

Dealing with Independent Contractor Issues

Now that flexible work arrangements are becoming more common, it is even more difficult to tell the difference between “employees” and “independent contractors.” Nevertheless, it is important for employers to make the distinction. A misclassification can land an employer in hot water with the IRS.

What is at stake: If the IRS determines that an employer has improperly treated a worker as an independent contractor, it can assess payroll taxes on the worker’s wages, plus penalties and interest. In addition, the business may be assessed a penalty for failure to withhold income taxes on the worker’s wages equal to 1.5% of the wages paid and a penalty equal to 20% of the employee’s share of payroll taxes.

Previously, the IRS utilized a list of 20 main factors to determine whether a worker was an employee or an independent contractor. However, the IRS has recently adopted a more streamlined approach, recognizing changes in the modern workplace. For instance, new technology, such as modems and computer networks, has expanded the scope of the workplace so that many employees now work off-site. Instead of the 20-factor analysis, the IRS will generally base worker classification on these three key factors:

1. Behavioral control: Evidence showing that the business has the right to direct and control the means by which the worker performs the required services tends to indicate that the worker is an employee. On the other hand, directions concerning what should be done, but not how it should be done, are often consistent with independent contractor status.
2. Financial control: The financial arrangements between the parties could indicate which party has the right to control the business aspect of the job. The ability to realize a profit or incur a loss is the strongest indicator that the worker is the one in control and may be an independent contractor.
3. Relationship between the parties: The legal and contractual relationship between the parties may also be important in determining a worker’s status. For example, providing employee-type benefits to the worker, such as paid vacation days, insurance or retirement benefits, is a trait of employee status. Similarly, the right to discharge the worker without penalty may be indicative of employee status.

Note that an employer may be entitled to special protection from reclassification if there is a “reasonable” basis for treating a worker as an independent contractor. To qualify, the employer must have consistently treated the worker (and similarly situated workers) as independent contractors and filed federal tax returns consistent with that treatment.

There are also a number of safe harbors for establishing a reasonable basis such as a court decision or official IRS ruling that classified similar workers as independent

contractors, a private letter ruling from the IRS classifying the particular worker as an independent contractor, a prior IRS audit that did not find similar workers to be employees or a long-standing practice in the employer's industry.

Reminder: The stakes are high, so it is important to be on firm ground. Obtain professional guidance for borderline situations.