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Getting Rid of the Misnomer: The Risks Behind the Term "1099 Employee"

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While many employers use the term "1099 employee" as a means to distinguish independent contractors from the company's W-2 employees, no such term exists from a legal standpoint.

In fact, in addition to being inaccurate, this term is hazardous and could be costly for companies. A common mistake made by employers across the nation is misclassifying its workers as independent contractors as opposed to employees, and this issue is only exacerbated by erroneous terms such as "1099 employee." Though it may seem to many that calling workers "1099 employees" is merely a use of inexact terminology, it should be noted that this lack of precision could lead to pitfalls, such as failure to withhold and pay taxes, operating without proper insurance, and United States Department of Labor ("DOL") audits.

What's the Truth Behind "1099 Employees"?

A "1099 employee" is a misnomer employers use to describe independent contractors. While the term has been coined by many and is commonly used by small business owners, the Internal Revenue Service ("IRS") generally refers to these workers as nonemployees. A 1099 refers to the tax form companies must provide to independent contractors for work performed throughout the year. Business taxpayers must report nonemployee compensation of $600 or more to the IRS using a Form 1099-NEC, Nonemployee Compensation.

Independent contractors are not protected by Equal Employment Opportunity laws, requirements to provide minimum wages and overtime pay, workers' compensation laws, or unemployment compensation laws, among other regulations. Further, independent contractors are not entitled to many benefits offered by employers. Due to the Form 1099, independent contractors self-report their earnings, meaning employers are not required to withhold taxes and payroll deductions for independent contractors. All of these advantages generally incentivize employers to use independent contractors or at least claim their employees are independent contractors because such classification can result in significant cost savings. Additionally, the relationship can be mutually beneficial to the independent contractor because they commonly receive greater control over their work environment, schedule, and methods used to complete the job.

What's the Problem?

The distinction between independent contractors and employees is a complex determination that employers must make regarding each worker. There is no single test to evaluate a worker's status as an independent contractor or an employee for all purposes, which further complicates the issue. The decision of whether workers are considered independent contractors or employees is assessed by federal courts through a list of factors, each of which has various issues that require further analysis, commonly known as the "Economic Realities Test." The cornerstone of the factors is the employer's right to control the performance of the worker as they complete the task assigned. The six factors utilized by courts are:

- The degree of control that the employer has over the manner in which the work is performed and by whom;
- The worker's opportunities for profit or loss depends on the worker's managerial skill;
- The employer's and worker's relative investment in equipment or material;
- The degree of skill and/or independent business judgment required for the work;
- The permanency of the working relationship; and,
- The degree to which the services rendered are an integral part of the employer's business.

Although this test was scheduled to be published and expressly adopted by the DOL, the final rule taking such action was withdrawn prior to taking effect. In addition to the complication of the test and the fact that the DOL has not further addressed the issue, the misnomer "1099 employee" completely misses the objective. The ultimate determination is whether a worker should be classified as an employee or an independent contractor who reports compensation via a Form 1099. The imprecise label "1099 employee" combines the two classifications, creating further confusion within the intricate issue.

Conclusion

Calling a worker a "1099 employee" can be an expensive mistake for a company. Independent contractors are not covered by workers' compensation insurance, are not subject to the company's unemployment or payroll taxes, and do not receive overtime or minimum wage. However, employers must ensure that all of these protections are maintained for employees. Calling a worker a "1099 employee" could potentially cause employers to pay for pricey insurance, payroll systems, and wages that are not otherwise required if the worker is actually an independent contractor. On the other hand, if a worker is truly an employee, then the company is risking six-figure workers' compensation claims, wage and hour claims seeking two years' back pay and overtime wages, and audits by the Department of Employment Security, the IRS, and the DOL.

While removing the term "1099 employee" from your vocabulary will not solve the issues associated with the difficulty of classifying workers, the use of this term further complicates the distinction between independent contractors and employees. Understanding the inaccuracy of this terminology could be the first step in avoiding a six-figure penalty associated with misclassifying workers. For further guidance to avoid misclassifying workers, you should evaluate the worker's position and job duties with your attorney and determine the appropriate measures to implement.

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