

How to Avoid IRS Penalties with Correct Worker Classification

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Every kid knows the saying, “Sticks and stones will break my bones, but names will never hurt me.” On the playground, it’s true; but in the construction business, naming workers as employees or independent contractors must be done correctly, or business owners risk penalties imposed by the Internal Revenue Service.

According to the Bureau of Labor Statistics, the construction industry has one of the highest instances of self-employed workers — more than 2 million people, or 20 percent of industry workers, label themselves independent contractors.

Classification differences are significant. Employees get a paycheck with certain taxes deducted, and a Form W-2 at the end of the year; independent contractors get checks with no taxes deducted, and a Form 1099 that states how much they were paid for the year. Classifying workers as contractors saves money for employers, because businesses don’t incur payroll taxes — such as Social Security and unemployment insurance — and don’t pay for employee benefits or workers’ compensation insurance.

While the temptation may be great to save on those items, there are serious drawbacks for employers who incorrectly classify workers as independent contractors. In fact, the IRS penalties for misclassifying workers are significant.

Who’s in control here?

To satisfy the IRS, the key question is, to what extent does the business have the right to direct and control the worker? Construction managers generally have the right to control how employees perform their work, but independent contractors determine for themselves how the work is to be performed.

In deciding worker-classification cases, the courts have looked at facts in three main categories: behavioral control, financial control, and the relationship of the parties.

Behavioral control factors include any instructions that the employer gives the worker about when, where, and how to work; and any training the worker receives. Independent contractors ordinarily control their own work schedule and any necessary learning or training.

Financial control might include the extent of unreimbursed business expenses, which are likely to occur more often with independent contractors; how much the worker invests in facilities or equipment; and the extent to which the worker can realize a profit or incur a loss.

The relationship of employers and workers can be defined by contracts that are in place, and by whether the business provides the worker with employee-type benefits such as insurance, vacation pay, or a retirement plan.

Crime and punishment

The liability for an employer that unintentionally misclassifies an employee is limited to 1.5 percent of the employee’s wages for income tax withholding and 20 percent of the employee’s portion of FICA tax. However, intentionally misclassifying a worker exposes the employer to more severe measures. The range of disciplinary actions can include the full amount of income tax that should have been withheld, the full amount of the employer’s and employee’s FICA payments, interest and penalty amounts, and possible civil and criminal penalties, including jail time for the worst offenders.

To take the safest route, when in doubt, employers should classify workers as employees. If a worker is classified as an independent contractor, the hiring firm has the burden of proving that it had no control over the work or the worker. Use this form to determine worker status: <http://www.irs.gov/pub/irs-pdf/fss8.pdf>.

Government agencies can find other reasons to look at an employer's classifying practices. When a former worker files an unemployment insurance claim, for example, an investigation is automatically triggered to determine the status of the employee.

Take the IRS test

The IRS uses a 20-factor test to determine proper classification, but also will look at written contracts for independent contractor classification. Contracts can include important language, stipulating that the independent contractor is not entitled to employee benefits programs, and acknowledging that the independent contractor is free to work elsewhere at any time.

Employers should not feel that they are secure simply because certain conditions exist. A hiring firm should not assume it is safe under any of these situations:

- The worker wanted to be treated as an independent contractor
- The worker signed a contract
- The worker does assignments sporadically, inconsistently, or is on call
- The worker is paid commission only
- The worker does assignments for more than one company.

Congress has established "safe-harbor," or defense, provisions for employers that misclassify workers as independent contractors. An employer's defense could be based on:

- Judicial precedent, published rulings, technical advice with respect to the taxpayer, or an IRS letter ruling to the taxpayer
- Past IRS audits, which applies only if there was no penalty assessment related to the treatment of individuals holding similar positions in the business
- Long-standing, recognized practice of a significant portion of the industry.

An employer may be denied the protection of safe harbor if it inconsistently classified workers who are doing the same tasks, or if the employer has not filed the appropriate tax forms consistent with the treatment of a worker as an independent contractor.

When business owners understand the rules and correctly classify their employees, they can save time and avoid penalties. Sticks and stones may not figure in the punishment, but the possibility of fines and jail time should be enough to get anyone's attention.