INDEPENDENT CONTRACTORS & 1099S

IRS 20-Factor Test & Three-Category Classification (2025 Updated)

Proper Classification, Tax Reporting & Compliance for Churches

Church Clergy Tax Management & Compliance

Today's Agenda

- Why Classification Matters: The Consequences
- IRS Three-Category Test (Behavioral, Financial, Relationship)
- Guest Speakers, Musicians & Ministerial Services
- W-2 vs. 1099: Key Differences & Reporting
- Church 1099 Reporting Requirements (Form 1099-NEC)
- Form W-9: Documentation & Record Retention
- Common Misclassification Mistakes Churches Make
- Compliance Framework & Best Practices

Why Classification Matters: The Stakes

- **IRS Burden of Proof:** Church MUST prove independent contractor status (IRS presumes employee)
- **Tax Withholding:** Employees require W-2 withholding; contractors = no withholding (1099 only)
- **Self-Employment Tax:** Contractors pay 15.3% SE tax; employees only pay FICA (7.65%)
- **Misclassification Penalties:** Back taxes + 20% accuracy penalty + interest (retroactive years)
- **Wage & Hour Violations:** Employee misclassified as contractor = potential liability for unpaid wages
- **Church Nonprofit Status:** Does NOT exempt church from 1099 reporting (myth!)
- **IRS Audit Risk:** Misclassification is common audit trigger for churches and nonprofits

IRS Classification Framework: Three Categories (2025)

1. Behavioral Control

- Does church control HOW work is done?
- Instructions & training?
- Work hours set?
- Set working location?

2. Financial Control

- Who provides equipment?
- Paid by project vs. salary?
- Can incur business expenses?
- Works for multiple clients?

3. Relationship of Parties

- One-time event vs. ongoing?
- Benefits provided?
- Written agreement?
- Permanence of relationship?

Category 1: Behavioral Control - Key Questions

- **HOW Much Control?:** Employee status = church controls HOW work is performed (methods, processes)
- **Independent Contractor:** Person controls HOW; church controls only OUTCOME/RESULT
- **Example - Employee:** Church says "lead worship at 10am, use our hymnals, follow our liturgy, report to music director"
- **Example - Contractor:** Church says "lead worship; you choose songs, style, approach (outcome: inspiring worship)"
- **Instructions & Training:** Extensive training = employee; minimal instruction = contractor
- **Work Schedule:** Set hours = employee; flexible scheduling = contractor
- **Location Control:** Must work at church = employee; can work from home/elsewhere = contractor

Category 2: Financial Control - Key Indicators

- **Equipment & Tools:** Church provides = employee; contractor uses own = contractor status
- **Example:** Church provides piano/organ = suggests employee; musician brings own instrument = contractor
- **Expense Reimbursement:** Church reimburses expenses = employee; contractor absorbs expenses = contractor
- **Payment Method:** Regular salary on payroll = employee; per-event payment via check/1099 = contractor
- **Profit/Loss Opportunity:** Contractor can profit/lose; employee gets steady pay regardless
- **Other Clients:** Works ONLY for church = employee; advertises services to public = contractor
- **NO Financial Control Factor Alone is Decisive:** Must weigh all three categories together

Category 3: Relationship of Parties - Permanence Test

- **Duration & Permanence:** Long-term, ongoing = employee; one-time/project-based = contractor
- **Example - Employee:** Hired as full-time music director, expected to stay indefinitely
- **Example - Contractor:** Hired for one Easter service, or seasonal Christmas special event
- **Benefits:** Health insurance, vacation, retirement = employee; no benefits = contractor
- **Written Agreement:** Clear IC agreement reduces employee classification risk
- **Integration into Church:** Part of church's core mission/structure = employee; separate service provider = contractor
- **Critical Context:** ALL three categories must be evaluated holistically (no single factor decisive)

Guest Speakers & Visiting Ministers: Typical Contractor Status

- **Definition:** Guest speaker = visiting preacher, pastoral guest, conference speaker invited for limited engagement
- **Typical Classification:** Independent contractor (one-time/occasional event)
- **Why Contractor:** (1) Usually one event only, (2) No church control over content/delivery, (3) No church benefits, (4) No ongoing relationship
- **Honorarium Amount:** Typical $200-500 per event (below $600 threshold = no 1099 required, but document payment)
- **$600+ Threshold:** If total payments in calendar year reach $600+, MUST issue Form 1099-NEC by Jan 31
- **W-9 Collection:** Request Form W-9 (W-9 is contractor info form, kept on file for 4 years)
- **EXCEPTION - Regular Guest:** If same person speaks 4x/year consistently = might be classified as employee (evaluate all factors)

Guest Musicians: Classification & Common Scenarios

- **Holiday Musicians:** One-time Christmas/Easter performers = contractor (one event, $200-300 typical)
- **Recurring Musicians:** Every Sunday worship = EMPLOYEE (regular hours, ongoing relationship, church integration)
- **Wedding/Funeral Musicians:** Typically contractor (one-off events, their own instruments, multiple clients)
- **Key Distinction:** (1) One Sunday pianist = contractor; (2) Every Sunday pianist = employee (salary/W-2)
- **Furnished Value Consideration:** If church provides piano/organ = suggests employee control; musician brings instrument = contractor
- **1099-NEC Threshold:** Holiday musicians: add up ALL payments for ENTIRE YEAR (Christmas + Easter + other events) - if $600+ total, issue 1099-NEC
- **Common Mistake:** Churches pay separately per event under $600, thinking they avoid 1099 (WRONG - must aggregate annually)

1099 Forms: Which Form to Use (2025)

Form 1099-NEC

- Nonemployee Compensation
- Services: speaking, music, labor
- Threshold: $600+
- Churches use THIS form
- Due Jan 31 (to IRS & worker)

Form 1099-MISC

- Miscellaneous Income
- Rent, royalties, prizes
- Threshold: $600+
- Rarely used by churches
- Due Jan 31

1099-NEC Reporting: Church Obligations

- **Threshold:** Issue 1099-NEC if payments total $600 or more in calendar year (2025 threshold; increases to $2,000 in 2026)
- **Aggregation Rule:** SUM ALL payments to same person in calendar year (not per event)
- **Example:** Pay guest speaker $300 for Easter, $400 for Christmas = $700 total = MUST issue 1099-NEC
- **Due Dates:** Copy to worker by Jan 31; File IRS copies (with Form 1096 transmittal) by Feb 28 (or March 31 if e-filing)
- **Payment Box:** Report in Box 1 (Nonemployee Compensation)
- **EIN Requirement:** MUST have contractor's TIN (Tax ID Number) - use Form W-9 to collect
- **Record Retention:** Keep 1099 records for 4+ years for IRS audit defense

Form W-9: Tax ID Collection & Verification

- **Purpose:** W-9 collects contractor's Tax ID (SSN or EIN) for 1099 reporting
- **Timing:** Request BEFORE first payment (best practice: when engaging contractor)
- **Document Retention:** Keep signed W-9 for 4 years (minimum) after last payment
- **Required Info:** Name, address, SSN/EIN, signature, certification date
- **Incomplete W-9:** If W-9 missing/invalid, backup withholding applies (24% tax withheld)
- **No Tax ID = No Payment:** Church should NOT pay contractor without valid W-9 in file
- **Contractor Refusal:** If contractor refuses to provide W-9, cannot report as independent contractor (must treat as employee or decline work)

W-2 Employee vs. 1099 Contractor: Side-by-Side

W-2 Employee

- Church controls HOW
- Set hours/location
- Church provides tools
- Church withholds taxes
- Church pays FICA (7.65%)
- Can receive benefits
- Form W-4 collected
- Form W-2 issued annually

1099 Contractor

- Controls own methods
- Flexible schedule
- Provides own tools
- NO tax withholding
- Pays 15.3% SE tax
- NO benefits
- Form W-9 collected
- Form 1099-NEC issued

Tax Withholding: W-2 vs. 1099 Requirement

- **W-2 Employees:** Church MUST withhold federal income tax + Social Security (6.2%) + Medicare (1.45%)
- **Withholding Calculation:** Based on Form W-4 provided by employee (determines tax bracket withholding)
- **Church Matching:** Church MATCHES Social Security (6.2%) and Medicare (1.45%) = 7.65% employer portion
- **1099 Contractors:** NO withholding (contractor pays own estimated tax quarterly)
- **Contractor Self-Employment Tax:** Contractor pays 15.3% self-employment tax on 1099 income (both employer & employee portion)
- **Example Impact:** $5,000 payment: W-2 = ~$650 withholding; 1099 = $0 withholding (contractor owes ~$765 SE tax)
- **CRITICAL:** Misclassifying employee as 1099 = church avoids withholding BUT contractor faces tax liability shock

Ministerial Services: Special IRS Rules (Publication 517)

- **Definition:** Services performed in connection with church/religious organization (preaching, leading worship, performing spiritual duties)
- **Self-Employment Status:** Ministerial income is ALWAYS subject to SE tax (regardless of W-2 vs. 1099 classification)
- **Exception - Clergy Opt-Out:** Ordained clergy can file Form 4361 to opt out of SE tax (but then lose Social Security)
- **Guest Speaker Example:** Pastor invited to preach at another church earns ministerial income = subject to SE tax on 1099
- **Not Ministerial:** Administrative work (church secretary), maintenance (janitor) = standard employee classification rules apply
- **Key Implication:** Even 1099 guest speaker/musician pays self-employment tax (unlike regular contractors)
- **Documentation:** Church should describe payment as "ministerial services" on 1099-NEC for clarity

Common Mistakes: How Churches Misclassify Workers

❌ MISTAKE

- Regular staff paid 1099 (no withholding)
- Paying under $600 = no 1099 needed
- Informal arrangement = contractor
- No written agreement = no compliance needed

✅ CORRECT

- Regular staff = W-2 employees
- Aggregate annually; $600+ = 1099
- Apply three-category test
- Written agreement + W-9 best practice

More Misclassification Pitfalls

❌ MISTAKE

- Nonprofit status = 1099 exempt
- No W-9 on file = no 1099 needed
- Backup withholding ignored
- No records = no audit risk

✅ CORRECT

- Nonprofits MUST file 1099-NEC
- Collect W-9 before payment
- 24% backup withholding if no TID
- Maintain 4-year file for audit

Backup Withholding: When W-9 is Missing/Invalid

- **Definition:** Backup withholding = 24% federal tax withheld from 1099 contractor payment if valid W-9 not provided
- **Triggers:** (1) No W-9 provided, (2) Invalid/incorrect TID, (3) IRS notifies church of noncompliance
- **Example:** Church pays guest speaker $500 for sermon without W-9 = must withhold $120 (24% x $500) = pay only $380
- **Church Obligation:** Church withholds $120, deposits with IRS, reports on contractor's 1099-NEC as backup withholding
- **Contractor Recovery:** Contractor claims backup withholding credit on tax return (may get refund if overpaid)
- **Prevention:** Always collect signed W-9 BEFORE first payment (eliminates backup withholding risk)
- **Common Church Problem:** Many churches don't withhold/deposit backup withholding = creates IRS compliance issue

Form SS-8: IRS Worker Classification Determination

- **Purpose:** Request IRS official determination if church/worker unsure about classification
- **Who Can File:** Either church OR worker can file Form SS-8
- **Timeline:** IRS takes 6+ months to issue ruling letter
- **Benefit:** IRS ruling protects church from reclassification penalty IF church followed ruling
- **Worker-Initiated:** Sometimes worker files SS-8 claiming employee status (triggers church audit risk)
- **Proactive Church Strategy:** File SS-8 if classification borderline = get advance IRS blessing before any issue arises
- **Complex Cases:** Recommend engaging CPA/tax attorney to prepare SS-8 (detailed analysis required)

Compliance Framework: Best Practices for Churches

- **Step 1 - Classification Decision:** Evaluate three-category test (behavioral, financial, relationship)
- **Step 2 - Documentation:** Maintain written record of classification decision & factors considered
- **Step 3 - W-9 Collection:** Request signed Form W-9 from all 1099 contractors BEFORE first payment
- **Step 4 - Payment Processing:** Pay contractors via check/ACH with clear description of work performed
- **Step 5 - 1099 Reporting:** Aggregate annual payments; issue 1099-NEC if $600+ by Jan 31
- **Step 6 - Record Retention:** File W-9s, payment records, 1099s for 4+ years (IRS audit defense)
- **Step 7 - Annual Review:** Quarterly/annual audit to ensure compliance, identify classification changes

Contractor Engagement Checklist

- ☐ Classify worker using three-category test (behavioral, financial, relationship)
- ☐ Document classification decision in writing
- ☐ Request and file signed Form W-9 (contractor info form)
- ☐ Create written contractor agreement (scope of work, compensation, independent status)
- ☐ Verify contractor maintains independent business (multiple clients, advertising, etc.)
- ☐ Ensure contractor uses own equipment/tools (not church-provided)
- ☐ Track payment method (check/1099, not payroll)
- ☐ Aggregate annual payments and maintain records for 4+ years
- ☐ Issue 1099-NEC if payments total $600+ (due Jan 31)
- ☐ File transmittal Form 1096 with IRS by Feb 28 / March 31 (e-file)

Red Flags: Signs Church Classification May Be Wrong

Reclassification Risk

- Same person paid weekly/monthly
- Church provides all equipment
- Regular set hours required
- Church provides training/direction
- Works exclusively for church

Safe Contractor Indicators

- One-time/occasional events
- Own equipment (instruments, tools)
- Flexible schedule
- Church specifies result, not method
- Works for multiple clients

Case Study: Misclassification Consequences

Scenario: Church pays choir director $400/week (1099 basis) for 3 years. Director is present every Sunday, follows church direction, uses church piano.

IRS Audit Finding: Choir director is EMPLOYEE (not contractor). Church should have withheld & paid payroll taxes for 3 years.

- **Back Taxes Owed:** Church pays 3 years of employer payroll taxes (7.65% employer FICA + unemployment) + penalties (20% x back taxes)
- **Total Cost:** ~$8,000-10,000 in back taxes + penalties + interest + possible wage & hour liability
- **Lesson:** Regular staff = W-2 employees, no exceptions for nonprofits

Key Takeaways

- Use IRS three-category test (behavioral, financial, relationship)
- Nonprofits are NOT exempt from 1099 reporting (common myth!)
- Aggregate payments annually; $600+ = must issue 1099-NEC
- Collect W-9 before payment to avoid backup withholding (24%)
- Regular staff = W-2 employees (weekly/monthly payments suggest employee)
- Document classification decision; maintain 4-year record retention
- Misclassification = back taxes + penalties + interest + wage liability

Next: Love Offerings & Honorariums for Visiting Clergy