



Independent Contractor or Employee; Which Are You?

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When You Are an Employee...

- Taxes must be withheld by your employer for social security & Medicare taxes;
- The employer must also pay their portion of social security & Medicare taxes, as well as federal & state unemployment taxes;
- Your employer must give you a W2 showing the amount of taxes withheld from your income in the following year.

BACKGROUND: RULES



People often think that a self-employed person is someone who owns his or her own convenient store, law firm, and restaurant, what-have-you; i.e., some sort of service or other retail business whether there is staff or not. The IRS has defined certain, specified workers in specific industries as always being independent contractors, and thus known as [Statutory Nonemployees \(direct sellers, licensed real estate agents & certain companion sitters\)](#). Specific workers in other industries are [always employees \(certain delivery drivers, full time life insurance sales agents, travelling salespersons, among other\)](#); these are [Statutory Employees](#) because they're already predefined by the IRS as being **controlled by their employer-employee relationship**. The former is subject to self-employment taxes while the latter is always subject to social security and Medicare taxes. But there are many industries for which the IRS has not defined the category, except to state how to categorize such workers. While the IRS says there is no "magic" or set number of factors that "make" the worker an employee or an independent contractor, what the **IRS does say is that it is very important "to look at the ENTIRE relationship, consider the degree or extent of the right to direct and control, and finally to document each of the factors used in coming up with the determination."** The way to do that, according to the IRS & Federal Courts, is to **look at seven key points** which determine whether a person is an employee or a contractor. [The IRS has condensed these 7 points into three focus areas for an easier understanding of who is an employee or an independent contractor:](#)

- 1) The degree of behavioral control over the person performing the work;
- 2) The financial control of the work performed; and,
- 3) The relationship of the parties involved.

We will cover these points in detail below, but if there still exists any doubt or lack of clarity as to who is an employee or independent contractor, the employer or the worker can file [Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding](#). The IRS would review the facts, and then make an appropriate decision, usually after six months.

Workers who feel that they have been improperly classified as independent contractors, can file [Form 8919](#), but must first file Form SS-8. The worker would pay the necessary social security & Medicare taxes with this form, and file it with their 1040, thus crediting the worker's social security & Medicare taxes towards their social security record. Form 4137 should NO longer be used for this purpose, except for "tipped employees" who

report social security & Medicare taxes on allocated tips & tips not reported to their employers.

VCSP: The penalties for not properly classifying employees are stiff and employers are encouraged to do the necessary research to make the proper classification. If employers need help with this area, they can enter into a voluntary classification program with the IRS which would assist employers to properly classify their workers as either employees or independent contractors. This [Voluntary Classification Settlement Program](#) allows employers to "voluntarily change the prospective classification of their workers," thus providing "an opportunity for taxpayers to reclassify their workers as employees for employment tax purposes for future tax periods with partial relief from federal employment taxes [social security, Medicare, federal unemployment and state unemployment]." Details of the program are vast, so contacting a tax specialist or CPA in their local area is a prudent move prior to contacting the IRS about this program.

When You Are an Independent Contractor...

- If you earned more than \$600 in the year, the business paying you must provide you a Form 1099-M Statement detailing your total income earned, if that business is an unincorporated business. A 1099-M may still be provided to you upon your request or as a courtesy by the incorporated business;

- You are responsible for paying your own income tax & self-employment tax;

BEHAVIORAL CONTROL:



whether or not the business has such rights, the IRS has broken it down as follows:

This first tenet basically boils down to who actually controls the way in which the work is completed by the person performing this work. Behavioral control implies that if the business has the right to direct and control the worker, then the person performing the work IS an employee. If the business does NOT have the right to direct and control the work, then the person performing the work is an independent contractor. To determine

- **Types of Instructions Given:**
 - When & Where to work;
 - What tools/equipment to use;
 - Where to purchase supplies & services;
 - What work must be performed by a specified individual; and,
 - What order or sequence to follow when performing the work.
- **Degree of Instructions:**
 - The more detailed the instructions from the person assigning the work, the more control the business exercises and the more likely is that the person performing the work is an employee.
- **Evaluation Systems:**
 - If the evaluation system measures the details of how the work is performed, without necessarily focusing just on the end result, then it would more likely point to the fact that the performer of the work is an employee.
 - However, if the eval. system measures a specific outcome or set of outcomes of the work performed (for example, attainment of specific target sales), then this lends more credence to the worker being an independent contractor.
- **Training:**
 - The more specific a training is as to HOW the work is to be performed, the more likely is that the person performing the work would be construed as an employee.

- The payer of your income is NOT responsible for withholding taxes from your income and remitting them to the IRS and any state revenue departments;
- You may need to make estimated tax payments to cover your responsibility for the right amount of income taxes you would be responsible for on your total profit for that specific job;
- Your expenses are deducted on Schedule C, attached to your 1040 Tax return which you file at tax filing time.

FINANCIAL CONTROL:



This type of control defines who is actually controlling the money aspects of the work performed; i.e., can the business control the economic aspects of the tasks at hand?

- **Significant Investment:** Although a significant monetary investment in equipment or monies invested in a specific job by the person performing the work are not necessary to be looked upon as an independent contractor by the IRS, a significant investment **can** help determine the difference between an employee and an independent contractor. Most employees, by contrast, do not bring their own tools or equipment and things like computers, and supplies; sometimes meals are even provided for them, reducing their investment in the job performed at hand;
- **Unreimbursed Expenses:** Independent contractors are more likely to have unreimbursed expenses, although employees can also have unreimbursed expenses. Again, the "more likely than not" scenario applies here such that if it happens consistently, then the person performing the work is more likely an independent contractor rather than an employee;
- **Opportunity for profit or loss:** Employees will and should be paid regardless of their employers' profitability. However, they do not share in the risk of their employers' business or economic loss. Independent contractors, by contrast, run the risk of loss of their significant investment right from the very beginning. For example, if there is a significant monetary investment in the job such that there exists a risk that the worker may not realize enough income to exceed the monetary investment made by him/her in the job (i.e., the prospect of an economic loss), then the more likely determination would be that the worker would be construed an independent contractor;
- **Services Available to the Market:** Independent contractors do not have restrictions on advertising their services, nor in seeking other income sources whilst at work. Thus independent contractors are "always for hire" in a visible business location (online or otherwise), and are available to work in the relevant market of their industry. This is not true of employees, who are not available to accept another job without the permission of their employer, in most cases;
- **Method of Payment:** Independent contractors are paid a flat fee, summarized on Form 1099-M (issued in the following year by February) from their employers. Although independent contractors may still be paid differently, across industries (i.e., hourly, weekly, or for other fixed period of time), fixed periodic payments remitted to the worker gives more credence to the fact that the worker is an employee rather than an independent contractor.

RELATIONSHIP OF THE PARTIES:



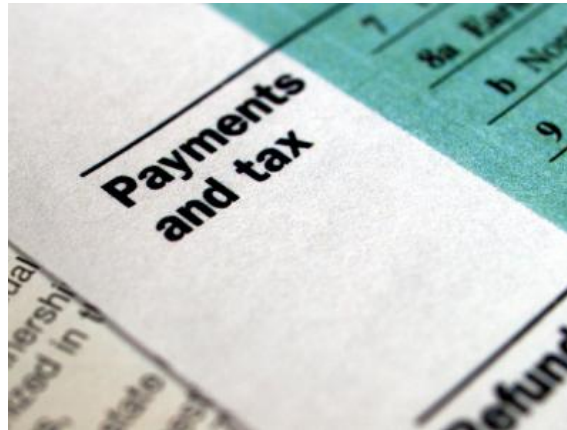
The old adage, "perception is reality" is no more true than it is here. How do the worker and business (i.e., payer of the income) view their relationship? The following four elements have a lot to say about how that perception prevails in the minds of both parties:

- Written Contracts:** In states where employers may hire and fire at will, employers will not usually have signed written agreements with their employees. As a contrast, independent contractors will usually have something in writing, either an agreement or an engagement letter of sorts, defining amongst other things, the work to be performed, and the start and end dates of the job. While those agreements may contain many other different things, including the responsibility of taxes and who is an independent contractor and employee, the IRS is not obligated to abide by such a contract, and neither is any state or local tax agency, in determining a worker's status as an employee or an independent contractor. The viability of such contracts SHOULD be reviewed by an independent, qualified attorney and tax professional, in these authors' opinion, prior to signing by either party to such contracts. In the tax world as well as the accounting world, the IRS has always harkened back to "substance over form" for defining many transactions and relationships; this means it is HOW the parties work together rather than what is written, in order to determine whether the worker is an employee or an independent contractor;
- Employee Benefits:** Although the absence of benefits such as health & life insurance, pension plans, paid vacation, sick days, & disability insurance does not mean that the worker would be construed as an independent contractor, the reverse is almost usually true. The more benefits a payer of income provides to the worker, the more likely that the worker is an employee rather than an independent contractor.
- Permanency of the Relationship:** Employees usually work indefinitely, either until they are fired, laid off, resign, or terminated due to some other cause or circumstance not related to the completion of the work assigned to them. Independent contractors have a definite start and end date, either due to completion of the work or contract, or both.
- Key Activity (or Services) Provided to the Business:** Does the independent contractor perform services that are in the same line as the business? If so, than he or she would most likely be treated as a W2ed employee. The reason for this is because the business will most likely have the right to direct and control the worker's activities. Examples would be an accounting firm presenting services to clients the work performed by its auditor, bookkeeper, or tax preparer as its own and a law firm utilizing the services of a lawyer, presenting work performed by that lawyer as its own. A firm utilizing the services of a computer Information Technology (IT) specialist to improve its own computer systems, can more likely than not construe that IT specialist as a contractor because those services are not a key activity of the firm itself, usually.

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TAX IMPLICATION



Finally, the part you've been waiting for; how does a self-employed person's tax return look? Each year, CPA firms like ours get dozens of phone calls, asking if one were to move from being an employee earning a W2, to an independent contractor, what would be the changes to their income taxes. The best part about being self-employed or an independent contractor is that you get to treat yourself like you are your own business, and can deduct all the expenses you incur as part of that business, dollar for dollar against your income on Schedule C or C-EZ of your 1040 tax return. Here is a summary of those changes related to income tax if one were to move from being a W2ed employee to an independent contractor:

1. **You would be paid without any taxes cut from your pay:** This means that no federal income tax, state income tax, social security tax, nor Medicare tax would be cut from your paychecks. You will be given the entire amount, and all taxes must be paid at the time of your income filing, or in quarterly estimates if you so decide (prudent to avoid withholding penalties by the IRS and the state revenue agencies). At the beginning of the following year, the business or person who hired you for that job would issue you a Form 1099-Miscellaneous Statement detailing the total income paid to you, INSTEAD of a W2. A duplicate 1099-M would be sent to the IRS by the business or person who paid you;
2. **You will pay Self-Employment (SE) Taxes:** This is known as SE taxes for those workers who are independent contractors (many independent contractors work alone and are known as Sole Proprietors because they are unincorporated). Contractors will pay a typical rate of 15.3% of their annual Schedule C profit, which is double the rate an employee typically pays on a W2ed job. However, the W2ed employee cannot write off expenses like an independent contractor can, unless they are a [statutory employee](#). Filers of Schedule C/C-EZ typically end up paying a lot more in SE taxes (at certain levels of income) than they would if they just would have incorporated, and certainly a lot more than they would have as a W2ed employee.
3. **You must file Quarterly Estimated Taxes:** Independent contractors get all of their pay up front; however, the IRS and local authorities want taxes on a monthly or quarterly basis. That is why employers are required to cut taxes from each employee's paycheck and deposit them with the IRS and state on the employee's behalf. Since independent contractors no longer get this "service" from their employer, they themselves must file and pay estimated quarterly taxes with the IRS and/or state, or face an underpayment penalty for not paying enough income and SE taxes throughout the year. Unemployment taxes are only owed if the independent contractor has employees who are construed as such.

4. File Schedule C or C-EZ – Sole Proprietor Business Income Tax Return:

You still file a form 1040 each year, but in addition to that, you must file additional Schedules C or C-EZ & SE (calculates SE tax), showing your income as a Self-Employed person; you can deduct all ordinary and necessary expenses you have incurred and paid while earning that self-employed income. Expenses such as travel, training, meals, office supplies, and professional fees may all be deductible. (It is best to consult a tax professional knowledgeable in Schedule C Filings before making any tax filing decisions). Employees who receive a W2 have a minimum threshold of how much they can deduct (2% of their total adjusted gross income gets removed from their expenses), and therefore they rarely can deduct any such expenses as itemized business expenses on [Forms 2106](#) & [Schedule A](#) up to the standard deduction amount on their personal tax returns.

5. You May Not Get a Refund: Because you have to file quarterly estimated taxes each quarter, you may not get a refund. That means you need to know your tax liability each quarter and "pay as you go" to the IRS and the state department of revenue (if applicable) before you file your tax return by the April 15th deadline of the following year. However, the IRS realizes that it is difficult to always know your profit for the whole year ahead of time; therefore, a quarter by quarter (every three months) assessment of your profit and payment of your tax liability will help you avoid having to pay a huge chunk of income and self-employment taxes at tax filing time. You can always file for an extension, but the total tax liability balance is always still due by April 15th of the following year. Remember, there is no extension to pay your taxes, only to file them.

Now you know the definition of a Self-Employed Individual, and how their taxes work. There are ways to lower the taxes for the Self-Employed person, such as setting up a corporation or a Limited Liability Company, but that is another Tax Topic Newsletter from Vimlan Tax.

Happy Filing!

Sincerely,

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