

Hiring Independent Contractors: Risks vs. Benefits

On the surface, there are a number of obvious benefits to hiring independent contractors as opposed to full-time employees. Increased flexibility and reduced labor costs - coupled with saving on taxes and employee benefit payments – make contract labor an appealing option.

But the process is not always as simple as it seems. The financial risks can be significant if a state of federal audit finds that an employer has misclassified an employee as an independent contractor. Such audits are commonly triggered by employees who file claims for unemployment compensation.

Internal Revenue Service policies dealing with this matter are often vague, but the penalties can be staggering. For instance, an employer who paid an independent computer consultant \$15,000 a year for three years could be liable for almost \$20, 000 in taxes, penalties and interest.

The main factor in discerning whether a worker can be classified as an independent contractor is the amount of control the hirer has over the worker and the work performed.

20-point checklist

The IRS uses 20 factors to determine control. Though these rules are intended to be used as only a guide, they may be helpful in distinguishing between an independent contractor and a regular employee. To avoid problems, NACD recommends that you consult with the IRS or state employment officials.

A “yes” answer to each of the first four questions indicates that the worker is probably an independent contractor. A “yes” answer to

any of the remaining questions generally indicates that the worker is a regular employee.

1. **Profit or loss.** Can the worker make a profit or suffer a loss as a result of the work, aside from the money earned from the project. (This should involve real economic risk – not just the risk of not getting paid.)
2. **Investment.** Does the worker have an investment in the equipment and facilities used to do the work for more than one company at a time? (If so, the worker is generally an independent contractor.)
3. **Working for more than one firm.** Does the person work for more than one company at a time? (If so, the worker is generally an independent contractor.)
4. **Services offered to the general public.** Are the worker’s services available to the general public? (This generally indicates independent contractor status.)
5. **Instructions.** Does the employer have the right to give the worker instructions about when, where and how to work? (If so, the worker is ordinarily an employee.)
6. **Training.** Does the employer train the worker to do the job in a particular way? (Contractors are already trained.)
7. **Integration.** Are the worker’s services so important that they have become a necessary part of the business? (Integration of the worker’s service into the business operation generally indicates that he/she is an employee.)
8. **Services rendered personally.** Must the worker provide the services personally, as opposed to delegating tasks to somebody else? (If so, the employer is

- probably interested in the worker as well as the results, often indicating an employee relationship.)
9. **Hiring assistants.** Does the employer hire, supervise and pay the worker's assistants? (Independent contractors hire their own staffs.)
 10. **Continuing relationship.** Is there an ongoing relationship between the employer and the worker? (This usually indicates an employer/employee relationship.)
 11. **Work hours.** Does the worker set his/her own hours? (Independent contractors generally do.)
 12. **Full-time work.** Must the worker spend all of his/her time on the job? (Contractors generally have a choice.)
 13. **Work done on premises.** Must the individual work on the employer's premises? (A "no" answer alone does not necessarily guarantee independent contractor status, but it may be an indicator.)
 14. **Sequence.** Does the employer have a right to determine the order in which services are performed? (Independent contractors can generally set their own pattern of work.)
 15. **Reports.** Must the worker provide reports accounting for his/her actions? (This may indicate lack of independence.)
 16. **Pay schedules.** Is the worker paid by the week, hour or month? (In dependent contractors are often paid by the job or on commission.)
 17. **Expenses.** Does the employer pay the worker's business or travel costs? (Contractors generally supply their own.)
 18. **Tools and materials.** Does the employer provide the worker with equipment, tools or materials? (Independent contractor generally supply their own.)
 19. **Right to fire.** Does the employer have the right to discharge the worker? (As long as the work result meet specifications, an independent contractor cannot be fired without the risk of a breach of contract lawsuit.)
 20. **Right to quit.** Can the worker quit at any time, without incurring liability? (An independent contractor is responsible for the successful completion of the specified job.)

INDEPENDENT CONTRACTOR OR EMPLOYEE?

In an effort to save thousands of dollars each year, many employers have turned to the use of “independent contractors” or “consultants”. Employers who utilize independent contractors may be able to avoid Social Security contributions, Unemployment and Workers’ Compensation insurance premiums and may realize even greater savings in company health and pension benefits.

In response to the surge of independent contracts, the IRS has increased its efforts to verify the classification of independent contractors and in some cases reclassify them as employees. The result of which has meant millions of dollars recovered in the form of an independent contractor including but not limited to, payroll taxes not withheld and unpaid unemployment compensation and social security taxes. Additional criminal penalties and civil fines may also be imposed.

Many employers are unclear as to how the International Revenue Service defines employees and independent contractors. However, the IRS has published a helpful checklist which may assist employers in determining the status of employees in determining the status of employees and independent contractors (IRS Form SS-8)

In general, an independent contractor is defined as being in business for himself/herself and does not have a traditional employee relationship with the employer. The independent contractor has the right to control the work and discretion in the performance of his/her services. Independent

contractors are responsible for their own (and their employees) employment taxes and related insurance obligations. Common indicators of independent contractor status include specialized skill(s) of the individual; performance of a non-integral part of the employer’s business; whether the individual provides their own tools, supplies, equipment; the method of payment for services is on a flat (not hourly) rate; there is a risk of monetary loss to the individual; and a non-permanent relationship with the employer.

The use of independent contractors may be an attractive, cost-saving alternative during economically difficult times. Employers may however, be subject to substantial fines and penalties if an individual is improperly classified as an independent contractor, rather than an employee. Accordingly, employers should consult with legal contractors.

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[Note: The National Labor Relations Board has adopted a similar list of factors for determining independent contractor status under the National Labor Relations Act. Similarly, the Department of Labor has also listed such factors for independent contractor status under the Fair Labor Standard Act. Each of these agencies has, however, identified additional criteria which is relative to the determination of independent contractor status, consistent with the respective purposes of the Acts.]