

The background of the image is a blurred office setting. In the foreground, the back of a silver laptop is visible on the left, and a white ceramic cup with black speckles is on the right. The background shows a desk with some green plants and a window with light coming through.

Contractors vs. Employees

WALLETKEEPING

Hey, I'm Sara!

Hiring someone new is incredibly exciting, but it comes with real responsibility! Before you hire your next team member, you need to understand *just* how serious it is that they are classified correctly as either an employee or a contractor.

Getting this wrong can cost your business in penalties, back taxes, fines, and even potential lawsuits!

This guide is designed to help you learn more about classifying your new team member correctly, so that you understand how to pay them, which onboarding documents you need from them, and how to avoid paying the consequences of getting the classification wrong!

This guide is for informational purposes only and isn't intended as legal, tax, or financial advice. While every effort has been made to ensure the accuracy of this content, please consult with a tax accountant or employment attorney for advice specific to your hiring situation.





Governing Bodies

The two main federal governing bodies on worker classification are:

THE IRS

Generally concerned with tax reporting, the IRS's tests center on the level of control + the relationship between the two parties.

THE DOL

Focusing on employment law under the Fair Labor Standards Act, the Department of Labor uses the “economic realities” test to determine whether a new hire is in business for themselves or economically dependent on their employer.



You'll also need to comply with all of your state(s)' employment laws (including unemployment insurance and workers' compensation requirements).

IRS Worker Classification:

⊕ Behavioral Control

Does the company control (or have the right to control) how and when the worker is performing their work?

⊕ Financial Control

Does the company control the financial + business aspects of the job (i.e., how the worker is paid, who provides tools, how expenses are reimbursed)?

⊕ Type of Relationship

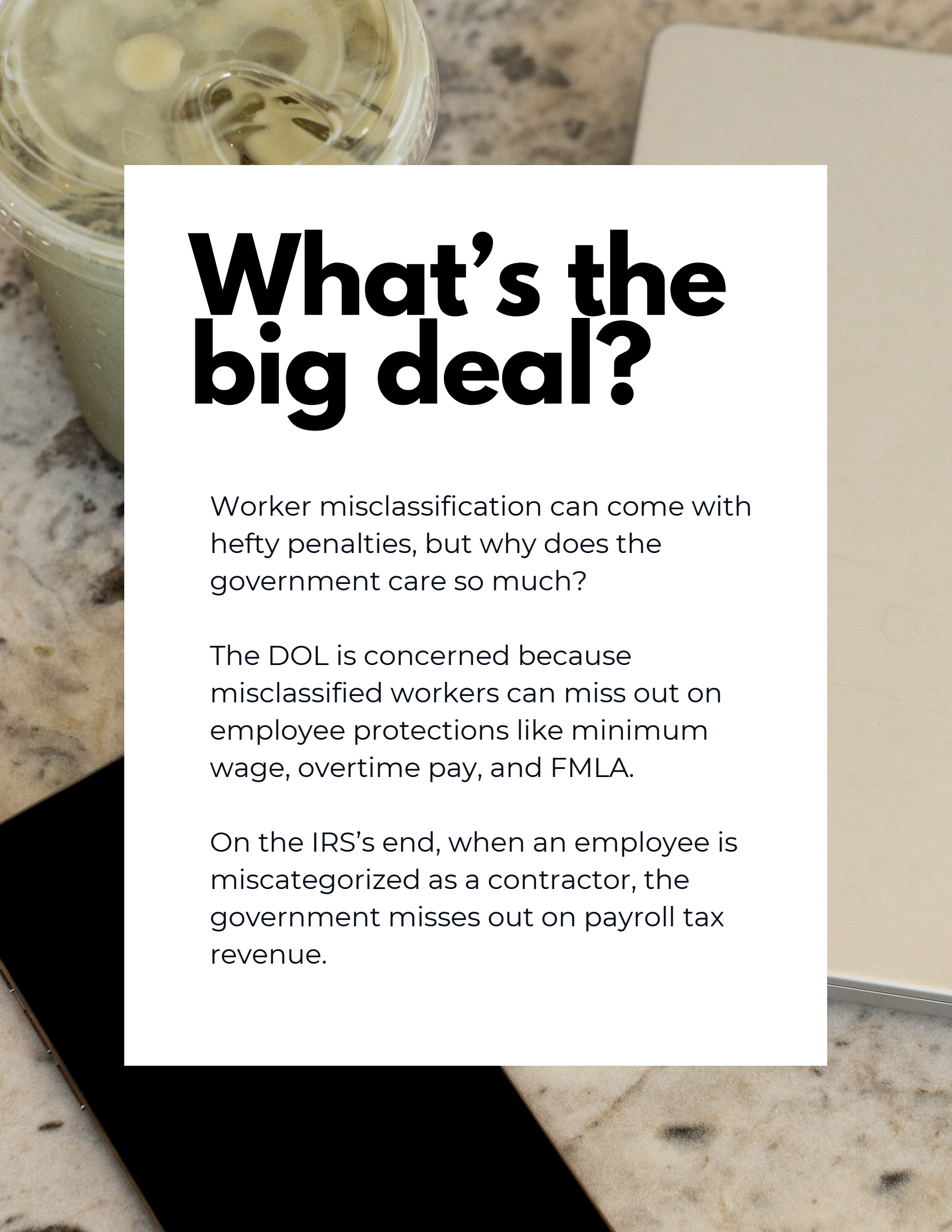
Are there written contracts or employee-type benefits such as a pension plan, insurance, or PTO? Will the relationship continue, and is the work performed a key aspect of the business?



DOL Tests

- ⊕ Is there an opportunity for profit or loss depending on the worker's managerial skill?
- ⊕ Has the worker made investments that are capital or entrepreneurial in nature?
- ⊕ What is the degree of permanence of the work relationship?
- ⊕ What is the nature and degree of control the company has over the worker?
- ⊕ What is the extent to which the work performed is an integral part of the company's business?
- ⊕ Is the worker using their skills and initiative to grow their own business?

**This information, sourced from Fact Sheet 13, is consistent with the 2024 Rule. This rule is currently under litigation.*



What's the big deal?

Worker misclassification can come with hefty penalties, but why does the government care so much?

The DOL is concerned because misclassified workers can miss out on employee protections like minimum wage, overtime pay, and FMLA.

On the IRS's end, when an employee is miscategorized as a contractor, the government misses out on payroll tax revenue.



WHAT ARE THE CONSEQUENCES OF

Misclassifying Workers

Incorrectly classifying an employee as a contractor can have significant penalties, including:

- Paying back taxes, failure-to-file and failure-to-pay penalties, and interest
- Paying back wages (unpaid overtime, minimum wage)
- Fines for labor law violations
- Fines for workers' compensation violations
- Penalties for unemployment insurance fraud



Workers can recover damages of **up to double** what is owed to them under the Fair Labor Standards Act.

The background of the entire page is a close-up photograph of green leaves, likely from a plant like a peace lily, with prominent veins and a slightly glossy texture. The leaves are layered, creating a sense of depth.

Contractor Considerations:

⊕ 1099 Filings

For 2025, you'll need to issue a 1099-NEC for contractors you've paid over \$600. To do so, you'll need to collect a Form W-9 from them.

⊕ Payment

Generally, contractors will issue an invoice to your company detailing the work performed and amount due.

⊕ Clear Contract

When working with contractors, you'll want a written contract detailing the scope of work, ownership, and any other important factors.



Employee Considerations

When you have employees, you'll need to issue them a W-2 each year to report how much you paid them. Employees should be paid on a regular basis via payroll.

The employer will need to withhold income tax, Social Security tax, and Medicare tax. Each employee should fill out a Form W-4 to share how much to withhold from their paycheck for federal income tax. Employers are also responsible for paying federal unemployment tax (FUTA), and filing payroll tax returns.

Employees may also be eligible for benefits like health care, retirement plans, and PTO, which need to be administered and accounted for carefully.

Employee vs. Contractor

How do you know which position you're looking to hire for? Consider these things:

- Do you need specialized help for a temporary project? Or do you need ongoing support for your business operations?
- Will you provide training and any necessary tools for your new worker, or do you expect them to provide their own tools?
- What level of control do you expect to have over how, when, and where your worker performs their work?



Summing It All Up!

When you choose to hire someone in your business, you don't necessarily get to choose whether they should be considered a contractor or an employee. The facts and circumstances of your relationship and the work performed should be used to determine the classification of the worker.

When in doubt, consult a qualified tax professional or employment attorney! Be sure to document any information used to make your decision for classifying a worker as a contractor.



PRO TIP: You can file Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, for an IRS determination on your worker's classification.



Let's Connect!

I'm passionate about helping small business owners make sense of their finances, bringing a level of organization and attention that makes all the difference. I'm here to ensure everything is in order, so you can focus on what you do best.



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