

Employee or Independent Contractor? An Explanation from the IRS

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In any employee-independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered. Facts that provide evidence of the degree of independence fall into three categories: behavioral control, financial control and the type of relationship of the parties.

Behavioral control

Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of:

- *Instructions the business gives the worker.* An employee is generally subject to the business's instructions about when, where and how to work. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved.
- *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.

Financial control

Facts that show whether the business has a right to control the business aspects of the worker's job include:

- *The extent to which the worker has unreimbursed business expenses.* Independent contractors are more likely to have unreimbursed expenses than 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 they perform for their business.
- *The extent of the worker's investment.* An independent contractor often has an investment in the facilities he or she uses in performing services for someone else. However, an investment is not required.
- *The extent to which the worker makes services available to the relevant market.*
- *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. However, it

is common in some professions, such as law, to pay independent contractors hourly.

- *The extent to which the worker can realize a profit or incur a loss.*

Type of relationship

Facts that show the parties' type of relationship include:

- *Written contracts describing the relationship the parties intended to create.*
- *Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay or sick pay.*
- *The permanency of the relationship.* 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 a key aspect of the regular business of the company.* If a worker provides services that are a key aspect of your regular business activity, it is more likely that you'll 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.
- *IRS help.* If you want the IRS to determine whether a worker is an employee, file Form SS-8—Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding—with the IRS.

Industry examples

The following examples may help you properly classify your workers:

- *Building and Construction Industry*
Example 1—Jerry Jones has an agreement with Wilma White to supervise the remodeling of her house. She does not advance funds to help him carry on the work. She makes direct payments to the suppliers for all necessary materials. She carries liability and workers' compensation insurance covering Jerry and others that he engaged to assist him. She pays them an hourly rate and exercises almost constant supervision over the work. Jerry is not free to transfer his assistants to other jobs. He may not work on other jobs while working for Wilma. He assumes no responsibility to complete the work and will incur no contractual liability if he fails to do so. He and his assistants perform personal services for hourly wages. They are employees of Wilma White.

Example 2—Milton Manning, an experienced tilesetter, orally agreed with a corporation to perform full-time services at construction sites. He uses his own tools and performs services in the order designated by the corporation and according to its specifications. The corporation supplies all materials, makes frequent inspections of his work, pays him on a piecework basis, and carries workers' compensation insurance on him. He does not have a place of business or

hold himself out to perform similar services for others. Either party can end the services at any time. Milton Manning is an employee of the corporation.

Example 3—Bill Plum contracted with Elm Corporation to complete the roofing on a housing complex. A signed contract established a flat amount for the services rendered by Bill Plum. Bill is a licensed roofer and carries workers' compensation and liability insurance under the business name, Plum Roofing. He hires his own roofers who are treated as employees for Federal employment tax purposes. If there is a problem with the roofing work, Plum Roofing is responsible for paying for any repairs. Bill Plum, doing business as Plum Roofing, is an independent contractor.

Example 4—Vera Elm, an electrician, submitted a job estimate to a housing complex for electrical work at \$16 per hour for 400 hours. She is to receive \$1,280 every 2 weeks for the next 10 weeks. This is not considered payment by the hour. Even if she works more or less than 400 hours to complete the work, Vera Elm will receive \$6,400. She also performs additional electrical installations under contracts with other companies, which she obtained through advertisements. Vera is an independent contractor.

- *Trucking Industry*
Rose Trucking contracts to deliver material for Forest Inc. at \$140 per ton. Rose Trucking is not paid for any articles that are not delivered. At times, Jan Rose, who operates as Rose Trucking, may also lease another truck and engage a driver to complete the contract. All operating expenses, including insurance coverage, are paid by Jan Rose. All equipment is owned or rented by Jan, and she is responsible for all maintenance. None of the drivers are provided by Forest Inc. Jan Rose, operating as Rose Trucking, is an independent contractor.
- *Computer Industry*
Steve Smith, a computer programmer, is laid off when Megabyte Inc. downsizes. Megabyte agrees to pay Steve a flat amount to complete a one-time project to create a certain product. It is not clear how long it will take to complete the project, and Steve is not guaranteed any minimum payment for the hours spent on the program. Megabyte provides Steve with no instructions beyond the specifications for the product itself. Steve and Megabyte have a written contract, which provides that Steve is considered to be an independent contractor, is required to pay federal and state taxes, and receives no benefits from Megabyte. Megabyte will file a Form 1099-MISC. Steve does the work on a new high-end computer which cost him \$7,000. Steve works at home and is not expected or allowed to attend meetings of the software development group. Steve is an independent contractor.
- *Automobile Industry*
Example 1—Donna Lee is a salesperson employed on a full-time basis by Bob Blue, an auto dealer. She works six days a week and is on duty in Bob'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 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 Bob. Bob also pays the cost of health insurance and group-term life insurance for Donna. Donna is an employee of Bob Blue.

Example 2—Sam Sparks performs auto repair services in the repair department of an auto sales company. He works regular hours and is paid on a percentage basis. He has no investment in the repair department. The sales company supplies all facilities, repair parts, and supplies; issues instructions on the amounts to be charged, parts to be used, and the time for completion of each job; and checks all estimates and repair orders. Sam is an employee of the sales company.

- *Attorney*
Donna Yuma is a sole practitioner who rents office space and pays for the following items: telephone, computer, online legal research link-up, fax machine, and photocopier. Donna buys office supplies and pays bar dues and membership dues for three other professional organizations. Donna has a part-time receptionist who also does the bookkeeping. She pays the receptionist, withholds and pays federal and state employment taxes, and files a Form W-2 each year. For the past 2 years, Donna has had only three clients, corporations with which there have been longstanding relationships. Donna charges the corporations an hourly rate for her services, sending monthly bills detailing the work performed for the prior month. The bills include charges for long distance calls, online research time, fax charges, photocopies, mailing costs and travel, costs for which the corporations have agreed to reimburse. Donna is an independent contractor.
- *Taxicab Driver*
Tom Spruce rents a cab from Taft Cab Co. for \$150 per day. He pays the costs of maintaining and operating the cab. Tom Spruce keeps all fares he receives from customers. Although he receives the benefit of Taft's two-way radio communication equipment, dispatcher and advertising, these items benefit both Taft and Tom Spruce. Tom Spruce is an independent contractor.
- *Salesperson*
To determine whether salespersons are employees under the usual common-law rules, you must evaluate each individual case. If a salesperson who works for you does not meet the tests for a common-law employee, discussed earlier, you do not have to withhold income tax from his or her pay. However, even if a salesperson is not an employee under the usual common-law rules, his or her pay may still be subject to Social Security, Medicare and FUTA taxes. To determine whether a salesperson is an employee for Social Security, Medicare and FUTA tax purposes, the salesperson must meet all eight elements of the statutory employee test. A salesperson is an employee for Social Security, Medicare and FUTA tax purposes if he or she:

1. Works full time for one person or company except, possibly, for sideline sales activities on behalf of some other person
2. Sells on behalf of, and turns his or her orders over to, the person or company for which he or she works
3. Sells to wholesalers, retailers, contractors, or operators of hotels, restaurants, or similar establishments
4. Sells merchandise for resale, or supplies for use in the customer's business
5. Agrees to do substantially all of this work personally
6. Has no substantial investment in the facilities used to do the work, other than in facilities for transportation
7. Maintains a continuing relationship with the person or company for which he or she works
8. Is not an employee under common-law rules.