

Employee or Independent Contractor

If you hire someone for a long-term, full-time project or a series of projects that are likely to last for an extended period, you must pay special attention to the difference between independent contractors and employees.

Why It Matters

The Internal Revenue Service and state regulators scrutinize the distinction between employees and independent contractors because many business owners try to categorize as many of their workers as possible as independent contractors rather than as employees. They do this because independent contractors are not covered by unemployment and workers' compensation, or by federal and state wage, hour, anti-discrimination, and labor laws. In addition, businesses do not have to pay federal payroll taxes on amounts paid to independent contractors.

Caution: If you incorrectly classify an employee as an independent contractor, you can be held liable for employment taxes for that worker, plus a penalty.

The Difference Between Employees and Independent Contractors

Independent Contractors are individuals who contract with a business to perform a specific project or set of projects. You, the payer, have the right to control or direct only the result of the work done by an independent contractor, and not the means and methods of accomplishing the result.

Example: Sam Smith, an electrician, submitted a job estimate to a housing complex for electrical work at \$16 per hour for 400 hours. He is to receive \$1,280 every 2 weeks for the next 10 weeks. This is not considered payment by the hour. Even if he works more or less than 400 hours to complete the work, Sam will receive \$6,400. He also performs additional electrical installations under contracts with other companies that he obtained through advertisements. Sam Smith is an independent contractor.

Employees provide work in an ongoing, structured basis. In general, anyone who performs services for you is your employee if you can control what will be done and how it will be done. A worker is still considered an employee even when you give them freedom of action. What matters is that you have the right to control the details of how the services are performed.

Example: Sally Jones is a salesperson employed on a full-time basis by Rob Robinson, an auto dealer. She works 6 days a week, and is on duty in Rob's showroom on certain assigned days and times. She appraises trade-ins, but her appraisals are subject to the sales manager's approval. Lists of prospective customers belong to the dealer. She has to develop leads and report results to the sales

Employee or Independent Contractor

manager. Because of her experience, she requires only minimal assistance in closing and financing sales and in other phases of her work. She is paid a commission and is eligible for prizes and bonuses offered by Rob. Rob also pays the cost of health insurance and group term life insurance for Sally.

Sally Jones is an employee of Rob Robinson.

Independent Contractor Qualification Checklist

The IRS, workers' compensation boards, unemployment compensation boards, federal agencies, and even courts all have slightly different definitions of what an independent contractor is, though their means of categorizing workers as independent contractors are similar.

One of the most prevalent approaches used to categorize a worker as either an employee or independent contractor is the analysis created by the IRS. The IRS considers the following:

1. What instructions the employer gives the worker about when, where, and how to work. The more specific the instructions and the more control exercised, the more likely the worker will be considered an employee.
2. What training the employer gives the worker. Independent contractors generally do not receive training from an employer.
3. The extent to which the worker has business expenses that are not reimbursed. Independent contractors are more likely to have unreimbursed expenses.
4. The extent of the worker's investment in the worker's own business. Independent contractors typically invest their own money in equipment or facilities.
5. The extent to which the worker makes services available to other employers. Independent contractors are more likely to make their services available to other employers.
6. How the business pays the worker. An employee is generally paid by the hour, week, or month. An independent contractor is usually paid by the job.
7. The extent to which the worker can make a profit or incur a loss. An independent contractor can make a profit or loss, but an employee does not.
8. Whether there are written contracts describing the relationship the parties intended to create. Independent contractors generally sign written contracts stating that they are independent contractors and setting forth the terms of their employment.
9. Whether the business provides the worker with employee benefits, such as insurance, a pension plan, vacation pay, or sick pay. Independent contractors generally do not get benefits.
10. The terms of the working relationship. An employee generally is employed at will (meaning the relationship can be terminated by either party at any time). An independent contractor is usually hired for a set period.

Employee or Independent Contractor

11. Whether the worker's services are a key aspect of the company's regular business. If the services are necessary for regular business activity, it is more likely that the employer has the right to direct and control the worker's activities. The more control an employer exerts over a worker, the more likely it is that the worker will be considered an employee.

Minimize the Risk of Misclassification

If you misclassify an employee as an independent contractor, you may end up before a state taxing authority or the IRS.

Sometimes the issue comes up when a terminated worker files for unemployment benefits and it's unclear whether the worker was an independent contractor or employee. The filing can trigger state or federal investigations that can cost many thousands of dollars to defend, even if you successfully fight the challenge.

There are ways to reduce the risk of an investigation or challenge by a state or federal authority. At a minimum, you should:

- Familiarize yourself with the rules. Ignorance of the rules is not a legitimate defense. Knowledge of the rules will allow you to structure and carefully manage your relationships with your workers to minimize risk.
- Document relationships with your workers and vendors. Although it won't always save you, it helps to have a written contract stating the terms of employment.

If you have any questions about how to classify your employees, please give us a call. We can help guide you in the right direction in the eyes of the IRS.