**Employee vs Contractor: Everything You Need to Know**

*When it comes to differentiating between an employee and an independent contractor, there are very few differences with regard to job performance.8 min read*

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**Employee vs Contractor**

The difference between employee versus contractor is very significant. As an employer, it is crucial to understand these differences and classify all workers accordingly.

**Being an Independent Contractor Versus Employee**

When it comes to differentiating between an employee and an independent contractor, there are very few differences with regard to job performance. Contracted employees will work side-by-side within the same company and often do similar work. However, there are some very important legal differences between contractors and employees.

Being employed by a company will come with certain privileges that a contractor will not receive. This can include employment benefits, tax implications, and liability.

As an independent contractor, it is important that you understand all the differences between employees and independent contractors. Courts have provided an economic realities test to help interpret the provision of the [Fair Labor Standards Act](https://www.upcounsel.com/fair-labor-standards-act). This helps discern the difference between employees and [independent contractors](https://www.upcounsel.com/blog/lead-best-life-work-home).

An economic realities test will look at the dependence of the workers on the business. People who get a large amount of their salary from the business will typically qualify as an [employee](https://www.upcounsel.com/blog/4-tips-creating-employee-handbook). The test will also include things like skill level, the nature of the work, paying taxes, and receiving benefits.

Additional questions are asked to help determine the relationship of work:

* How much control does the worker have over the work and who controls that decision?
* What is the level of loss with all parties in the relationship?
* Who is paying for the materials used for that work?
* What skills are required?
* Is the worker a significant part of the business?
* Is the work of a permanent or temporary nature?

If the employer does not have the power over those working on his or her tasks, the hired individual would be considered an independent contractor. Many businesses will use this to hire contractors rather than employees to help save money on their employment costs.

Businesses that are smaller and already working with minimal budgets are often tempted to use independent contractors even when an employee classification is necessary. Classifying a worker as an independent contractor can save money and cost of benefits.

For independent contractors, an employer only has to complete a form 1099 – MISC at the end of the tax year. It is crucial that all workers are properly classified. Not doing so can result in major ramifications. The Internal Revenue Service has provided guidelines to its agents to help with deciding the status of a worker.

At one time, there were 20 factors provided by the IRS that had to be used in court decisions to decide worker status. This list was called the [20 Factor Test](http://www.oregon.gov/ODA/shared/Documents/Publications/NaturalResources/20FactorTestforIndependentContractors.pdf). It is often still used as a tool, but many of the factors are not relevant today.

Deciding if a worker is an employee or an independent contractor is based on [common law](https://www.upcounsel.com/common-law) rules. They look at the relationship of the worker and the business and consider the different levels of independence and control within both parties.

**Employee**

Employees typically only work for one employer during the hours that the employer states. He or she works at the employer’s business and will typically receive employment benefits. This includes health care, disability insurance, and additional benefits provided by the employer.

Costs are directed and controlled by the employer with regard to the work assignment. The employee will accomplish tasks as requested by the employer. There are no costs or investments in the work that is done for the employer.

The employee generally has education and experience in the industry. There is also a special training provided by the employer in order to better accomplish job tasks. Employees will receive a salary with the income tax withheld by the employer. [Social Security and Medicare taxes](https://www.upcounsel.com/social-security-and-medicare-tax) are also withheld.

If a layoff were to occur, employees are likely eligible to receive unemployment compensation. They may also receive workers' compensation benefits for any injury occurring in the workplace.

An employee can be terminated by an employer for a good cause and without notice, unless the employment is in an at-will state, in which case good cause is not necessary. Employees are covered by federal and state wages and hours laws, such as minimum wage and overtime. He or she will have the protection of [workplace safety](https://www.upcounsel.com/workplace-safety) and anti-discrimination laws. The ability to join or form a union is also a possibility.

The employee’s work is considered to be essential to the business. An employee will likely be required to provide any intellectual property created during the employment to the employer, such as a [patent](https://www.upcounsel.com/patent).

Employees often work with only one employer. They may collaborate with others and have a social structure at work. Employees can also approach a glass ceiling and receive fewer advances in career opportunities. They are often in less control of moving up with any company.

**Independent Contractor**

Independent contractors will provide consulting services to more than one business. They will set their own hours and work out of their own office or home. The contractor will not receive any employment benefits from an employer.

Independent contractors will have the authority to do whatever they need to do in order to accomplish tasks. There is no input from an employer. All costs that are associated with doing a job will fall to the independent contractor.

Contractors acquire specialized skill sets and come to the workplace with a very specialized education and experience. The contractor is responsible for his or her own self-employment taxes, but is not subject to employment taxes or FICA withholding.

As a contractor, there are no opportunities to collect unemployment compensation benefits or workers' compensation benefits. Unless the contract is for a certain amount of time, the contractor can be let go buy an employer for any reason.

Contractors are paid according to the terms listed in the contract. There is no extra compensation for any overtime worked. There is typically no protection for employment antidiscrimination or workplace safety laws. Contractors also may not join or form a union.

Contractors are responsible for supplying their own equipment, tools, or materials needed for work. They may be discharged at any point and can choose whether to come back to work without worrying about losing employment. Their work can be temporary or permanent.

One disadvantage of being an independent contractor is the fact that there can be feelings of loneliness and solitude. However, that can be a bonus if that fits your personality.

Independent contractors are their own boss and are typically self-motivating. They have to constantly sell to their sponsors and be in charge of all their own budget planning. As work is completed, a contractor will provide an invoice for payment.

**Employer Tax Liability**

The tax liability of an employer is determined by the worker’s employment status. When a worker is an employee, he or she must pay state and federal unemployment tax. [Social Security tax](https://www.upcounsel.com/social-security-tax), workers' compensation, and disability will also need to be paid into a state insurance fund.

For independent contractors, the hiring individual is not required to make any of those payments.

If the employer mistakenly or incorrectly defines a worker as an independent contractor, they can find themselves responsible for any unpaid taxes, such as federal unemployment tax.

**Behavioral Control**

There are several factors that can show whether or not a business has the right to direct and control how the worker completes a task.

* Instructions: An employee is subject to instructions provided by a business on when, where, and how work is to be completed. If no instructions are provided, there may be behavioral control if the employer has that right.
* Training: An employee can be trained to perform a task in a specified way. Independent contractors will utilize their own methods of completing a task.

**Financial Control**

The factors that show whether or not a business has a right to control a job can include:

* How much a worker is reimbursed for business expenses. Independent contractors are more likely to have unreimbursed expenses than regular employees. There are ongoing costs that are incurred regardless if the work is being done. However, employees can also have unreimbursed expenses connected to their work.
* Amount of investment made by the worker. Independent contractors often have major investment in equipment that they will use when performing tasks for another person. However, a major investment is not necessarily required to be an employee.
* The extent of a profit or loss. The possibility of incurring a loss can indicate if the worker is an independent contractor.

**Type of Relationship**

Several factors can show the relationship between parties and can include the following:

* A [written contract](https://www.upcounsel.com/written-contract) describing the type of relationship among all parties that is intended to develop a strategy on how they are to work together.
* Whether or not the business will provide the worker with [employee benefits](https://www.upcounsel.com/employee-benefits), including insurance, pension, vacation, or sick pay.

**Risks When You Misclassify Employees**

If you intentionally misclassified an employee as an independent contractor, you could face penalties and interest. If you unintentionally misclassify an employee, you may still face some problems. However, it is not as serious as intentionally misclassifying an employee.

If an employer files a form 1099 for an employee, which unintentionally misclassifies the employee as an independent contractor, the liability for federal income tax withholding is limited to 1.5 percent of employee wages.

Liability for FICA tax can be 20 percent of the employee’s share, as well as all money owed by the employee. The employer has no rights to recover any money from the employee.

Employers who do not file any information returns, such as form 1099, may be subject to double the usual amounts. The employer will need to pay 3 percent for federal income tax withholding. The employer is also responsible for 40 percent of the employees’ portion of FICA as well as the employer’s share.

The employer is also liable for unemployment taxes. The IRS can assess interest and penalties but only on the amount of the liability of the employer.

The liability of the employer will include the percentage of taxes that should have been withheld from the employee. If the employer intentionally misclassified an employee, it can result in significant liabilities. The full amount of income tax that should have been withheld will need to be repaid.

Additionally, the full amount of FICA for both the employer and the employee will have to be repaid. All interest and penalties will also need to be paid for the unintentional misclassification. Civil and criminal penalties may also occur.

**Playing It Safe**

If there is a doubt about how an employer should classify a worker, the best way to accomplish classification is to classify them as an employee and comply with all taxes in [employment laws](https://www.upcounsel.com/employment-law).

It is best to get a professional opinion from an attorney or an accountant. IRS form SS – 8 may be used to ask for a determination of status for any individual worker. The IRS uses the information on this form to decide if [payroll tax](https://www.upcounsel.com/payroll-tax) laws will cover an individual.

Though taxpayers can seek guidance on classification through form SS – 8, it should not be used as guidance for additional industry members.