



Failure to Understand the Difference Between Subcontractor vs. Employee Can be Costly

A common issue we see taxpayers face is their ability to properly distinguish between a subcontractor and employee. Generally, employers must withhold income, Social Security, Medicare, and unemployment taxes on wages paid to an employee. However, if the individual is a subcontractor, these taxes are generally not withheld.

To assist with deciding between the two classifications, the Internal Revenue Service (IRS) requires taxpayers to focus on the “degree of control” the company has over the worker.

Facts that help distinguish the degree of control fall into three categories:

- **Behavioral:** Does the company control or have the right to control what the worker does, as well as how and when the worker does the job?
- **Financial:** Are the business aspects of the worker’s job controlled by the payer? This includes things like how worker is paid, whether expenses are reimbursed, and who provides the necessary tools and supplies to do the job.
- **Relationship:** Are there written contracts or employee type benefits, such as a pension plan, insurance, vacation pay, etc.? Will the relationship continue? Is the work that is performed a key aspect of the business?

Businesses must weigh all of these factors when determining how to classify an individual. Some factors may indicate that the worker is an employee, while other factors may indicate a subcontractor. There is no set number of factors that makes the determination as to whether or not the worker an employee or a subcontractor, nor does one factor stand alone in making this determination.

As such, the key is to look at the overall relationship and consider the degree or extent of the right to direct and control the individual’s work and work product.

If the IRS or state deems an incorrect classification has been made, employers may face substantial penalties. Therefore, it is advisable to document each of the factors used in making the determination for each employee since gray areas may exist.

If you would like assistance with distinguishing between an employer or subcontractor relationship, please contact us.

FOR MORE INFORMATION



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