

# Hiring Independent Contractors

As a company grows and the demand for its products increases, business owner(s) are faced with the challenge of how to increase resources effectively. Though this may appear to be a rather innocuous dilemma, hiring is quite a complicated process, and misclassifying an employee as an independent contractor can have both financial and legal consequences.

Hiring an independent contractor offers employers many advantages. Unlike a traditional employee, an employer does not pay an independent contractor a wage or salary, federal and state payroll taxes on his/her earnings, social security tax, federal unemployment insurance tax, state unemployment insurance, workers' compensation premiums, benefits or overtime. Employers do, however, pay for office space, along with supplies and equipment for the independent contractor to use. Employers can often save 30 to 40 percent by using an independent contractor versus hiring an individual to do the same job. Beyond this, if an employer is dissatisfied with the contractor's performance, he/she can simply seek out someone else to do the job which is far less stressful than having performance discussions with an employee.

At the end of the year, the company is required to issue the contractor a Form 1099 (if the contractor earned \$600 or more during the year) and submit a Form 1096 to the Internal Revenue Service (IRS) explaining the payments made to the contractor. This entire process may seem pain-free and far more economical; however, there are hefty government-imposed penalties if an employer classifies an individual as an independent contractor when he or she is actually an employee. The IRS, the U.S. Department of Labor and various state agencies constantly monitor compliance with employee and independent contractor classification through somewhat ambiguous criteria. Using the Employment Tax Examination Program (ETE), special IRS teams investigate misclassified workers through audits. Those who file Form 1099 are subject to audits, as are industries that tend to abuse the privilege of hiring an independent contractor.

## **Who is an Independent Contractor?**

According to the IRS, the general rule requires an employer to have the right to control or direct only the result of the work done by an independent contractor, and not the means and methods of accomplishing the result. Contractors are selected and contracted to provide only specified services for a specific price, over a given time frame, etc. An employer would not supervise the task as it is completed, nor provide supplies or tools accomplish the task. If the task is not done to the employer's specifications, he/she is free to hire someone else and not compensate the independent contractor for the work. On the other hand, the IRS classifies an employee as an individual in which the employer can control how and when he/she performs tasks. Additionally, employees get paid regardless of the quality of their work. Essentially, the facts that provide evidence of the degree of control and independence determine whether someone is an employee or independent contractor. There are a few exceptions to common law rule though.

## Statutory Employees:

Some independent contractors may be treated as employees by statute. Generally, if an independent contractor falls within any of the following four categories, he/she will be classified as an employee for certain employment tax purposes:

- 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.
- 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.
- 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.
- 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.

## Statutory Non-employees:

There are two categories of statutory non-employees: **direct sellers** and **licensed real estate agents**. They are treated as self-employed for all Federal tax purposes, including income and employment taxes, if:

1. Substantially all payments for their services as direct sellers or real estate agents are directly related to sales or other output, rather than to the number of hours worked; and
2. Their services are performed under a written contract providing that they will not be treated as employees for Federal tax purposes.

## Determining Classification-Common Law Control Test:

When determining whether the person a company hires (or contracts) is an employee or an independent contractor, the IRS has devised a common law "control" test consisting of a number of factors. If the majority of the answers to the control test describe someone who is an employee, then the individual will probably be seen as an employee or vice versa.

### IRS Factors Used to Determine Control

1. The individual can earn a profit or suffer a loss from doing the task (indicative of independent contractor)
2. The individual is instructed where to work
3. The individual offers services to the general public (indicative of independent contractor)
4. The individual can be fired by the hired company
5. The individual provides his/her own tools, materials or supplies needed to complete the work (indicative of independent contractor)
6. The individual is paid by the hour or paid by the job completed (employees are generally paid by the hour whereas independent contractors are paid by the job)

7. The individual does services for more than one contracted company at a time (indicative of independent contractor)
8. The individual has a continuous long-term relationship with the company (indicative of employee status)
9. The individual has an investment in office space and equipment needed to complete tasks (indicative of independent contractor)
10. The individual pays for travel and business expenses (indicative of independent contractor)
11. The individual can quit without being liable for breaking a contract (indicative of employee status)
12. The individual receives specific instructions from the company (indicative of employee status)
13. The individual is told exactly how to perform his/her job (indicative of employee status)
14. The individual receives training for the job he/she is to perform (indicative of employee status)
15. The individual performs the services him/herself
16. The individual hires his/her own assistant and pays that person's salary (indicative of independent contractor)
17. The individual sets his/her working hours (indicative of independent contractor)
18. The individual gives the company reports on his/her progress on work completed
19. The individual works full-time for the company (indicative of employee status)
20. The individual's work is considered part of the core operations of the company's daily operations (indicative of employee status)

Other government agencies such as the States' Unemployment Compensation Board, Workers' Compensation Insurance Agency, Tax Department and Department of Labor have ways of determining an individual's status within a company. Since each state is different, it is imperative that employers contact these agencies directly for more information.

### **Determining Classification-Categories of Evidence:**

Since common law factors change, the courts and the IRS have placed some of the items within the control test into three main categories, known as the "categories of evidence."

- **Behavioral Control** – Facts that show whether the business has a right to direct and control. These include:
  - Instructions - an employee is generally told:
    1. when, where, and how to work
    2. what tools or equipment to use
    3. what workers to hire or to assist with the work
    4. where to purchase supplies and services
    5. what work must be performed by a specified individual
    6. what order or sequence to follow
  - Training – an employee may be trained to perform services in a particular manner.
- **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 un-reimbursed expenses
  - The extent of the worker's investment

- The extent to which the worker makes services available to the relevant market
- How the business pays the worker
- The extent to which the worker can realize a profit or loss
- **Type of Relationship** – Facts that show the type of relationship include:
  - Written contracts describing the relationship the parties intended to create
  - Whether the worker is provided with employee-type benefits
  - The permanency of the relationship
  - How integral the services are to the principal activity

### **Protection against Misclassification:**

Companies wishing to hire an independent contractor should proceed with caution in order to avoid potential penalties. An independent contractor agreement is a good first step. This document should contain a description of the services the individual will perform, how long the task should take and how the person shall be paid. This agreement serves as evidence of the person's status with regard to the company in case there is a discrepancy or if the individual claims that he/she was actually an employee.

While hiring an independent contractor provides many advantages to companies, it is not as simple as it may seem. The pivotal detail to remember is that as the employer's control increases, the likelihood that the individual will be classified as an employee increases as well. With that said, it pays to be highly scrupulous when deciding to hire someone as an independent contractor.