



Independent Contractor or Employee? Find out now or pay fines later!

The IRS recently announced they will audit several thousand for-profit and non-profit entities to determine whether or not these organizations are properly classifying their workers. Many businesses mistakenly believe worker classification is a choice. Unfortunately, this belief can lead to costly headaches if the IRS chooses to examine those businesses and disagrees with the way the business is handling its workers. The IRS can and will hold business owners, or the personnel they deem responsible for the payment of payroll taxes, personally liable for the assessed taxes, penalties and interest.

Historically, both federal and state governments tend to side with the worker in a disagreement, so it is very important to make the correct determination at the beginning of the relationship with your workers. Salmon Sims Thomas is available to help your organization make these complex determinations.

COMMON LAW RULES - There are three basic determining factors the IRS uses to decide if your workers are independent contractors or employees:

1. **BEHAVIOR** – If the organization has the right, whether or not this right is actually exercised, to direct or control what the worker does and how the worker performs his or her job, this is indicative of employee status.
2. **FINANCIAL** – If the organization has the right, whether or not this right is actually exercised, to direct or control the financial and business aspects of the worker's job, this is also indicative of employee status. By financial, the IRS means; does the business control cash transactions of the worker? For instance, if the business makes a significant dollar investment in training the worker, reimburses expenses to the worker and/or has the risk of profit or loss in relation to that worker, are all situations that point to employee status.
3. **RELATIONSHIP** – How do the workers and the organization perceive the relationship? Both the business and worker should determine (preferably in a written contract) whether the worker is considered an employee or an independent contractor. This contract should be signed and dated by both parties and contain the “who, what, when, where and why” of the relationship.

TAX FILING REQUIREMENTS – As you might expect, there are tax filing requirements whether you have independent contractors or employees. Many businesses have both types of workers. In this case, the business must file all the required reports.

1. **EMPLOYEE PAYROLL REPORTS:**

Form 941 – Quarterly Federal Tax Return. If you have been notified by the IRS to file Form 944 (Employer’s Annual Federal Tax Return) instead of Form 941, you must file Form 944.

Form 940 – Employer’s Annual Federal Unemployment (FUTA) Tax Return.

Form W-3 – Transmittal of Wage and Tax Statements (this is a cover sheet that accompanies the W-2’s).

Form W-2 – Wage and Tax Statement (one must be completed for each employee)

State Reports - Additionally, you must file payroll reports mandated by the states in which you have employees. These filing requirements vary from state to state, but most states require quarterly wage reporting, and the computation and remittance of unemployment taxes.

2. **INDEPENDENT CONTRACTOR REPORTS:**

Form 1096 – Annual Summary and Transmittal of US Information Returns (this is a cover sheet that accompanies the 1099-MISC forms).

Form 1099-MISC – Miscellaneous Income. If you pay an independent contractor \$600 or more, you must complete a 1099-MISC for each contractor, unless the contractor falls under a reporting exception. Box Z is used to report nonemployee compensation paid to an independent contractor.

PENALTIES- If a business misclassifies a worker as an independent contractor when he or she is actually an employee, the IRS will assess penalties. If this occurs, the business may have to pay payroll taxes, penalties and interest retroactively for each misclassified employee going back as far as seven years.

If you have any questions regarding these or other tax issues, please contact one of our tax specialists listed below to arrange a consultation regarding these tax planning opportunities.

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