

Employee or Independent Contractor

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Employee or Independent Contractor?

In order for a business owner to know how to treat payments made to workers for services, he or she must first know the business relationship that exists between the business and the person performing the services. A worker's status determines what taxes are paid and who is responsible for reporting and paying those taxes.

A worker performing services for a business is generally an employee or an independent contractor. If a worker is classified incorrectly, the IRS may assess penalties on the employer for nonpayment of certain taxes.

Penalties and Interest

When the IRS determines that a worker is actually an employee rather than an independent contractor, the employer is subject to penalties for failure to withhold and remit income, FICA (Social Security and Medicare) and FUTA (federal unemployment tax) taxes, interest on the underpaid amounts, and penalties for failure to file information returns. The state will also seek to collect workers' compensation and unemployment compensation premiums for unreported wages.

Independent Contractor

An independent contractor is self-employed and is generally responsible for paying his or her own taxes through estimated tax payments. A business issues Form 1099-MISC, *Miscellaneous Income*, to any one independent contractor, subcontractor, freelancer, etc., to whom the business made \$600 or more in payments over the course of the tax year. The business is not generally responsible for withholding income tax or FICA.

Employee

A worker treated as an employee will be issued Form W-2 for wages paid. The business hiring the worker is responsible for withholding income tax and FICA. The employer is also liable for FUTA and various state employment taxes. Also, the employee may be eligible for certain fringe benefits offered by the employer, such as health care.

Factors to Determine Worker Status

The general rules for classifying workers as independent contractors or common-law employees center on who has the right to control the details of how services are to be performed. The factors can be grouped into three categories.

- 1) **Behavioral control.** Factors that indicate a business has the right to control a worker's behavior include the following.
 - **Instructions that the business gives to the worker.** Employers generally control when and where work is to be done, what tools or equipment to use, what workers to hire or to assist with the work, where to purchase supplies and services, what work must be performed by a specified individual, and what order or sequence to follow.
 - **Training that the business gives to the worker.** Employees may be trained to perform a service in a particular manner. Independent contractors generally use their own methods.

continued



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2) **Financial control.** Factors that indicate a business has the right to control the business aspects of a worker's job include the following.

- **Extent of the worker's unreimbursed business expenses.** Independent contractors are more likely to incur expenses that are not reimbursed, such as fixed overhead costs that the worker incurs regardless of whether work is currently being performed.
- **Extent of the worker's investment.** Independent contractors often have significant investment in facilities used to perform services for someone else, such as maintaining a separate office or other business location.
- **Extent to which the worker makes his or her services available to the public.** Independent contractors are generally free to offer their services to other businesses or consumers. They often advertise and maintain a visible business location.
- **Method of payment for services performed.** Employees generally are guaranteed a regular wage and work for an hourly fee or a salary. Independent contractors are generally paid a flat fee for a specific job. Exceptions apply to some professions, such as accountants and lawyers who charge hourly fees for their services.
- **Extent to which the worker can make a profit.** Independent contractors can make a profit or a loss.

3) **Type of relationship between the parties.** Factors that indicate the type of relationship include the following.

- **Written contracts** that describe the relationship and intent between the worker and the business hiring the worker.
- **Employee-type benefits provided to worker.** Employers often provide fringe benefits to employees, such as health insurance, pensions, and vacation pay.
- **Permanency of the relationship.** Employer-employee relationships generally continue indefinitely.
- **Extent services performed by the worker are a key aspect of the business hiring the worker.** A worker who is key to the success of a business is more likely to be controlled by the business, which indicates employee status. For example, an accounting firm hires an accountant to provide accounting services for clients. It is more likely that the accounting firm will present the accountant's

work as its own and would have the right to control or direct that work.

Incorrect Treatment of Employees as Independent Contractors

A worker who receives a 1099-MISC instead of a W-2 has two options.

- 1) Agree with the way the business has classified the worker, file Schedules C and SE, and pay self-employment tax on the earnings, or
- 2) File Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*. The IRS will then decide if the worker should have been treated as an employee, subject to income and FICA tax withholding. If the IRS agrees that the worker really is an employee, the employer will be liable for employment taxes. However, if the IRS determines that the worker is really an independent contractor, the worker will be liable for paying SE tax.

Example: Harold owns a restaurant and hires Jim, a gardener, to mow the lawn and weed the landscaping once a week. The contract states that Jim will arrive at the restaurant on Monday mornings, mow the lawn, pull weeds, and tend to the landscaping. In exchange, Harold agrees to pay Jim \$50 for this service each week. Jim supplies his own lawnmower, weed eater, and hedge clippers. Jim decides what time he arrives and how long the job will take him. Harold does not supervise Jim in his tasks or dictate to him how they are to be done. Jim is an independent contractor.

Example: Jeffrey owns Jeffrey's Gardening Service and employs three gardeners to perform services for his business. Jeffrey pays his gardeners a fixed wage and withholds taxes, FICA, and various benefits and remits those withholdings to the appropriate government agencies. In addition, Jeffrey provides his employees with the tools and equipment they need to perform their work, instructs his employees which jobs to go to, and supervises them while they are doing their work. Jeffrey's workers are employees.

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 70½.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of \$5,000.

This brochure contains general information for taxpayers and should not be relied upon as the only source of authority. Taxpayers should seek professional tax advice for more information.

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