

# Employees v. Independent Contractors

## Costly Mistakes to Avoid.



As an employer, you are responsible for paying Social Security and Medicare (FICA) in addition to federal and state unemployment taxes for each employee. Because independent contractors are responsible for their own FICA taxes and do not pay unemployment taxes, there is a financial benefit to employers who misclassify employees as independent contractors. Although the misclassification could be an honest mistake, you may not be relieved of your tax liability if successfully challenged by the Internal Revenue Service.

In February 2010, the Internal Revenue Service launched a three year National Research Program to evaluate compliance with employment tax laws. The goal is to audit 6,000 randomly selected employers to determine whether workers are properly classified as employees or independent contractors. The Program will focus on federal employment taxes: FICA, FUTA and personal income tax withholding. It is estimated that misclassification accounts for as much as 82% of uncollected taxes. A 2007 study by the U.S. General Accounting Office estimated that 15 percent of all employers misclassify 3.4 million workers as independent contractors each year. Misclassification has cost the government \$2.7 billion in Social Security, unemployment and income tax revenues. Given those figures, it is no surprise that the Obama administration and the IRS are aggressively seeking to identify and penalize those who misclassify workers.

According to the IRS, there are three characteristics are used to determine the relationship between businesses and workers: Behavioral Control, Financial Control, and the Type of Relationship.

- Behavioral Control covers facts that show

whether the business has a right to direct or control how the work is done through instructions, training or other means.

- Financial Control covers facts that show whether the business has a right to direct or control the financial and business aspects of the worker's job.

- The Type of Relationship factor relates to how the workers and the business owner perceive their relationship.

If you have the right to control or direct not only what is to be done, but also how it is to be done, then your workers are most likely employees. If you can direct or control only the result of the work done - and not the means and methods of accomplishing the result - then your workers are probably independent contractors. According to the IRS, "There is no magic or set number of factors that makes the worker an employee or an independent contractor, and no one factor stands alone in making this determination. Also, factors which are relevant in one situation may not be relevant in another. The keys are to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally, to document each of the factors used in coming up with the determination." (<http://www.irs.gov/businesses/small/article/0,,id-99921,00.html>)

Misclassifying workers as independent contractors can cause an employer to end up with substantial tax bills. Additionally, employers can face penalties for failing to pay employment taxes and for failing to file required tax forms. Contact our office and we can perform an in depth review and help document your decisions before you are faced with an audit.