

# Independent Contractors vs Employees – Hiring, Reporting, & Classification Issues

By David Peters, CPA, MST, CLU, CPCU

# About your instructor

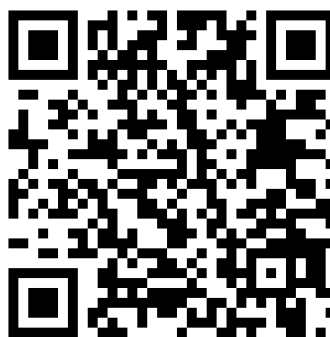


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# Learning Objectives

- Recall the 3 determination categories (incorporating the 20 historical factors) that the IRS uses to determine employees versus independent contractors
- Identify the basic tax forms needed when hiring employees and independent contractors
- Recognize the different types of 1099 forms
- State the tax implications of scholarships

# Why do we care about this classification?

- Employers pay payroll taxes on employee wages (6.2% FICA / 1.45% Medicare). They also withhold income taxes and pay unemployment insurance as well.
- Employers do not pay these items on independent contractors. Independent contractors are treated like separate businesses.
- If a person is treated as a contractor when they should have been treated as an employee, the employer could be liable for back payroll taxes, penalties, and interest.

# Why should a worker care though?

- Employees should care about misclassification, because they could be missing out on benefits (including retirement plan contributions)
- Also, unemployment benefits may not be available to the employee.
- Employees could end up with a very large, unexpected balance due on their tax return!

# Can I just let the worker choose?

- No. The IRS uses facts and circumstances to figure out how workers should be classified. The employee's opinion is not considered. Neither is the employer's opinion.
- Historically, the IRS has used a 20-factor test to make the determination. In more recent times, 3 categories are considered – financial control, behavioral control, and relationship between the parties. ***Important: No one factor is determinative.***
- It should be noted that this is an area where the IRS has consistently refused to give bright line guidance. (It is normally listed in a Rev Proc every year showing items that the IRS refuses to determine.)

# Publication 1779 – Behavioral Control

- “A worker is an employee when the business has the right to direct and control the worker.”
- **Instructions** – Extensive instructions on any of the following suggest the worker is an employee:
  - how, when, or where to do the work
  - what tools or equipment to use
  - what assistants to hire to help with the work
  - where to purchase supplies and services
- **Training** – If the business provides you with training about required procedures and methods, this indicates that the business wants the work done in a certain way, and this suggests that you may be an employee.

# Publication 1779 – Financial Control



- **Significant Investment** – If you have made a significant investment in your own business (legal advice, tools, equipment, etc.), you are more likely an independent contractor
  - *There is no specific dollar amount to indicate “significance.”*
- **Expense Reimbursement** – If your expenses are generally NOT reimbursed, you are more likely an independent contractor
- **Profit or Loss** – Employees generally can’t show a loss on their efforts. Independent Contractors can gain or lose money.



# Publication 1779 – Relationship of the Parties

- **Employee Benefits** – Independent Contractors are generally not paid employee benefits. Therefore, if the person is entitled to benefits, they are more likely an employee.
- **Written Contracts** – Written contracts will often dictate what the parties intended. This can help sway the decision but remember – no single factor is determinative. Therefore, just because there is a contract saying the person is a contractor, other facts & circumstances may dictate otherwise.

# Form SS-8 Determination

- A business can ask the IRS to make a worker determination by filing a **Form SS-8**. A letter stating the determination will be sent to both *the business **AND** the employee*. (No user fee.)
- Per instructions: *“The IRS does not issue a determination letter for proposed transactions, or on hypothetical situations, cases involving current worker classification litigation, cases involving state or local government workers who may be performing services under an agreement entered into pursuant to Section 218 of the Social Security Act, or business-to-business transactions, or for other reasons not in the best interests of tax administration.”*
- The determination only counts for federal tax matters – **NOT** state and local.

# Voluntary Classification Settlement Program (VCSP)



- A taxpayer participating in the VCSP will agree to prospectively treat the class or classes of workers as employees for future tax periods. In exchange, the taxpayer will:
  - Pay 10% of the employment tax liability that would have been due on compensation paid to the workers for the most recent tax year, determined under the reduced rates of section 3509(a) of the Internal Revenue Code.
  - Not be liable for any interest and penalties on the amount; and
  - Not be subject to an employment tax audit with respect to the worker classification of the workers being reclassified under the VCSP for prior years.

# Voluntary Classification Settlement Program (VCSP)



- A taxpayer must file Form 8952 and be eligible to participate in the VCSP:
  1. A taxpayer must have consistently treated the workers to be reclassified as independent contractors or other nonemployees, including having filed all required Forms 1099 for the workers to be reclassified under the VCSP for the previous three years to participate.
  2. Additionally, the taxpayer cannot currently be under employment tax audit by the IRS and the taxpayer cannot be currently under audit concerning the classification of the workers by the Department of Labor or by a state government agency.
  3. If the IRS or the Department of Labor has previously audited a taxpayer concerning the classification of the workers, the taxpayer will be eligible only if the taxpayer has complied with the results of that audit and is not currently contesting the classification in court.

# Hiring New Workers

- Whenever you hire a new worker, there is initial paperwork to fill out.
- **Employees:**
  - Form W-4 – Calculates how much to withhold from each paycheck and confirms taxpayer information
  - State Withholding Forms
  - Form I-9 - Verifies the identity and employment authorization of individuals hired for employment in the United States.
- **Independent Contractors:**
  - Form W-9 – Confirms taxpayer information and entity type

# Form W-4

- **5 Steps on the Form:**

1. Personal Information
2. Multiple Jobs or if the Spouse Works
3. Claim Dependents
4. Other Adjustments
5. Signature

- A new W-4 should be filed each time an employee's financial situation changes.
- **Per Topic 753:** *"If an employee fails to give you a properly completed Form W-4, you must withhold federal income taxes from his or her wages as if he or she were single or married filing separately with no other entries on step 2, 3, or 4 of the Form W-4. This means that a single filer's standard deduction with no other entries will be considered in determining withholding."*

# Immigration Reform & Control Act

- May not hire undocumented workers
- Immigration services under Department of Homeland Security ([www.uscis.gov](http://www.uscis.gov))
- Form I-9 Required since November 6, 1986

# Due Date for Form I-9

- Section 1 — By day 1 of employment
- Section 2 — By day 3 of employment — Employee must present authentic documents from the following:
  - List A (establishes identity and work eligibility) or
  - List B (establishes only identity) and
  - List C (establishes only employment)



# What about rehires? Two Choices...

1. If you rehire an employee **within three years** from the date the employee's Form I-9 was first completed, you may complete the supplement and attach it to the employee's previously completed Form I-9. If the employee remains employment-authorized, as indicated on the previously completed Form I-9, record the date of rehire and any name changes.
  - *If the employee's employment authorization or List A or C documents have expired, you must reverify the employee*
2. Treat them like a new employee (which might be easier)

# Form W-9

- Best practice is to get a W-9 from all vendors who you work with before paying them the first time.
- The IRS website offers TIN Matching e-services for certain payers to validate name and TIN combinations
- If no W-9 is provided, the payer (employer) must begin backup withholding (currently, at a rate of 24%). If the payer does not withhold from payee, the payer becomes liable for the backup withholding that should have been collected.

# Form W-9

- The payee can put “Applied For” in Part I, if they do not have a TIN.
- If they do not supply the TIN to the payer within 60 days, then the payer must begin backup withholding.
- Certain payees and certain payments are exempt from backup withholding.

# Exempt from Backup Withholding

1. An organization exempt from tax under section 501(a), any IRA, or a custodial account under section 403(b)(7) if the account satisfies the requirements of section 401(f)(2);
2. The United States or any of its agencies or instrumentalities;
3. A state, the District of Columbia, a U.S. commonwealth or possession, or any of their political subdivisions, agencies, or instrumentalities;
4. A foreign government or any of its political subdivisions, agencies, or instrumentalities;
5. A corporation;
6. A dealer in securities or commodities required to register in the United States, the District of Columbia, or a U.S. commonwealth or possession;

# Exempt from Backup Withholding

7. A futures commission merchant registered with the Commodity Futures Trading Commission;
8. A real estate investment trust;
9. An entity registered at all times during the tax year under the Investment Company Act of 1940;
10. A common trust fund operated by a bank under section 584(a);
11. A financial institution;
12. A middleman known in the investment community as a nominee or custodian; or
13. A trust exempt from tax under section 664 or described in section 4947.

# Key Payments Exempt from Backup Withholding

- Interest and dividend payments -All listed payees are exempt except the payee in item 7.
- Broker transactions - All payees listed in items 1 through 4 and 6 through 11 are exempt. Also, C corporations are exempt. A person registered under the Investment Advisers Act of 1940 who regularly acts as a broker also is exempt.
- Barter exchange transactions and patronage dividends - Only payees listed in items 1 through 4 are exempt.

# Key Payments Exempt from Backup Withholding

- **Payments reportable under sections 6041 and 6041A** - Payees listed in items 1 through 5 generally are exempt.
- **Payments made in settlement of payment card or third-party network transactions** - Only payees listed in items 1 through 4 are exempt.
- If a payment is NOT subject to information reporting, then it is not subject to backup withholding (ex: expense reimbursements)

# Other Issues

- **Form I-9 Retention is either**
  - three years or
  - one year past termination whichever is longer
- Employer can be penalized for a W-2 with name that doesn't match SSA.
- Up to employee to resolve W-2 that conflicts with SSA.
- **Form W-4:**
  - Must be filled out before first payroll
  - Exempt - Expects no tax liability this year and none last year.
  - Extra amounts (Line 4c)



# End of the Year

- Form W-2 must be furnished to the employee by January 31st each year. This is also the due date for Form 1099-NEC.
  - Form 1099-MISC are due on 2/28, if you file on paper (or 3/31, if you file electronically)
- In the case of an incorrect W-2, the best move for the employee is to have the employer issue a corrected W-2.
- Expense reimbursements are not put back into the W-2 as long as the employer uses an accountable plan.

# Accountable vs. Non-Accountable Plans



- If expense reimbursements are received under an accountable plan:
  - Reimbursements are non-taxable to employee
  - Deductible to employer
- Non-Accountable plans are any employee reimbursement plan that does not meet the criteria to be an Accountable plan
  - Reimbursements are taxable as compensation to employee (generally subject to withholding and payroll taxes)
  - Generally deductible to employer

# Accountable Plans – 3 Criteria

1. Expenses must have a business connection
2. The expenses must be substantiated within a reasonable period
  - Substantiation: Generally amount, time, place, and business purpose
3. The employee must return any money not spent to the employer, also within a reasonable period.
  - “Reasonable Time” Safe Harbors (Reg 1.62-2(g))
    - Fixed-Date Method & Periodic Statement Method

# Form 1099 – General Rules

- There are 21 different types of 1099s. For the most part, employers care most about the 1099-NEC, which is required to be given to contractors.
- Personal payments are not reportable – only payments made in the course of a trade/business
- **IRS Instructions:** *“You are engaged in a trade or business if you operate for gain or profit. However, nonprofit organizations are considered to be engaged in a trade or business and are subject to these reporting requirements. Other organizations subject to these reporting requirements include trusts of qualified pension or profit-sharing plans of employers, certain organizations exempt from tax under section 501(c) or (d), farmers' cooperatives that are exempt from tax under section 521, and widely held fixed investment trusts. Payments by federal, state, or local government agencies are also reportable.”*

# Form 1099 – General Rules

- Payments to a corporation (including a limited liability company (LLC) that is treated as a C or S corporation) are generally exempt from 1099 reporting (no reporting on 1099-NEC or 1099-MISC).
- **EXCEPTIONS** – Items that **must be** reported if paid to a corporation:
  - Cash payments for the purchase of fish for resale reported in box 11.
  - Medical and health care payments reported in box 6.
  - Substitute payments in lieu of dividends or tax-exempt interest reported in box 8.
  - **Gross proceeds paid to an attorney reported in box 10.**

# Form 1099 – Exempt from Reporting

- Payments for merchandise, telegrams, telephone, freight, storage, and similar items.
- Payments of rent to real estate agents or property managers. However, the real estate agent or property manager must use Form 1099-MISC to report the rent paid over to the property owner. See Regulations section 1.6041-3(d); Regulations section 1.6041-1(e)(5), Example 5; and the instructions for box 1.
- Wages paid to employees (report on Form W-2).
- Military differential wage payments made to employees while they are on active duty in the U.S. Armed Forces or other uniformed services (report on Form W-2).
- Business travel allowances paid to employees (may be reportable on Form W-2).

# Form 1099 – Exempt from Reporting

- **Cost of current life insurance protection** (report on Form W-2 or Form 1099-R).
- **Payments to a tax-exempt organization** including tax-exempt trusts (IRAs, HSAs, Archer MSAs, Coverdell ESAs, and ABLE (529A) accounts), the United States, a state, the District of Columbia, a U.S. possession or territory, or a foreign government.
- **Payments made to or for homeowners from the HFA Hardest Hit Fund** or similar state program (report on Form 1098-MA).
- **Compensation for injuries or sickness by the Department of Justice** as a public safety officer disability or survivor's benefit, or under a state program that provides benefits for surviving dependents of a public safety officer who has died as the direct and proximate result of a personal injury sustained in the line of duty.
- **Compensation for wrongful incarceration** for any criminal offense for which there was a conviction under federal or state law. See section 139F, Certain amounts received by wrongfully incarcerated individuals.

# Scholarships

- Tuition and fees that are paid must be reported on a Form 1098-T. Scholarships that are received may or may not be taxable to the recipient depending on what they cover.
- Scholarship or fellowship grants that are taxable to the recipient because they are paid for teaching, research, or other services as a condition for receiving the grant are considered wages and must be reported on Form W-2.
- Other taxable scholarship or fellowship payments (to a degree or nondegree candidate) do not have to be reported to the IRS on any form, unless section 6050S requires reporting of such amounts by an educational institution on Form 1098-T. See section 117(b)–(d) and Regulations section 1.6041-3(n) for more information.



# Non-Taxable Scholarships

- Scholarships are generally not taxable if both of the following are true:
  - You're a candidate for a degree at an educational institution that maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where it carries on its educational activities.
  - The amounts you receive are used to pay for tuition and fees required for enrollment or attendance at the educational institution, or for fees, books, supplies, and equipment required for courses at the educational institution

# Taxable Scholarships

- **You must include in gross income:**
  - Amounts used for incidental expenses, such as room and board, travel, and optional equipment.
  - Amounts received as payments for teaching, research, or other services required as a condition for receiving the scholarship or fellowship grant.
- **However, you don't need to include** in gross income any amounts you receive for services that are required by the National Health Service Corps Scholarship Program, the Armed Forces Health Professions Scholarship and Financial Assistance Program, or a comprehensive student work-learning-service program (as defined in section 448(e) of the Higher Education Act of 1965) operated by a work college.

# 1099 Electronic Filing – Prior to 2024

- Section 6011(e) of the Internal Revenue Code and the regulations thereunder require any person, including a corporation, partnership, estate, or trust, who files **250 or more information returns**, such as Forms 1042-S, 1098, 1099-INT, 1099-DIV, 3921, 3922, 5498, 5498-ESA, W-2, etc., to file these returns electronically.
- This **250-threshold requirement applies separately for each type of form** required to be filed, and to both original and corrected forms.
- For purposes of Forms 1042-S, a financial institution must file all returns electronically regardless of the number of forms being filed.

# 1099 Electronic Filing – 2024

- Starting in 2024 (for the 2023 tax year), organizations will need to begin filing electronically if they have 10 or more returns or statements (previously more than 250) in a calendar year.
- This is an ***aggregate requirement*** – not a per form requirement anymore.
- This basically means that all organizations will need to begin filing 1099s electronically.

# Summing It Up

- The determination of employees vs. independent contractors is made based on facts & circumstances – but 3 categories shape the decision. The determination is formalized using the Form SS-8.
- When bringing on new workers, it is important to notify the payroll company and obtain the correct forms (W-4, W-9, and I-9). There are time limits that dictate how long employers have to collect these forms.
- Recent IRS changes have made it so most 1099s need to be filed electronically.

# Thank you!



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