

Worker Classification 101: 1099 or W2

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Agenda

- Why is this topic important?
- IRS, DOL and State Viewpoints
- IRS 3-factor test
- Dealing with gray areas
- Options in an audit

Introduction

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Introduction

- When you pay someone for their labor or services, that person is either an employee, or a contractor
- Determining if a worker is an employee or a contractor is called worker classification
- Employee = payroll taxes and possibly various benefits as well
- Contractor = no payroll taxes, no benefits, just pay them and off you go

Contractor vs. Employee



Workers who are contractors need no tax withholdings done (federal or state)



You cannot just say “this person is a contractor”



Audits happen at all levels (IRS, state, DOL)

DOL and Contractors

- DOL has released proposed regulations on worker classification
- Basically, going back to the “old way” of doing things
 - 2024: Biden Administration DOL had come up with a new interpretation of the economic realities test
 - New: current DOL wants to go back to the way things were

DOL

- 1) The extent to which the services rendered are an integral part of the principal's business.
- 2) The permanency of the relationship.
- 3) The amount of the alleged contractor's investment in facilities and equipment.
- 4) The nature and degree of control by the principal.
- 5) The alleged contractor's opportunities for profit and loss.
- 6) The amount of initiative, judgment, or foresight in open market competition with others required for the success of the claimed independent contractor.
- 7) The degree of independent business organization and operation.

Contractor vs. Employee: States

States vary widely on what they look for in a contractor vs. employee relationship

Some states have codified their viewpoint into what's called the "ABC" test

ABC Test

Under the ABC test, a worker is a contractor if all 3 of these are true:

The worker is free from the control and direction of the hirer in relation to the performance of the work, both under the contract and in fact;

The worker performs work that is outside the usual course of the hirer's business; and

The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hirer

ABC Test

Source: <https://www.patriotsoftware.com/blog/payroll/abc-test-worker-classification/>

- Alaska
- California
- Connecticut
- Delaware
- District of Columbia
- Hawaii
- Illinois
- Indiana
- Louisiana
- Maine
- Maryland
- Massachusetts
- Nebraska
- Nevada
- New Hampshire
- New Jersey
- New Mexico
- Vermont
- Washington
- West Virginia

IRS

The IRS uses a 3-factor test:

- Behavioral control
- Financial control
- Nature of relationship

Form SS-8

- Form SS-8 can be a valuable tool
- Typically, a worker who believes that they should be an employee rather than a contractor, will fill out this form and send to the IRS
- You can use it internally as a tool for working through the worker-classification process
- Form: <https://www.irs.gov/pub/irs-pdf/fss8.pdf>
- Instructions: <https://www.irs.gov/pub/irs-pdf/iss8.pdf>

General Questions

- The SS-8 starts with a series of general questions
 - Are other workers doing similar work?
 - If both a W-2 and 1099-NEC were issued to the worker during the year, explain why
 - What are the worker's job duties?
 - Is there a written contract? If not, what is the understanding of the oral agreement?

Test 1: Behavioral Control

Behavioral Control

- As the name of the test implies, behavioral control looks at the amount of control you exert of how, when and where the worker does the work
- The IRS does not like “training” a contractor
 - Why?
 - Contractors are separate business entities – why are you training a separate business entity?
 - On other items indicating “behavioral control,” why are you exerting “control” over a separate business entity, if they are a contractor?

Behavioral Control

One of the ways to keep the behavioral control subject straight is: independent contractors are taxed as separate business entities.

- When you give a 1099-NEC to an individual for contract labor, they file a business form called a Schedule C, which is attached to their personal tax return.
- The IRS's perspective is: why are you training a separate business? Why are you controlling the schedule of a separate business?

Behavioral Control

Let's look at some specific items off Form SS-8 relating to behavioral control

- If you are training, determining the way the work is done, and requiring reports, this would point toward the worker being an employee

Part II Behavioral Control (Provide names and titles of specific individuals, if applicable.)

1 What specific training and/or instruction is the worker given by the firm? _____

2 Who gives the worker work assignments? _____
How are the assignments received? In person Phone Email Text message
 Other (specify) _____

3 Who determines the methods by which the assignments are performed? _____

4 If problems or complaints arise, who is contacted? _____
Who is responsible for their resolution? _____

Did you remember to answer all questions and refer to the Instructions for Form SS-8 at www.irs.gov/pub/irs-pdf/iss8.pdf?

Form **SS-8** (Rev. 12-2023)

Form SS-8 (Rev. 12-2023) Page **3**

Part II Behavioral Control (Provide names and titles of specific individuals, if applicable.) *(continued)*

5 Is the worker required to complete reports? Yes No
If "Yes," attach examples.

Behavioral Control

Requiring reports:

- Of course you can require reports from your contractor, and of course you can have standards for how the work is done
- But again, think of how contractors are separate businesses:
 - Contractors operate project-to-project
 - Typically your main concern is that the project gets done on time and done right
 - With an employee, you're also concerned about how the work was done along the way

Behavioral Control

6a How frequently does the worker perform services? As scheduled As needed As available
 Other (specify) _____

b Describe the worker's primary services. Sales Timesheets Patient logs
 Other (specify) _____

7 Where are the services performed? If more than one location, what percentage of the worker's time is spent at each location?

<input type="checkbox"/> Firm premises	_____	%
<input type="checkbox"/> Worker's office or shop	_____	%
<input type="checkbox"/> Customer's location	_____	%
<input type="checkbox"/> Other (specify) _____	_____	%

8a Is the worker required to attend meetings? Yes No
 If "Yes," what type of meetings? Sales Staff Other (specify) _____

b Is the worker penalized if unable to attend a meeting? Yes No
 If "Yes," what is the penalty? _____

9 Is the worker required to provide the services personally? Yes No

10 Can the worker hire substitutes or helpers? Yes No

11 If the worker hires the substitutes or helpers, is approval required? Yes No
 If "Yes," who approves the hiring? Firm Other (specify) _____

12 Does the worker pay substitutes or helpers? Yes No
 If "Yes," is the worker reimbursed? Yes No
 If the worker is reimbursed, explain who reimburses them. _____

Behavioral Control

- All of the items on the prior slide tie back to controlling a schedule and how the work is done – pointing toward employee
- Are you requiring the worker – and only the worker – to do the work, or can they sub-contract it to someone else?
 - As a separate business, they should be free to get the work done as they see fit
- But of course, remember that there are shades of gray on all of this (not just on these tests here, but on the entirety of worker classification)

Test 2: Financial Control

Financial Control

The second test is financial control -- who has the financial risk in the relationship? The Form SS-8 lists 10 questions under this test:

Part III Financial Control (Provide names and titles of specific individuals, if applicable.)

1a List the supplies, equipment, materials, and property provided by
The firm: _____
The worker: _____

b Are supplies, equipment, materials, or property provided by another party? **Yes** **No**
If "Yes," explain. _____

2 Does the worker lease equipment, space, or a facility? **Yes** **No**
If "Yes," what are the terms of the lease? (Attach a copy or explanatory statement.) _____

3 Are expenses incurred by the worker in the performance of services for the firm? **Yes** **No**
If "Yes," explain. _____

4a Are expenses reimbursed by the firm? **Yes** **No**
If "Yes," provide the frequency and amount. _____

b Are expenses reimbursed by another party? **Yes** **No**
If "Yes," explain. _____

Financial Control

- Contractors typically provide their own tools and supplies and equipment
- Employees typically use your tools and supplies and equipment
- Of course you can find exceptions to this, but this is “in general”

Financial Control

Expense reimbursements

- While you “can” reimburse expenses a contractor incurs, this is typically an employee concept
- If a worker must incur expenses out of pocket and they aren’t reimbursed, this could indicate they are a contractor

Financial Control

5a What type of pay does the worker receive? Salary Commission Hourly wage Piece work Lump sum
 Other (specify) _____

b If paid commission, does the firm guarantee a minimum amount of pay? **Yes** **No**
If "Yes," explain. _____

6 Can the worker request advance pay? **Yes** **No**
If "Yes," how often? Daily Weekly Monthly Other (specify) _____

7 Whom does the customer pay? Firm Worker
If worker, does the worker pay the total amount to the firm? **Yes** **No** If "No," explain. _____

8 Does the firm carry workers' compensation insurance on the worker? **Yes** **No**

Financial Control

- There's a lot of nuance to all of this, and gray area
- It is legitimate to pay a contractor by the hour, but the IRS lists hourly pay as being more of an employee concept
- Workers' compensation: another nuanced area
 - If your contractor isn't carrying liability insurance, your workers' comp provider might include them in your coverage
- In your presenter's opinion, these are not things to panic about
 - **It depends on the other things going on in your relationship with the contractor**

Financial Control

Part III **Financial Control** (Provide names and titles of specific individuals, if applicable.) *(continued)*

9a Does the worker take a financial risk by performing services? **Yes** **No**
If "Yes," explain. _____

b Can the worker suffer a financial loss by performing services? **Yes** **No**
If "Yes," explain. _____

10a Who sets the rate of pay for the services performed? Firm Worker Other (specify) _____
b If products are sold, who sets the product price? Firm Worker Other (specify) _____

Financial Control

- What those tests are saying is this:
 - A contractor might bid a job at \$5,000
 - They get into the job and discover that their costs are \$6,000
 - Maybe they can change what they're charging you ... but maybe not
 - They might just have to eat the loss, and hope that future jobs turn a profit
- Now, think about an employee:
 - How many times would an employee have that situation arise?
 - Maybe if they are the owner of the business, but otherwise that seems almost unheard of for an employee to spend more money out of pocket than they get paid in wages from the job
 - If an employee is in this situation, **then they are probably not an employee!**

Test 3: Nature of Relationship

Relationship

Part IV Relationship of the Worker and Firm

1 Are benefits made available to the worker? Yes No
 If "Yes," which benefits are available? Paid vacations Sick pay Paid holidays
 Personal days Pensions Insurance benefits Bonuses
 Other (specify) _____

2 Can the firm or worker end the work relationship without penalty? Yes No
 If "No," explain. _____

3 Did the worker perform similar services for others during the time period entered in Part I, line 1? Yes No
 If "Yes," is the worker required to get approval from the firm? Yes No

4 Is there an agreement prohibiting competition between the firm and the worker? Yes No
 If "Yes," explain or attach available documentation. _____

5 Reserved for future use.

6 Does the worker advertise? Yes No
 If "Yes," what type of advertising does the worker do? Provide copies, if available. _____

7 Does the worker assemble or process a product at home? Yes No
 If "Yes," who provides the materials and instructions or patterns? _____
 If "Yes," what does the worker do with the finished product? Return to the firm Provide to another party Sell it
 Other (specify) _____

8a Does the firm introduce the worker to its customers? Yes No
 If "Yes," how is the worker introduced? Employee Partner Representative Contractor
 Other (specify) _____

b Under whose name are services performed? Firm Worker
 Other (specify) _____

9 Does the worker still perform services for the firm? Yes No
 If "No," how did the work relationship end? Firm ended the work relationship Worker ended the work relationship
 Job completed Contract ended Firm or worker went out of business
 Other (specify) _____

Relationship

Benefits is an employee concept

- PTO/vacation pay: this is an employee concept
 - Behavioral/schedule control
- SS-8 lists “pensions,” which is an all-encompassing term for retirement plans, including 401(k) plans; the form also lists insurance benefits
 - Again, employee concepts
 - Might even be violating laws by covering a contractor in a benefit program
 - Example: pension plans/401(k) law says retirement plans are organized for the benefit of employees of the employer
 - Your contractor is not your employee – they can’t be in your 401(k) plan

Relationship

- How does your relationship with the worker end?
 - With contractors, there may be a written contract in place that specifies how “the end” comes, and how you can terminate the relationship or they terminate the relationship
 - With employees, employment is typically “at will,” meaning you can terminate the relationship at any time and for any reason (as long as not discriminatory)

Relationship

- Contractors exist on a project-to-project basis
- Employees are working a job description
- Contractors should be free to work for others, not just you

Relationship

In other places, the IRS mentions “system integration”

- This could be behavioral control or nature of the relationship
- How many logins does the worker have?
 - Again, nuance. Contractors can have logins to your system, but the more logins and access a worker has, the more likely that they are an employee
- What does your business do to make money?
 - An employee is likely to be more involved in the process of helping your business make money

IRS Audits

IRS Audits

- If the IRS audits you, and reclassifies your contractors as employees, they will go back as far as they can
 - 3 years, maybe longer
- They'll assess some or all of the various taxes that should have been paid or withheld
 - 100% of employer-side FICA taxes and unemployment tax
 - A portion (or sometimes all) of the employee-side FICA taxes that should have been withheld
 - A portion of the wages paid as income tax withholding that should have been done
 - Penalties (think: Form 941 failure-to-deposit penalties)
 - Interest

If You're Audited

If you're audited:

- Winning over the IRS by convincing them you are right is the best scenario ... but in practicality is quite difficult

So then, you're looking at:

- Section 530 relief
- Section 3509 relief

Section 530

Section 530

Section 530 relief:

- Provides a safe harbor where the IRS is prevented from reclassifying contractors as employees, even if the worker otherwise meets the common-law tests to be an employee
- If you qualify for this relief, you can keep treating the contractors under audit as contractors, for federal tax purposes
- Can cause other headaches, such as qualified plans and benefit programs, since it only holds for income tax/payroll tax purposes
 - Seek out an attorney or an accountant

Section 530

- Since the IRS cannot reclassify your workers under Section 530, this is obviously a good type of relief
 - However, you don't just "get" Section 530 relief ... **you must qualify**

Section 530

Section 530 qualifications:

1. Consistency
2. Filed the 1099s
3. Have a reasonable basis

Section 530 – Consistency

- Under the consistency requirement, a business will only get relief if all workers doing substantially similar work are paid as contractors
 - If some workers doing substantially similar work are paid as W-2 employees ... no Section 530 relief
 - This is why it was recommended, earlier, to look at your workers and see if some (doing similar work) are paid as contractors and some are paid as employees

Section 530 – Reporting Consistency

- The “reporting consistency” requirement means you must have filed the 1099s (if ones were required to be filed)
- The IRS has maintained that the 1099s need to have been filed on time
 - Courts have held that if the 1099s were late, but filed in good faith, the business might still be able to meet this requirement

Section 530 – Reasonableness Requirement

The “reasonable requirement” means you need to show you had a reasonable basis for treating the worker(s) as contractors:

1. Court Case or Published Ruling.
2. IRS Prior Audit Safe Harbor. A past IRS audit involving the status of people holding similar positions to the current workers.
3. Industry Practice Safe Harbor. The business can show there is a long-standing practice by a significant segment of the industry in which the worker was engaged for treatment of the worker as a contractor.
4. Other Reasonable Basis.

Section 530 – Reasonableness Requirement

- Not on the list of “reasonable”
 - “It’s easier for me to pay them as contractors”
 - “I didn’t want to deal with the payroll taxes”
 - “It’s a hassle to do withholdings, 941s, etc.”

Reasonableness: Court Cases or Rulings

- Important to choose court cases or rulings that have a “generally similar” fact pattern.
- Be careful about using state court cases or state laws, unless the state has similar provisions to federal law
- Can also rely on Revenue Rulings or Regulations

Reasonableness: Prior Audits

- If your business was audited in the past on the subject of worker classification, and you got Section 530 relief, you might be able to rely on that audit:
 - If the workers being examined in that audit hold substantially similar duties to the workers in question now
- NOTE: Keep copies of the audit findings, you will need to show them if you are relying on this safe harbor

Reasonableness: Industry Practice

You might be able to meet the reasonableness requirement by showing that it's standard industry practice to pay this type of worker as a contractor.

- Essentially an “everyone else is doing it” argument, with 3 tests:

1. Industry. Businesses located in the same the geographic or metropolitan area in which the taxpayer conducts business and for which a business competes with for customers

2. Significant industry segment. At least 25% of an industry. A lower percentage might work, depending on the facts and circumstances.

3. Long-standing practice. an industry practice that has continued for more than 10 years. A shorter time period might work, depending on the facts and circumstances.

You must also show that you were reasonable in relying on this standard.

Reasonableness: Other Reasonable Basis

The 4th avenue for meeting the reasonableness requirement, if the other three don't work, is "other reasonable basis."

- The law directs the IRS to interpret other reasonable basis "liberally"
 - But "other reasonable basis" does NOT mean "I treated them as contractors because I didn't want to pay the payroll taxes."
- See next slide for some things that might count as other reasonable basis

Other Reasonable Basis

Some things that might count:

- Reliance on guidance other than court cases, Regulations or Revenue Rulings
- Various other pieces of guidance if your business can show you used the guidance to make a reasonable decision – example: the Queensgate court case, where a dentist’s office treated dentists as contractors based on an inquiry to the state dental board.
- State-level audits, if the state uses similar concepts to federal tax law for classifying workers
- Reliance on accountants or attorneys might qualify
 - Depends on the competence level of your accountant or attorney, **and if you can show you made a decision based on their advice**

Reasonable Reliance

This would apply both to relying on accountants/attorneys, and to the test relating to standard industry practice – you must show you made a reasonable decision based on the advice or industry practice:

- If you simply didn't want to deal with payroll taxes, so you classified your workers as contractors, it doesn't matter what standard industry practice is or what your accountant might have said
 - You weren't really "relying" on these things in making your decision
 - Obviously a nebulous thing

Section 3509

Section 3509 Relief

If Section 530 relief is not available, Section 3509 relief may apply.

- If you can show you did not deliberately misclassify workers
- “I didn’t want to deal with payroll” is not an argument that will fly here!

Once you have cleared that hurdle, then you look at the 1099s:

- If you filed the 1099s on time (if ones were required to be filed), you get better relief, called Section 3509(a)
- If you didn’t file the 1099s, or filed them late, you get Section 3509(b) relief

Section 3509 Relief

- Under Section 3509 relief, a portion of the potential back taxes is owed, rather than the full amount
 - A smaller amount under 3509(a)
 - A larger amount under 3509(b)

Calculations

Let's look at an example where you paid a contractor \$40,000 in 2023, and the IRS has now determined that the contractor should have been an employee

No Relief

Intentional Disregard -- No Relief		
Amount reclassified	\$ 40,000	
Employer FICA	\$ 3,060	7.65 percent
Employee FICA	\$ 3,060	7.65 percent
FUTA	\$ 42	.006 x \$7,000
22% assessed as income tax withholding	\$ 8,800	
TOTAL	\$ 14,962	
PENALTIES AND INTEREST WOULD BE ASSESSED ALSO		

No Relief

- 22% would be the basic amount of income tax withholding assessed
- Can vary, the IRS may assess using “existing law” and no W-4 on file, meaning withholding assessed based on single with no other adjustments
- Employer may be able to get an abatement of this withholding if it can get certification that the worker reported the income on their personal tax return and paid the income tax
 - Form 4669 – can use to get this certification
 - May be difficult to get the worker to actually fill it out

3509(a)

3509(a) Relief		
Amount reclassified	\$ 40,000	
Employer FICA	\$ 3,060	7.65 percent
Employee FICA	\$ 612	20% of full amount
FUTA	\$ 42	.006 x \$7,000
1.5% assessed as income tax withholding	\$ 600	
TOTAL	\$ 4,314	
PENALTIES AND INTEREST WOULD BE ASSESSED ALSO		

3509(b)

3509(b) Relief		
Amount reclassified	\$ 40,000	
Employer FICA	\$ 3,060	7.65 percent
Employee FICA	\$ 1,224	40% of full amount
FUTA	\$ 42	.006 x \$7,000
3% assessed as income tax withholding	\$ 1,200	
TOTAL	\$ 5,526	
PENALTIES AND INTEREST WOULD BE ASSESSED ALSO		

Calculations

This is one year of reclassification of \$40,000 of wages

- No relief: \$14,962
- 3509(a): \$4,314
- 3509(b): \$5,526

Does not include penalties or interest. **And it's just one year (we used 2023 – they'd likely look at other years too)**

Classification Settlement Program

Classification Settlement Program (CSP):

- These audits usually involve multiple years
- Amounts owed, even reduced under 3509(a), can be the 3509(a) amount times however many years the IRS is examining
- In our example of \$40,000 of wages, let's say the IRS is examining three years and the wages were the same each year:
 - 4,314 liability under 3509(a) x 3 = \$12,942
- CSP can help soften the blow

CSP

- Continuing our example of \$12,942 owed over 3 years of audit
- Let's say you filed the 1099s (if needed) and consistently treated the worker as a contractor but you fail the "reasonableness" requirement
 - **A common boat many employers will be in**
- Section 530 relief is not available because of the reasonableness requirement being failed, but the IRS might agree to a CSP

CSP

- **Terms can vary**, but one example that the IRS might agree to is to assess only on one year (\$4,314), and the employer agrees to treat the worker as an employee going forward

CSP – 25% Offer

- The IRS may agree to a CSP where the employer owes just 25% of the employment taxes due in the latest year in the audit
 - Example: 2024, 2023 and 2022 under audit; IRS may agree to the employer paying 25% of the 2024 liability, and agreeing to treat the worker(s) as employees going forward

CSP – 25% Offer

The IRS may agree to a 25% offer if the 1099s were timely filed (if required to be filed) and at least one of these is true:

1. The reasonable basis test was met and the business has a colorable argument for the substantive consistency test.
2. The substantive consistency test was met and the business has a colorable argument for the reasonable basis test.
3. The business has a colorable argument for both the reasonable basis and substantive consistency tests.

CSP – 25% Offer

- "Reasonable basis" for a 25% offer can be slightly different from the Section 530 tests
- CSP looks at if the argument has "merit"
- Proceed with caution before agreeing to a 25% offer
 - You might qualify for Section 530 relief, which is better because you owe no prior payroll taxes AND can continue to treat the worker as a contractor
 - If you accept the 25% offer, you are only paying 25% of the most-recent year under audit, but you also are agreeing to treat the worker as an employee going forward
 - Issues with benefit programs
 - Cost going forward
 - But, if you reject the 25% offer, then you have to hope your Section 530 argument wins, or else you could owe for multiple years with no relief!

Early Referral to Appeals

Taxpayers under a worker-classification audit can make an “early referral to appeals”

- Puts the case immediately before appeals, even if the audit is not finished
- May be beneficial if IRS agent or supervisor is not recognizing the business’s Section 530 argument, or a plain argument that the business is right on contractor status for a worker
- Employer must initiate in writing

Early Referral to Appeals

The IRS says (Rev. Proc. 99-28) early referral to appeals is appropriate for:

1. Worker classification issues, including whether a worker is a statutory employee or statutory nonemployee, or meets the common law definition of an employee.
2. Whether the taxpayer qualifies for Section 530 relief.
3. Whether Section 3509 rates are appropriate.
4. Whether the taxpayer qualifies for an interest-free adjustment. **(This relates to late payroll deposits in an audit)**
5. Whether, for purposes of the payroll tax rules, certain payments are excluded from the definition of wages (such as fringe benefits that qualify as de minimis under IRC Sec. 132) or certain services are excepted from the definition of employment.

Gray Areas, Commentary, Scenarios

Commentary

- There is a lot of gray area on this
- People often ask highly specific questions – the problem with answering such question is, “it depends”
- But if you’re looking for things that tilt the scales more heavily in one direction or another, look at anything falling under the heading of “control”

Strengthening the Case

Strengthening the case for continuing to treat a contractor as a contractor:

- Use Form SS-8
 - Understand its limitations: biased toward employee status
 - Use for internal purposes, rather than actually filing with the IRS
- Look at written agreements with contractors
 - Written agreements do not “prove” contractor status, but they can be a key piece of evidence

Strengthening the Case

- Periodically review your arrangement with the contractor
 - They might clearly be a contractor in the beginning, but could veer towards being an employee as time goes on
 - Periodic reviews of your arrangements help catch these situations
- See if Section 530 status could apply to the contractor

Handling Misclassified Workers (Not Under Audit)

If you discover a contractor should probably have been an employee:

1. See if Section 530 relief applies
2. Keep as a contractor and strengthen the case
3. Change the contractor to an employee going forward
4. Voluntary Classification Settlement Program

Always, always, always talk to your accountant or an attorney before making a decision!!!!!!

Handling Misclassified Workers

Section 530

- We already discussed this
- If you think Section 530 relief would apply, you can keep treating the worker as a contractor
- **But obviously, be prepared to defend this in an audit**

Handling Misclassified Workers

Keep as a contractor and strengthen the case – if you think Section 530 wouldn't apply to the past

- If Section 530 would apply, it's still a good idea to strengthen the case, but it's more of a moot point
- Think back to the 3 factors ... especially CONTROL -- strengthen the concepts relating to your contractor really being a contractor
- BEWARE: after you strengthen the case, if you get audited in the next 3 years, the IRS might try reclassifying the worker to an employee for the time prior to the strengthening
- Worker could also disagree and file a Form SS-8, inviting IRS scrutiny

Handling Misclassified Workers

Change the contractor to an employee

- While you might think the IRS would be all for this, it is fraught with danger
 - It fixes things going forward but leaves you open for problems with prior years
 - The IRS would likely wonder, why wasn't this person an employee in the past?
 - Document, document, document: can you find a reasonable argument for saying the worker was a contractor in the past? And document what has changed now to warrant a change to employee

Voluntary Classification Settlement Program

Voluntary Classification Settlement Program (VCSP)

- Allows employers to reclassify contractors as employees going forward
- This can be complicated: your presenter believes it's a "tax attorney thing"
- Basically you're filing paperwork with the IRS and coming clean that a worker or workers should have been employees in the past
- You pay a fraction of the amounts calculated under Section 3509
- Advantage: audit protection for prior years, you can reclassify to employee while being protected from audit on the years the workers were contractors

Can a Worker Be Both?

- The IRS does not like when a worker receives both a W-2 and a 1099 from the same company in the same year
- Sometimes it might work, either by law, or by facts and circumstances

Can a Worker Be Both?

Times when dual-status is allowed by law or other ruling:

- Officer and director: officers of a corporation who provides services to the corporation MUST be paid W-2 wages; however, if the company compensates for service on the board of directors, this is 1099-NEC/contractor
- More on the next slide

Can a Worker Be Both?

- Officer and salesperson: in Revenue Ruling 58-505, the Treasury Department analyzed a situation of the owners of a “mutual insurance company”
- Ruling:
 - Administrative work by the officers is W-2/employee pay
 - Sales commissions could be contract labor

Can a Worker Be Both?

And, Proposed Regulation 31.3508-1(j)(2), Example 1:

- In this example, a worker was a real estate agent who also did bookkeeping work for the agency
- The Regulation says the sales commissions relating to being a real estate agent would be contract labor, but the bookkeeping work is W-2/employee

Can a Worker Be Both?

- WARNING: partners of a partnership cannot be employees of the partnership (here is a good article on the subject, with multiple citations: <https://www.journalofaccountancy.com/issues/2014/aug/20149676.html>)
- And sole proprietors (including proprietors of one-owner/disregarded entity LLCs) are also not employees of the proprietorship

Can a Worker Be Both?

In a few cases, the dreaded facts and circumstances could side with treating a worker as both a W-2 employee and a 1099 contractor at the same time. See the Internal Revenue Manual 4.23.5.2.1.1:

- “When the taxpayer has issued both a Form W-2 and a Form 1099 to a worker in the same calendar year, the examiner must consider whether the Form 1099 amounts represent additional compensation to the worker:
 - For the same services the worker performed as an employee, or
 - For separate and distinct services that are unrelated to the services provided by the worker as an employee.”

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Examples:

- Example: a garden center has an employee who is also a carpenter on the side. The employee works for the garden center during the week, but then moonlights for the center to build a fence on the weekends. The work building a fence would probably be okay as contract labor.

Note that in this example, the worker has a legitimate side business, and the garden center happens to be a client of his side business.

Can a Worker Be Both?

- Ramirez v. Commissioner, Tax Court Summary Opinion 2013-38
- This is a fascinating case – your presenter highly recommends looking it up
- One of the few times where W-2 wages (some of them, anyway) were reclassified as contract labor
- Let's examine

Can a Worker Be Both?

- Ramirez was program director at a radio station
- The station was struggling financially, and he took it upon himself to find sponsors
- He would sometimes do promotional work for his sponsors and was paid \$82,000 for this work in 2007 (the year of the audit)
- The radio station sent invoices to the sponsors, with separate line items for the regular advertising fees to the station, plus a line item for the promotional work of Ramirez
- The station gave Ramirez a W-2 for wages paid, for his regular pay plus the \$82,000 passing through to him for his promotional work for sponsors

Can a Worker Be Both?

- On his personal tax return, Ramirez filed a Schedule C (self-employment filing) showing \$0 of wages, and expenses of \$26,303 – the expenses related to the \$82,000 of talent fees
 - Ramirez's accountant justified this treatment on the grounds that \$82,000 of talent fees were self-employment income (not wages) but were already included in income via Ramirez's W-2, so no income was shown on Schedule C
 - The IRS audited this
 - The case went to Tax Court
 - In short, the issue was: if Ramirez was NOT a contractor, then his deductions would have been limited if not eliminated
- *(*-for the accountants and others in the room with tax experience: under the law that existed in 2007, the expenses would have been reclassified as miscellaneous itemized deductions subject to the 2% of AGI limitation, and would have been non-deductible for alternative minimum tax purposes)*

Can a Worker Be Both?

- The Tax Court sided with Ramirez
- They said he had enough discretion in his sales work to justify treating the talent fees from the advertisers as self-employment income (i.e. contract labor)
- Note that in this case, the fees from the advertisers were paid to the station but then turned over to Ramirez; thus it was as if they were paying Ramirez directly for his services to them

Forms SS-8 and 8919

Form SS-8

We talked about the SS-8 at length during the 3-factor test

- A worker can fill out an SS-8 and send it to the IRS, asking for an IRS determination on their prior status
- Businesses can fill it out and send it to the IRS as well, for the same purpose ... though this would be a rarity
- As we discussed, you can fill out the SS-8 internally (not submitting to the IRS) as it can be a valuable resource for you

Form SS-8

When a worker submits an SS-8 to the IRS, the IRS will contact the business

- The IRS will send a blank SS-8 and ask the business to fill it out
- IRS may ask for additional information from you, the employee or from third parties
- IRS will issue a determination letter relating to that worker or class of workers
- Since it's not an audit, you have no appeal rights
- But you can ask the IRS to re-consider information you have already sent, or ask them to consider new information
- Definitely a "stop and talk to your accountant or perhaps an attorney" sort of thing
 - Do you need to pay payroll taxes on the worker now?
 - What about Section 530?
 - **The IRS does NOT consider Section 530 in issuing determinations relating to Form SS-8**

Form 8919

Another form that comes up in the worker-classification realm is Form 8919

To understand this form, we need to think about how employees are taxed, versus how contractors are taxed – see next slide

Form 8919

	Income taxes	FICA Percent
Employee	Yes, withheld on each paycheck	Employee pays 7.65% through paycheck withholding; employer matches 7.65%
Contractor	Income tax is accounted for and paid on the contractor's personal tax return	Contractor pays both halves of the FICA equation (so 15.3%) on their personal tax return (This is called self-employment tax)

Form 8919

Now that we have this understanding ... what exactly is Form 8919?

- The contractor will file Form 8919 if they think they should be an employee – they'll file on their personal tax return
- The worker pays only half of the self-employment tax/FICA (7.65%) rather than the full 15.3%

Form 8919

From the form:

Who must file. You must file Form 8919 if **all** of the following apply.

- You performed services for a firm.
- You believe your pay from the firm wasn't for services as an independent contractor.
- The firm didn't withhold your share of social security and Medicare taxes from your pay.
- One of the reasons listed below under *Reason codes* applies to you.

Reason codes. For each firm listed below, enter in column (c) the applicable reason code for filing this form. If none of the reason codes apply to you, but you believe you should have been treated as an employee, enter reason code G and **file Form SS-8 on or before the date you file your tax return.**

- A** I filed Form SS-8 and received a determination letter stating that I am an employee of this firm.
- C** I received other correspondence from the IRS stating that I am an employee.
- G** I filed Form SS-8 with the IRS and haven't received a reply.
- H** I received a Form W-2 and a Form 1099-MISC and/or 1099-NEC from this firm for 2023. The amount on Form 1099-MISC and/or 1099-NEC should have been included as wages on Form W-2. **(Don't file Form SS-8 if you select reason code H.)**

Form 8919

- The IRS will find out all about your business on Form 8919!

	(a) Name of firm	(b) Firm's federal identification number (see instructions)	(c) Enter reason code from above.	(d) Date of IRS determination or correspondence (MM/DD/YYYY) (see instructions)	(e) Check if Form 1099-MISC and/or 1099-NEC was received.	(f) Total wages received with no social security or Medicare tax withholding and not reported on Form W-2
1					<input type="checkbox"/>	
2					<input type="checkbox"/>	
3					<input type="checkbox"/>	
4					<input type="checkbox"/>	
5					<input type="checkbox"/>	

Final Thoughts as Time Allows

Final Thoughts

- Determining if someone is a contractor or employee is a big deal ... do not take this lightly!
- My biggest point for you: have a reasonable basis for treating a workers as a contractor.
 - **Reasonable basis DOES NOT mean “I didn’t want to pay the payroll taxes.”**
 - If you are to outright win an audit, you certainly need a reasonable basis
 - If you are going to get any relief, whether it’s Section 530, Collection Settlement Program, or Section 3509, you need a reasonable basis argument

Final Thoughts

Among the many consequences of deliberate worker misclassification:

- Liability for back payroll taxes and penalties with no relief at all (**and back payroll taxes and penalties can not only be assessed against the business but can also attach to each owner or officer of a company as individuals**)
- Qualified plan issues – not covering an employee who is eligible could cause your plan to be out of compliance; this is fixable ... but at a cost
 - Similar issue: health insurance coverage; other benefit programs
- Depending on the size of your business, reclassification to employee could result in issues with things such as ADA/FMLA/other government programs or requirements based on the size of your business

Actionable Takeaways

1. Determining if someone is a contractor or employee is a big deal ... do not take this lightly!
2. Have a reasonable basis for treating a workers as a contractor.
3. Know your options in an audit – but it all comes back to having a reasonable basis.

The End!

- Thank you!

QUESTIONS?

{Last Slide - Speaker contact details }

REMINDER!

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- Please scan this QR code using your mobile to access a short feedback survey →
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WEDS 2:15 | Independent Contractor or Employee? A Deep Dive into Classification, Compliance, and AP Risk