" and Employee?**

If a company incorrectly pays employees as independent contractors and is "caught" by the IRS, the financial repercussions can be massive. Costs which can be incurred by a company if "1099 workers" are reclassified to employee status include:

- Back Federal, state, FICA, Medicare and unemployment taxes.
- Substantial and numerous penalties for misclassification of employees as " independent contractors"; and
- Back overtime pay, workers' compensation insurance premiums, and fringe benefits available to employees of the company.

### **What Should I Do?**

- Carefully review the "behavioral control", "financial control" and "type of relationship" you have with each worker you classify as a contractor. Put people "on the payroll" if the various factors provide little support for independent contractor status.
- If your review does not clearly conclude that a worker is an "employee" or a "contractor", you have the following 2 options:
  - ✓ Reduce your uncertainty and risk by putting the worker "on the payroll"; or
  - ✓ Modify your written "contractor" or "consulting" agreement to include provisions which strengthen your contractor relationship.

**NOTE** – If you change a worker's classification from a contractor to an employee, you should consider decreasing compensation to the contractor/now employee by 15% to offset your

increased costs resulting from employment (matching payroll taxes, workers compensation insurance, benefits, etc).

### **In Conclusion**

Due to the massive costs which a company can incur if its workers are reclassified from contractors to employees, it is very important that you carefully review your relationships with your workers. This is especially true in light of increasing audits and regulations by both the Federal and State governments in the “worker classification” area.

**AccuPay’s staff includes certified experts in payroll, tax law and “HR”. Call us at 885-7600 with any questions you have about “worker classification” matters.**

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