EMPLOYEES VS. CONTRACTORS

The legal difference, why getting it wrong is costly, and how to decide which one fits the work.

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AT A GLANCE

- **Employees** work under your direction. You withhold taxes, pay employer taxes and follow employment laws.
- **Independent contractors** run their own business, control how they do the work, and handle their own taxes.
- The label you choose doesn't decide it. **How the work actually happens** does. Getting it wrong can mean back taxes, penalties and lawsuits.

WATCH OUT

Federal and state tests differ, and some states use stricter rules. Check with a lawyer, accountant or your state labor department when in doubt.

Why it matters

Calling a worker a contractor when they're really an employee is called **misclassification**. It's one of the most common and costly mistakes small businesses make. Agencies can require unpaid taxes, overtime and penalties, sometimes for several years back.

How to tell the difference

Question	Points toward employee	Points toward contractor
Who controls how, when and where the work is done?	You do	They do
Who provides tools and equipment?	You do	They do
Is the work a core part of your business?	Yes	No, it's a separate service
How are they paid?	By the hour or salary, on a schedule	By the project, with invoices
Do they work for other clients?	Rarely	Yes, they offer services to the public
Can they make or lose money on the job?	No	Yes
Is the relationship ongoing with no end?	Yes	Usually for a defined project

Some states use an **"ABC test,"** which presumes a worker is an employee unless the business proves the work is outside its usual business and the worker is truly independent.

Examples

> EXAMPLE
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> - **Probably an employee:** a stylist who works shifts **Tasha** sets, in her salon, using her products, serving her clients.
> - **Probably a contractor:** a freelance designer who creates Tasha's logo from their own studio, using their own software, and works for many clients.
> - **Gray area:** a cleaner who works only for **Rosa**, follows her schedule and checklist, and uses her supplies. This is likely an employee in many states, even if paid per job.

If you use contractors

1. **Use a written contractor agreement** covering scope, payment, deadlines and ownership of work. See **B-09 Contracts Every New Business Needs**.
2. **Collect Form W-9** before you pay them.
3. **Send Form 1099-NEC** each year to contractors you paid above the IRS reporting threshold. See **B-14 Business Taxes: What You Owe and When**.
4. **Don't control how they do the work.** Focus on results.
5. **Review regularly.** Relationships change over time.

Common mistakes

- **Calling everyone a contractor** to avoid payroll.

- **Treating contractors like employees**: set hours, training, supervision.
- **No written agreement.**
- **Missing 1099 forms.**

Your checklist

- ☐ List everyone who works for your business
- ☐ Use the table above to check each one
- ☐ Check your state's test
- ☐ Put contractor agreements in writing
- ☐ Collect W-9s and send 1099s as required

Key words, explained

Word	What it means
Misclassification	Treating an employee as a contractor.
ABC test	A stricter state test for contractor status.
Form W-9	Collects a contractor's tax ID.
Form 1099-NEC	Reports payments to contractors to the IRS.

Where to go next

- **O-01 Your First Hire: When and How**
- **O-03 Payroll Basics**
- **B-09 Contracts Every New Business Needs**

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