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To my Clients and Friends:

Here are the factors you should consider in determining the classification between independent contractors and employees. It's an important determination to make and a potentially expensive one if you're wrong. Additionally, we have enclosed an independent contractor form at the end of this letter, which you can use if you determine that the individual in question is an independent contractor.

Reason for concern: For workers who are considered independent contractors, you, the employer, are not liable for: (1) withholding of income taxes, (2) Social Security taxes (FICA) or the withholding of the employee's FICA share, and (3) federal or state unemployment taxes. Should the IRS ever prove the classification wrong, a classification of the worker as an employee can be very costly.

If the employer (your company) properly filed a Form 1099 for the individual and the IRS later determines that he's really an employee, the employer will have to pay 1.5% of the wages paid towards the income tax of the employee, plus 20% of the employee's share of the FICA taxes that should have been paid, and 100% of the employer's share of the FICA taxes that should have been paid.

If the employer inadvertently failed to file a 1099, the penalty is 3% of the wages paid towards the income tax of the employee, plus 40% of the employee's share of the FICA taxes that should have been paid, and 100% of the employer's share of the FICA taxes that should have been paid.

Generally, an employer-employee relationship exists when the person for whom the services are performed has the right to control and direct the individual who performs the services. This applies not only as to the means by which the result is accomplished.

An employee is subject to the will and control of the employer not only as to what will be done, but as to how it will be done. It's not necessary that the employer exercise this right, but merely that it has the right to control what is to be done and how.

A) The IRS is very aggressive in the area of worker classification and the penalties for misclassifying workers are severe. In past years, the IRS relied on a list of 20 common law factors to classify workers. More recently, however, the IRS has looked at three factors to determine appropriate worker classification:

1. Behavioral Control – Facts that show whether the business has a right to control how the worker performs the required task. The IRS looks to the degree of:
 - a) Instruction that needs to be given to the worker. For example:
 - (1) When and where to do the work.

- (2) What tools or equipment to use.
 - (3) What workers to hire or to assist with the work.
 - (4) Where to purchase supplies, materials, or services.
 - (5) What order sequence to follow.
- b) Training that the business gives to the worker.
2. Financial Control – Facts that show whether the business has the right to control the business aspects of the worker’s job including:
- a) The extent to which the worker has unreimbursed business expenses.
 - b) The extent of the worker’s investment in the business
 - c) The extent to which the worker makes services available to other customers (i.e., marketing, business location, etc...).
 - d) The method by which the worker is paid. For example, is there a guaranteed wage or a set price at the outset of the project.
 - e) The extent to which the worker can realize a profit or loss. Who bears the financial risk?
3. Relationship of the Parties Involved – the substance of the relationship between the parties governs the worker’s status, not the label. The IRS will look to:
- a) Are there written contracts between the employer and the worker?
 - b) Is the worker provided the employee type fringe benefits?
 - c) The permanency of the relationship between the worker and the employer.
 - d) The extent to which services performed by the worker are a key aspect of the regular business of the employer company.

The IRS recognizes that the degree of importance of each factor varies depending upon the occupation and the actual context in which the services are performed. In certain occupations, some of the factors may not exist at all. Ultimately, the final determination is a question of the facts and circumstances in each situation.

B. SAFE HARBOR RELIEF

A safe harbor rule minimizes the uncertainty of taxpayers concerning the proper classification of workers. Under section 530 of the Revenue Act of 1978, an individual will

not be **retroactively** (the taxpayer may still have to reclassify the worker for future tax periods) reclassified as a common law employee for employment tax purposes providing the taxpayer meets all three of the following requirements:

1. You must have a reasonable basis for your classification. Evidence of reasonable basis includes:
 - a) Reliance on a court case or IRS ruling.
 - b) In a prior audit, the IRS raised the issue of independent contractor v. employee and the workers were not reclassified.
 - c) Industry practice by a significant segment of the taxpayer's industry (note that a "significant segment" has been held by the courts to be as little as 18% (REAG Inc., v. Comr., US District Court, 8/28/92). To substantiate industry practice, the taxpayer will usually need to conduct a survey.
 - (1) The best time to take the survey is before adopting the plan. However, the IRS Training Manual tells the auditor not to reject a survey done at the time of an audit.
 - (2) The practice must have existed at the time the independent contractor status began.
2. The current and any predecessor businesses must have consistently classified the workers as independent contractors.
3. The business has consistently reported all information and filed all required form 1099's. If form 1099 were filed for some workers but not for others, relief is not available for the workers for whom forms 1099 were not filed.

C. TAX CONSEQUENCES TO EMPLOYER FOR IMPROPERLY CLASSIFYING INDEPENDENT CONTRACTOR

- A. If an employer treats an individual as an independent contractor and the IRS later determines that the individual is in fact an employee, the employer is subject to a penalty of 1.5% of the individual's wages (3% if no Form 1099 was issued) for failure to withhold income tax (Code Sec 3509). The employee is liable for his or her income tax, even though the employer treated him or her as an independent contractor and failed to withhold the income tax.
- B. The employer is subject to a "FICA penalty" of 20% of the employee's share of FICA taxes (40% if no Form 1099 filed).
- C. The employer must pay their share of the FICA tax.

- D. The employer is subject to the full amount of the employee's taxes if it intentionally disregards the withholding rules. This could happen where the employer treats all individuals as independent contractors.
- E. An employee can file an amended return claiming a refund for overpaid self employment tax after being reclassified as an employee (assuming it was in fact overpaid).

Generally, independent contractors have special skills or knowledge that set them apart from other workers. Many may have licenses.

If these skills are recognized and marketable to the general public, they are considered independent contractors unless they work exclusively for your company. (Incidentally, a director of a corporation is considered to be an independent contractor even if he's a full-time employee of the corporation.)

Sincerely yours,



Donald D. Wilson Jr.
Certified Public Accountant
DDW/cc

Pursuant to applicable U.S. Treasury Regulations, we must advise you that any tax advice included in this communication is not intended or written to be used, and cannot be used, by a recipient for avoiding penalties that may be imposed on the recipient by any governmental taxing authority or agency.

INDEPENDENT CONTRACTOR FORM

This form confirms the independent contractor status of _____ and as such will remit contracted amounts without regard to Federal or State tax withholding, unemployment tax or social security remittances. Independent contractors are expected to facilitate their compliance with Federal and State tax law, pursuant to Code Section 3401 of the Internal Revenue Code and Act Section 530 of the Revenue Act of 1978.

Independent Contractor Signature

Social Security Number

Address: _____

Company Official _____