










Can You Pass an IRS or DOL Audit of Independent Contractors vs Employees?

<p>GET THE FACTS ON MISCLASSIFICATION UNDER THE FAIR LABOR STANDARDS ACT Employee or Independent Contractor?</p> <p>The Fair Labor Standards Act (FLSA) provides minimum wage and overtime pay protections to nearly all workers in the U.S. Some employers incorrectly treat workers who are employees under this federal law as independent contractors. We call that "misclassification." If you are misclassified as an independent contractor, your employer may try to deny you benefits and protections to which you are legally entitled.</p> <p>Please refer to Fact Sheet 13 for more information on the factors used to determine whether you're an employee or an independent contractor.</p>	 <p>Receiving a 1099 does not make you an independent contractor under the FLSA.</p>	 <p>Even if you are an independent contractor under another law (for example, tax law or state law), you may still be an employee under the FLSA.</p>	
 <p>WAGE AND HOUR DIVISION UNITED STATES DEPARTMENT OF LABOR</p>	<p>1-866-4US-WAGE dol.gov/whd</p>	 <p>Signing an independent contractor agreement does not make you an independent contractor under the FLSA.</p>	 <p>Having an employee identification number (EIN) or paperwork stating that you are performing services as a Limited Liability Company (LLC) or other business entity does not make you an independent contractor under the FLSA.</p>
 <p>EMPLOYEES contractor</p> <p>Employers may not misclassify an employee for any reason, even if the employee agrees.</p>	 <p>You are not an independent contractor under the FLSA merely because you work offsite or from home with some flexibility over work hours.</p>	 <p>Whether you are paid by cash or by check, on the books or off, you may still be an employee under the FLSA.</p>	 <p>"Common industry practice" is not an excuse to misclassify you under the FLSA.</p>

**A SPECIAL REPORT FOR BUSINESS OWNERS
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Worker Misclassification Calling Someone an Independent Contractor Does Not Make Them an Independent Contractor.

Misclassification of Workers can be costly!

The purpose of this Special Report is to assist business owners in understanding the difference between independent contractors and employees. While this area might not seem important to some, the truth is it represents a huge liability for those that misclassify workers, and can in some cases lead to tax liens, fines and penalties large enough to put even the most successful business out of business.

Employee classification is an often misunderstood area of the law, with many government agencies with oversight and rulemaking authority. These agencies include The Department of Labor, The Internal Revenue Service, State Authorities and others. These agencies often have differing rules and jurisdictions. While we have gathered information in the preparation of this report from many sources, it would be impossible to include every agency, so we will stick to the basics.

This is all an area in which myths, old business owner tales and plain misinformation abounds, so it's important to vet the information you are told, especially when that information comes from other business owners. Doing what others in your industry do won't protect you when the regulators come calling. Many times, we hear stories of methods used by others that offer no protection and are simply effective "so far" because they have not been caught yet.

This report is not intended to give legal or tax advice, it is intended to provide general information and education that will assist you in knowing when and what to ask your legal and tax professionals.

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Summary

The IRS has long understood that the misclassification of employees is costly to the Treasury Department and creates greater opportunities for individuals to underpay, or not be able to pay, their taxes. Tax withholding from payroll represents a substantial portion of tax collected and it helps avoid the inability to pay that many would suffer from if taxes were not withheld before money was paid to wage earners. According to the Government Accountability Office (GAO), improperly classifying employees as independent contractors (IC) costs the U.S. billions in revenue every year.

In 2010, the IRS began a national research project that involved the examination of 6,000 taxpayers, with a focus on whether they were complying with the employment tax reporting and withholding rules. One of the examination areas was worker classification issues. The taxpayers were randomly selected and included large, mid-sized, and small business employers and nonprofit organizations. Not surprisingly, a majority of the audits were of small businesses (because smaller businesses comprise a majority of the taxpayer community). An IRS representative recently confirmed that the IRS is finishing up the last of the national research project audits now and that they should have information soon about areas of noncompliance.

Worker classification is also a high priority for the U.S. Department of Labor (DOL), state attorneys general, and state agencies. Over the last few years, there have been numerous federal and state legislative and administrative proposals relating to independent contractors.

There is little doubt that all too many business owners have independent contractors that are really employees, with nothing to back up their classification other than hopes and prayers. Worse yet is the number of businesses that have unknowing exposure liabilities they can't even imagine.

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The purpose of this special report is to assist business owners in recognizing and minimizing the liabilities they are exposed to unknowingly and to assist them in properly categorizing employees and independent contractors. In some cases this will require changes to the relationship and documentation in others the only good choice may be making the independent contractor an employee.

What you do with the information provided in this report is up to you. Our responsibility as Accounting, Tax and Payroll professionals is to provide you with the information so that whatever choice you make will be an informed one.

The Threat

Who does it come from?

Both federal and state governments are looking to increase revenue and employers that misclassify employees as independent contractors make a great target for tax collection officials. The department of labor also has the authority to fine and penalize those that violate employment law, which means that converting independent contractors to employees gives them authority to deal with the relationship you have with those who work for you as employees.

Add to this the fact that the TCJA Tax Cuts and Jobs Act of 2017 makes reasonable compensation of corporate officers an important requirement for the new Code Section 199A, Qualified Business Income Deduction, and IRS has even more reason to spend time on payroll matters when it comes to Audits.

The DOL, (U.S. Department of Labor) has drastically increased the enforcement of wage and hour laws under the Fair Labor Standards Act or FLSA.

The DOL is cracking down on employers who unlawfully misclassify

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workers as contractors instead of employees – calling the practice “workplace fraud.” A change in classification could mean additional wages due to federal minimum wage violations or a requirement to make-up unpaid overtime.

States with a state income tax also have a reason to look at the relationship between independent contractors and those hiring them. Even states without a state income tax are still dealing with the reporting and collection of unemployment insurance taxes.

Most states also have a state DOL, Department of Labor, and while the rules may be different state by state these agencies also have the ability to assess taxes, penalties, and wage assessments for subminimum wage and overtime.

The worst news is that none of these agencies are working alone. If one of them determines that employees have been wrongly treated as independent contractors once they complete collecting the taxes and penalties they can assess and collect they notify the other agencies so that they can also get in line for their share of the revenue pie.

There are more than government agencies and audits to worry about. Your contractors could also decide to file a complaint with any of the government agencies, claiming that they were really employees not independent contractors. They can make a claim to the IRS by filing IRS form SS-8 asking for a determination from the IRS as to whether they are misclassified or they can hire an attorney to make a wage and hour claim.

What will it cost?

Exact penalty and liability figures are impossible to predict because each case is unique unto itself. A misclassification determination could lead to anywhere from a thousand-dollar tax bill to a multimillion-dollar verdict with civil penalties attached.

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For those who don't think you can be held over the barrel for millions of dollars for a simple, or perhaps unintentional, worker classification violation, what you're about to read may change your mind.

IRS penalties

If the IRS determines an employer has misclassified independent contractors it will send a tax bill. But before sending a bill the IRS consider whether the misclassification was unintentional or intentional.

If unintentional: The IRS will cap the employer's liability for the employee's unpaid taxes to a fraction of the total amount due. But it will not relieve the employer of any unpaid liability for employer taxes - i.e., Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA) and state unemployment taxes.

For example, the tax liabilities added to employer taxes are as follows:

- If the employer properly issued Form 1099, the tax due is 1.5% of the worker's wages as federal income tax withholding, plus 20% of the employee's share of FICA.
- If the employer failed to issue Form 1099, the penalties double to paying 3% of the worker's wages as federal income tax withholding, plus 40% of the employee's share of FICA.

If intentional: The tax bill will be far greater. In addition to having to pay all the taxes you'd ordinarily be liable for, your tax liability will be as follows:

- 100% of federal income tax that should've been withheld from the employee's pay, plus
- 100% of the employee's share of FICA.

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DOL penalties

If the DOL decides you have misclassified employees as independent contractors the news can be far worse. This is because independent contractors are typically paid a set or flat amount for delivering some sort of completed product or service. In other words, they are not paid on an hourly or salary basis. If they are deemed to be misclassified under the Fair Labor Standards Act (FLSA), there's a chance the employer will be found guilty of violating the law's minimum wage and overtime regulations.

If an employer is found to have violated those regulations, here's what they could be required to pay:

- back pay – in the form of both regular wages and overtime wages
- an equal amount in liquidated damages
- attorney's fees
- court costs, and
- civil and criminal penalties for willful violations of the FLSA, up to \$1,000 for each non-willful violation and up to \$10,000 for each willful violation.

In addition, because there are no recordkeeping requirements pertaining to independent contractors, employers won't have much documentation on those workers. That will create additional problems, and potential fines for recordkeeping violations under the FLSA, if they are deemed to be incorrectly classified.

Misclassification can even become an Equal Employment Opportunity Commission (EEOC) issue if the DOL finds that an employer wrongly treated a certain group of workers who belong to a protected class as contractors instead of employees to deny them pay or benefits. In that case, the EEOC can charge the employer with illegal employment discrimination, which can run up the tab even more.

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State penalties

Depending on your state you may also be responsible for uncollected state income and other taxes along with penalties, along with state minimum wage laws and overtime requirements.

It's Not All Bad News

Independent contractors, when properly classified, can be an excellent resource for many businesses. You can mitigate or even eliminate much of the risk by properly treating independent contractors as independent contractors - not as employees. This in combination with proper documentation can go a long way in protecting your business from the liabilities mentioned earlier.

Independents can be a cost-effective resource to complete projects that are outside the scope and expertise of the business's employees. Because their engagement is on a project by project basis, they do not create an ongoing expense to the business. They are not eligible for any of the benefits you provide for your employees and can address projects you do not have the manpower for.

The key again is that they can't take the place of employees that work in your business and are required for you to provide the basic services your business sells. We will talk more later about what makes an independent contractor a true independent contractor, along with more do's and don'ts of using independent contractors, in your business and how to separate them and keep them from being reclassified as employees.

What Makes Someone an Employee

At the most basic level employees are those who are under the control of an employer. They are generally paid by the hour or receive a salary, and hence do not have the ability to make a profit or suffer a loss based on the

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speed and quality with which they perform the tasks assigned. But nothing is quite that simple when it comes to the IRS and the DOL.

According to the IRS in [Publication 15a](#) "Common-Law Rules - To determine whether an individual is an employee or an independent contractor under the common-law, the relationship of the worker and the business must be examined. In any employee-independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered. Facts that provide evidence of the degree of control and independence fall into three categories: behavioral control, financial control, and the type of relationship of the parties."

Behavioral Control is the ability to direct who the worker does the job it does not require one to exercise control over how the work does the job but simply to have the right to control the worker. Examples of Behavioral Control are:

- Setting the hours for work to be done or having the right to set the hours
- Controlling who can and who can't do the tasks or work (can I send someone else to do the task)
- Providing instructions or directions as to how the work is to be performed or having the right to do so
- Having the ability to determine in what order or sequence the work is to be done
- Providing training and other instruction programs to those performing work
- The ability to require what tools are to be used

While the above is not an all-inclusive list of things that indicate behavioral control, they clearly illustrate the concept of behavioral control. If you could tell someone what to do, when to do it and how to do it they are likely an employee.

Financial control. Facts that show whether the business has a right to control the business aspects of the worker's job include:

- Is the worker reimbursed for expenses by the business and to what extent?
- How much if any investment is required of the worker? (Tools, Equipment, Licensing)
- Does the worker make the same services available to others in the market?
- Does the business pay for the workers services on an hourly or salary basis instead of a project fee or upon completion?
- Is the working paid for time / attendance rather than having the ability to make a profit or suffer a loss based on how he or she performs?

Type of relationship of the parties. The following facts can be used to demonstrate an employee / employer relationship exists instead of a business / independent contractor:

- No written contract describing the relationship the parties intend to create
- Benefits are provided such as insurance, pension plan, vacation and or sick pay
- Permanency of the relationship the worker continues for the business on an ongoing basis and or performs services exclusively for the business
- The services performed for the business are key services and a regular part of the business day to day operations

Remember that only some of the above must apply to weight the scale and make someone an employee instead of an independent contractor. The above factors are not an all or nothing determination when in doubt the IRS is prone to choosing employee over independent contractor so be prepared to defend you position.

If you want the IRS to make the determination you can file form [SS-8](#) and

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request a determination from the IRS. This is the same form those that were treated as independent contractors use to ask the IRS to find that they should have been treated as employees and hence their employer should be responsible for the Social Security and Medicare taxes that were not paid by their employer or withheld from their checks. *So, it might be a good idea not to open this can of worms.*

When it comes to the IRS sometimes the rules above don't apply!

There are two classes of people where different rules apply these are the statutory employee and the statutory nonemployee.

Statutory Employees - If workers are independent contractors under the common-law rules above, such workers may nevertheless be treated as employees by statute, or law. When the law determines that someone who would be an independent contractor an employee by statute the employee is called a statutory employee. A business that has statutory employees must treat them as such and is responsible for certain employment taxes.

Statutory employees are those that fall into one of the following four categories and meet the three conditions described next under Social security and Medicare taxes.

1. A driver who distributes beverages (other than milk) or meat, vegetable, fruit, or bakery products; or who picks up and delivers laundry or dry cleaning, if the driver is your agent or is paid on commission.
2. A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.
3. An individual who works at home on materials or goods that you supply and that must be returned to you or to a person you name, if you also furnish specifications for the work to be done.

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4. A full-time traveling or city salesperson who works on your behalf and turns in order to you from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for you must be the salesperson's principal business activity.

Social security and Medicare taxes. You must withhold social security and Medicare taxes from the wages of statutory employees if all three of the following conditions apply.

1. The service contract states or implies that substantially all the services are to be performed personally by them.
2. They don't have a substantial investment in the equipment and property used to perform the services (other than an investment in facilities for transportation, such as a car or truck).
3. The services are performed on a continuing basis for the same payer.

Statutory Nonemployees - There are three categories of statutory nonemployees:

1. Direct Sellers
2. Licensed Real Estate Agents
3. Certain Companion Sitters.

Direct sellers and licensed real estate agents are treated as self-employed for all federal tax purposes, including income and employment taxes, if:

- Substantially all payments for their services as direct sellers or real estate agents are directly related to sales or other output, rather than to the number of hours worked, and
- Their services are performed under a written contract providing that they won't be treated as employees for federal tax purposes

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The Department of Labor uses an economic realities test. It classifies someone as an independent contractor if they don't "follow the usual path of an employee." To the DOL, that means the worker isn't totally dependent upon the business he or she serves.

To determine if a worker has been misclassified under the FLSA, the DOL will look at six factors it says the Supreme Court has deemed significant in determining how economically dependent a worker is upon a single business.

The Supreme Court has said that a classification determination cannot be based on isolated factors or a single one of the six factors it has identified, but instead depends upon the circumstances of the whole activity.

The six factors of the court's FLSA economic realities test:

1. The extent to which the worker's services are an integral part of the employer's business. Some questions used to determine how integral a worker's services are include:
 - Does the worker perform the primary type of work that the employer performs for its customers or clients?
 - Does the worker perform a discrete job that is a part of the business' overall production process?
 - Does the worker supervise any of the company's employees?
2. The permanency of the relationship.
3. The amount of the worker's investment in facilities and equipment. Similar to the IRS' test, the DOL is looking for signs a worker can use his or her own equipment, which would suggest an IC relationship.
4. The nature and degree of control by the principal. In other words, the DOL wants to know if the worker has control over his or her activities – like whether or not he or she can work for another company or can set his or her own hours. The more

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control the worker has, the better the chances are he or she's a contractor.

5. The worker's opportunities for profit and loss. Again, this mirrors the IRS test.
6. The level of skill required in performing the job and the amount of initiative, judgment or foresight in open market competition with others required for the success of the claimed independent enterprise. The DOL says some signs a worker runs his or her own independent business are that he or she advertises the business independently and has a stand-alone business website.

State law may also play a part in determining employee vs independent contractor status and every state has its own rules and agencies so it is important to understand the law in the state in which your business is located along with the laws of states in which you have business operations.

Signs you may be misclassifying employees as contractors include:

- They don't have a business license
- They don't have their own place of business
- They lack their own equipment
- They are solely dependent on your business to survive financially, or
- They perform the same work as employees.

The above are often used as red flags by auditors when looking for if independent contractors that should actually be classified as employees. If any of these apply to contractors working for you, it's time to revisit whether or not they should be reclassified as employees.

For the feds to consider workers bona fide ICs, the workers must be in

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business for themselves. They must also have the power to determine whether to do the work themselves or use their own employees or subcontractors.

In addition, they should:

- Have their own equipment and supplies, and
- Not be working full-time for your company

Tips to protect yourself from auditors

Here are the 13 other steps you should take to protect your company should your classifications come under the microscope:

1. **Establish contractual agreements.** Make sure there is a written contract in place for each Independent Contractor working for you. The contracts should explain why they are classified as contractors. Remember, this does not provide blanket protection for audits, since courts and regulators will look beyond contracts to establish the actual work relationship. But contracts can help strengthen your defenses should you come under fire.
2. **Identify contractor responsibilities.** Spell out the independent contractor's responsibilities to carry and maintain his or her own licenses and insurance. Make sure to stipulate that he or she is in charge of how to perform the work assigned. And spell out the authority of the contractor (the more the better). When it comes to listing the services to be provided, specificity always helps. Vagueness or omissions can be held against you.
3. **Spell out the method of payment.** Never provide payment through your regular payroll process. Keep it as far away from your regular payroll process as possible (e.g., make it the responsibility of Accounts Payable).
4. **Spell out tax responsibilities.** Make sure the contractor knows

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he or she is responsible for making tax payments.

5. **Spell out the circumstances for contract termination.** Companies should not be able to let the contractor go at will. That would smell like an employer/employee relationship.
6. **Deny benefits.** Make sure contractors know they are not entitled to traditional employee benefits (health insurance, retirement contributions, paid vacation/sick time, etc.) – and put this in writing.
7. **Make sure there's no exclusivity.** Do not restrict the independent contractor's ability to provide services to others not associated with your business.
8. **Train managers.** Many companies have their classifications overturned because their managers/supervisors get too involved and start treating and directing contractors as if they were employees. Tell your managers to only address work results, not work methods, in their discussions with contractors. Remind them to give contractors the power to determine work hours, work location, what equipment will be used (contractors should bring their own), what expenses contractors will incur and what workers contractors can hire to complete the job.
9. **Keep your policies to yourself.** Avoid disseminating employee manuals and other workplace policies to contractors.
10. **Don't make contractors look like employees.** In other words, don't issue them business cards, voice mail boxes, email addresses or a permanent work location.
11. **Don't discipline or train contractors.** Disciplining workers makes them look like employees. And training them makes it look like you're trying to control how they do their jobs.
12. **Treat them like entrepreneurs.** If you called a plumber to your building to fix a leaky toilet, you wouldn't treat him or her like an employee. Treat your contractors like you'd treat the plumber.
13. **Issue 1099s.** Make sure all independent contractors working for

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you receive a Form 1099 and all employees receive W-2s.

When in Doubt Get help

Regulatory and tax authorities like the IRS and DOL train their auditors in how to spot misclassification issues. The auditors have access to attorneys and other specialists that are on staff at their agency. They can will use anything or your employees you say against you given a chance to it is best to hire a professional when faced with an audit. The kind of expert you need will depend on the kind or audit and what agency is doing the audit. The experts available to you include Enrolled Agents and Attorneys. But not all Enrolled Agents or attorneys have the experience necessary so make sure you are hiring someone that understands representing business with employment and contractor classification.

Don't talk to the auditor yourself - as soon as you are contacted by anyone representing the state or federal government tell them that you will contact your representative who will get back with them and don't say any more. If you have an attorney or enrolled agent that you work with call them right away.

Who We Are

We are RMS Accounting a division of Royale Management Services, Inc., and we have been helping businesses make and keep more money since 1984. Our staff includes Enrolled Agents and other professionals that understand the tax and employment laws. We provide a full suite of accounting, bookkeeping, consulting, payroll, representation and tax services. We work with businesses of all sizes throughout the United States.

Our professionals are available when you have questions needs assistance or just don't know who to call. Want to know more just give us a call 800-382-1040

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This publication is not intended to provide legal, tax or business advice. It is intended purely for education purposes and assist business owners by providing a basic understanding of independent contractor misclassification issues.

Consult your legal counsel or tax advisor for assistance in applying the concepts covered within to specific situations.

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