



# Employment Classification

## 1099 vs. W-2—which one is right for you?

With an increase in the use of contractors by companies, and more people choosing to become consultants or other sole proprietors, it is more important than ever to make sure that you understand the rules that the IRS uses in determining worker classification. Getting the worker classification correct upfront is important for both the candidate and the employer. It affects taxes, eligibility for benefits, and how one files tax returns. It is important to remember that all the evidence must be considered when making a determination—no single factor can be used alone.

For a W-2 employee, the employing company not only withholds income taxes and part of the social security and Medicare taxes, but pays social security, unemployment, and Medicare taxes on the employee's salary. In contrast, with an independent contractor, the business issues a form 1099-MISC to the contractor and the contractor is responsible for paying his or her income and self-employment taxes. While those simple distinctions are well known to business owners and independent contractors alike, the devil is in the details.

**Self-Employed,  
Independent  
Contractor vs.  
Employee Status  
accounts for 3.70% of  
the cases litigated by  
the IRS**

The IRS and the courts think of three main areas when determining whether a person is an employee (W-2) or an independent contractor (1099-MISC): behavioral control, financial control, and the relationship of the parties. They apply what is called the Twenty Factors to those three characteristics, and that's where the details lie. We will consider those questions further below.

### For Employers

While studies have shown that around 30 percent of employers misclassify some or all of their workers, intentionally misclassifying employees as independent contractors is illegal. The Treasury and Labor Departments see it as an evasion of taxes and social security responsibilities, among other things, and both departments have special task forces to enforce federal law.

If the business classifies an employee as an independent contractor without a reasonable basis, the business may be held liable for employment taxes for that worker—and without the benefits of the relief provisions the IRS allows. If the business believes it has a reasonable basis for the classification it must file all required federal information and must not have classified any worker holding a similar position as an employee.

### For Candidates

While it seems simplistic to say it, candidates must know whether they are true employees or independent contractors. The time to understand that is not when filing your personal income tax return. It is possible for unscrupulous businesses to misclassify an employee as an independent contractor to avoid paying taxes, social security, unemployment, or workers compensation.

Though each state may define “employee” or “independent contractor” slightly differently, there is a means to have the IRS determine the worker’s classification in the eyes of the federal government by filing a Form SS-8 (more below). The IRS reports as many as 85% of all SS-8 filers submit the form to the IRS because they want to contest their treatment as independent contractors.

## The Three Categories

The IRS uses three categories or characteristics of the worker–employer relationship to determine the worker’s status or classification. These three categories, with many subparts and other considerations, establish the relationship between the parties, who has financial control of the work, and who controls the behavior of the worker.

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- Financial Control

Profit or loss? Independent contractors can realize a profit or incur a loss from the work. They may have a significant investment in their tools or place of work. They are generally not reimbursed for business expenses.

- Behavioral Control

What controls are in place? If the business has the right to control the work, provide instructions on how, when, or where to perform the work, what tools to use, or where to purchase supplies, the person is an employee. If the business provides training about their methods or processes, the worker is an employee.

- Relationship Between Parties

How do you perceive the relationship? If the worker receives benefits such as paid leave or insurance, he is an employee—but some employees don’t receive such benefits. If there is a written contract between the business and the worker it may help determine the status if other factors are unclear. Will the relationship continue? Is the work a key aspect of the employment? Can the worker perform services for another party at the same time?

## 20 Questions to Ask—the Twenty Factor Test

IRS and Social Security Administration have compiled a list of 20 questions used in court decisions to determine the classification of a worker. They have become a well known analytical tool to determine worker status. The true legal test, however, remains whether the company has a right to direct and control the means and details of the work. It is sufficient proof if the business merely has the right to do so.

The relative weight of each of the twenty factors has changed over time. The factors, however, must be considered through the filter of the three categories of financial control, behavioral control, and the relationship of the parties as briefly described above.

1. **Instructions to workers.** A worker is probably an employee if the firm requires him or her to follow instructions on when, where, and how work is to be done. The weight of "instructions" depends on the degree to which instructions determine how the job gets done rather than to the end result.
2. **Job training.** If the company provides for training it is a sign the company expects work to be performed in a certain way. That indicates the worker is an employee. Training can be as informal as requiring the worker to attend meetings or work along with someone who's more experienced. Not all training may be construed as proving an employee relationship, though. An orientation session or training on a new product line could reasonably be asked of an independent contractor.
3. **Profit or loss.** Workers who receive predetermined earnings and have little chance to realize significant profit or loss through their work generally are employees. An employee may be rewarded, disciplined, demoted, or fired depending on job performance, but only an independent contractor can realize a profit or incur a financial loss from his or her work.
4. **Importance of the worker's services.** If a worker provides services that are integral to the success of the business, the worker is likely an employee. If the company requires the worker to perform the work personally, that shows a level of control that indicates he is an employee.
5. **Significant investment in facilities.** Independent contractors typically invest in and maintain their own work facilities. By contrast, most employees rely on their employer to provide work facilities.
6. **Payment of business or travel expenses.** Independent contractors typically bear the cost of travel or business expenses, and most contractors set their fees high enough to cover these costs. Direct reimbursement of travel and other business costs by a company often suggests an employment relationship, unless the contract with the independent contractor specifically addresses this issue.
7. **Tools and materials.** Workers who perform most of their work using company-provided equipment, tools, and materials are more likely to be considered employees. Independent contractors usually supply their own tools and equipment.
8. **Work for multiple companies.** People who simultaneously provide services for several unrelated companies are likely to qualify as independent contractors.
9. **Availability to public.** Independent contractors regularly make their services available to the general public.
10. **Pay basis.** If the worker gets paid on an hourly, weekly, or monthly basis, the IRS will consider it a sign the worker is an employee. An independent is generally paid by the job, project, or assignment or receives a commission or similar fee.
11. **W-2 or 1099.** The business reports payments to independents on Form 1099-MISC. Reporting on a Form W-2 indicates both the company and the worker consider the worker to be an employee.

12. **Intent of your company and of the worker.** A written agreement stating the worker is an independent contractor who will be paid by the job or project, provide his or her own tools, etc. is the great way to establish the case for an independent contractor.
13. **Benefits.** If the company provides benefits the worker is an employee. If a worker is incorporated he is usually considered to be working for himself.
14. **Providing assistants.** There's likely an employer-employee relationship if the company hires, supervises, and pays assistants for the worker. An independent contractor normally has the freedom to subcontract work at his or her expense (and, thus, to generate profits or incur losses).
15. **Ongoing relationship.** A continuous relationship between a company and a worker indicates a possible employment relationship. The worker doesn't have to work for the company continuously to be considered an employee; it may be enough if the worker gets assignments at frequently recurring, even if irregular, intervals.
16. **Demands for full-time work.** Full-time work indicates an employment relationship. An independent contractor decides his or her schedule daily and long term.
17. **Need for on-site services.** Requiring someone to work at the company may indicate a possible employment relationship and may be relevant to the extent it illustrates the business's right to direct and control how the work is performed.
18. **Requirements for reports.** If a worker regularly must provide written or oral reports on the status of a project, this arrangement indicates a possible employment relationship.
19. **Control over discharge.** A company's right to fire a worker suggests an employment relationship. In contrast, a company's ability to terminate independent contractor relationships generally depends on contract terms.
20. **Right of termination.** Most employees unilaterally can terminate their work for a company without liability. Independent contractors cannot quit their contracted services without liability, except as allowed under their contracts.

If you still can't figure it out, either the worker or the business may file a Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, with the IRS. The IRS will review the facts and circumstances and officially determine the worker's status. Be advised, however, some tax specialists claim the IRS normally classifies workers as employees whenever their status is questionable. In addition, employers who request a determination from the IRS lose certain protections against liability for misclassification. Regardless of whether the company actually submits the Form SS-8, though, it can still be used as a guide for the firm to avoid the hazards of misclassification.

**For more information:**

IRS Publication 1779 (rev. 8-2008), "Independent Contractor...or Employee"

"Independent Contractor...or Employee" Training Material, <http://www.irs.gov/pub/irs-utl/emporind.pdf>

<http://www.irs.gov/businesses/small/article/0,,id=99921,00.html>