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Hired Hands: Employees or Independent Contractors?

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It is more than a matter of semantics to the Internal Revenue Service when a business owner determines that the people who work for him or her are independent contractors rather than employees.

If an individual is a genuine employee, the employer must withhold and pay Social Security and Medicare taxes, withhold income taxes, and pay unemployment taxes on the wages. An employer also might offer benefits such as health insurance, vacation pay, and retirement incentives.

If an individual is an independent contractor, the employer does not have to withhold taxes or offer benefits or retirement incentives. The independent contractor must file an income tax return and pay income tax as well as self-employment tax to cover his or her own Social Security and Medicare liabilities.

The question of how to classify a worker all boils down to the degree of control and independence enjoyed by the person performing the work.

Making a determination

In general, an individual is considered to be an independent contractor if the client — the person or business who is hiring him or her to complete a job or perform a service — exercises control over the end product but does not dictate how or when it will be done. “Independent” is the key word here.

An employee, on the other hand, exercises little independence or autonomy at work. The employer controls what is done and how it is done, dictates when and how payment is made, and provides the tools necessary to do the job. In other words, the employer controls the details of how the services are performed.

Independent contractors include lawyers, contractors, freelance writers and editors, subcontractors, stenographers, and others engaged in an independent trade or profession who offer their services to the public. They also include people involved in direct sales and real estate agents because their pay depends not on hours worked, but on products sold.

The IRS has no specific formula for determining whether a worker is an employee or an independent contractor. Factors that might be relevant in one situation may be irrelevant in another, and the equation can be complex.

Consequences of misclassification

An employer who misclassifies an employee as an independent contractor — willfully or not — can be liable for back taxes, penalties, and interest on that employee's compensation, even if that person has already paid tax on the income. The employer may also face fines and criminal charges.

For further information, visit the IRS Web site at irs.gov and read Publication 1779, or consult a tax professional.

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