

## ANDERS STARTUP GROUP

# EMPLOYEE VS. CONTRACTOR FACT SHEET

As startup companies grow, at some point it's necessary to start hiring staff to provide new expertise or take over certain responsibilities of the business owner. Once you hire someone, it's important to know if they classify as an employee or an independent contractor for tax purposes.

To determine whether the staff member is an employee or independent contractor, it depends on the amount of control the company has over its workers and the relationship with those workers. The control tests fall into three broad categories:

### 1) BEHAVIOR CONTROL

A worker is an employee when the business has the right to direct and control the work performed, even if that right is not exercised. Behavioral control categories are:

- Type of instructions given, such as when and where to work, what tools to use or where to purchase supplies and services. Receiving these type of instructions may indicate a worker is an employee
- Degree of instruction, more detailed instructions may indicate that the worker is an employee. Less detailed instructions reflect less control, indicating that the worker is more likely an independent contractor
- Evaluation systems to measure the details of how the work is done points to an employee. Evaluation systems measuring just the end result point to either an independent contractor or an employee
- Training a worker on how to do the job, or periodic or on-going training about procedures and methods, is strong evidence that the worker is an employee. Independent contractors ordinarily use their own methods

### 2) FINANCIAL CONTROL

Does the business have a right to direct or control the financial and business aspects of the worker's job? Consider:

- Significant investment in the equipment the worker uses in working for someone else
- Independent contractors are more likely to incur unreimbursed expenses than employees
- Opportunity for profit or loss is often an indicator of an independent contractor independent contractors are generally free to seek out other business opportunities
- An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time even when supplemented by a commission. Independent contractors are most often paid for the job by a flat fee

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### 3) RELATIONSHIP

The type of relationship depends upon how the worker and business perceive their interaction with one another. This includes:

- Written contracts which describe the relationship the parties intend to create. Although, a contract stating the worker is an employee or an independent contractor is not sufficient to determine the worker's status
- Businesses providing employee-type benefits, such as insurance, a pension plan, vacation pay or sick pay have employees. Businesses generally do not grant these benefits to independent contractors
- An expectation that the relationship will continue indefinitely, rather than for a specific project or period, is generally seen as evidence that the intent was to create an employer-employee relationship
- The extent to which services performed by the worker are seen as a key aspect of the regular business of the company

### EMPLOYEE VS. INDEPENDENT CONTRACTOR FOR TAX PURPOSES

After using the criteria to decide whether your staff member is an employee or independent contractor, it's important to know the business' tax responsibility.

If they are an **employee**, as an employer you are responsible for:

- Withholding income tax (Federal, State, and some cities), social security and Medicare taxes
- Paying social security, Medicare, unemployment taxes (FUTA and SUTA), and local taxes (depending on the city) on the employee's wages (various payment frequencies on these taxes)
- Filing payroll tax returns (various filing frequencies for these)
- Providing a year-end Form W-2 showing the amount of wages paid taxes withheld, and other informational reporting

If they are an **independent contractor**, the business is responsible for:

- Providing a Form 1099-MISC to report the total amount paid to the contractor for the year

Please note these are the tax implications of the employee versus contractor classification. There are also legal implications of the worker classification; please consult your business attorney for those considerations.

### SECTION 530 RELIEF

While the correct classification is important, the IRS provides a safe harbor for employers if the IRS disagrees with their worker classification. Section 530 of the Revenue Act of 1978 applies if the business treated workers as independent contractors, but the IRS later says they are employees. To qualify for Section 530 relief, a company must meet three statutory requirements. If these requirements are met, the company may be relieved of the back due payroll taxes, fines and penalties.

