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## Are You Properly Classifying Independent Contractors?

The U.S. Department of Labor (DOL) and the Internal Revenue Service (IRS) are cracking down on employers who misclassify employees as independent contractors.

Federal and state governments are seeking to contest these misclassifications due to the current economic strain on their finances. Independent contractors, who can be re-classified as employees, represent increased revenue in the form of federal and state payroll income taxes, Social Security taxes, Medicare taxes, and Unemployment Insurance taxes. President Obama has allocated \$25M to the DOL to hire additional federal investigators to lead this effort, and predicts the outcome will bring in another \$7B in tax revenues over the next ten (10) years.

## What Steps Should Employers Take to Properly Classify Their Workers?

1. **Written, signed contracts.** Independent contractors should have specific contracts with the employer, including all terms and conditions citing when and where the work will be performed and that the contractor is NOT entitled to the same benefits as an employee. You should seek legal assistance to help with the preparation of these contracts.
2. **Performance of duties.** Provide an independent contractor with a general overview of their responsibilities within the contract itself.
3. **Form 1099 vs. W-2.** Independent contractors should receive a Form 1099 at the end of a calendar year, not a W-2. W-2s are reserved for employees. A Form 1099 demonstrates the contractor was treated as any other accounts payable, and not as an employee requiring taxation.
4. **Be consistent.** Treat your employees like employees and your contractors like contractors. Independent contractors should not be supplied with the same perks (ex. equipment, cars, expenses, etc.) as your employees.
5. **Recordkeeping.** Retain any information that demonstrates the independent contractor is in business for themselves and not an "employee" of your organization. These items could include business cards, letterhead, signed contracts, federal taxpayer ID number, copies of business insurance and worker's compensation insurance policies.
6. **Conduct your own audit.** You can have your attorney, auditor, or an HR professional conduct an audit on your behalf to ensure these steps and others are being followed to properly classify your workers.

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Many employers have sought to cut labor costs by increasing their use of independent contractors. However, if the IRS and/or DOL rule these workers to actually be employees, it can cost a business in back taxes, penalties, and even employee benefits now owed to these workers, including retirement plan contributions.

### Defining Independent Contractor

According to the IRS, in determining whether the person providing service is an employee or an independent contractor, all information that provides evidence of the degree of control and independence must be considered.

Facts that provide evidence of the degree of control and independence fall into three categories:

1. **Behavioral:** Does the company control or have the right to control what the worker does and how the worker does his or her job? (A worker is an employee when the business has the right to direct and control the worker.)
2. **Financial:** Are the business aspects of the worker's job controlled by the payer? (These include things like how worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)
3. **Type of Relationship:** Are there written contracts or employee type benefits (i.e. pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?

Businesses must weigh all these factors when determining whether a worker is an employee or independent contractor. Some factors may indicate that the worker is an employee, while other factors indicate that the worker is an independent contractor. There is no "magic" or set number of factors that "makes" the worker an employee or an independent contractor, and no one factor stands alone in making this determination. Also, factors which are relevant in one situation may not be relevant in another.

The keys are to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally, to document each of the factors used in coming up with the determination. For more information refer to the [IRS web-site](#).

Additionally, the IRS uses Form SS-8 as a guideline for determining worker classification. Familiarizing yourself with the contents of this form and the questions asked will help you when classifying your workers – <http://tinyurl.com/irs-ss8>.

### Legislative Note

Congress is currently considering legislation targeting misclassification of employees as independent contractors.

The **Employee Misclassification Prevention Act** (HR 5107), which was introduced April 2010, would amend the Fair Labor Standards Act (FLSA) to impose additional compliance and record-keeping requirements on employers to prohibit the misclassification of employees. Under the legislation, employers would have to provide written notice of classification to each individual hired, alerting the worker of his/her particular status as an employee or independent contractor. Employers also would be required to keep wage and hour records, similar to current records kept for employees, for each independent contractor hired.

Employers would have six months from the bill's effective date to notify current employees and independent contractors of their classification, and then workers hired after the effective date of the legislation would be informed of their status at the time of hire. If employers fail to comply with these notice requirements, workers would be presumed to be employees unless the employer showed clear and convincing contrary evidence.

For additional information see <http://tinyurl.com/hr-5107>.