

The Risks of Misclassifying Employees and Independent Contractors

THOUGHT LEADERSHIP

A large crowd of people, seen from an aerial perspective, is arranged to form the shape of a dollar sign (\$). The people are diverse in age and clothing, and they are standing on a light-colored, reflective surface. The background is a gradient of light blue and white, with some faint geometric shapes. The overall image conveys a sense of scale and the impact of financial decisions.

**GLOBAL
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01

THE MOST IMPORTANT RESOURCE

In business, one resource stands above all: employees.

They are the driving force behind every operation. Without them, growth, revenue, and customer service stop. Whether you're a solo entrepreneur or managing a team, recognizing the importance of proper employee classification is vital.

Employee classification isn't just about pay; it's about access to crucial benefits like healthcare and retirement plans. Full-time, part-time, independent contractor – each classification carries its responsibilities and legal implications. Understanding these differences is essential to running a successful business.

This eBook serves as your guide through the maze of employee classification. We'll break down the distinctions between independent contractors and salaried employees, explore the rights of independent contractors, and delve into the business impacts of each classification.

Most importantly, we'll highlight the grave consequences of misclassification, from legal battles to financial ruin.



02

WHAT IS AN INDEPENDENT CONTRACTOR?

The [IRS defines independent contractors](#) as professionals who offer services to the public independently. They include doctors, lawyers, and contractors, among others.

What distinguishes them is that the payer, or employer, can only control the outcome of their work, not how it's done. For instance, if you hire a web designer, you can't dictate their process, only the final result.

However, not all work arrangements fit this definition. If an employer controls both what and how work is done, the worker isn't considered an independent contractor.

The crucial distinction lies in the employer-employee relationship: if it exists, you're not an independent contractor, and your earnings aren't subject to self-employment tax.

So, beyond tax implications, the core difference boils down to who controls the work process. But is that the whole story?

Let's examine the differences between [independent contractors and employees](#) as defined by the IRS.



1. Employment Laws

The first thing we'll discuss is the difference between the laws regulating employment for employees and independent contractors. According to the IRS, employees are covered and protected by federal labor laws and state employment laws.

Independent contractors, on the other hand, are not covered by these laws and have the choice to contract out their skills, services, and trades as they wish, which would negate the need for their protection under the law.



2. Hiring

This is an interesting one because it can sometimes go both ways. After all, independent contractors are often hired similarly. They're interviewed, onboarded, and hired to perform their service.

But, the IRS likes to make a clear distinction between the hiring practices of employees and independent contractors by suggesting that employees complete applications before hiring, while independent contractors do not. Again, this is a bit murky.

However, it becomes clearer after the application process. For business employees, the business is required to record and file the personal information of the employee. For instance, their citizenship status, their marital status, their date of birth, and their work history will all be filed away.

On the end of an independent contractor, all they're required to do is sign a Statement of Work contract, with no need to disclose personal information.

3. Taxation

In the way of taxation, employees and independent contractors are treated quite differently. For example, employers are required to withhold federal and state tax, which is typically reflected in an employee's weekly or bi-weekly paycheck.

Further, employees are required to provide all their tax information upon their hiring, including their name and address, their social security number, and their tax filing status/exemptions through a W-4 form.

Independent contractors are not required to withhold taxes on their pay because they're typically paid on a per-job basis. This means that they're subjected to something called self-employment tax.

Along with that, they're still required to pay social security tax, Medicare tax, and FICA tax, but this is something that they'll do on their own either through estimated tax payments made to the IRS quarterly or at the end of the year when they file before the April 15th Tax Day deadline.

In addition, independent contractors are not required to fill out a W-4 form. Instead, they complete a document called a W-9 form. These forms require independent contractors to provide their name, address, and their Taxpayer Identification Number.

4. Business Reporting Requirements

As a business owner, you're required to report the amount of money that you pay out in payroll every year as part of your annual tax filing requirements. As with employees, you're also required to report payments made to independent contractors.

For your typical employees, you send out something called a W-2 form each year, which reports all the money paid to individual employees throughout that specific tax year. For your independent contractors, you're required to send out a 1099 form, which outlines all payments made over \$600 in that given tax year.

However, these reporting requirements are only reserved for the IRS. Employers with salaried employees, on the other hand, must also submit reports for state and federal unemployment insurance to show that their employees are protected through unemployment laws.

5. Payments and Contracts

This is something that we touched on earlier, but let's allow the IRS to give us some more clarification in terms of just how payments to employees and independent contractors are structured.

First and foremost, you already know that your employees are hired based on some sort of wage—whether it be a salaried wage where they earn an annual income or an hourly wage where they earn based on the number of hours worked during a given pay period, typically between one and two weeks.

With an independent contractor, there is a bit more flexibility in terms of financial compensation. For example, a contract can be written where you're required to pay an independent contractor for a total amount, regardless of the length of time, the scope of the work, expenses, etc.

This is a simple form of payment because you can define the terms up front, and know that no matter what happens, they won't change without a formal amendment to the contract.

On the other hand, you can also pay your independent contractors by the hour, by the day, by the week, or by the specific job or service being completed. You can also dictate exactly when you want to complete the payment.

You can offer payment beforehand, or you can wait until the job is completed. As long as the terms are clearly defined and stated in the work contract, this would be considered acceptable.

6. Invoicing and Payment Periods

With an employee, pay periods must remain constant, predictable, and unchanged as guided by both state and federal laws. The IRS says, "An employee pay period must remain the same unless formally changed."

Federal and state laws require that an employee be paid on the normal pay date or earlier if the paycheck is not negotiable on the normal pay date, which can occur on holidays."

In terms of an independent contractor, things are a little bit different.

Independent contractors are responsible for submitting an invoice to the payer or employer. Until the payer or employer receives this invoice, they are not required to pay for the services.

Your Accounts Payable department shall pay the invoice when received and would be subjected to the terms of that invoice, in addition to the contract or Statement of Work, which also indicates when payment should be completed.



What Does It All Mean for Your Business?

Understanding the differences between employees and independent contractors is crucial for your organization's operations.

Let's take the example of a high-end real estate firm. You have salaried administrative staff and a team of realtors, brokers, and agents who receive commissions.

Your administrative staff are considered payroll employees. This means you must withhold taxes from their paychecks and ensure their rights and benefits are upheld.

For marketing needs like professional photography and videos, hiring independent contractors might be more cost-effective than maintaining an in-house team. For instance, you could hire a real estate photographer on a project basis, negotiating rates based on work completed.

This approach saves on payroll and benefits while giving you the flexibility to hire experts for specific tasks. It's a win-win for both your business and the independent contractor.

What are the Benefits of an Independent Contractor?

When an organization hires an independent contractor, it benefits from the following:

- ✓ **Flexibility:** Independent contractors can maintain relationships with multiple clients, diversifying their portfolio and pursuing various job opportunities.
- ✓ **Expanded Expertise:** Working independently allows contractors to gain experience in different areas of their trade, enhancing their skills and services over time.
- ✓ **Cost Savings:** Hiring independent contractors instead of adding them to the payroll can save on expenses for benefits and taxes.
- ✓ **Opportunity for Growth:** Contractors have the freedom to explore different avenues in their field, leading to personal and professional growth.
- ✓ **Win-Win Situation:** Both the business and the contractor benefit from this arrangement, as it allows for cost-effective solutions and professional development opportunities.

03

HOW TO CHOOSE BETWEEN AN INDEPENDENT CONTRACTOR AND AN EMPLOYEE

In your business, how do you choose between hiring an independent contractor or an employee?

Luckily, the IRS provides guidance. Selecting the right classification is crucial for legal compliance. The IRS outlines three key factors, which can help you make an informed decision:

- ▶ Behavioral Control
- ▶ Financial Control
- ▶ Relationships

Let's explore these categories to guide your decision-making.



1. Behavioral Control

Regarding behavioral control, the IRS says:

“A worker is an employee when the business has the right to direct and control the work performed by the worker, even if that right is not exercised.”

This means that an employer can not only determine the scope of the work for an employee, but it can also determine how the scope of work is completed by that particular employee.

The IRS lists the categories of behavioral control as follows:

“Type of instructions given, such as when and where to work.”

In addition, they specify the type of tools that can be used, where to purchase supplies, and how to receive the instructions required to complete a task.

“Degree of instruction. More detailed instructions may indicate that the worker is an employee.”

This means that employees typically receive guided instructions on how to complete a task. Independent contractors, on the other hand, complete the task as they see fit because they are considered tradesmen or experts.

“Using evaluation systems to measure the details of how work is done, points to an employee.”

Typically, employees and independent contractors are evaluated differently. While a worker might be evaluated on their process, an independent contractor is more likely to be evaluated by the result and the experience.

“Training a worker on how to do the job—or periodic or ongoing training about procedures and methods—is strong evidence that the worker is an employee.”

Typically, independent contractors have their own set of methods, processes, or approaches, which they're given the discretion to use to complete a project.

As you can see, the behavioral differences between employees and independent contractors are quite clear. Depending on the amount of behavioral control you'd like your workers to have, you should be able to decide between hiring an employee or an independent contractor.

2. Financial Control

Do you want your business to maintain direction or control over the financial and business aspects of your work? This one comes down to the expenditures of hiring a worker, including the costs of equipment, services, etc.

The IRS recommends considering:

- ▶ Do you want to make a significant investment in equipment that a worker might use with another client?
- ▶ How do you feel about unreimbursed expenses? Independent contractors might want to include a percentage of this in their final invoice.
- ▶ Are you prepared to profit or accept a loss over hiring a worker as an independent contractor or an employee?
- ▶ Are you looking for long-term help, or are you fine working with an independent contractor who is free to seek out other opportunities in the market?
- ▶ Would you rather pay an employee weekly, bi-weekly, or monthly, or agree to a specified flat rate with an independent contractor?

These are important points to consider because they could directly impact your bottom line. Depending on the level that your employee or independent contractor is at, you could set yourself up for some significant cost savings, or some significant expense increases simply from paying them for their services.



3. Relationships

Lastly, let's tackle the concept of employer-employee and employer-contractor relationships.

When it comes to hiring an employee or an independent contractor, you can automatically assume a different type of relationship from case to case. In other words, what type of interactions do you want to have with your new worker?

Do you want to see this person every day in your office?

Do you want to know what they're working on and be able to lend your input wherever necessary to ensure that their work is completed in a way that aligns with your business goals?

Perhaps you merely need a task accomplished, and it doesn't matter how it gets accomplished.

Let's break down these relationships as described by the IRS:

- ▶ Do you want to enter into written contracts with an employer designed to describe this relationship in plain, simple, and clear terms?

- ▶ How do you want to deal with benefits? Are you willing to provide your full-time or part-time employee with healthcare benefits, retirement benefits, paid time off, etc.? Or are you fine paying a little more out of pocket to hire an independent contractor whose benefits you're not responsible for?
- ▶ Do you want a permanent relationship with this individual, or are you prepared to potentially lose their services to another competitor?
- ▶ Are the services that you're seeking essential to your business? If they're necessary to help ensure the continuity of your operations, then it might be worth it to consider hiring this individual as a full-time employee.

Defining the relationship that you wish to have with your new employee is a crucial step in determining just how you want to proceed in classifying them.

This last category directly plays into the business impact of hiring employees and independent contractors. And that's exactly what we're going to get into in the next section.

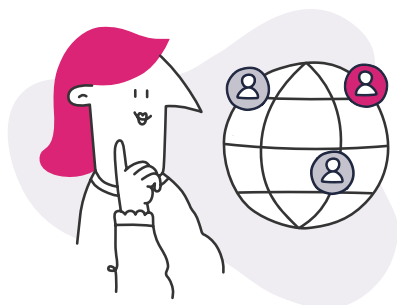
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THE BUSINESS IMPACT

When deciding between hiring an employee or an independent contractor, the biggest business impact revolves around payments and relationships. While behavioral control plays a role, it's a smaller part of the equation. Ultimately, it boils down to how much you're willing to pay and the type of relationship you're comfortable with. However, it's important to note that this varies from case to case.

Every business is unique, and independent contractors often build strong and enduring relationships with their clients.

Hiring an independent contractor doesn't necessarily mean a distant relationship, nor does hiring an employee guarantee a close-knit team. The key differences in payments and relationships have the most significant impact on a business.



Withholding Taxes



As a business, you're responsible for withholding federal income tax, social security tax, Medicaid tax, and unemployment tax on all wages paid to your employees. This essentially means that you pay a portion of these taxes every year to the federal government, while also withholding some of that money from your employees' paychecks every pay period.

When it comes to independent contractors, you're not responsible for withholding any of the above or [paying taxes for your payments to independent contractors](#). While you might be subjected to a higher flat rate, hourly rate, or fee since these contractors are offering their services on the competitive open market, you strategically position your business to save a bit more when it comes to taxes.

Plain and simple, this is often a defining factor for business owners when making the key distinction between an employee and an independent contractor.

In some cases, the savings could be quite substantial, and you can still build powerful and positive relationships with these contractors, ultimately resulting in a long-term partnership that remains outside the bounds of employee classification.

Relationships

While it's important to remember that your employees are protected by federal and state laws, your independent contractors aren't privy to the same protections.

This makes your relationship with independent contractors a bit more flexible in terms of how you proceed in purchasing their services or enlisting their assistance on a given project.

This is important to consider, because should the independent contractor not meet your expectations in terms of the quality of work performed, you can sever ties with them after submitting payment. From there, you'd be free to explore a new relationship with another independent contractor.

On the other hand, employees are protected, and you wouldn't exactly have the ability to fire an employee for performing subpar work a handful of times for a few years.



What This Means for Your Business

There are always going to be a few key areas of concern that business owners need to consider when deciding whether to hire an employee or an independent contractor for their business.

At the end of the day, that decision will leave an impact on your business, either financially or in terms of production. Use the information provided in this eBook to better understand the potential impact of your decision so that you can move forward to making the right choice for your business.

In the next part, we're going to talk about the implications of misclassifying your employees as independent contractors and your independent contractors as employees. In some cases, these implications could potentially be catastrophic.



THE IMPLICATIONS OF MISCLASSIFICATION

Over 50 years ago, the Supreme Court handled a case involving newspaper boys and publishers, sparking concerns about how they were classified as employees. The boys argued for employee status to form unions and gain protections. This landmark case set a precedent for how businesses differentiate between employees and independent contractors.

Today, misclassifying workers has serious consequences for businesses. According to a report by Mondaq.com, this issue remains contentious, with blurred lines between employee and independent contractor relationships. To provide clarity, the IRS has outlined financial implications for businesses that misclassify their employees.

The Consequence

The IRS says, ***“Classifying an employee as an independent contractor with no reasonable basis for doing so makes employers liable for employment taxes. Certain employers that can provide a reasonable basis for not treating a worker as an employee may have the opportunity to avoid paying employment taxes.”***

Again, there is a clear fine in the form of employment taxes, but there is a grey area because some businesses might be able to avoid this penalty. In addition, businesses also have the opportunity to reclassify their employees if they suspect that they have incorrectly classified them to begin with.

However, only eligible businesses can qualify for this program. This program called the [Voluntary Classification Settlement Program](#), was designed to help businesses correct misclassifications without forcing them to pay those employment tax penalties.



For Independent Contractors

Independent contractors who have reason to believe that they should be reclassified as employees have a way to challenge their classification with the employer and report this challenge to the IRS for consideration. In these cases, an independent contractor would fill out and submit [Form 8919](#).

How This Affects Your Business

Your choices are clear. Either you want a seamless relationship with your employees and a seamless experience with your independent contractors, or you want to open yourself up for a headache of tax payments and potential legal issues.

Following the rules, laws, and regulations can be the key difference-maker in terms of how you go about staffing your business. There are financial implications that come along with misclassifying your employees, and there are personal relationships at stake with independent contractors who feel as though they've been cheated by you.

While we can't point you in one way or another, all we can do is recommend that you understand these implications and do everything in your power as a business owner to avoid them.



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CONCLUSION

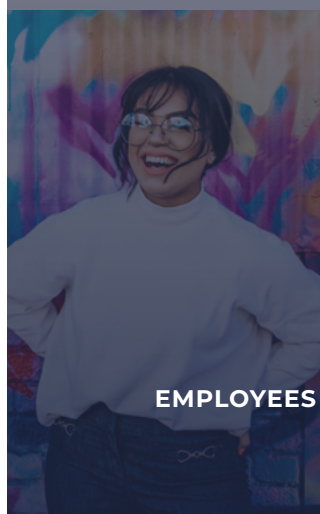
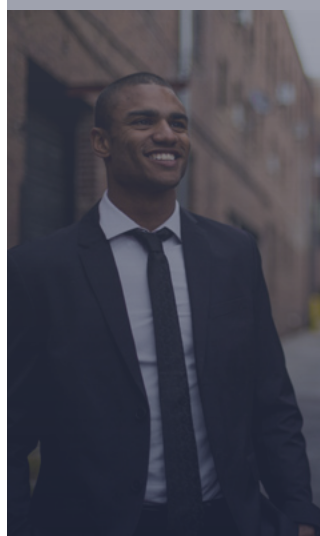
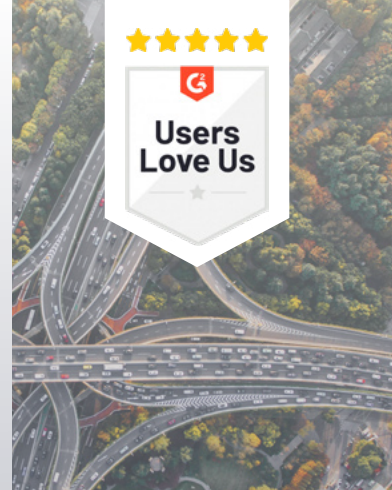
As a business owner, you should now have a better understanding of the differences between employees and independent contractors on a fundamental level. You know how the IRS defines these classifications and have a better understanding of how these classifications impact your relationships with your workers.

You've also seen how hiring employees and independent contractors can impact your business, both in terms of expenses and profit. And you've learned about the legal implications that come from misclassifying your workers as employees or independent contractors.

With this information, it's time for you to trust your decision-making process, knowing that as long as you try to navigate the grey areas gracefully, you should be able to avoid any potential misclassifications.

At Global Expansion, we provide [employment compliance](#) designed for peace of mind. We can be your trusted partner in keeping up with labor laws, tax requirements, and other regulations.

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