

# **Employment Tax Backgrounder:**

(Source: Internal Revenue Service)

## **What Are Employment Taxes?**

Small business owners often have great responsibilities while operating and managing a business. Before you become an employer and hire employees, you need a Federal Employer Identification Number ([EIN](#)).

If you have employees, you are responsible for several federal, state and local taxes. As an employer, you must withhold certain taxes from your employees' wages. Federal employment taxes include the following.

- Federal income tax withholding
- Social Security and Medicare taxes
- Federal unemployment tax (FUTA)

### **Federal Income Taxes/Social Security and Medicare Taxes**

You generally must withhold federal income tax from your employees' wages.

Social Security and Medicare taxes pay for benefits that workers and families receive under the Federal Insurance Contributions Act (FICA). Social Security tax pays for benefits under the old-age, survivors, and disability insurance part of FICA. Medicare tax pays for benefits under the hospital insurance part of FICA. You withhold part of these taxes from your employee's wages and you pay a matching amount yourself.

### **Federal Unemployment (FUTA) Tax**

The federal unemployment tax is part of the federal and state program under the Federal Unemployment Tax Act (FUTA) that pays unemployment compensation to workers who lose their jobs. You report and pay FUTA tax separately from Social Security and Medicare taxes and withheld income tax. You pay FUTA tax only from your own funds. **Employees do not pay this tax or have it withheld from their pay.**

### **Depositing Taxes**

In general, you must deposit income tax withheld and both the employer and employee Social Security and Medicare taxes (minus any advance EIC payments) by depositing electronically, mailing or delivering a check, money order, or cash to a financial institution that is an authorized depository for federal taxes.

## **More Detailed Explanations are outlined in IRS Publication 15-A, Employer's Supplemental Tax Guide:**

### **1. Who Are Employees?**

Before you can know how to treat payments that you make to workers for services, you must first know the business relationship that exists between you and the person performing the services. The person performing the services may be:

- An independent contractor,
- A common-law employee,
- A statutory employee, or
- A statutory nonemployee.

This discussion explains these four categories. A later discussion, *Employee or Independent Contractor?* (section 2), points out the differences between an independent contractor and an employee and gives examples from various types of occupations. If an individual who works for you is not an employee under the common-law rules (see section 2), you generally do not have to withhold federal income tax from that individual's pay. However, in some cases you may be required to withhold under backup withholding requirements on these payments. See Publication 15 (Circular E) for information on backup withholding.

#### ***Independent Contractors***

People such as lawyers, contractors, subcontractors, and auctioneers who follow an independent trade, business, or profession in which they offer their services to the public, are generally not employees. However, whether such people are employees or independent contractors depends on the facts in each case. The general rule is that an individual is an independent contractor if you, the person for whom the services are performed, have the right to control or direct only the result of the work and not the means and methods of accomplishing the result.

#### ***Common-Law Employees***

Under common-law rules, anyone who performs services for you is your employee if you have the right to control what will be done and how it will be done. This is so even when you give the employee freedom of action. What matters is that you have the right to control the details of how the services are performed. For a discussion of facts that indicate whether an individual providing services is an independent contractor or employee, see *Employee or Independent Contractor?* (section 2).

If you have an employer-employee relationship, it makes no difference how it is labeled. The substance of the relationship, not the label, governs the worker's status. Nor does it matter whether the individual is employed full time or part time.

For employment tax purposes, no distinction is made between classes of employees. Superintendents, managers, and other supervisory personnel are all employees. An officer of a corporation is generally an employee; however, an officer who performs no services or only minor services, and neither receives nor is entitled to receive any pay, is not considered an employee. A director of a corporation is not an employee with respect to services performed as a director.

You generally have to withhold and pay income, social security, and Medicare taxes on wages that you pay to common-law employees. However, the wages of certain employees may be exempt from one or more of these taxes. See *Employees of Exempt Organizations* (section 3) and *Religious Exemptions* (section 4).

**Leased employees.** Under certain circumstances, a corporation furnishing workers to various professional people and firms is the employer of those workers for employment tax purposes. For example, a professional service corporation may provide the services of secretaries, nurses, and other similarly trained workers to its subscribers.

The service corporation enters into contracts with the subscribers under which the subscribers specify the services to be provided and a fee is paid to the service corporation for each individual furnished. The service corporation has the right to control and direct the worker's services for the subscriber, including the right to discharge or reassign the worker. The service corporation hires the workers, controls the payment of their wages, provides them with unemployment insurance and other benefits, and is the employer for employment tax purposes. For information on employee leasing as it relates to pension plan qualification requirements, see *Leased employee* in Publication 560, Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans).

**Additional information.** For more information about the treatment of special types of employment, the treatment of special types of payments, and similar subjects, refer to Publication 15 (Circular E); or Publication 51 (Circular A) for agricultural employers.

## ***Statutory Employees***

If workers are independent contractors under the common law rules, such workers may nevertheless be treated as employees by statute ("statutory employees") for certain employment tax purposes if they fall within any one of the following four categories and meet the three conditions described under *Social security and Medicare taxes*, below.

1. A driver who distributes beverages (other than milk) or meat, vegetable, fruit, or bakery products; or who picks up and delivers laundry or dry cleaning, if the driver is your agent or is paid on commission.
2. A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.
3. An individual who works at home on materials or goods that you supply and that must be returned to you or to a person you name, if you also furnish specifications for the work to be done.
4. A full-time traveling or city salesperson who works on your behalf and turns in orders to you from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for you must be the salesperson's principal business activity. See *Salesperson* in section 2.

**Social security and Medicare taxes.** Withhold social security and Medicare taxes from the wages of statutory employees if all three of the following conditions apply.

- The service contract states or implies that substantially all the services are to be performed personally by them.
- They do not have a substantial investment in the equipment and property used to perform the services (other than an investment in transportation facilities).
- The services are performed on a continuing basis for the same payer.

**Federal unemployment (FUTA) tax.** For FUTA tax, the term “employee” means the same as it does for social security and Medicare taxes, except that it does not include statutory employees in categories 2 and 3 above. Thus, any individual who is an employee under category 1 or 4 is also an employee for FUTA tax purposes and subject to FUTA tax.

## *Misclassification of Employees*

**Consequences of treating an employee as an independent contractor.** If you classify an employee as an independent contractor and you have no reasonable basis for doing so, you may be held liable for employment taxes for that worker (the relief provisions, discussed below, will not apply). See Internal Revenue Code section 3509 for more information.

**Relief provisions.** If you have a reasonable basis for not treating a worker as an employee, you may be relieved from having to pay employment taxes for that worker. To get this relief, you must file all required federal information returns on a basis consistent with your treatment of the worker. You (or your predecessor) must not have treated any worker holding a substantially similar position as an employee for any periods beginning after 1977.

**Technical service specialists.** This relief provision does not apply for a technical services specialist you provide to another business under an arrangement between you and the other business. A technical service specialist is an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.

This limit on the application of the rule does not affect the determination of whether such workers are employees under the common-law rules. The common-law rules control whether the specialist is treated as an employee or an independent contractor. However, if you directly contract with a technical service specialist to provide services for your business and not for another business, you may still be entitled to the relief provision.

**Test proctors and room supervisors.** The consistent treatment requirement does not apply to services performed after December 31, 2006, by an individual as a test proctor or room supervisor assisting in the administration of college entrance or placement examinations if the individual:

- Is performing the services for a section 501(c) organization exempt from tax under section 501(a) of the code, and
- Is not otherwise treated as an employee of the organization for employment taxes.

## **2. Employee or Independent Contractor?**

An employer must generally withhold federal income taxes, withhold and pay social security and Medicare taxes, and pay unemployment tax on wages paid to an employee. An employer does not generally have to withhold or pay any taxes on payments to independent contractors.

### *Common-Law Rules*

To determine whether an individual is an employee or an independent contractor under the common law, the relationship of the worker and the business must be examined. In any employee-independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered.

Facts that provide evidence of the degree of control and independence fall into three categories: behavioral control, financial control, and the type of relationship of the parties. These facts are discussed below.

**Behavioral control.** Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of:

**Instructions that the business gives to the worker.** An employee is generally subject to the business' instructions about when, where, and how to work. All of the following are examples of types of instructions about how to do work.

- When and where to do the work.
- What tools or equipment to use.
- What workers to hire or to assist with the work.
- Where to purchase supplies and services.
- What work must be performed by a specified individual.
- What order or sequence to follow.

The amount of instruction needed varies among different jobs. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. A business may lack the knowledge to instruct some highly specialized professionals; in other cases, the task may require little or no instruction. The key consideration is whether the business has retained the right to control the details of a worker's performance or instead has given up that right.

**Training that the business gives to the worker.** An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

**Financial control.** Facts that show whether the business has a right to control the business aspects of the worker's job include:

**The extent to which the worker has unreimbursed business expenses.** Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services that they perform for their business.

**The extent of the worker's investment.** An independent contractor often has a significant investment in the facilities he or she uses in performing services for someone else. However, a significant investment is not necessary for independent contractor status.

**The extent to which the worker makes his or her services available to the relevant market.** An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.

**How the business pays the worker.** An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is usually paid by a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.

**The extent to which the worker can realize a profit or loss.** An independent contractor can make a profit or loss.

## Sole Proprietors and Independent Contractors must pay Self Employment Tax:

### Self-Employment Tax (source: IRS)

This section discusses self-employment tax.. The list of items below should not be construed as all-inclusive. Other information may be appropriate for your specific type of business.

#### What is Self-Employment Tax?

Self-employment tax (SE tax) is a social security and Medicare tax primarily for individuals who work for themselves. It is similar to the social security and Medicare taxes withheld from the pay of most wage earners.

You figure SE tax yourself using Schedule SE (Form 1040). Social security and Medicare taxes of most wage earners are figured by their employers. Also you can deduct half of your SE tax in figuring your adjusted gross income. Wage earners cannot deduct social security

and Medicare taxes.

**SE tax rate.** The self-employment tax rate is 15.3%. The rate consists of two parts: 12.4% for social security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance).

**Maximum earnings subject to SE tax.** Only the first \$94,200 of your combined wages, tips, and net earnings in 2006 is subject to any combination of the 12.4% social security part of SE tax, social security tax, or railroad retirement (tier 1) tax.

All your combined wages, tips, and net earnings in 2006 are subject to any combination of the 2.9% Medicare part of SE tax, social security tax, or railroad retirement (tier 1) tax.

**Fiscal year filer.** If you use a tax year other than the calendar year, you must use the tax rate and maximum earnings limit in effect at the beginning of your tax year. Even if the tax rate or maximum earnings limit changes during your tax year, continue to use the same rate and limit throughout your tax year.

### How to Pay Self-Employment Tax

To pay SE tax, you must have a social security number (SSN) or an individual taxpayer identification number (ITIN). This section explains how to:

- Obtain an SSN or ITIN
- Pay your SE tax using estimated tax.

**Obtaining a Social Security Number.** If you never had an SSN, apply for one using Form SS-5, Application for a Social Security Card. You can get this form at any Social Security office or by calling (800) 772-1213. Download the form from the [Social Security Online](#) Web site.

**Obtaining an Individual Taxpayer Identification Number.** The IRS will issue you an ITIN if you are a nonresident or resident alien and you do not have and are not eligible to get an SSN. To apply for an ITIN, file Form W-7, Application for IRS Individual Taxpayer Identification Number.

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### Estimated Taxes

Federal income tax is a pay-as-you-go tax. You must pay the tax as you earn or receive income during the year. You generally have to make estimated tax payments if you expect to owe tax, including SE tax, of \$1,000 or more when you file your return. There are two ways to pay as you go: withholding and estimated taxes. If you are a self-employed individual and do not have income tax withheld, you must make [estimated tax payments](#).

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### Who Must Pay Self-Employment Tax?

You must pay SE tax and file Schedule SE (Form 1040) if either of the following applies.

- Your net earnings from self-employment (excluding church employee income) were \$400 or more.

- You had church employee income of \$108.28 or more.

Your net earnings from self-employment are based on your earnings subject to SE tax. Most earnings from self-employment are subject to SE tax. Some earnings from employment (certain earnings that are not subject to social security and Medicare taxes) are subject to SE tax.

If you have earnings subject to SE tax, use Schedule SE to figure your net earnings from self-employment. Before you figure your net earnings, you generally need to figure your total earnings subject to SE tax.

**Note:** The SE tax rules apply no matter how old you are and even if you are already receiving social Security or Medicare.