

## *EMPLOYEE VS. INDEPENDENT CONTRACTOR*

As the economy slowly recovers, many small businesses are expanding their workforces, yet are understandably reluctant to commit to the hiring of full time traditional “W-2” employees. The retention of independent contractors/consultants is an increasingly popular means of maintaining flexibility and tax simplicity.

Generally, you must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee. You do not generally have to withhold or pay any taxes on payments to independent contractors.

However, if you improperly misclassify an employee as an independent contractor, you may be held liable for employment taxes for that worker. You will also run afoul of state Worker’s Compensation and Unemployment Compensation laws. The information below is intended as a broad overview to assist small business owners.

Before you can determine how to treat payments you make for services, you must first know the business relationship that exists between you and the person performing the services. The person performing the services may be:

- An independent contractor
- An employee (common-law employee)
- A statutory employee
- A statutory nonemployee

In determining whether the person providing service is an employee or an independent contractor, all information that provides evidence of the degree of control and independence must be considered.

Facts that provide evidence of the degree of control and independence fall into three categories:

1. Behavioral Control: Does the company control or have the right to control what the worker does and how the worker does his or her job?
2. Financial Control: Includes how workers are paid, whether expenses are reimbursed, who provides tools/supplies, etc.
3. Type of Relationship: Are there written contracts or employee type benefits (i.e. pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business.

**[This brochure is meant to provide general information and is NOT legal advice.]**

## 1. Behavioral Control

Behavioral control refers to facts that show whether there is a right to direct or control how the worker does the work. A worker is an employee when the business has the right to direct and control the worker. The business does not have to actually direct or control the way the work is done – as long as the employer has the right to direct and control the work.

The behavioral control factors fall into the categories of:

- Type of instructions given
- Degree of instruction
- Evaluation systems
- Training

### **Types of Instructions Given**

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

- When and where to do the work.
- 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.
- What order or sequence to follow when performing the work.

### **Degree of Instruction**

Degree of Instruction means that the more detailed the instructions, the more control the business exercises over the worker. More detailed instructions indicate that the worker is an employee. Less detailed instructions reflects less control, indicating that the worker is more likely an independent contractor.

### **Evaluation System**

If an evaluation system measures the details of how the work is performed, then these factors would point to an employee. If the evaluation system measures just the end result, then this can point to either an independent contractor or an employee.

### **Training**

If your business provides the worker with training on how to do the job, this indicates that the business wants the job done in a particular way. This is strong evidence that the worker is an employee. Periodic or on-going training about procedures and methods is even stronger evidence of an employer-employee relationship. However, independent contractors ordinarily use their own methods.

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## 2. Financial Control

Financial control refers to facts that show whether or not the business has the right to control the economic aspects of the worker's job.

The financial control factors fall into the categories of: Significant investment; Unreimbursed expenses; Opportunity for profit or loss; Services available to the market; and Method of payment.

### **Significant investment**

An independent contractor often has a significant investment in the equipment he or she uses in working for someone else. However, in many occupations, such as construction, workers spend thousands of dollars on the tools and equipment they use and are still considered to be employees. There are no precise dollar limits that must be met in order to have a significant investment. Furthermore, a significant investment is not necessary for independent contractor status as some types of work simply do not require large expenditures.

### **Unreimbursed expenses**

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

### **Opportunity for profit or loss**

The opportunity to make a profit or loss is another important factor. If a worker has a significant investment in the tools and equipment used and if the worker has unreimbursed expenses, the worker has a greater opportunity to lose money (i.e., their expenses will exceed their income from the work). Having the possibility of incurring a loss indicates that the worker is an independent contractor.

### **Services available to the market**

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.

### **Method of payment**

An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. 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.

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### 3. Type of Relationship

Type of relationship refers to facts that show how the worker and business perceive their relationship to each other.

The factors, for the type of relationship between two parties, generally fall into the categories of: Written contracts; Employee benefits; Permanency of the relationship; and Services provided as key activity of the business.

#### Written Contracts

Although a contract may state that the worker is an employee or an independent contractor, this is not sufficient to determine the worker's status. The IRS is not required to follow a contract stating that the worker is an independent contractor, responsible for paying his or her own self-employment tax. How the parties work together determines whether the worker is an employee or an independent contractor.

#### Employee Benefits

Employee benefits include things like insurance, pension plans, paid vacation, sick days, and disability insurance. Businesses generally do not grant these benefits to independent contractors. However, the lack of these types of benefits does not necessarily mean the worker is an independent contractor.

#### Permanency of the Relationship

If you hire 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 the intent was to create an employer-employee relationship.

#### Services Provided as Key Activity of the Business

If a worker provides services that are a key aspect of the business, it is more likely that the business will have the right to direct and control his or her activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

***DO NOT RETAIN ANYONE WITHOUT FIRST CONSULTING LEGAL COUNSEL.***

The Law Offices of Peter G. Erdely LLC represents small businesses and individuals in a wide range of employment matters. Even after reviewing these materials, no business should retain the services of any individual under any classification without first consulting with legal counsel.

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