

SHOULD THAT VENDOR GET A 1099 or a W2?

The IRS and Taxes

In recent years, the IRS has begun to realize the large sums of potential tax revenue they are losing due to misclassified 1099 independent contractors who should legally be W-2 employees. When a company pays a contractor on a 1099-misc form, they avoid the following: federal and state tax withholdings, deposits and reports, the employer's share of Social Security and Medicare taxes, state and federal unemployment insurance premiums, state disability insurance premiums, Workers' Compensation costs, fringe benefits, vicarious liability for employee negligence, and EEOC regulations.

The IRS estimates that it loses between \$4 to \$20 billion per year in unpaid taxes as a result of this misclassification problem. Understandably, the IRS has made it a priority to investigate 1099-misc forms that are turned in at the end of the tax year. The IRS is continually conducting audits to determine whether or not contractors are being properly classified.

1099s and Taxes

When a person is paid on the form, 1099-misc, all money earned by the individual is paid on an untaxed basis. It is then the responsibility of the individual to file and pay the appropriate taxes. These taxes can be owed to Federal, State and Local governments. Workers compensation and unemployment issues also must be addressed independently.

W-2s and Taxes

When a person is paid on the form W-2, the employer automatically withholds and pays all of the necessary employee income taxes as required by the IRS. These taxes include: Federal Income Tax, State Income Tax, and FICA (Social Security and Medicare). In addition, the employer will pay all of the necessary employer taxes. These taxes include: FICA (Social Security and Medicare), FUTA (Federal Unemployment Tax), and SUI (State Unemployment Tax).

What Tips the IRS Off?

Following are some standard occurrences that may flag your company for an audit:

- The independent contractor files a claim for unemployment benefits.
- The independent contractor files a claim for workers' compensation.
- The independent contractor files a claim for disability benefits.
- The IRS finds out the independent contractor hasn't been paying taxes.

A True Independent Contractor

An individual that is an independent contractor fills the following roles:

- The independent contractor will work with a number of clients.
- The independent contractor's role is to accomplish a final result and it's the independent contractor who will determine the best way to achieve that result. The independent contractor will define what the agreed upon "result" is in a contract with your customer.
- The independent contractor pays his/her own taxes and files the required government forms.
- A city license, business license, and a fictitious name or d/b/a statement will be obtained by the independent contractor. Also, the independent contractor must obtain any necessary permits.
- Social Security taxes are the sole responsibility of the independent contractor.
- The independent contractor must obtain his/her own benefits including workers' compensation, disability, etc. The contractor is not entitled to any typical employee benefits from any government agency.
- Independent contractor agreements traditionally provide professional liability coverage.

IRS 20-Point Checklist

How do you determine if a payee should be paid on a W-2 or a 1099?

The IRS has established a 20-point checklist that can be used as a guideline in determining whether or not a payee can legally be paid on a 1099.

This checklist helps determine who has the "right of control." Does the employer have control or the "right of control" over the individual's performance of the job and how the individual accomplishes the job? The greater the control exercised over the terms and conditions of employment, the greater the chance that the controlling entity will be held to be the employer. The **right** to control (not the act itself) determines the status as an independent contractor or employee.

The 20-point checklist is only a guide line. It does not guarantee that a person is correctly classified. There is no one single homogenous definition of the term "employee." Most agencies and courts typically look to the totality of the circumstances and balance the factors to determine whether a worker is an employee.

Following are the 20-points that have been established:

1. Must the individual take instructions from your management staff regarding when, where, and how work is to be done?
2. Does the individual receive training from your company?
3. Is the success or continuation of your business somewhat dependent on the type of service provided by the individual?
4. Must the individual personally perform the contracted services?
5. Have you hired, supervised, or paid individuals to assist the worker in completing the project stated in the contract?
6. Is there a continuing relationship between your company and the individual?
7. Must the individual work set hours?
8. Is the individual required to work full time at your company?
9. Is the work performed on company premises?
10. Is the individual required to follow a set sequence or routine in the performance of his work?
11. Must the individual give you reports regarding his/her work?
12. Is the individual paid by the hour, week, or month?
13. Do you reimburse the individual for business/travel expenses?
14. Do you supply the individual with needed tools or materials?
15. Have you made a significant investment in facilities used by the individual to perform services?
16. Is the individual free from suffering a loss or realizing a profit based on his work?
17. Does the individual only perform services for your company?
18. Does the individual limit the availability of his services to the general public?
19. Do you have the right to discharge the individual?
20. May the individual terminate his services at any time?

In general, "no" answers to questions 1-16 and "yes" answers to questions 17-20 indicate an independent contractor.

However, a simple majority of "no" answers to questions 1 to 16 and "yes" answers to questions 17 to 20 does not guarantee independent contractor treatment.

Some questions are either irrelevant or of less importance because the answers may apply equally to employees and independent contractors.

Contractor Classification: 1099 vs. W-2

FINES AND PENALTIES

Back taxes can total:

15.30 % Social Security Tax (on income up to the cap, plus 2.9 % of income above that cap)

20.00 % Federal Income Tax

+6.20 % Unemployment Insurance

41.50 % of the contractor's pay!

Auditors can go back three years. Fortunately, for those companies the IRS feels did not intentionally ignore the law, the fines are less (Section 3509 of the Internal Revenue Code). Be advised that any relief of tax liability provided by the IRS -- such as Section 530 of the Revenue Act of 1978 -- is of limited applicability in the staffing industry. This section, also referred to as the "Safe Harbor Act," was amended in 1986 to not relieve engineers, designers, drafters, computer programmers, systems analysts, or other similar skills or lines of work of tax liability.

Additional fines can be imposed by the IRS depending on the situation. The violations and associated fines are:

<u>Violation</u>	<u>Potential Fine</u>
Failure to file W-2 or 1099 form	The minimum fine is \$50 for each form that you failed to file. The maximum fine is \$250,000 per business or \$100,000 for small businesses.
Failure to file quarterly returns	25 percent of the unpaid tax liability.
Failure to pay taxes	0.5 percent of the unpaid tax liability for each month up to 25 percent.
Failure to get Social Security number	\$50 for each Social Security number you didn't get.

There are also significant fines if the IRS believes you committed fraud or were negligent, plus fines for many other situations. Contact the IRS if you want further information. In addition, any responsible person (including corporate officers and employees or members or employees of a partnership) with authority over the financial affairs of the business who willfully fails to collect and pay taxes may be held personally liable for the total amount of the uncollected tax under the "100 percent" provisions of the Internal Revenue Code (I.R.C.). Another point to keep in mind is that independent contractors who wrongfully benefited as a result of being paid on a 1099 are virtually free from penalties. The IRS may audit them and require them to eliminate any business deductions they took; however, the main focus is on the entity with the deepest pockets, in most cases, the company.

Furthermore, if a company classifies workers to avoid paying overtime according to the FLSA, the company can be subject penalties, from the payment of unpaid overtime premiums to liquidated damages, fines of \$10,000, and six months imprisonment for willful violations. Unpaid overtime premiums alone may represent substantial monetary liability depending upon the size of the work force and the length of time that the company has failed to pay appropriate overtime.