

## **There is No Such Thing as a 1099 Employee**

A current hot topic in the construction industry is determining who should be considered an independent contractor versus who should be considered an employee of the business.

When you have determined that you need to hire someone to perform a task for your business, many factors must be considered in determining this distinction.

In recent years as the “gig economy” has grown, we have seen a heightening of interest around this subject as governments large and small worry that they are not getting their full share of the pie. In 2020 California voters passed Proposition 22 which enacted an incredible amount of new rules around who could legally be considered to be an independent contractor. While legal battles continue to rage around this proposition, it highlights that the winds of change are blowing regarding this hot button issue. It’s clear that how your company chooses to pay and classify those that it hires is an issue that should be clearly understood by management of businesses both large and small.

Another sign of this changing focus across the nation is the recent reversal by the IRS to an older policy of requiring Non Employee Compensation to be reported on a separate form from other types of income such as rents and lottery winnings. The 1099-NEC was brought back out from the dusty IRS basement in the same year that California passed Prop 22 and accountants across the nation are noting that IRS interest in 1099s seems to be heightened. A recent (though very informal) survey conducted by our firm found that accounting firms are seeing higher than normal numbers of Notice CP-2100A being sent to their clients regarding inaccurate reporting of information on 1099 forms.

So business owners should definitely educate themselves on the ins and outs of what both the IRS and other entities such as state and local governments and even their insurance carriers have to say about who IS and who ISN'T considered an independent contractor.

### **IRS 1099 Rules**

First, let’s examine the determining factors that the IRS looks at regarding who can and who can NOT be classified as an independent contractor. The IRS focuses on three categories of degrees of control and independence:

1. Behavioral
2. Financial
3. Type of Relationship



## Behavioral

From a behavioral perspective, the IRS seeks to understand: what types of instruction are given to individuals performing certain tasks, what the degree of instruction is, what type of evaluation system is in place, and if the business is providing a lot of training.

If you tell your new hire when and where to go every day for work, what tools or equipment they must use, where they have to purchase supplies, and what order or sequence to follow when performing the work; if you give extremely detailed instructions, if you evaluate them on the details (rather than the results) of their work, and if you train them in the specifics of their job, there is a high likelihood that they should, in fact, be classified as an employee.

For example: If Roofing Company A hires someone to perform inspections for them and simply says, "Here is a list of places that we need you to inspect. We expect reports from you by the end of next week. Thanks for your help!" that hire would seem from a behavioral standpoint to not be an employee of the company. The roofing company is not dictating which software to use, providing any training on how to inspect, or evaluating on anything besides the final reports. On the other hand, if the same roofing company hires someone to install shingles and says, "You'll need to be at the Smith home by 6 pm on Monday. I'll meet you there with a uniform and your tools. You'll need to clock in on our timekeeping system and hand me a report of your hours at the end of the week. John will be training you on our installation procedures and after 90 days we'll be measuring how many shingles you can install for your performance reviews." that new hire would seem from a behavioral standpoint to be an employee. The roofing company is dictating all of the processes and procedures necessary to do the work, and even providing the tools.

## Financial

When the IRS considers this metric, they will consider whether or not the person being hired has made their own significant investment in items such as tools, equipment, etc. They'll also seek to understand if expenses incurred by the hire are reimbursable, what their method of payment is (i.e. on a fixed regular basis or only when projects are completed) and are their services also available to others regularly. Significantly, they'll consider whether or not this person has the ability to make a profit or a loss.

To use our earlier example of a roofing company: in the case of the first hire, a roofing inspector, they are probably inspecting roofs for a dozen other roofing companies, have their own truck and tools and are paid when they turn in the inspection reports. In the case of the person installing the shingles, they are handed tools and equipment owned by the company to perform the work, so they make no investment there, they are working a full 40 hours a week for the roofing company and not for any other business, and they can turn in expense reports. Now it



becomes even more clear that the first hire is an independent contractor and the second should be treated as an employee.

## **Type of Relationship**

When it comes to this point, much is often made of the idea of written contracts being a determining factor. This is sometimes very misleading. Regardless of what a contract states about whether a person is an independent contractor or an employee, the IRS may still weigh other factors more highly. Additionally, an argument is often made that because the company is not offering benefits to those it contracts with, that they are not employees, but this is not always a very important determining factor either. Permanency is a very strong indicator. (If the roofing inspector is sometimes hired by the company and sometimes not, then they are likely independent contractors, but if they are the only inspector ever hired and they work for no other company, suddenly their classification could come into question.)

Key in the discussion about Type of Relationship these days is “are the services provided as a key activity of the business”. What makes this so key is that Proposition 22 made it nearly impossible for anyone to be considered an independent contractor if they are performing the main work of the business.

To frame this in an example, let’s continue with the roofing industry, but take a look at a different scenario. Let’s say that a local independent contractor named Joe often advertises himself as a handyman and does odd jobs including roofing repairs. Now let’s say that Roofing Company B is overworked and having a hard time finding staff to complete some of their smaller roof repair jobs. They happen to see Joe’s ad and request his help on a few of their smaller jobs - they want to subcontract to him, he is happy to take the work. He doesn’t intend on becoming one of their employees, but he is happy for the extra work and they give him a large number of jobs over a few months. In the state of California, it would be nearly impossible under Proposition 22 to make the case that Joe should be paid as an independent contractor simply because roofing repairs is a key activity of Roofing Company B’s business.

To be clear, the IRS rules are not as stringent as California’s Prop 22 rules, but it is still worth thinking about this very important distinction because phrasing about key aspects of the business are also included in IRS wording currently. This particular point can be one of the most important aspects to consider and avoid getting into hot water.

## **Worker’s Compensation Rules**

Besides government agencies wanting their take, insurance companies are becoming increasingly sensitive on this subject as well. In the past, subcontractors who were being paid under a 1099 were often overlooked on worker’s compensation reporting.



However, more and more insurance companies have been embroiled in messes when workers are injured on the job and can prove that they should have technically been treated as an employee rather than an independent contractor. This means that they, too, are now tightening their focus and requiring not just certificates of insurance for larger construction subs, but they want to be paid on and have reports on the small independent contractors that you hire for day labor, etc.

## **Complaints and Investigations**

There are multiple ways that an investigation could be triggered into an employers business regarding their employment practices:

- A complaint regarding wages or overtime disputes filed with the state DOL.
- When there is an investigation regarding past due taxes or incorrect taxes uncovered during a tax audit or upon the complaint of an employee.
- Many states have a Memorandum of Understanding with the IRS which allows the free flow of information back and forth between the agencies.

This means that a complaint from any one direction (insurance related, IRS related, or state DOL related) can come with steep penalties and fines from more than one direction as well.

## **Now for the Scary Stuff: Penalties and Fines**

Any or all of the following could be assessed for failure to classify workers properly:

- A fine for each W-2 the employer failed to file
- Penalties for failure to withhold income taxes
- Penalties for failure to withhold Social Security and Medicare taxes
- Unpaid employer taxes
- And, of course, penalties and interest for all of the above.

Fines and penalties could also be faced at a state level with enforcement being carried out by the agency that is in charge of Worker's Compensation regulations. Many states now have an Uninsured Employer's Guaranty fund and the employer could be assessed the full amount advanced by the fund to pay for any workers who are not properly covered. The injured worker also has the right to sue for negligence.

If a tax agency finds that the misclassification was intentional or fraudulent, they may even refer the case to a criminal agency.

## **More Information**



For more specific information from the IRS on the differences and how to make a determination, you can visit the IRS website's informational page here:

<https://www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee>

To learn more about how to file a complaint with the U.S. Department of Labor, you can visit:

<https://www.dol.gov/agencies/whd/contact/complaints>

If you are still struggling with classification of employees, or if you would like our team to evaluate if your current workers are classified properly, please contact The Profit Constructors Team at 480-442-4032 or email [hello@theprofitconstructors.com](mailto:hello@theprofitconstructors.com)

*Tonya Schulte of The Profit Constructors is a profitability educator and construction accounting specialist. She founded the company five and a half years ago to help mid-sized companies in the construction industry, "run with the big dogs." In so doing, she delivers advisory board level counsel and instruction centering around their accounting and systems needs. Like the construction firms she serves, she is dedicated to superior craftsmanship in her trade.*

