

Independent Contractors v. Employees

Today more and more businesses are making increasing use of outside workers to cut costs, including payroll tax costs. Unfortunately, this trend has caught the attention of the IRS. What the IRS is looking for are workers who are treated as independent contractors but who actually are employees. If the IRS is successful in reclassifying workers, there is the potential of a substantial tax bill, consisting of, just for starters, the employer's back social security taxes and FUTA taxes, plus possible penalties and interest.

The amounts involved are significant. For 2007, apart from income tax withholding, the employer has to withhold 6.2% from taxable wages up to \$97,500 (\$94,000 for 2006) for the employee's share of the Old Age, Survivor and Disability portion of social security and 1.45% of all taxable wages for the Hospital Insurance, or Medicare, portion. It also has to pay an equal amount for the employer's share. FUTA, the federal unemployment tax, comes in at 6.2% of the first \$7,000 of taxable wages (subject to a maximum credit for state unemployment insurance on all but 0.8%).

Despite the high stakes, classifying a worker as either an independent contractor or an employee is not straightforward. The determination depends on a number of factors and can be quite complex. Control of how and when the worker gets the job done may or may not be the most important factor. Some workers are employees no matter how little or how much they are supervised. Others are independent contractors no matter how tightly a business controls them. For some, the IRS uses a 20-factor control test as an analytical tool.

There is some good news in all this intricacy. First, taxes due may be reduced if the misclassification is unintentional. Second, in some cases, if you have always treated workers as independent contractors the IRS may let you go on doing so. You cannot take advantage of this unless there was a reasonable basis for not classifying the individual as an employee in the first place and unless you have filed all returns required for nonemployees, such as Form 1099 information returns. Third, if you are unable to meet all the safe-haven requirements but have filed returns, the IRS may let you settle for a fraction of the cost. Of course, there are times when the IRS is incorrect in its demands for reclassification and litigation, rather than quick settlement, may be the better course of action.

Please do not hesitate to call us. We can work with you to review existing payment arrangements, help you with future plans and advise you what, if any, action is necessary. We may even find workers are actually independent contractors who have been misclassified as employees. One last word: Congress is aware that reform is necessary. We will let you know promptly of any action from Washington.