

TaxBrief

Keeping you informed

Are You an Employee or an Independent Contractor?

Are you unsure whether you or someone working for you should be classified as an employee or an independent contractor? This subject is among the most important questions for businesses and workers. The answer affects how taxes are paid, who is responsible for withholding and remitting those taxes, and eligibility for benefits like Social Security and Medicare. Misclassification can lead to costly penalties, so it's crucial to get it right.

Why does worker classification matter?

Classifying a worker as an employee or an independent contractor affects key responsibilities. It determines who must withhold and pay federal taxes, whether the worker qualifies for benefits like unemployment or workers' comp., and how the worker and business report income. Misclassifying a worker can lead to serious consequences like owing back taxes, penalties and interest. Worker classification determines:

- Who pays and withholds federal income, Social Security and Medicare taxes
- Eligibility for benefits such as unemployment insurance and workers' compensation
- How workers and businesses report income and expenses on their tax returns
- Potential liability for back taxes, penalties and interest if a worker is misclassified

Key definitions

- **Employee:** A worker who performs services for you and you have the right to control what will be done and how it will be done, even if you give the worker freedom of action.

- **Independent contractor:** A worker who is in business for themselves and is only subject to the hiring party's control or direction as to the work's result, not the means and methods of accomplishing it.

How does the IRS determine worker status?

The IRS uses a "common law" test, which looks at the facts of each case. No single factor is decisive. Instead, the IRS considers all information that shows the degree of control and independence in the relationship. These facts fall into three main categories:

Behavioral control

- **Instructions:** Does the business have the right to tell the worker how, when and where to do the work? Employees typically receive detailed instructions; independent contractors usually decide how to do the job.
- **Training:** The business often trains employees; independent contractors use their own methods.

Financial control

- **Significant investment:** Independent contractors invest significantly in their work facilities or equipment.
- **Unreimbursed expenses:** Contractors are more likely to have unreimbursed business expenses.
- **Opportunity for profit or loss:** Contractors can make a profit or suffer a loss; employees are generally paid a regular wage.
- **Method of payment:** Employees are usually paid by the hour, week or month; contractors are often paid by the job or project.

Relationship of the parties

Written contracts: A contract may state the parties' intent, but the actual working relationship is what matters.

Benefits: Employees may receive benefits like insurance, pension or paid leave; contractors typically do not.

Permanency: An expectation that the relationship will continue indefinitely suggests employee status; a relationship for a specific project or period suggests contractor status.

Services provided: If the workers' services are a key aspect of the business, this may indicate employee status.

The 20-factor test

The 20-factor test is a tool developed by the IRS to help determine whether a worker is an independent contractor or an employee. It examines behavioral and financial control, and the nature of the relationship between the business and the worker. No single factor is decisive; rather, the overall picture of the working relationship is what matters.

1. **Instructions:** Required compliance with instructions suggests employee status
2. **Training:** Training by the business suggests employee status
3. **Integration:** Performing services integral to the business suggest employee status
4. **Personal services:** A requirement to personally perform services suggests employee status
5. **Set hours of work:** Set hours indicate employee status
6. **Full-time work:** Requiring full-time work suggests employee status
7. **Doing work on employer's premises:** Working on the business' premises suggests employee status
8. **Order or sequence set:** A work order or sequence set by the business suggests employee status
9. **Payment by hour, week or month:** Regular payments suggest employee status

10. **Furnishing tools and materials:** Tools provided by the business suggest employee status
11. **Right to discharge:** The right to fire a worker suggests employee status
12. **Right to terminate:** The ability to quit without liability suggests employee status

As stated above, no single factor is controlling; the entire relationship must be considered.

Example one – employee: A hairdresser works at Supercuts, follows a set schedule, uses the salon's facilities and can be discharged by the owner. The salon withheld taxes and provided workers' compensation. This worker is an employee.

Example two – independent contractor: A seamstress picks up garments from a business, works at her shop, uses her own equipment, sets her own hours and is paid per job. She advertises her services to the public and can realize a profit or loss. She is an independent contractor.

What if you are still unsure?

If you are unsure about your status, you can file Form SS-8 with the IRS to request a determination. The IRS will review the facts and circumstances and issue a ruling. If not, you can contact our office to help you decide.

Consequences of misclassification

If a business incorrectly classifies an employee as an independent contractor and has no reasonable basis, it may be liable for employment taxes, penalties and interest. Relief provisions may apply in some cases, but not for certain technical service specialists (such as engineers, computer programmers and similar workers provided for another business).