

## Tax Ramifications of Worker Misclassification as Independent Contractor

Misclassifying an employee as an independent contractor can lead to serious financial consequences. An employer may be held responsible for back taxes—including the worker's share of unpaid payroll and income taxes—along with penalties and interest. But the risks don't end there. Employers are required to withhold federal and state income taxes, Social Security, and Medicare from employees' wages, and must also pay the employer's share of these taxes, plus unemployment taxes.

Since these obligations generally do not apply to independent contractors, it may be tempting to classify the workers as independent contractors. But, misclassification can expose your business to liabilities for unpaid taxes, benefits, minimum wage and overtime violations, workers' compensation, and state disability insurance. Therefore, correct classification is essential to avoid costly legal and financial pitfalls.

The IRS evaluates several factors when determining worker classification. No single factor is definitive—each must be considered within the broader context of the relationship. These factors fall into three main categories:

1. Behavioral Control: Who directs the work and how it's performed? Employees often receive training and detailed instructions, indicating a higher level of employer control.
2. Financial Control: Who dictates the financial terms? Independent contractors typically bear financial risk, invoice for services, and provide services for multiple other companies.
3. Type of Relationship: Workers who perform core business functions and are engaged indefinitely are more likely to be employees.

Even if a contract labels a worker as an independent contractor, that designation alone is not sufficient—it may be used as evidence but isn't determinative.

Many workers are working remote now, but that does not change the rules. Simply working from home does not qualify the worker as independent contractor since the same classification standards apply, whether a worker is on-site or remote. The focus remains on who controls the work and how it's done.

An employer may wish to file a detailed 5 page form - IRS Form SS-8 - to request an official determination. Consider consulting an attorney before taking this step.

State tax laws and wage/hour rules may impose different standards. Inconsistent treatment of workers across jurisdictions can create administrative burdens and legal exposure. Review each worker's classification carefully and comprehensively before making a final decision under your state's law.

For example in New Jersey, there is the so called ABC Test which is more rigid than the federal standard for classification as employee and is used to determine whether a worker is an independent contractor or an employee under state wage and hour laws. To classify a worker as an independent contractor, the employer must prove **all three parts** of the test:

- **A:** The worker is free from control or direction over how they perform their work, both under the contract and in actual practice.
- **B:** The work performed is outside the usual course of the employer's business or performed outside all of the employer's places of business.
- **C:** The worker is customarily engaged in an independently established trade, occupation, profession, or business.

If the employer fails to meet any one of these three criteria, the worker must be classified as an **employee**. This test is designed to ensure workers receive proper protections like minimum wage, overtime pay, and unemployment benefits.