



## Independent Contractors vs. W-2 Employee

Many workers who are treated as independent contractors for tax purposes are actually employees. If the IRS reclassifies a worker as an employee, the employer:

1. Becomes liable for the employment taxes that should have been withheld from the worker's pay, such as FICA taxes,
2. Becomes liable for the employer's share of FICA taxes,
3. Becomes liable for federal unemployment taxes,
4. Becomes liable for penalties and interest for failure to (a) pay these taxes, and (b) file payroll tax returns,
5. May have a retirement plan retroactively disqualified which could cause all vested accrued benefits to become fully taxable for all employees enrolled in the plan (which usually includes the owners in either an S-Elected entity or a C-Corp) and
6. May have the state pursue liability for state unemployment taxes.

(Note) The employee remains liable for any unpaid FITW and the employee's share of FICA tax, even when the IRS collects from the employer. It is also possible that a reclassified employee will owe additional income tax because deductions previously claimed on Schedule C may be reduced or lost when reported on Schedule A as miscellaneous itemized deductions.

### Common Law Rules

Revenue Ruling 87 - 41 contains 20 factors used to determine if a worker is an employee or an independent contractor. An IRS training manual organizes the 20 factors into the following four groups.

1. **Behavior Control Factor:** An employer has the right to control how an employee does the work. An independent contractor usually retains control over how the work is done.  
Group 1 common law factors that indicate employee status include:
  - Instructions; Workers are required to follow instructions about when, where and how to work, such as the need for prior approval before proceeding with a job.
  - Services must be rendered personally by the worker.
  - Training is provided to perform a job in a particular manner (other than orientation and safety training).
2. **Financial Control Factor:** An employer has the right to control how the business aspects of an employee's activities are conducted. An independent contractor has the



right to control his or her own business activities. Group 2 common law factors that indicate employee statuses include:

- Realization of profit or loss; Workers do not realize a profit or suffer a loss as a result of services performed (other than agreed - upon compensation for work performed).
  - Significant investment; Workers depend on the employer to provide the facilities, tools, equipment and materials needed to perform a particular job. Workers are generally reimbursed for business and travel expenses incurred.
  - Services available to public; Workers do not work for more than one company at a time and do not make their services available to the general public.
  - Manner of payment; Workers are either paid by the hour or on a salary. Independent contractors are usually paid by the job or receive a commission.
3. **Relationship Factor:** The following factors illustrate how the worker and the business perceive their relationship:
- Written contract: The contract must have substance (method of payment, handling of expenses, how work is done) designating the worker an independent contractor.
  - Employee Benefits; Health insurance, pension plans, vacation and sick pay benefits are only paid to employees.
  - Continuing Education; A temporary relationship is more likely to indicate independent contractor status (even if long term).
  - Integration; If the worker's services are an integral part of the business operations, the worker is generally an employee.
4. **Less Important Factors:** The following common law factors are considered less important than those in groups 1-3:
- Employer's right to discharge the worker.
  - Worker's right to terminate the relationship.
  - Part-time or full -time work requirement.
  - Work required to be done on employer's premises.
  - Setting of hours to do the work.
  - Setting of an order or sequence of the work.
  - Interim oral or written reports requirement.