Distinguishing Independent Contractors and Employees
By Linet Megerdomian

The difference between an independent contractor and an employee is extremely important because the difference determines one's liability to pay and withhold Federal income tax, social security and Medicare taxes, and Federal unemployment tax. The term "independent contractor" is not defined in federal tax laws. Remarkably, the tax laws specifically prohibit the Internal Revenue Service (IRS) from defining the term. Instead, the common law provides a general test to determine if one is an independent contractor or an employee, and this test hinges on the degree of control that an employer has over the employee. The general rule is that an individual is an independent contractor if his or her employer has the right to control the results of the work but not the means and methods of accomplishing it.

Independent Contractor Versus Employee.

Who is an independent contractor?

According to the IRS, an independent contractor is someone who is in business for themselves. Some additional terms that have been used to describe independent contractors include consultants, freelancers, the self-employed, and even entrepreneurs and business owners. Furthermore, an independent contractor could be a sole proprietor, a limited liability corporation, an S Corporation, or a partnership. Independent contractors can earn a living from their own independent businesses instead of depending upon an employer. An independent contractor is different from an employee in that he/she is usually not eligible for benefits such as health insurance or paid time off, is not covered by worker's compensation insurance, and is responsible for submitting his/her own income taxes to the IRS.

"Independent contractor" is more than a label. In fact, someone can be an employee even if he/she signs a contract or agreement that labels him/her an independent contractor. A government agency or the courts can still classify him/her as an employee.

Who is an employee?

Generally, an employee is someone who performs services for the employer and who is controlled by the employer as for what will be done and how it will be done. Employees are defined either under common law or under special statutes for certain situations. Under the common law, an employee is someone who performs duties dictated or controlled by others, usually the employer or principal. The employee usually undergoes training for work to be done, and usually works for only one employer. In an employer-employee relationship, the employer retains the right to terminate the employee and the employer provides the employee with tools and a place to work. Just as in the case of independent contractors, it does not matter how the employer-employee relationship is labeled. The substance of the relationship, not the label, governs the employee's status. Furthermore, it does not matter whether the individual is employed full-time or part-time.

How the courts have decided.

The courts consider many facts in deciding whether a worker is an independent contractor or an employee. These facts fall into three main categories: Behavioral control, financial control, and type of relationship. The first factor, behavioral control, covers facts that show whether the business has a right to direct or control how the work is done through instructions, training, or other means. As for instructions, an employee is generally told when, where, and how to work, where to purchase supplies and services, or what work a specified individual must perform. As regards training, an employee may be trained to perform services in a particular manner.

The second factor is financial control. Financial control covers facts that show whether the business has a right to direct or control the financial and business aspects of the worker's job. Such considerations include the extent to which the worker has unreimbursed expenses, the extent of the worker's investment, how the business pays the worker or the extent to which the worker can realize a profit or loss. Finally, the type of work relationship covers facts that show how the parties perceive their relationship. This includes written contracts describing the relationship the parties intended to create, whether the worker is provided with employee-type benefits or the permanency of the relationship.

The Importance of Distinguishing Between an Independent Contractor and an Employee.

Taxes

One of the major reasons businesses should carefully make a distinction between independent contractors and employees is to avoid potential problems with government agencies such as the IRS. For instance, if an employer mistakenly labels an individual as an independent contractor rather than an employee and fails to withhold social security, federal unemployment, and Medicare taxes, the employer will be liable for a portion of those taxes. However, the IRS allows for employers to be relieved from paying such taxes for that worker if the employer meets all the relief requirements of the Internal Revenue Code section 5309. The requirements are as follows: Whether there was a reasonable basis for classifying the worker as an independent contractor if the employer relied on a court case or an IRS ruling; whether there was substantive consistency with the employer treating the worker and any similar workers as independent contractors; and whether there was reporting consistency in that the employer filed a Form 1099-MISC for each worker labeled as an independent contractor.

Employees should also be cognizant about whether they are classified as an employee or an independent contractor. For example, if a employee is mistakenly classified as an independent contractor, he/she may have to pay the amount that would have been withheld by the employer had the individual been classified as an employee.

Tax forms

The distinction between independent contractors and employees is also important in

preparing tax forms. Each year, employers report wages, tips, and other compensation paid to an employee on Form W-2. Form W-2 also reports the employees' income tax and Social Security taxes withheld and any advanced earned income credit payments. The employer provides Form W-2 to the employee and the Social Security Administration. In contrast, an independent contractor's wages are reported on Form 1099-MISC. This form is used to report payments made in the course of a trade or business to another person or business that is not an employee. The form is required to be completed and filed with the IRS, among other things, when payments of $10 or more in gross royalties or $600 or more in rents or compensation are paid. The form is provided by the payor to the IRS and the person or business that received the payment. Both Form W-2 and 1099 MISC are called information returns.

How the IRS Distinguishes Between Independent Contractors and Employees.

The test the IRS uses to distinguish between the two is the common law "right control" test. Under the test, workers are employees if the employer they work for has the right to direct and control the way they work, including the final results and the details of when, where, and how the job is accomplished. On the other hand, employers do not have nearly as much control over independent contractors. For the most part, an employer's control is limited to accepting or rejecting the final results of an independent contractor's work.

What the IRS Can Do in Making the Independent Contractor/Employee Determination.

The IRS can also determine the status of the worker if the employer is having difficulty. If no determination can be made by the IRS, employers should consider filing a Form SS-8, *Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding* with the IRS for a determination. Employees who are not sure whether they are an independent contractor or an employee can also complete Form SS-8. Form SS-8 will include all pertinent facts relating to the individual's work arrangement. If a contract has been executed between the worker and the entity, a copy should be included with Form SS-8. Once the IRS concludes its review of the facts, a decision will be presented to the employer in the form of a Determination of Ruling Letter.

Conclusion

Because the employer-employee relationship is very different from that of an employer and an independent contractor, the tax treatment of employees is also different from that of independent contractors and the penalties for misclassification for *both* employers and employees are substantial. Thus, both employers and employees need to be cautious of such classifications. And, if employers are uncertain, they should contact the IRS for assistance.

Independent Contractors v. Employees

Employees

- are usually under the control of one employer
- have Social Security and Medicare withheld by federal government
- their wages, tips, and other compensation are reported on the W-2 by their employer.

Independent Contractors

- are not under the control of their employers in terms of the means and methods of their work
- are usually not eligible for benefits such as health insurance or paid time off, and are not covered by worker's compensation insurance
- make their services available to more than one person or company.