


W-2 VS 1099

What Employers Need to Know About
this Apples and Oranges Comparison

Why Know the Difference?



Many business owners don't want to consider themselves an "employer." Maybe you don't want to pay those employer related taxes, state unemployment taxes, FICA, FUTA, you don't want to handle garnishments, or anything like that. So, you decide you're going to use independent contractors. We're here to warn you that this is something on the fed's radar. Be careful as you choose to use independent contractors rather than employees because it may get you into some big trouble if you don't do it the right way.

So, what are those fed regulations? What do they say? What do they mean?

This issue is complex and leaves employers at risk for paying expensive fines. It's a powder keg.

Especially with stepped up audit and compliance enforcement that the feds are looking for. This is the DOL's conclusion when they apply an [independent contractor test](#) to the wide spectrum industries, and the people working within those industries. Their conclusion is that most workers should be considered employees, regardless of whether you think they are an independent contractor or not.

The IRS estimates 80% of workers classified as independent contractors are actually employees.

Regulations are murky and confusing at best. The reason for that is because two different federal regulatory agencies have different tests for whether someone working for you is considered an independent contractor—the Department of Labor (DOL), and Internal Revenue Service (IRS)

There's the Fair Labor Standards Act (FLSA) with a 6 prong economic realities test. The FLSA is controlled by the DOL and they are the ones who come in to look at your business' use of independent contractors in order to decide whether or not the relationship with the independent contractor meets the economic realities test. IRS, on the other hand, uses a 3 prong test known as the Darden factors. We'll go through what those are a little later.

As an employer, it is your responsibility to correctly classify your workers. It's best to get this right from the very start. If you don't, there's a lot at stake, and it could come back to haunt you.



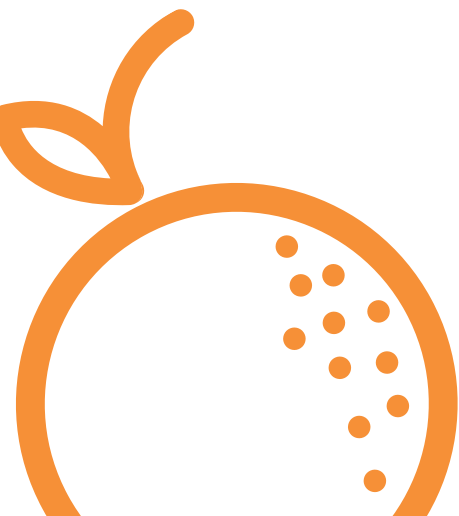
“Is this worker an employee or an independent contractor?”

First, let us just say we commend you for seeking out answers to help you get this right. Too often we see employers wait until a question is raised by an employee, agency, or even a lawyer before they worry themselves with this question. By that time, it's much too late.

Instead, it's better to get it right **from day one**.

It will take you extra time, and yes, you might even take on some tax liability for that W-2 employee that you're not thrilled about, but you need to think long-term. This cost is nothing compared to the penalties and fines you might face later if you get it wrong.

You're just a few pages away from being able to answer this question confidently. Continue Reading >>



The Difference Between Independent Contractor (1099) and Employee (W-2)

This issue is not as simple as you might think, and what you think you know about this may be wrong. The difference may feel like comparing apples and oranges, but it is much more difficult and complicated than that. Even if it is an honest mistake, misclassifying your workers could lead to some rotten fines from the DOL. Learn about the differences and choose wisely, because there are pros and cons for each choice.

Classifying Employees (W-2)



“A person in the service of another under any contract for hire, express or implied, oral or written, where the employer has the power and right to control and direct the employee in the material details of how the work is performed.” - [Black’s Law Dictionary](#)

Employees are anyone who performs services that are controlled by their employer. Read the full definition and an example on the [IRS website](#). When you classify your worker as an “employee” you must withhold different taxes and maintain obligations as their employer.

Employer Obligations

With employees, you are required to maintain the following obligations:

- You must provide a base wage or commission-based pay equal to or greater than the federal minimum wage. Or, subject to state, county, or municipal [specific requirements for non-exempt employees](#).
- You must track and pay all hours worked for non-exempt employees, or pay salary for exempt employees.
- You must pay overtime at a rate of 1½ times the base rate for all hours worked in excess of 40 hours per week. Or, subject to state specific requirements for non-exempt employees.
- If you offer your full-time employees medical, vision, or dental benefits, this must be reported on your W2s.
- You must ensure employees meet the [duties test](#) and salary thresholds if they are given exempt classification.

Feel Fuzzy About Exempt vs. Non-Exempt Employee Status?

This Article Will Clear it Up!

Employer must abide by the following acts and laws:

- [FICA](#) (Federal Insurance Contributions Act)
- [FUTA](#) (Federal Unemployment Tax Act)
- [FLSA](#) (Fair Labor Standards Act)
- [Title VII](#) (Civil Rights Act)
- [ADEA](#) (Age Discrimination in Employment Act)
- [ERISA](#) (Employment Security in Retirement Act)
- [ADA/ADAAA](#) (Americans with Disabilities Act)
- [FMLA](#) (Family Medical Leave Act)
- [NLRA](#) (National Labor Relations Act)
- [Applicable State Employment Laws](#)



Employer Tax Burdens

As the employer, you carry the responsibility of withholding the following taxes from your employee's paychecks and submitting them to the IRS:

- [FICA](#) (Federal Income Contribution Act)
- [FUTA](#) (Federal Unemployment Tax Act)
- [SUI Rates](#) (State Unemployment Tax Act)
- [Social Security Tax](#)
- [Medicare Tax](#)
- [Employee's Specific Withholding Elections](#)

A few other things to remember about W-2 employees:

- Collecting federal or state taxes & remitting those on the employee's behalf to the appropriate agencies is an additional soft cost labor and accounting expense.
- Tax filing deadlines apply to the employer with penalty and interest exposure if the employer misses the filing deadlines.
- Unemployment claims costs affect an employer's annual assigned state unemployment tax rate.
- Workers' compensation premiums are calculated based on an employee's base wages and are an additional hard cost expense absorbed by the employer.

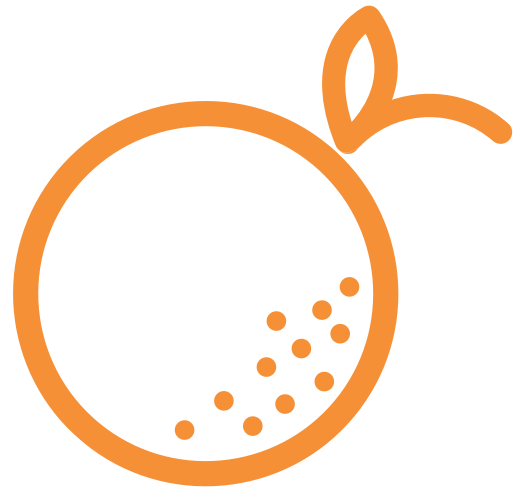
Classifying Independent Contractors (1099)

A 1099 employee is an independent contractor. The [1099 form](#) reports the income the independent contractor received throughout the year to the IRS for tax purposes. This form replaces the need for a [W-2 form](#), and indicates that the independent contractor is not an employee, no employer is responsible for paying their FICA taxes or withholding income tax, and they are responsible for paying Self-Employment Taxes.

A worker who is identified as an independent contractor practices independent employment and can contract with you and/or your business to do work according to their own methods. The independent contractor usually ends their employment relationship with your business once the piece of work or assignment is completed.

Here Are Some Examples of Common 1099 Employees:

- Carpenters
- Doctors
- Dentists
- Childcare Workers
- Veterinarians
- Real Estate Agents
- Lawyers
- Accountants
- Construction Contractors



Professionals who offer their services to the public **are generally classified as independent contractors and require a 1099 form**. However, it's not always that easy to classify.

You might want to consider some perks of employing workers as independent contractors, such as reducing your overhead costs and reducing various legal obligations. It is not always that simple, though. Sometimes, things get a little more complicated...

Be careful!

You must ensure that your independent contractors' employment status legally qualifies. In the event of [misclassification](#), the IRS can seek back taxes and other contributions that should have been paid on the employee's behalf. Workers can also seek compensation for job benefits that were denied due to improper classification. Not to mention, the DOL can also assess fines and penalties against your business.

How the **IRS** Views Independent Contractors

"The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done."

[- IRS.gov, Independent Contractor Defined](#)

The IRS is all about control. You're probably thinking about your last tax return and nodding your head in agreement right now, but in this case we're talking about their view of Independent Contractor and Employer relationships. To the IRS, the most important factor is who has the right to direct and control the 1099 employee.

After observing hundreds of cases and the facts involved in them, there are three consistent areas of information that defends or convicts employers of wrongdoing when it comes to worker classification.

The **IRS** Three Prong Test (*Darden Factors*):

1. *Behavioral control of the organization over that independent contractor.*

These are facts that illustrate whether there is a right to direct or control how the worker performs their work.

- Does the employer moderate instructions and training the worker receives?
- Do they dictate how the worker performs their work?

2. *Financial control over them (providing tools, uniforms, vehicle).*

These are facts that illustrate whether there is a right to direct control how the business aspects of the worker's activities are conducted.

- Was there a significant investment in tools or materials required to do the job?
- Were there unreimbursed expenses related to carrying out job duties?
- Are their services available to the relevant public market?
- What is the method of payment?
- What is the opportunity for profit or loss? Can they lose money doing the job?

3. *Relationship of the parties.*

These are facts that illustrate how the parties perceive their relationship.

- Is the intent of each involved party defined?
- Are there written contracts between the parties?
- Is the worker offered employee benefits?
- What does discharge or termination look like?
- Is the worker doing a task that is part of regular business activity?

Over the years, the IRS has developed a list of twenty common law factors that employers can use as a guide when looking at whether sufficient control exists to establish an employer-employee relationship. These 20 factors were eventually published by the IRS in [Rev. Rul. 87-41](#), and are referred to by some as the [Twenty Factor Test](#).

Remember though, that the Twenty Factor Test is only meant to be an analytical tool, and not the legal test used for determining worker status. The legal test is whether there is a right to direct and control the means and details of the work, while the Twenty Factor Test is simply a useful guide.

Here are the twenty factors that the IRS have identified as these indicators:

1. Instructions
2. Training
3. Integration
4. Services rendered personally
5. Hiring assistants
6. Continuing relationship
7. Set hours of work
8. Full time required
9. Work done on premises
10. Order or sequence set
11. Reports
12. Payment method
13. Expenses
14. Tools and materials
15. Investment
16. Profit or loss
17. Works for more than one person at a time
18. Services available to general public
19. Right to fire
20. Right to quit

**The IRS does note that some of the common law factors don't always apply to certain occupations and that the degree of importance to be given to factors may vary in particular situations. These factors have also been [recently revised](#) in order to simplify and refine the test.*

How the DOL Views Independent Contractors

The DOL focuses on the economic reality of the worker's relationship with the employer. *A worker is an employee if he or she is economically dependent on the employer, whereas a worker is an independent contractor if he or she is in business for himself or herself.* Basically, they ask the question of whether the employee is in business for themselves or an employer.

The courts generally apply a number of [six “economic realities” factors](#) as guides when making a determination in this area. According to the DOL, the Supreme Court has indicated that it is important to note it is not a checklist. No one single factor should be used on its own to make a determination. Instead, these factors are to be used in order to weigh the totality of a situation, and should always be used together. This is the test the DOL uses to determine if your workers are independent contractors or employees.

FLSA 6 Prong “Economic Realities” Test:

- *What is the extent of work performed by the worker?*
- *Does the worker's managerial skills affect his/her opportunity for profit or loss of company?*
- *Does the worker invest in facilities/equipment?*
- *What is the worker's skill and initiative?*
- *What is the permanency of the relationship between the worker and employer? (ie. Do you work with them every day?)*
- *What is the nature and degree of control by the employer?*

The DOL Debunks 12 Myths About Independent Contractors

The DOL has stated many times that they believe the misclassification of employees as independent contractors is a serious problem our country is facing. On their website, the dispel some of the most pervasive myths about 1099 employees. The infographic below outlines these 12 myths.

[Click image to view larger version >>](#)

12 Myths ABOUT INDEPENDENT CONTRACTORS DEBUNKED BY DOL

1

If the employee is an IC under one law, they are an IC under other laws.

Even if they are a legitimate independent contractor under one law, they may still be an employee under other laws.

2

If I classified them as an independent contractor, they are not eligible for unemployment insurance (UI).

They may still qualify for UI even if they are classified as an independent contractor.

3

The EE received a 1099 tax form from my company, and this makes them an independent contractor.

Receiving a 1099 does not make them an independent contractor.

4

It does not make a difference if they are classified as an independent contractor or an employee.

If you misclassify as an independent contractor, they may be denied benefits and protections to which employees are legally entitled. Misclassification also has negative effects on businesses.

5

They are an independent contractor because they signed an independent contractor agreement.

Signing an independent contractor agreement does not make them an independent contractor.

6

The employee is not on the payroll, so they are not an employee.

Even if they are not on the payroll, they may still be an employee.

7

They have their own employer identification number (EIN) or paperwork stating that they are performing services as a Limited Liability Corporation (LLC) or other business entity. This means that they are an independent contractor.

An EIN or paperwork stating that they are performing services as an LLC or other business entity does not make them an independent contractor.

8

I want the EE to be an independent contractor, and that means they are not an employee.

You cannot misclassify employees for any reason.

9

They telework or work off-site, so they are an independent contractor.

They are not an independent contractor simply because they work off-site or from home.

10

They have been an independent contractor for years; this means they will continue to be an independent contractor.

Being a bona fide independent contractor in the past does not mean they will always be an independent contractor.

11

They operate a franchise. This means that they are an independent business.

Operating a franchise does not make them an independent contractor.

12

They are an independent contractor because it is established practice in my industry to classify workers like them as independent contractors.

"Common industry practice" is not an excuse to misclassify under the FLSA.

Misclassification of employees as independent contractors is a serious problem our country is facing. Don't fall victim to one of these myths and pay serious penalties.

<https://www.dol.gov/whd/workers/Misclassification/myths-main.htm>

The Other Guests at the Party

Workers' Compensation

There are other interested parties that care whether your workers are properly classified or not. Parties like insurance providers or workers' compensation also use the same or similar factors to determine the relationship between you and your employees. This infographic provides an overview of how these four different parties determine this relationship, and which factors are most important to them.

The same applies to workers' compensation insurance. If an independent contractor is injured on the job and claims that they were misclassified and meet the requirements to be considered an employee, then you or your insurance carrier may be ordered to pay. You could also be fined for failure to provide workers' compensation coverage as required by law. There are [many other](#) ramifications if you misclassify your workers as independent contractors, but they are actually employees.

State Regulations

If the state finds that the worker was misclassified, the business is subject to unemployment claims and may face fines.

Different states may have different classification requirements and violations. An employer can be found to properly classify someone under federal standards and still be guilty of misclassification under state statutes. Be sure to verify that you are in compliance with state related parties, such as tax and labor commissions.

How Four Different Agencies Determine Independent Contractor-Employee Relationships

	DOL	IRS	INS	Workers' Comp
No right to control worker	★	▲	▲	▲
No instructions		★		
No training		★		
Assistants can do work		★		
Work not hiring firm's primary business	★	★	★	★
Not set work hours		★		
Not a continuing relationship	★	★	★	★
Control assistants		★	★	★
Time to work for others		★		
Determine job location		★	★	★
Set order of work		★		
No interim reports		★		
Paid by job		★	★	★
Work for many companies		★		
Pay own expenses		★		
Have own tools		★	★	★
Made significant investment	★	★	★	
Offer services to public		★		
Can make profit or loss	★	★	★	
Can't be fired at will		★	★	★
Aren't paid for partial work		★		
Distinct occupation or operates separate business			★	★
Skill required			★	★
Work typically non-supervised			★	★
Parties believe worker is independent contractor			★	★
Amount of initiative, judgement or foresight needed to succeed	★			



Important factor



Most important factor

Sources: CalChamber - [Independent Contractor vs. Employee - How Six Agencies Determine Relationships](#)

Beware! This topic is on the Fed's Radar

The DOL is strengthening enforcement of these rules by granting funding to nineteen states in order to enhance auditing programs. These nineteen states have been granted an \$8.2 million pot to split in effort to enhance [misclassification auditing programs](#). The DOL, EEOC, and IRS have also been aggressively auditing employers.

Play it safe. Do the workers you use actually qualify as independent contractors? We have run into businesses who classified workers as independent contractors only to have those workers file for unemployment after their assignment ended. In order to avoid this, it is better to do things the right way from the beginning instead of needing to fix a mistake later.

Notice: This information is not to be considered as legal services and is not designated to replace legal services.

About Employers Resource

We are a [PEO](#) who provides business leaders relief from administrative burdens, business costs, and compliance risk in the four main areas of payroll and tax compliance, employee benefits, HR and compliance, along with worker's compensation and safety. Our mission is to protect and set free the spirit of entrepreneurship -- one dream, one business, and one paycheck at a time.



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