

TAX TALK
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INDEPENDENT CONTRACTORS VS. EMPLOYEES, WHAT'S THE DIFFERENCE?

One long standing area of concern among businesses has always been whether to classify certain workers as "independent contractors" or employees.

What's the difference between the two categories?

Employees generally perform services for an employer that has the right to control what will be done and how it will be done. Income is reported to these individuals on Form W-2.

Independent contractors are people such as lawyers, contractors, accountants, etc., that are in an independent trade, business or profession in which they offer their services to the public. These people are generally hired to perform a service, but the hiring company does not control how the service is performed. Income is reported to these individuals on Form 1099.

If both categories report income then why all the controversy?

There are a variety of reasons why businesses like to classify individuals as independent contractors. If a business can classify an individual as an independent contractor, then they do not have to withhold or pay payroll taxes. Furthermore they do not have to offer employee benefits such as health insurance, workmen's compensation or pension and profit sharing plans. Lastly, independent contractors are not covered by minimum wage and hour laws and, as a result, businesses do not have to pay the independent contractors for down time.

The IRS would like individuals classified as employees because it is much easier for them to collect Social Security, Medicare and Federal income tax from 1 business then collecting Self Employment tax (an independent contractor's equivalent of Social Security and Medicare tax) and Federal income tax from a number of individuals that a business may classify as independent contractors. Additionally, independent contractors may reduce their Self Employment tax with business deductions while businesses and employees pay and withhold Social Security and Medicare tax based on gross salaries.

What happens if individuals are classified incorrectly?

Generally, the IRS can audit for 3 years. The consequences for misclassifying an individual can be over 10% (of compensation paid) in tax for 3 years plus penalties and interest. In many cases this could put smaller businesses in a hole they can never climb out of.

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The IRS has launched a new program in which businesses can voluntarily reclassify individuals formerly classified as independent contractors as employees in the future for a fraction of the penalty that would be paid if caught.

Conclusion

This article gives a very basic overview of the raging debate of independent contractors vs. employees. It is an area that has been contested for many years and seems to be a hotter topic than ever. If you either own or work for a small business, then you should be contacting your tax professional in order to make sure that you do not become subject to any unintended consequences.