



**Are you still leaving 1099
Compliance to chance?**

IC Compliance 101

Submitted by: ICon Professional Services

ICo's Overview of Services.



1 Introduction

If compliance with state and federal regulations of independent contractors (ICs) were simple, there would be few visitors to this site. It's not that regulators haven't tried to simplify the rules, they have. The problem is that there's no simple definition of "employee," and as you might guess, defining who's not an employee is even harder.

You can be sure the lawyers have had their shot at it – the Fair Labor Standards Act was challenged all the way to the Supreme Court, which, essentially, threw its hands in the air when it declared that "there was no definition that solves all problems relating to the employer-employee relationship." In one case, the Court provided regulators with a five-part "economic reality test" it would consider when determining the nature of a work relationship.

The IRS and state regulators have issued guidance to employers in an attempt to bring certainty to the Court's broadly-defined instructions. The IRS has a list of "20 Factors" it considers and an "ABC Test," as well as numerous rulings and publications. Most states have adopted similar policies or refer to the IRS guidance. But, the Court has stated that there can be no certainty; the issue is by definition uncertain. The 20 Factors, ABC Test, and other IRS guidance confirm this as none are stated in absolute terms – any factor "probably means" this or is "likely to mean" that.

The results have become a regulatory House of Mirrors for employers seeking to hire ICs – things may not be as they seem, and the intent of the parties may not matter. The worker can claim to be anything – a freelancer, consultant, contractor, sole proprietor, vendor, supplier, temp, whatever – and the parties can sign an agreement declaring that no employment is intended, but if evidence suggests an employee relationship, that will be the determination. The government's determination of work status looks at the myriad circumstances surrounding a working relationship, and specifically, at which party controls those circumstances.

Employee or Independent Contractor? The Basics.

With the appropriate disclaimers now made, we can look at the basic differences between worker classifications and understand when an IC classification might be appropriate.

The distinction lies in how the worker's income is reported and taxes collected. An employee's income is reported on a Form W-2 and his or her estimated income taxes are retained by the employer as a paycheck deduction. An employee pays half of the statutory taxes (FICA and Medicare) due on that income, also as a payroll deduction. The other half is paid by the employer. Employers are responsible for remitting all tax payments on a quarterly basis.

Payments made to an IC are reported on Form 1099 when they exceed \$600 in a year. The IC must pay all income and statutory taxes due on that payment, but is able to deduct reasonable business expenses. The company is not responsible for withholding estimated taxes from contractor payments or for submission of other employee-related reports for that worker.

The company is required, however, to document and archive its rationale for choosing to report any worker payments using Form 1099, and it should be prepared to provide that information to auditors upon request. As stressed above, worker classification is a complex determination, but in general, it addresses these three issues:

Behavioral Control

A company will be able to show that the IC maintained personal control over how work was to be performed. If, instead, the taxing authority determines that the company provided direction or exerted control over the work process, the worker would be considered a company employee.

Financial Control

The IC should operate as an independent business with the expectation of profit, but also, the potential for loss. Such a business will have invested in facilities and tools used to perform the contracted services. It will have unreimbursed business expenses and be actively marketing its products and services to other customers. Typically, it will not be wholly dependent on one customer for its revenue.

Relationship Type

Auditors will assess how the parties perceive the work relationship, both in word, as evidenced by written contracts, and in effect, such as whether the worker receives employee-like benefits, works for an extended term, or performs services that are critical to the company's success. If the worker is restricted from working for other companies in the same industry, auditors may classify the worker as an employee.

Why Do They Care?

Lest we drift towards Big Brother government paranoia, review quickly why government agencies or an individual plaintiff care about private work relationships (one hint: money).

Tax Enforcement

It is simply easier and more cost effective for the government to collect taxes from a few employers than from many employees. It's also harder for employees to avoid paying taxes that are deducted from their paychecks than it is for ICs who are responsible for their own tax payments. Therefore, to maximize the timely intake of tax revenues, taxing authorities assume all workers are employees unless the employer can substantiate the IC classification.

Fair Labor Standards Act et al

There are numerous mandates embodied in various state and federal laws that seek fairness in the workplace. In general, those rules are only applicable to employer-employee relationships and not to temporary workers-for-hire. Companies will, therefore, seek to classify workers as ICs in order to avoid the cost of those compliance requirements. The government, of course, wants to prevent that.

Civil Actions

Lawyers seek damages for workplace discrimination as companies avoid providing insurance, unemployment, retirement, and other benefits by misclassifying workers as ICs. Those actions can drive a government agency to make a determination regarding worker classifications. While the use of Independent Contractors may appear to be the perfect arrangement it is not without its pitfalls and risks. Governing laws, tax codes and other ordinances are complex and rapidly becoming more challenging than ever. Pending legislation only promises increased audits, more stringent oversight and extensive reporting requirements. According to testimony provided to the House of Representatives, the government itself stated, "There is neither a single or simple test used to determine whether a worker is an independent contractor or employee."

Even attempting to ascertain the proper classification standards by utilizing government supplied "tests" has become increasingly convoluted as criteria increasingly conflict with one another. In addition to the IRS 20 Factors Test, which was recently changed to the Three Categories of Evidence, nearly every state has its own laws and means for determining worker status.

Stepped-up Enforcement

The IRS has announced its intention to increase its efforts to enforce IC compliance and is in the midst of conducting a National Research Program (NRP) that will audit approximately 5,000 companies over the next year. While several large companies will likely be targeted as high-profile examples, most of the companies audited will be small and mid-sized businesses (SMBs).

Due to the decrease in tax revenue caused by the current economy, Congress and the Department of Labor have also indicated an intention to attain higher compliance rates among employers by passing new and tougher rules and penalties. States are facing the same budget crisis and can be expected to also look at tightening IC enforcement.

The Impact on Your Business

Using ICs obviously saves a company money, but that's rarely the reason ICs are hired. Contractors offer strategic value – the company can add unique expertise for as long as it's needed without incurring employee-related costs. However, you better classify any workers correctly. The penalties for non-compliance can be significant and include:

- Liability for back taxes and any penalties and fines for late payment
- Liability for back pay, including overtime pay
- Invalidation of benefit plans
- Reimbursement for unpaid benefits, including retirement plans, health insurance, stock options, and paid vacation, holidays, and sick leave
- Claims and back claims for unemployment benefits
- Civil liability for the actions of the reclassified worker, including harassment and personal injury
- Attorney costs for related litigation
- Unwanted public scrutiny and publicity
- Criminal sanctions, including imprisonment and fines, in some cases
- Personal liability for corporate officers

Treble and punitive damages can also be awarded if the company is found to have engaged in intentional misclassification of workers.

The Easy Solution? ICsimplify

Yes, IC compliance is complex and carries significant risk, but that doesn't mean you shouldn't engage ICs and benefit from the financial and strategic advantages of temporary talent. ICsimplify is a powerful and cost-effective IC compliance solution for small and mid-sized businesses delivered as an efficient online application that you only pay for when you use it. ICsimplify assesses the contractor, project, and engagement agreement by every variable considered by state and federal tax authorities, including the 20 Factors, ABC Test, all IRS revenue rulings, and associated case law. No other IC compliance solution is as fast and accurate as ICsimplify.

About Us

ICsimplify is a service provided by ICon Professional Services, a leading national Human Resource Outsourcing firm specializing in the classification and management of independent contractors. Since 1997, ICon has protected companies from the financial risks of worker misclassification.