IRS

Understanding Employee vs. Contractor Designation

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The Internal Revenue Service reminds small businesses of the importance of understanding and correctly applying the rules for classifying a worker as an employee or an independent contractor. For federal employment tax purposes, a business must examine the relationship between it and the worker. The IRS Small Business and Self-Employed Tax Center on the IRS website offers helpful resources.

Worker classification is important because it determines if an employer must withhold income taxes and pay Social Security, Medicare taxes and unemployment tax on wages paid to an employee. Businesses normally do not have to withhold or pay any taxes on payments to independent contractors. The earnings of a person working as an independent contractor are subject to self-employment tax.

The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work, not *what* will be done and *how* it will be done. Small businesses should consider all evidence of the degree of control and independence in the employer/worker relationship. Whether a worker is an independent contractor or employee depends on the facts in each situation.

Help with Deciding

To better determine how to properly classify a worker, consider these three categories – Behavioral Control, Financial Control and Relationship of the Parties.

Behavioral Control: A worker is an employee when the business has the right to direct and control the work performed by the worker, even if that right is not exercised. Behavioral control categories are:

- Type of instructions given, such as when and where to work, what tools to use or where to purchase supplies and services. Receiving the types of instructions in these examples may indicate a worker is an employee.
- Degree of instruction, more detailed instructions may indicate that the worker is an employee. Less detailed instructions reflects less control, indicating that the worker is more likely an independent contractor.
- Evaluation systems to measure the details of how the work is done points to an employee. Evaluation systems measuring just the end result point to either an independent contractor or an employee.
- Training a worker on how to do the job -- or periodic or on-going training about procedures and methods -- is strong evidence that the worker is an employee. Independent contractors ordinarily use their own methods.

Financial Control: Does the business have a right to direct or control the financial and business aspects of the worker's job? Consider:

- Significant investment in the equipment the worker uses in working for someone else.
- Unreimbursed expenses, independent contractors are more likely to incur unreimbursed expenses than employees.
- Opportunity for profit or loss is often an indicator of an independent contractor.
- Services available to the market. Independent contractors are generally free to seek out business opportunities.
- Method of payment. An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time even when supplemented by a commission. However, independent contractors are most often paid for the job by a flat fee.

Relationship: The type of relationship depends upon how the worker and business perceive their interaction with one another. This includes:

- Written contracts which describe the relationship the parties intend to create. Although a contract stating the worker is an employee or an independent contractor is not sufficient to determine the worker's status.
- Benefits. Businesses providing employee-type benefits, such as insurance, a pension plan, vacation pay or sick pay have employees. Businesses generally do not grant these benefits to independent contractors.
- The permanency of the relationship is important. An expectation that the relationship will continue indefinitely, rather than for a specific project or period, is generally seen as evidence that the intent was to create an employer-employee relationship.

- Services provided which are a key activity of the business. The extent to which services performed by the worker are seen as a key aspect of the regular business of the company.

Consequences of Misclassifying an Employee

Classifying an employee as an independent contractor with no reasonable basis for doing so makes employers liable for employment taxes. Certain employers that can provide a reasonable basis for not treating a worker as an employee may have the opportunity to avoid paying employment taxes. See Publication 1976, Section 530, Employment Tax Relief Requirements for more information.

In addition, the Voluntary Classification Settlement Program (VCSP) offers certain eligible businesses the option to reclassify their workers as employees with partial relief from federal employment taxes.

The IRS can help employers determine the status of their workers by using Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding. IRS Publication 15-A, Employer's Supplemental Tax Guide, is also an excellent resource.

Workers who believe an employer improperly classified them as independent contractors can use Form 8919 to figure and report the employee's share of uncollected Social Security and Medicare taxes due on their compensation.

The IRS Small Business and Self-Employed Tax Center provides a multitude of resources for small businesses as well as self-employed independent contractors.

Additional Resources:

- Publication 15-A, Employer's Supplemental Tax Guide
- Form 1040-ES, Estimated Tax for Individuals
- Publication 505, Tax Withholding and Estimated Tax
- Publication 535, Business Expenses
- For information on eligibility for a voluntary program to reclassify workers as employees with partial relief from federal employment taxes, visit Voluntary Classification Settlement Program (VCSP).

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