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Clarifying Classifications: 1099 Contractors and W2 Employees

Contract employment is rapidly growing and can be a great solution for both businesses and individuals in search of flexibility and efficiency. Many companies utilize a group of specialized workers to hire on a contingent basis for special projects, short- or long-term contracts, or busy seasons. Using contingent hires allows these employers to maintain a flexible workforce to better accommodate their fluctuating workload. At the same time, contract or contingent workers benefit from the increased flexibility and autonomy offered by these project-based employment opportunities.

And while contingent hiring offers a cost-effective, flexible employment solution, it's not without risks. Contract or project-based employment can carry a number of complexities, legal issues and confusion regarding the differences between a 1099 independent contractor and W-2 employee. It's a serious consideration employers can't afford to take lightly; misclassifying employees can have harsh legal and financial repercussions for businesses, recruiters, and even employees. Companies who wish to hire a contract employee may not actually understand the various tests that are used to properly classify a 1099 position, while prospective employees cannot legally classify themselves as "contractors" just by saying so.

The IRS has recently been cracking down on worker misclassification, and has raised the number and amounts of the fines and penalties in an attempt to end these issues. The fine for an intentional misclassification can be a penalty equal to 100% of the amount in taxes owed. In cases where an

employee negligently reports or under-reports employee status, the IRS can impose a 20% accuracy-related penalty. In 2013, Bowlin Group LLC, which provides installation services for Insight Communications, a cable television, telephone, and Internet service provider in Kentucky, agreed to a consent judgment in federal court to pay \$1,075,000 in back wages and liquidated damages.ⁱ Also in 2013, car service drivers filed a proposed nationwide class action lawsuit against Lyft, Inc. in California federal district court seeking a minimum of \$6.5 million in damages for allegedly misclassifying them as independent contractors, taking 20% of the gratuities given to each driver by a rider, failing to provide the drivers with complete wage statements, and failing to reimburse them for mileage costs in violation of the state labor laws. The proposed class action covers drivers in California, Washington, Illinois, Massachusetts, Indiana, Minnesota, Georgia, and the District of Columbia. *Cotter et al., v. Lyft, Inc. et al.*, 3:13-cv-04065-EDL (N.D. Cal. September 3, 2013).ⁱⁱ

With so much to lose, it's simply not worth it to avoid due diligence when it comes to employee classification. Although the penalties for incorrectly classifying employees are steep, they can easily be avoided by knowing the differences between employee classifications.

What Defines an Independent Contractor or W2 Employee?

The easiest way to avoid employee classification errors is for employers to maintain a clear understanding of the factors that determine an employee's status as 1099 or W2, and the differences between them. A 1099 position must include a contract with a specific end date. The worker is free to set their own schedule, and is only responsible for completing the project by the date set in their contract. Conversely, a W2 employee has a set schedule of work hours managed by the employer and has no specified end-date of employment. Essentially, a 1099 contractor is paid on a project basis, whereas a W2 employee is paid based on hours worked. Other more specific differences between 1099 contractors and W2 employees are laid out in the [IRS' guide for determining employee classification](#).

Employee W2

- Does not control how, when, or where he/she works
- Has no personal risk and is covered by Worker's Compensation
- Day-to-day work is important to the business
- Uses company resources

Independent Contractor 1099

- Controls every aspect of how, when and where the work will be done
- Assumes all risk and is not covered by anyone
- Not important for daily company workflow
- Use own resources to get job completed

The IRS Guidelines

Workers are considered employees if the company they work for has the right to direct and control the way they work – including the details of when, where, and how the job is accomplished. In contrast, the IRS will consider workers independent contractors if the company they work for does not manage how they work, except to accept or reject their final results. In addition, the IRS looks at a number of factors, including whether or not a worker:

- Is paid by the job or by the hour
- Furnishes the tools and materials needed to do the work
- Sets his or her own working hours
- Is told in what sequence or order to work by the hiring company
- Receives training from the hiring company
- Works full-time for the hiring company
- Works for more than one company at a time

- Pays their own business and travel expenses
- Provides regular oral or written progress reports to the hiring company
- Provides services that are an integral part of the hiring company's day-to-day operations

If the IRS would likely consider the employee an independent contractor, it is not necessary to withhold federal payroll taxes for the worker, including Social Security taxes, federal disability taxes and federal income taxes. However, if the IRS would not consider the worker an independent contractor it is necessary to make sure all of these taxes are accurately withheld or there could be severe penalties.

Potential Consequences

Should the IRS determine that an employee has been misclassified, they may then enact a lengthy list of legal repercussions for employers such as:

- Reimbursement of the employee for wages they are entitled to, including overtime and minimum wage
- Mandatory provision of (or back pay for) employee benefits
- Back pay of taxes and penalties for federal and state income taxes, unemployment, Medicare, and Social Security
- Pay for misclassified injured employees workers' compensation benefitsⁱⁱⁱ

Correcting Classification Errors

If an employer realizes they have been misclassifying employees, there is no need to panic, but corrections should be made as soon as possible. The best thing to do is identify the errors and then make the changes going forward. If errors have already been made in the hiring and payroll process, it may be necessary to consult an employment law expert or HR specialist to make the required corrections. For future hires, however, risk can be mitigated significantly before it ever starts by utilizing the services of a 1099 evaluation provider. Innovative Employee Solutions has a great deal of expertise in 1099 hiring and IRS compliance, and regularly provides clients with guidance regarding such issues during the hiring process, helping them to avoid potential risks and pitfalls

down the road. A simple phone call may be all it takes to clear up any confusion and avoid potentially hefty penalties down the line.

Since misclassifying employees can cost your business a loss of time, effort and money, it is important to stay educated on this trending topic and apply strict rules for how your company will approach the vetting and engagement processes for all independent contractors.

The confusion of classifying workers in accordance with IRS standards can also be avoided by engaging an Employer of Record service to act as the legal W2 employer for contingent hires. This service can help not only with risk management, but it can offer significant bottom-line savings by allowing companies to outsource the on/off boarding process, workers' compensation benefits, and ACA compliance for their pool of contingent or contract workers. By outsourcing payroll for contingent hires, companies can eliminate their risk of misclassification, and ultimately ensure that they are spending time and resources on their core business objectives rather than defending themselves from an IRS audit.

ⁱ <http://independentcontractorcompliance.com/2013/05/14/cable-company-pays-1-075-million-to-settle-misclassification-case-with-u-s-department-of-labor-for-cable-telephone-and-internet-installers/>

ⁱⁱ <http://independentcontractorcompliance.com/2013/10/03/september-2013-monthly-independent-contractor-compliance-and-misclassification-update/>

ⁱⁱⁱ <https://www.sba.gov/content/hire-contractor-or-employee>

About Innovative Employee Solutions

Innovative Employee Solutions (IES) provides payrolling and human resource (HR) administration services as the employer of record for companies throughout the US and Canada. By outsourcing employees' payroll and benefits administration to IES, employers significantly reduce the time, costs, and risks involved with handling these roles in-house. With a 40+ year history in the staffing and payrolling industry, IES has extensive experience and knowledge in the complexities of payroll and HR administration across all 50 states and throughout the globe. We offer a complete menu of payroll services, including: weekly and bi-weekly pay, 1099 contractor evaluations, industrial security clearance processing, Affordable Care Act compliance, and risk control management. For questions or more information, visit us online at www.InnovativeEmployeeSolutions.com, or contact us at:

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