

Strictly Business

A Business Law Blog for Entrepreneurs, Emerging Companies, and the Investment Management Industry.



ABOUT THE AUTHOR

Alexander J. Davie is an attorney based in the Nashville, TN area. His practice focuses on corporate, finance, and real estate transactions. He works mainly with emerging companies, venture funds, entrepreneurs, and startups. His firm's website can be found at www.alexanderdavie.com.

In his corporate practice, Mr. Davie has worked extensively with his clients on all aspects of their businesses, including company formation, business planning, mergers and acquisitions, vendor and customer contracts, corporate governance, debt and equity financings, and securities offerings. In addition, he has represented investment advisors, securities brokers, hedge funds, private equity funds, and real estate partnership syndicators in numerous private offerings of securities and in ongoing compliance. Prior to returning to private practice, Mr. Davie served as the general counsel to a private investment fund manager.

In his real estate practice, he has participated in property acquisitions, mortgage financings, and commercial leasing matters throughout the United States. He has represented developers, governmental entities, life insurance companies, banks, and owners of malls, shopping centers, industrial parks, and office towers. He has worked on a number of transactions involving the syndication of real estate partnerships, advising sponsors on both real estate and securities issues.

There is no such thing as a "1099 employee."

Business owners will often say that they hired someone as a "1099 employee." What they actually mean is that the business came to an arrangement with a worker that deems him to be an independent contractor, and as a result, it doesn't have to follow any of the laws involved in hiring an employee. This includes not having to withhold any amounts for taxes, not having to pay the employer's portion of social security and Medicare taxes, and not having to pay any premiums for workers compensation or unemployment insurance. It becomes the worker's responsibility to pay the employer's portion of social security and Medicare taxes through the self employment tax. The worker must also perform their own withholding through quarterly payments to the IRS. From the employer's perspective, this seems to be a great arrangement. They avoid administrative and tax expenses. The only problem is that it is often illegal.

There is no such thing as a "1099 employee." The "1099" part of the name refers to the fact that independent contractors receive a form 1099 at the end of the year, which reports to the IRS how much money was paid to the contractor. In contrast, employees receive a W-2. Service providers are either employees or independent contractors; they cannot be both. Often a company may choose to designate certain service providers to be independent contractors instead of employees, but this is not always up to the parties to decide. In many situations, workers who are deemed to be independent contractors by agreement between the company and the worker are still considered to be employees by law. When that happens, the IRS, the department of labor, and state agencies, will reclassify the worker to be an employee and treat the employer as if it simply violated its legal obligations in how it handled that employee. As a result, the consequences for misclassifying a worker can be quite severe.

How do you correctly decide whether a worker can be considered an independent contractor and when they must be considered an employee? The IRS has published [guidelines](#) on making this determination based on three sets of factors: behavioral control factors, financial control factors, and relationship control factors. [1] Examples of each are:

- **Behavioral Control Factors**
 - Does the worker decide their own schedule and location of work?
 - Is the company providing training to the worker?
 - Does the worker have their own employees?
 - Does the worker decide the order and sequence of services?
 - Does the worker decide what kind of reporting is provided to the company?
- **Financial Control Factors**
 - Will the worker submit invoices?
 - Will the worker pay their own business and travel expenses?
 - Does the worker furnish his own tools and materials
 - Does the worker have his own business?
 - Does the worker advertise their services?
 - Will the worker recognize profit or loss based on good or bad decisions?
- **Relationship Factors**
 - Is the worker is retained for a specific project or are they involved in ongoing operations?
 - Does the worker have other clients?
 - Will the worker maintain independent activities?
 - Does the worker maintain his own insurance?
 - Is there a signed contract between the worker and the company specifying that they have an independent contractor relationship?
 - Does the worker receive benefits?

- Is the relationship temporary or open-ended?
- Are the services provided a key aspect of the regular business of the company?

The final determination is made by weighing whether the factors favor classifying the worker as an independent contractor or as an employee. If the weight of the factors indicate that the worker should be classified as an employee, then the worker must be so classified, regardless of any agreement between the employer and the worker. Misclassifying a person who should be an employee as an independent contractor can have significant consequences. The IRS can and often does take action against employers who misclassify employees, including requiring the employer to pay all taxes that should have been withheld plus an additional penalty. In addition, the state government may seek worker's compensation insurance and unemployment insurance premiums that should have been paid. Finally, the worker himself may file suit, seeking back pay for overtime, payroll tax contributions, and employee benefits.

Misclassifying employees as independent contractors can be an expensive mistake for a business. Therefore, you should consult an attorney or accountant to ensure that your employment relationships are in compliance with the law.

Footnotes

[1] The IRS previously used a 20-factor test to make this determination. This 20-factor test has since been replaced with the one described in this post.

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