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Regulatory: The IRS wants to know if your independent contractors are really employees

Given the potentially stiff penalties, companies should exercise care in how they classify service providers

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The mischaracterization of employees as independent contractors has been identified as a major contributor to the rapidly growing gap between what taxpayers owe and what is actually collected. It's a gap the IRS is making renewed efforts to close.

The full extent of tax revenue lost due to mischaracterization is not known, but recent government estimates suggest nonpayment and underpayment of employment taxes contributes more than \$50 billion to the almost \$500 billion tax gap. The Government Accounting Office recently estimated that anywhere from 10 percent to 30 percent of employers misclassified at least some employees.

The IRS considers unpaid taxes from the misclassification of employees to be low-hanging fruit and, accordingly, has stepped up its efforts to collect those taxes. Consequently, employers would be wise to re-assess their classification of employees and independent contractors.

Every service provider must be classified as being either an employee or an independent contractor for tax purposes. There is no other classification category. Although the classification may be difficult and subtle in some cases, the classification must nevertheless be made. Generally, if the service provider is classified an employee, the employer is responsible for the withholding and payment of employment taxes. If the service provider is classified as an independent contractor, the employment taxes are the

responsibility of the service provider. An employer who incorrectly classifies an employee as an independent contractor may be liable for significant penalties in addition to being liable for unpaid employment taxes.

Under common law rules, a service provider will be classified as an employee if the employer has the right to control and direct the service provider's performance with respect to both the result to be accomplished and the means of providing the services. Service providers not classified as employees will be considered independent contractors.

In determining the proper classification of a service provider, the IRS currently analyzes the following three general factors:

- **Behavioral control.** To what extent does the employer specify or dictate how the service provider is to perform a given task?
- **Financial control.** Has the employer made a significant financial investment in the service provider or does the service provider have the opportunity to share in profits or losses?
- **The nature of the parties' relationship.** Is the intent of the parties set forth in written agreements? Does the employer provide employment benefits to the service provider? Are the services to be provided part of the employer's regular business activities?

About the Author



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