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Employee vs. Independent Contractor

An often overlooked, important issue is whether to treat someone who does work for you as an employee or an independent contractor. Why does it matter? This answer can be extensive, but one of the more important issues is who is responsible for the taxes and what forms need filed. If you pay an employee, you are responsible for withholding the appropriate Social Security, Medicare, federal, and state taxes. Thus, you are also responsible for reporting and paying these withholdings to the proper departments along with any employer required matching taxes. A form W-2 needs to be filed at year end to issue to the employee for use in preparing their tax return. If you pay an independent contractor, you withhold no taxes and the recipient is responsible for paying all applicable taxes when they file their tax return. You report their earnings via a 1099-MISC. Another concern between the two categories is eligibility for fringe benefits. Most often, independent contractors are not eligible for fringe benefits whereas an employee may be eligible.

Obviously paying someone as an independent contractor is much simpler for the business owner. However, if audited, the penalties for paying a bona fide employee as an independent contractor can be large and they can go back years prior to the audit year. Therefore, it is important to classify workers correctly. A revenue ruling by the IRS uses 20 factors to determine if you have an employee or you have an independent contractor. This may sound like a lot, but some will make your decision pretty easy. All factors need to be considered, but there is no "magic" number of factors to determine one way or the other. Some factors are more relevant in certain situations and some may not be a factor in your decision.

1. Does the owner provide instructions to the worker about when, where, and how work is to be performed?
2. Does the owner provide training to the worker?
3. Are the services provided by the worker integrated into the owner's business operations?
4. Must the services be rendered personally by the worker?
5. Does the owner hire, supervise, and pay assistants to the worker?
6. Is there a continuing relationship between the owner and worker?
7. Does the owner set the work hours and schedule?
8. Does the worker devote substantially full time to the business of the owner?
9. Is the work performed on the owner's premises?
10. Is the worker required to perform services in order or sequence set by the owner?
11. Is the worker required to submit oral or written reports to the owner?
12. Is the worker paid by the hour, week, or month?
13. Does the owner have the right to discharge the worker at will?
14. Can the worker terminate the relationship with the owner at any time without incurring liability to the owner?
15. Does the owner pay the business or traveling expenses of the worker?
16. Does the worker furnish significant tools, materials, and equipment?

17. Does the worker have significant investment in facilities?
18. Can the worker realize profit and loss as a result of their services?
19. Does the worker provide services for more than one business at a time?
20. Does the worker make their services available to the general public?

As you can see, this is quite the list of factors. However, in most cases it is pretty easy to determine which situation you are involved. A simple example could be hiring a neighbor to come harvest your one field of wheat you planted this year. He already has his combine out and cut his acres and you decided it would be easier to have him come harvest yours rather than getting your combine out. This would be a case of an independent contractor situation since he uses his own equipment, harvests when it is convenient for him, and could hire out his services to anyone else. Alternatively, if you hired someone to run your grain cart during fall harvest, that is going to be an employee situation. You provide the equipment, you provide the training if needed, you set their work schedule, and they don't have a profit or loss business situation.

While recently going through a payroll audit with a client, there were several forms of documentation the Department of Labor wanted to see to help determine if the business owner had correctly paid individuals as employees and independent contractors. The Department of Labor wanted proof of filed W-2s and/or 1099s, payroll journals or check register, and a description of services performed by independent contractors along with proof of status such as invoices paid, a signed contract of work to be performed, or a business card advertising their services.

So you can see it is important to classify workers correctly. Don't fall into the trap of paying everyone as an independent contractor just because it is simpler for you. If you know you have an employee situation, you will benefit greatly by classifying them properly. The extra paperwork can save yourself from much larger issues down the road. If you need help with determining your situation or with payroll if applicable, be sure to contact a tax professional.