

# Contractor or Employee: Be Sure to Get It Right

By Paul Sullivan

One of the challenges for you as a business owner is to make sure you're properly classifying those you pay to perform services. The IRS looks at these relationships closely, and if you don't get it right you could be in for severe financial penalties. The main issue is who is responsible for withholding and paying employment taxes for the individual.

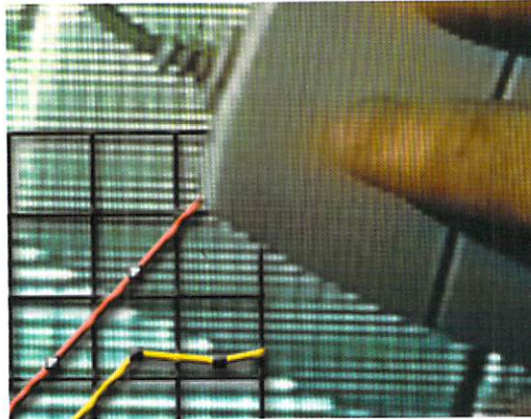
From a business-owner's perspective, not having to pay the FICA and Medicare match or unemployment taxes is obviously a plus, making the "independent contractor" option attractive. But you must take care not to treat employees as independent contractors.

Under the IRS definition, workers who perform services for you fall into one of four categories: independent contractor, common-law employee, statutory employee, and statutory non-employee.

Independent contractors follow an independent trade or profession and are generally not employees. There are, however, circumstances in each case that dictate the classification. Generally, an individual is an independent contractor if he or she controls or directs not only the work but also the means to get it done. Common-law employees perform services under the employer's control and direction. Distinguishing between these two classes generates the most confusion and triggers the most disputes with the IRS.

## Distinguishing contractors from employees

To determine whether an individual is an employee or independent contractor under the common law, the IRS looks at evidence showing degree of hiring-party control and worker independence. The inquiry divides into three major categories per IRS publication 15-A (*Employer's Supplemental Tax*



*You risk financial penalty if you treat an employee as an independent contractor.*

*Guide – Supplement to Circular E).*

**1. Behavioral control.** Facts that show whether the business has a right to direct and control the work – and thus has an employer-employee relationship with the worker – include the following:

*Instructions the business gives the worker.* An employee is generally subject to the business' instructions about when, where, and how to work. All of the following are examples of instructions about how to do work:

- when and where to do the work;
- what tools or equipment to use;
- what assistants to hire;
- where to purchase supplies and services;
- what work must be performed by a specified individual;
- what order or sequence to follow.

The amount of instruction needed varies among different jobs. Even an employer that gives no instructions may exercise control if it has the right to direct how work results are achieved. The key consideration is whether the business has retained or given up the

right to control the details of a worker's performance.

*Training the business gives the worker.* An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

**2. Financial control.** Facts that show whether the business has a right to control the business aspects of the worker's job include the following:

*The extent to which the worker has unreimbursed business expenses.*

Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs incurred regardless of whether work is being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services they perform for their business.

*The extent of the worker's investment.* An independent contractor often has a significant investment in the facilities he or she uses to perform services for someone else. However, a significant investment is not necessary for independent-contractor status.

*The extent to which the worker makes services available to others.* An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.

*How the business pays the worker.* An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is usually paid by a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.

*The extent to which the worker can real-*

ize a profit or loss. An independent contractor can make a profit or loss; an employee cannot.

**3. Type of relationship.** Factors that help determine the parties' relationship include the following:

*Whether the parties have a written contract describing the relationship they intended to create.*

*Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.*

*Whether the relationship is permanent.* If you engage a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that your intent was to create an employer-employee relationship.

*The extent to which services performed by the worker are key to company business.* If a worker's services are a key aspect of your regular business activity, you are more likely to have the right to direct and control his or her activities.

For example, if a law firm hires an at-

torney, it is likely to present the attorney's work as its own and have the right to control or direct that work. This indicates an employer-employee relationship.

### **Statutory employees and nonemployees**

*Statutory employees* are independent contractors treated by statute as employees. For a law office, the person most likely to fall into this category works at home using materials or goods you supply. The work must be returned to a named person in your office, and you furnish specifications for the work. You are required to withhold Social Security and Medicare taxes if the following conditions are met:

- You direct that substantially all services are to be performed by that particular person.
- The person does not have a substantial investment in equipment to perform the services.
- He or she performs the services on a continuing basis for the same payer.

This type of statutory employee would not be subject to FUTA tax in your office, nor would you withhold income tax for that person. You would report his or her earnings on a W-2 as a statutory employee, not a 1099 as an independent contractor.

*Statutory nonemployees* are direct sellers or licensed real-estate agents. They are treated as self-employed for all federal tax purposes.

Note that the guidelines above represent some changes from an earlier IRS publication that used a list of 20 factors in evaluating a specific worker situation. Take the time to make sure you have it right. ■

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