

A game of 20 questions

How to avoid misclassifying employees as independent contractors

Is the IRS knocking at your door? If you've been misclassifying employees as independent contractors, an IRS audit could be closer than you think.

"The trouble is, many companies are misclassifying workers without even realizing it," says Russell Stein, vice president of finance for Principal Technical Services. "It is important for businesses to understand the employee versus independent contractor distinction. Correctly classifying workers before they perform services can save a business from confusion, hassles and possible fines down the road."

Smart Business spoke with Stein about what businesses need to know in order to properly classify their workers.

What is the difference between an employee and an independent contractor?

The determination of whether a worker is an employee or an independent contractor is based on common-law rules derived in part from the IRS 20-Factor Test. The determination depends primarily on the extent to which the business receiving the services has the right to direct and control the worker with regard to what is to be done and how it is to be done. An employer generally has the right to control how an employee performs the service. Independent contractors determine for themselves how the work is to be performed.

When in doubt about how to classify a worker, it is best to classify him or her as an employee. It is the hiring company and not the individual who has the burden of proving that the classification is correct.

Can you summarize the IRS 20-Factor Test?

The questions on the IRS 20-Factor Test can be grouped into three categories: behavioral control, financial control and type of relationship.

Behavioral control — An employee is



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generally subject to a business's instructions about when, where and how to work. An employee may receive training to perform their work in a particular manner. Independent contractors can work off-site, determine their own work hours, and determine which work methods are most appropriate. They are also free to delegate and/or subcontract work to others.

Financial control — An employee is paid based on the number of hours worked or on a fixed salary. Also, an employee typically is provided a work space, equipment, tools and office supplies. An independent contractor is generally paid for results, not the amount of time worked. Contractors also incur expenses related to work space, equipment and supplies like any other business owner.

Type of relationship — An employee may receive benefits such as health insurance, paid time off and retirement plans. An employee can quit at any time and can typically be released 'at will' by the employer. An independent contractor is legally obligated to complete projects according to contract provisions and can only be dismissed for failing to do so.

What are the consequences of misclassifying an employee as an independent contractor?

Unintentional misclassification of workers violates both federal and state laws. The IRS can demand a penalty of 20 percent of the amount of taxes that should have been withheld, plus 1.5 percent of wages. The employer is responsible for payment, and no amount may be recovered from the employee. The employer would also be liable for its share of FICA and unemployment taxes that should have been paid, plus interest and penalties. Then after the IRS concludes its audit, the employer may face penalties at the state level as well.

Intentionally misclassifying workers carries stiffer penalties — the full amount of income tax that should have been withheld, the full amount of both the employer and employee share of FICA taxes, and interest and penalties computed on far larger amounts than in the case of unintentional misclassification.

Are there other risks besides tax penalties?

Misclassification of workers can result in lawsuits in which an individual hired as an independent contractor later claims to have been an employee.

Let's say one of your independent contractors is injured in an accident or suffers a catastrophic medical problem. Chances are that he doesn't have workers' compensation insurance, and he may not even have health insurance. This individual could sue your company, claiming to be an employee rather than an independent contractor. If, by the IRS 20-Factor Test, he should have been classified as an employee, your company could be held liable for his medical and lost time expenses.

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