

## W-2 vs. 1099



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).

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.

### Could the contractor be considered an independent?

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 dba 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 independent contractor is not entitled to any typical employee benefits from any government agency.
- The independent contractor can deduct business expenses from his/her income tax.

### Does Incorporation Matter?

There is a lot of confusion regarding independent contractors. Many employers realize that it is not a good idea to pay contractors on a 1099, but believe that if the worker is incorporated, it is okay. This is not necessarily the case. It is very simple to obtain a Federal Tax ID number for a business. This ID number is not an automatic protection from misclassification.

As always the IRS' 20 Point Checklist comes into play. Ultimately, the IRS is going to look at the work environment and who has control. An individual that is incorporated and working at a company could easily be considered an employee depending on the circumstances.

### Three Main IRS Factors

Basically, the IRS' **20-Point Checklist** focuses on three main factors:

- How much control the employer has over the worker's behavior and work results. (*Who controls training, where and what time the person works, what equipment they use?*)
- How much control the employer has over finances? (*Does the employer have primary control over the person's profit or loss?*)
- What is the relationship between the parties? (*Does the worker receive benefits? Is it a long-term relationship?*)

### IRS Questions in Court

Ask the five questions one court asked an employer (company) when considering whether workers were common-law employees:

1. *Who recruited them?* (Recruiter/company = more risk.)
2. *Who trained them?* (Company training = more risk.)
3. *What was the duration of employment?* (Longer assignment = more risk.)
4. *Did you have the right to assign extra work?* (Yes = more risk.)
5. *Did you have control over such things as firing, discipline, and rewards?* (Yes = more risk.)

## **IRS 20-Point Checklist**

### **How do you determine if a contractor 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 contractor 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 guideline, 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.