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Are you mishandling independent contractors?

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For business owners who hire consultants and treat them as independent contractors, it is important to be aware of the worker classification rules. Will they be viewed as independent contractors or employees in the eyes of the Internal Revenue Service (IRS)? This depends on certain facts and circumstances, which can vary from year to year, and can potentially lead to incorrect classifications.

What's the big deal, you ask? Well, as a business owner, if you misclassify a worker as an independent contractor, you can be liable for their share of unpaid payroll taxes and fringe benefits including retirement plan contributions. That is why it is best to determine their status the first time a contractor is hired and continue to review their status on an annual basis.

Factors to Consider

Determining independent contractor status can be tricky. Make sure that your accountant and/or management is aware of the criteria. They should know that the IRS employs a 20-factor test for employee versus independent contractor status with focus on the employer's right of control over the worker. The state of Massachusetts uses the same 20-factor test for wage withholding requirements, plus an additional 3-factor test to determine worker status for various taxes encompassed by labor and industries laws summarized as follows:

1. Start with the basic premise that if you control how the worker performs the services, you probably have an employee. The worker must be virtually free from direction and control from the employer. If the employer controls when, where, and how the work is done, the worker is generally considered an employee.
2. The services must be outside the usual course of business of the employer. Many employers hire workers to help during busy periods in their businesses. If the services performed by the worker are similar to the services performed by employees, the worker is an employee.
3. The worker must have an independent business outside of the business of the employer to be considered an independent contractor and the worker cannot be exclusively hired by the employer. If the worker is performing services for numerous unrelated persons, there is an assumption that the worker is an independent contractor. Workers who depend on a single employer for all of their business are employees.

Be sure to check other state rules that may apply to employees located out of state.

How Do You Correct Misclassifications?

Businesses that have unintentionally misclassified independent contractors may be granted relief with the new IRS voluntary classification settlement program. Established in September of 2011, this program provides partial relief for eligible businesses that agree to treat workers as employees.

(Unfortunately, there is no corresponding Massachusetts program.) Additionally, the IRS has made available a four-page "checklist" to help gather information from both the business and the worker for a formal determination of worker status.

Stay Vigilant

As advisors who help our clients with independent contractor classification issues on a regular basis, we recommend that you stay informed, proactive and vigilant. The IRS and Massachusetts Department of Revenue have been challenging worker classification for years. The only certainty is that their efforts will continue. If you are concerned that some of your independent contractors should be reclassified as employees, consult with an advisor who is well-informed on this particular topic.

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