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Abstract: If a business engages independent contractors to address staffing needs, it needs to be careful that these workers are properly classified for federal tax purposes. This article reviews the general rules for distinguishing an independent contractor from an employee.

Worker classification is still important

In 2020 and 2021, many companies have experienced “workforce fluctuations.” If your business has engaged independent contractors to address staffing needs, be careful that these workers are properly classified for federal tax purposes.

Tax obligations

The question of whether a worker is an independent contractor or an employee for federal income and employment tax purposes is a complex one. If a worker is an employee, the company must withhold federal income and payroll taxes, and pay the employer’s share of FICA taxes on the wages, plus FUTA tax. Often, a business must also provide the worker with the fringe benefits that it makes available to other employees. And there may be state tax obligations as well.

These obligations don’t apply if a worker is an independent contractor. In that case, the business simply sends the contractor a Form 1099-NEC for the year showing the amount paid (if the amount is \$600 or more).

No uniform definition

The IRS and courts have generally ruled that individuals are employees if the organization they work for has the right to control and direct them in the jobs they’re performing. Otherwise, the individuals are generally independent contractors, though other factors are considered.

Some employers that have misclassified workers as independent contractors may get some relief from employment tax liabilities under Internal Revenue Code Section 530. In general, this protection applies only if an employer filed all federal returns consistent with its treatment of a worker as a contractor and treated all similarly situated workers as contractors.

The employer must also have a “reasonable basis” for not treating the worker as an employee. For example, a “reasonable basis” exists if a significant segment of the employer’s industry traditionally treats similar workers as contractors. (Note: Sec. 530 doesn’t apply to certain types of technical services workers. And some categories of individuals are subject to special rules because of their occupations or identities.)

Asking for a determination

Under certain circumstances, you may want to ask the IRS (on Form SS-8) to rule on whether a worker is an independent contractor or employee. However, be aware that the IRS has a history of classifying workers as employees rather than independent contractors.

Consult a CPA before filing Form SS-8 because filing the form may alert the IRS that your company has worker classification issues — and inadvertently trigger an employment tax audit. It may be better to properly treat a worker as an independent contractor so that the relationship complies with the tax rules.

Latest developments

In January 2021, the Trump Administration published a final rule revising the Fair Labor Standards Act's employee classification provision. The rule change was considered favorable to employers.

The Biden Administration initially delayed the effective date and then issued a Notice of Proposed Rulemaking (NPRM) to withdraw the rule. After reviewing approximately 1,000 comments submitted in response to the NPRM, it withdrew the rule change before the deferred effective date. Contact your tax advisor for any help you may need with employee classification.

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