



## Independent Contractor or Employee?

Gary Hoff

Department of Agricultural and Consumer Economics  
University of Illinois

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### Synopsis

Many farmers do not want the burden of withholding payroll taxes on part-time help. Consequently, they classify these individuals as independent contractors. Therefore, the farmer or rancher only needs to file a Form 1099-MISC if the individual is paid over \$600 per year. Upon close inspection, the IRS would probably classify many of these individuals as employees. If this is the case, the IRS could impose some severe penalties on the employer. However, the IRS has a new program that can substantially reduce the amount of withholding tax and penalties that can be assessed.

### Classification

In determining if an individual is an employee, the IRS uses a 20-point test. The test can be divided into three basic categories. These are behavioral control, financial control, and the relationship between the worker and the farmer.

Some of the factors used to determine behavioral control include what specific training was given by the farmer and how the worker receives job assignments. It also includes who determines work methods and where the work is performed. Financial control is determined by the tools furnished by the worker compared to those furnished by the farmer. One question asked is what expenses are incurred by the worker?

Factors used in the relationship test include whether the worker receives any benefits such as paid vacations, sick pay, insurance benefits, etc. Another factor is whether the worker performs similar services for other people.

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Let's use an illustration of a seasonal farm worker. The individual is hired to haul grain during harvest season. He drives a truck furnished by the farmer using fuel furnished by the farmer. The farmer tells him when to show up for work and where to haul the grain. Except that it is a seasonal job, this meets all of the requirements for the worker to be considered as an employee. Therefore, the worker should receive a Form W-2 and the farmer should be withholding FICA tax and matching the withheld amount. As an independent contractor, the worker is paying all of his self-employment tax when the farmer should be paying half.

### **1099 failure-to-file penalties**

In some cases the farmer does not even give the worker a Form 1099. Penalties were recently increased for failure to file a Form 1099. If the 1099 is filed between March 1 and March 31, the penalty is \$30 for each failure. Late filing between April 1 and July 31, the penalty is \$60 per failure. Filing after August 1 can result in a \$100 per failure penalty. There is a maximum \$500,000 penalty for a small business.

In situations where the farmer is challenged by the IRS as to the classification of the worker and determines the worker is really an employee, there is a different result.

### **Misclassification Penalties**

If the IRS determines the farmer has misclassified a worker as an independent contractor, it can assert a different set of penalties. These include [reference IRC §3509]:

- 1.5% of each misclassified worker's wages because income taxes were not withheld;
- 20% of each misclassified worker's FICA taxes that were not withheld;
- The employer's FICA must be paid; and
- Any other applicable penalties and interest.

**Example 1** Perry has a large grain farming operation. He has 5 seasonal workers that assist with planting and harvesting. In 2010, he treated the workers as independent contractors and paid them a total of \$40,000. He paid the workers \$38,000 in 2011 and has paid them \$20,000 at the time of the IRS audit in 2012. No worker earned over the FICA wage base. If the IRS determines the workers are employees, Perry will owe the following penalties:

- 1.5% of \$98,000 (\$40,000 + \$38,000 + \$20,000), or \$1,470 for income taxes not withheld;
- 20% of FICA taxes not withheld (7.65% x \$98,000), or \$1,499;
- \$7,497 (7.65% x \$98,000) for the employer's share of FICA tax; and
- Any other applicable penalties and interest.

Perry will owe the IRS at least \$10,466 (\$1,470 + \$1,499 + \$7,497).

### **Penalty Relief**

On September 21, 2011, the IRS announced a new voluntary worker classification settlement program (VCSP) that is providing payroll tax relief to employers who voluntarily reclassify their employees. This program offers the employer a lower cost way of reclassifying their employees.

To be eligible for the program, the employer must:

- Consistently have treated the workers in the past as nonemployees,
- Have filed all required Forms 1099-MISC for the workers for the previous three years,
- Not currently be under audit by the IRS, and
- Not currently be under audit by the Department of Labor or a state agency concerning the classification of these workers.

Employers that have been subject to an IRS, Department of Labor or state agency audit may still qualify for this amnesty program if all requirements of the audit have been complied with.

An employer can apply for the program by filing Form 8952, Application for Voluntary Classification Settlement Program (VCSP), at least 60 days before they want to begin treating the workers as employees.

If an employer is accepted into the program, they will pay an amount effectively equaling just over 1% of the wages paid to the reclassified workers over the past year. No interest or penalties are due and the employer will not be audited for payroll taxes related to these workers for the prior years. Employers under the program are subject to a special 6-year statute of limitations, rather than the usual three years that generally applies to payroll taxes [reference IR-2011-95 (Sep. 21, 2011)].

**Example 2** If Perry is not under audit, using the facts from Example 1, he can apply for the VCSP. Perry completes and files Form 8952 and requests the beginning date to be January 1, 2013. His payment will be based on his 2011 payroll of \$38,000 as 2012 has not yet ended. Following the instructions on the form, Perry calculates the payment using 10.28% of \$38,000, or \$3,906. Under the VCSP, he pays the IRS 10% of this amount, or \$391. Perry's savings by voluntarily reclassifying his employees is \$10,075 (\$10,466 – \$391).

Once the IRS has accepted the VCSP payment, the farmer must treat prospectively all current and future workers as employees.

Additional information on the VCSP program is available on the IRS website at <http://www.irs.gov/businesses/small/article/0,,id=246014,00.html>