

# **WHAT'S THE DIFFERENCE BETWEEN ...**

## **AN *EMPLOYEE* AND AN *INDEPENDENT CONTRACTOR*?**

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The definition of independent contractor vs. employee has come under great scrutiny in recent years because federal and state governments found that persons treated as independent contractors didn't pay their fair share of taxes. Thus, government agencies have become very aggressive in efforts to ensure that all persons performing labors are categorized properly.

The IRS defines independent contractors as people such as lawyers, contractors, subcontractors, public stenographers, auctioneers, etc., who follow an independent trade, business, or profession in which they offer their services to the general public. However, determining whether such people are employees or independent contractors depends on the facts of each case. The general rule of thumb is that the individual is an independent contractor if you, the employer, have the right to control or direct the result of the work, but not the means and methods of accomplishing the result.

If you classify an individual as an independent contractor and the IRS later rules that individual to be an employee, you can be held liable. The resulting penalties could include:

- back taxes
- penalties and interest on Social Security
- state and federal unemployment negligence
- fraud
- state and federal withholding taxes

To determine independent contractor classification, ask these questions:

- Is there risk of profit and loss to the individual?
- Does the individual have the authority to delegate responsibility?

- Does the individual provide his or her own work location and the necessary tools, equipment, and materials?
- Does the individual have unrestricted control over the work schedule, other than general discretionary direction?
- Does the individual have control over when, where, and how the required work is accomplished?
- Does the individual incur non-reimbursed expenses in the completion of tasks?
- Is the individual free to provide similar tasks and services for others outside the business relationship?
- Is there a formal agreement defining scope of work, compensation, conditions, and statement of independent contractor basis?

Although the above restrictions are not inclusive and may vary from situation to situation, they provide a general outline of IRS tests. Just because a business and individual agreed to independent contractor status, that agreement alone doesn't necessarily meet IRS requirements. State requirements defining employees should be investigated. It's common for the question to arise not on the federal level but on the state level should an individual apply for unemployment.

Evaluate each case with your financial or legal counsel. In addition, IRS Publication 539, *Employment Taxes*, will provide answers to some questions on the federal level.