

Abstract: Classifying a worker as an independent contractor means an employer isn't obligated to pay many payroll-related taxes. But doing so may also draw IRS scrutiny. This article discusses key factors and proactive measures in following the rules when it comes to independent contractors.

How businesses can assess risk of worker misclassification

Classifying a worker as an independent contractor frees a business from its portion of payroll tax liability and allows it to forgo providing overtime pay, unemployment compensation and other employee benefits. It also frees the business from responsibility for withholding income taxes and the worker's share of payroll taxes.

For these reasons, the federal government looks unfavorably on misclassifying a bona fide employee as an independent contractor. If the IRS reclassifies a worker as an employee, your business could be hit with back taxes, interest and penalties.

Key factors

When assessing worker classification, the IRS typically looks at the:

Level of behavioral control. The more control the company exercises, the more likely the worker is an employee. So, the IRS looks at the extent to which the company instructs a worker on when, where and how to work; what tools or equipment to use; where to purchase supplies and so on.

Level of financial control. Independent contractors are more likely to invest in their own equipment or facilities, incur unreimbursed business expenses, and market their services to other customers. Employees are more likely to be paid hourly, weekly or bimonthly; independent contractors are more likely to receive a flat fee.

Relationship of the parties. Independent contractors are often engaged for a specific project, while employees are typically hired permanently (or at least for an indefinite period). Also, workers who serve a key business function are more likely to be classified as employees.

The IRS examines a variety of factors within each category, as well as the totality of facts and circumstances.

Protective measures

When in doubt, reclassify questionable independent contractors as employees. This may increase your tax and benefits costs, but it will eliminate reclassification risk.

From there, modify your relationships with independent contractors to better ensure compliance. For example, you might exercise less behavioral control by reducing your level of supervision or allowing workers to set their own hours or work from home.

Also, consider using an employee-leasing company. Workers leased from these firms are employees of the leasing company, which is responsible for taxes, benefits and other employer obligations.

Handle with care

Taxes, interest and penalties aren't the only possible negative consequences of a worker being reclassified as an employee. Your business also could be liable for employee benefits that should have been provided but weren't. Contact us if you have questions about worker classification.

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