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1099 vs. W-2: How Independent Contractors and Employees Differ

An employee performs work for you under your direct or indirect supervision, during hours that you specify and conditions you control. You also withhold payroll taxes from the wages you pay him or her. As an employer, you pay certain taxes that are an expense to you on the employee's behalf. You issue employees a W-2 at yearend for them to report compensation and taxes withheld on their personal tax return.

Independent contractors are individuals who perform a service for you, usually at a pre-arranged fee, and who also meet the following criteria:

- They have a business card.
- They submit an invoice to you for each occurrence of services rendered.
- You have no control over the hours worked, or the tools used.
- They perform similar services for others.
- They do not have any major responsibilities within your organization, such as management or supervision of employees.
- A contract or work order exists between you and the independent contractor.
- They supply you with a business license number (issued to them by the city in which they work).
- They may also show evidence of being licensed by the state; for example, doctors, lawyers, electricians, etc.



Some examples of independent contractors include:

Janitors Plumbers Accountants Painter Salespeople Lawyers Electricians Landlords Consultants

It is important to properly classify the people you pay. If you pay someone as an independent contractor and he or she is in fact an employee, an audit by state and/or federal agencies may prove costly to you. Back taxes, which should have been withheld, could be assessed against you. Penalties for failure to report employee earnings could also be assessed, as well as penalties and interest for delinquent withholding payments.

Federal Requirements for Independent Contractors

Have each independent contractor fill out a W-9 form *prior to paying them*. If the contractor will not fill out the form, or if for any other reason you cannot get his or her identification number, you are required to withhold 28% of each payment. This is called back-up withholding, and the money is forwarded to the IRS, just like payroll taxes. Once it is withheld from the payment, you do not refund it to the contractor or pay it back to him or her in any way. Consider entering into a written agreement with your sub-contractor.

Example:

An electrician does some work for you and hands you an invoice for \$800. You ask him to fill out a W-9. He says he doesn't have the information he needs with him. At this point, you should offer the electrician a choice. He can either wait to collect his payment until the W-9 is supplied, or he can be paid \$576 immediately, with \$224 to be sent to the IRS.

We recommend taking a firm stand that independent contractors must supply you with a W-9 before you make any payments to them. This will protect you from IRS penalties at the end of the year. In addition to penalties for errors on forms, the IRS fines for late forms, missing forms, wrong or missing taxpayer information, and not filing electronically when you should have.



Certificates of Insurance

Employers should obtain a certificate of insurance from all individual independent contractors. Your workmen’s compensation insurance company requires them in an audit. They will assess additional insurance premiums when they do their annual audit if they do not receive the insurance certificates. If the employer does not have a certificate of insurance, the insurance company will bill the company as if that person is an employee for workers compensation insurance.

Corporations

You are not required to report income paid to corporations on the form 1099, but you do for LLC’s. However, it is in your best interest to have anyone claiming to be a corporation, fill out a W-9 anyway. All attorneys are to fill out a W-9 and receive a 1099 regardless of the entity of their firm.

Wisconsin Statues for Independent Contractors

Effective January 1, 2011, the definition of employee was amended for private sector employers other than nonprofits and trucking and logging operators. This definition is used to determine which individuals who provide services for them need to be included in the Unemployment insurance program. In other words, it determines when an individual’s risk of unemployment belongs with an employing unit rather than with an individual who bears the risk of his or her own unemployment. The latter is known as an independent contractor. The amendment was made to clarify the test used to determine if an individual providing service is an employee or an independent contractor under the Unemployment Insurance Law. See the definitions of employee below for services performed both before and after January 1, 2011 under Other Private Sector Employers. Wisconsin's Unemployment Insurance Law defines the term "employee" differently for individuals who provide services in the trucking or logging industry and individuals working for government units and non-profit organizations from individuals working in other industries.

For more information on Independent Contractor Self Employed or Employees, visit www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee.

| <u>Benefits of Hiring Employees</u> | <u>Challenges of Hiring Employees</u> |
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| Company loyalty: Employees often identify strongly with their job, value the financial security, and may want to stay with the company longer than independent contractors who jump from gig to gig. | Higher expense: You’re not only responsible for employees’ wages, you also have to pay your share of their Social Security and Medicare taxes. You may need to provide employee benefits like health insurance and paid sick leave as well. |
| Ongoing support: During busy periods, you can count on your employees to pitch in, work late, and help get the job done. Employees can wear multiple hats and help out where they’re most needed. | Resources: You need to supply your employees with everything they need to do their jobs (unlike contractors). Employees are generally based onsite as well, so you need to ensure there are sufficient workspaces for everyone. |
| Greater control: Employers have control over their employees’ schedules, deciding when and how they work. If you need something done a certain way at a certain time, it makes sense to hire an employee to do the job. | Managing employees: When you have employees working for you, you need to train, manage, and motivate them. Make sure you have time to commit |

| <u>Benefits of Hiring Independent Contractors</u> | <u>Challenges of Hiring Independent Contractors</u> |
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| Expertise: Contractors typically are well trained in their field and can hit the ground running with minimal training (they are independent, after all). They can focus on a very specific project that you may not have expertise in. | Less control: Businesses have less control over independent contractors, who tend to enjoy a greater amount of autonomy. Plus they generally only work for a business for a short amount of time, which can be disruptive. |
| Expenses: Contractors are not classified as employees. So you don’t have to withhold payroll taxes from their payments, and you don’t have to offer benefits like health insurance. (Payments to international contractors may be subject to separate withholding taxes.) This can save money (although not always since contractors get paid at a higher rate in some cases). | Legal considerations: Everything about your terms with your independent contractors is controlled by your contract. So draft your contract carefully and get a legal professional to review it. While you can dismiss an employee at will, you might not be able to fire the independent contractor without being in breach of contract. |
| Flexibility and independence: Independent contractors are hired for a specific project or set amount of time, which gives businesses more flexibility in hiring and dismissing them. | Insurance: If contractors get injured on the job, they could choose to sue the business. Employees, on the other hand, are covered by workers’ compensation insurance and generally can’t sue their employer for work-related injuries. |

Please note that the information contained herein is limited in scope and is only intended as an overview of the differences in reporting forms for independent contractors and employees. For guidance or advice specific to your business, you should consult with a tax or legal professional.