

The SMB Quick-Reference FAQ: Employee vs. Contractor

Q1: Why should my business care about worker classification?

The Short Answer: Financial survival.

Regulatory agencies like the IRS and Department of Labor (DOL) are heavily cracking down on businesses that misclassify workers to save on payroll taxes and benefits. According to compliance data from Bloomberg, making a mistake here can trigger devastating audits, multi-million dollar class-action lawsuits, back taxes, and steep penalty fees that can easily bankrupt a growing SMB.

Q2: What is the main difference between an Employee (W-2) and a Contractor (1099)?

It boils down to **control** and **independence**:

- **W-2 Employee:** You control *how, when, and where* they work. They are integrated into your core business operations and are economically dependent on your company.
- **1099 Contractor:** They control *their own* schedule and methods. They run an independent, separate business entity and are hired only to deliver a specific end result.

Q3: What is the IRS "Control Test" and how do I apply it?

The IRS looks at three categories to determine if you have too much control over a worker to call them a contractor:

1. **Behavioral:** Do you give them detailed instructions, step-by-step training, or set their exact hours? (If yes → **Employee**).
2. **Financial:** Do you provide their laptop, software, and tools, or reimburse their business expenses? Do you pay them a steady hourly/salaried wage? (If yes → **Employee**).
3. **Relationship:** Do they get benefits (PTO, healthcare)? Is the relationship open-ended with no clear end date? (If yes → **Employee**).

Q4: What is the DOL's "Economic Reality Test"?

The Department of Labor looks at whether the worker is truly in business for themselves. For SMBs, the most critical factor is **Core Business Integration**:



- *Example:* If your SMB is a marketing agency and you hire a graphic designer to work on client projects daily, they are integral to your core service and should likely be an **employee**.
- *Example:* If that same marketing agency hires an electrician to fix the office wiring, that work is peripheral, making them a **contractor**.

Q5: Can I just have a worker sign a contract agreeing to be a 1099 contractor?

No. Both the IRS and DOL explicitly state that a signed contract or a worker's preference **does not matter** if their daily operational reality looks like employment. It is the *actual relationship* and level of control that dictates the law, not the paperwork.

 **Golden Rules for SMB Compliance**

To protect your business from legal risks, use this quick cheat sheet when hiring:

If the worker...	...they are an Employee (W-2)	...they are a Contractor (1099)
Uses equipment...	Provided entirely by your business.	That they bought and own themselves.
Gets paid...	A regular salary or hourly wage.	A flat fee or per-project rate via invoice.
Works for...	Just your business (economically dependent).	Multiple different clients or businesses.
Takes financial risk...	None. They get paid regardless of profit/loss.	Yes. They can lose money if they mismanage a project.

