

*An ounce of prevention is worth a pound of cure – Benjamin Franklin*

## To Employ or Not to Employ – W2 vs. 1099

Deciding to add new resources to your staff is never an easy decision. There are many considerations, unknowns, and moving targets - Is the work really there? Will it continue? Do I need or can I afford a full-time employee? If you're a business owner, chances are pretty good that you've walked this tightrope and it stands to reason that you may have considered hiring 1099's instead of W2's. If you're not sure what a 1099 or W2 is, or you're just not sure about when or how to use which, this article is for you.

### **Introduction.**

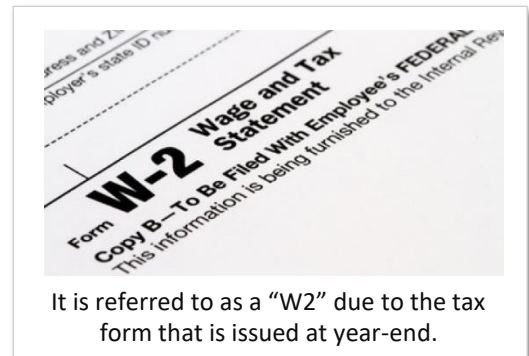
Before jumping in, let's understand the key difference between these two *employment statuses*. An individual's employment status indicates how the IRS views the relationship and governs many of the applicable tax regulations that must be followed to remain compliant with the law.

- ✓ A "W2 Employee" is the type of employment status that most people are familiar with – the standard employee / employer relationship. It is referred to as a "W2" because of the tax form that is issued at year-end to report all income paid to the individual.
- ✓ Conversely, a "1099" is an employment relationship whereby the employed individual is not considered to be an employee, but rather an independent contractor. Similarly, an independent contractor is referred to as a 1099 because of the tax form issued at year-end.

With those terms defined, we can take a closer look at each status. More importantly, considering the IRS' *unofficial* motto ("*We've got what it takes to take what you've got.*"), it's a good idea to understand how to keep your business out of trouble with the IRS.

### **W2.**

When a company decides to hire a W2 Employee, the employer must withhold income taxes, withhold and pay Social Security and Medicare taxes ("FICA Tax"), secure workers' compensation insurance, and pay unemployment tax on wages paid to an employee. This is an ideal arrangement when the employee will work solely for your business and you wish to maintain more control over how services are actually performed. This may include key details, such as setting the employee's work schedule, defining certain processes that must be followed, and requiring the employee to wear a uniform. W2 employees may be eligible to receive unemployment benefits if fired under certain circumstances.



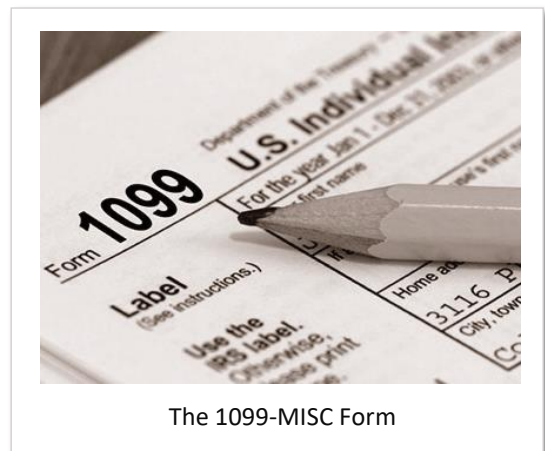
Full-time W2 Employees are also generally eligible to participate in the company's fringe benefit plan (if any is provided) – this might include benefits such as health insurance, dental, vision, life and disability insurance, bonuses, stock options, 401(k) plan contributions, etc. These benefits are offered by many companies to help retain talented employees, enhance productivity, and minimize the cost of recruiting and training new people. If your company paid any individual wages during the calendar year, you are required to send the employee a W2 form on or before January 31<sup>st</sup> of the following year.

The IRS is likely to require a company to classify an individual as a W2 employee if the individual:

- ✓ Has assigned work hours or a set work schedule
- ✓ Can be fired at any time and/or has the right to quit without incurring any contractual liability
- ✓ Receives specific work instructions from the company
- ✓ Receives training from the company
- ✓ Works full-time for the company
- ✓ Receives employee benefits
- ✓ Provides services that are an integral part of the company's day-to-day operations

#### 1099.

An independent contractor can be an ideal arrangement when the company does not see a permanent or regular need for a specific individual. This is common with professional services, such as lawyers, accountants, and other contractors who offer their service on a per-use basis to a variety of companies. An important distinction from an individual who is retained as an employee is that the independent contractor is responsible for their own insurance, payroll taxes, and profit (the hiring company does not withhold taxes and does not pay FICA taxes, unemployment, or workers' compensation insurance).



An independent contractor generally performs a certain scope of work at a certain price, as agreed to. As a general rule, the hiring company may only control or direct only the result of the work and not the means and methods of accomplishing the result. If your company paid any individual at least \$600 for services during the calendar year, you are required to send a Form 1099-MISC on or before January 31<sup>st</sup> of the following year.

One of the main benefits of hiring independent contractors is that you can use them on an “as-needed” basis. This means that your company doesn't have to carry the burden of employees year-round (nor does it need to lay employees off). This can be a huge savings and help companies grow at a comfortable pace. As noted, there additional cost savings as there is no need for the company to pay FICA taxes (7.65% of wages), workers compensation, or unemployment insurance. (It should be noted that the independent contractor will be liable for their own taxes, referred to as “Self-Employment Taxes.”)



The IRS is likely to allow a company to classify individuals as 1099 independent contractors if the individual:

- ✓ May earn a profit or suffer a loss from the activity
- ✓ Furnishes the tools and materials needed to do the work
- ✓ Is paid by the job (as opposed to hourly or salary)
- ✓ Works for more than one company at a time
- ✓ Invests in their own equipment and facilities
- ✓ Pays his or her own business and travel expenses
- ✓ Hires and pays assistants
- ✓ Sets his or her own working hours

### **Legal Pitfalls.**

Companies may be tempted to classify individuals as independent contractors solely to save money however, the business owner is urged to consider the important distinctions noted above. Generally, if a company has the right to direct how an individual performs work (as opposed to only the result), or if there is a pattern of other characteristics common to employees, the IRS has tended to classify individuals as employees. Employers who disregard these guidelines place themselves at risk for penalties and fines should the state conduct a 1099 audit and determine that individuals have been improperly classified.

### **Where to Get Help.**

This overview is provided for informational purposes only and is not intended to provide any legal or tax advice of any nature. You should consult your legal and/or tax professional before making any key decisions about your business.

### **About MBC.**

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