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Independent Contractor vs. Employee

As the economy continues to slide into recession one of the areas that employers tend to look at to potentially save expenses is to reclassify employees to that of Independent Contractors.

This is not only dangerous but can come to haunt an employer several years later should the IRS or any other taxing authority involved in collecting payroll taxes determine that what would have otherwise been an employer/employee relationship was misclassified and the appropriate payroll taxes were not paid. This is especially true in California where if it is found that there is **willful misclassification** of an independent contractor severe penalties exist for employers ranging from \$5,000 to \$25,000 per violation in addition to the payroll taxes that would have been due along with penalties and interest for those violations. This past week a business in Southern California was found to be guilty of doing so and was fined over \$500,000.00.

The question that arises is whether workers are independent contractors or employees, and in most cases where workers were previously determined to be employees the change to Independent Contractor will be set aside with substantial penalties and back taxes being assessed against an errant employer.

The answer lays in the relationship between the business and the worker. Generally, whether a worker is an employee, or an independent contractor depends upon how much control exists between the business and the worker(s).

Should the right to control or direct what is to be done but also how it is to be done then workers are most likely employees.

Should direction or control exist only as to the result of the work done, and not the means and methods of accomplishing the result, then there may exist an independent contractor relationship, but this is also dependent upon other factors.

The IRS has published over 21 specific criteria (these can be found at our website www.petemcpa.com under FAQ's – Independent Contractor Guidelines).

Three broad characteristics are used by the IRS 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.

While the answer can have a profound impact on how much tax a business will incur, knowing whether your workers are or are not employees will affect the amount of taxes you must withhold from their pay.

The determination will also affect the additional costs the business entity must bear, what documents and information that must be provided, and what tax documents must be produced.

Employers who misclassify workers as independent contractors can end up with substantial tax bills as well as penalties for failing to pay employment taxes and failing to file required tax forms. There also exists the problematical area of whether workers have lost benefits as to their employment status and therefore have a defensible claim against the business for those lost benefits.

Both employers and workers can ask the IRS to make a determination on whether a specific individual is an independent contractor or an employee by filing a Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, with the IRS.

Knowing the proper worker classification can be critical to your business. Being wrong as to classification can be very costly in terms of the potential assessments of back taxes, penalties, and interest, defense costs, and potential employee litigation relating to lost benefits.

Should your business have a pension plan or other like benefit program relating to employees that have been misclassified who have effectively lost benefits, or effectively barred from inclusion as to those plans, there exist substantial penalties relating to the pension plans themselves.

Bottom line is to ask us before making a decision. If there is any doubt, then we will suggest obtaining a determination from a labor attorney, or the IRS.

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