

INDEPENDENT CONTRACTORS: The Legal Boundaries

Companies everywhere are scrutinizing their payrolls and full-time employee head counts with an eye toward cost-saving measures. Clearly, you need full-time employees to perform duties essential to your company's bottom line on a daily basis. But you may need more help to handle some tasks in peak business periods, for work requiring special expertise not needed on a full-time basis or for special projects outside your core business. For these kinds of situations it makes perfect sense to use independent contractors. Just be aware that you'll need a concrete policy for managers to steer clear of the IRS and legal headaches in hiring outside workers.

What's at Issue

Not all tasks are right for independent contractors, and the contractual and regulatory burdens of the relationship can be very complex. On the positive side, though, the benefits are easy to see. As a U.S. Chamber of Commerce study showed, for each full-time employee's salary, a company on average pays 12.4 percent in Social Security, workers' comp, unemployment and disability insurance; another 12.4 percent in vacation time, sick leave and lunch and work breaks; and 15.5 percent in pensions, health insurance and other benefits. In addition, federal statutes such as Title VII, the Americans with Disabilities Act and the Family and Medical Leave Act don't apply to freelancers. All the above are powerful bottom-line incentives to use contract labor.

Some of the downsides are equally obvious. The IRS is fully aware of the employer's potential savings from hiring independent contractors, which is why it scrutinizes employee records for "red flags." If the IRS concludes that you misclassified a worker, you could be liable for back taxes, penalties and interest charges. Not only that, but the reclassified employee could sue to be included retroactively in your benefits plan—another huge cost.

The other downsides, however, are not as clear. Control of your company's confidential information, undue reliance on outsiders for key policy or product decisions, competition for contractors' time with their other assignments and just plain shoddy work can reduce or eliminate the savings you expected from employing an outside contractor.

Policy Considerations

As a key starting point, determine which business functions in your company might be outsourced to contractors. Management consultants recommend that you look at:

- The centrality of the function to your day-to-day operations.
- The amount of control you want to exert over the operations side of these functions: that is, how the tasks are being accomplished.
- The special expertise required to perform the needed function (which may or may not be needed full time in your company).
- The cost of hiring full-time qualified individuals to perform this function.
- Whether or not using contractors will meet the complicated IRS standards for worker classifications, which have recently changed.

The main issue in determining a worker's tax status is whether or not the employer can control the worker. In recent years, the IRS' "20 factor test" was the key tool to deciding whether a worker qualified as an independent contractor or an employee. But even labor lawyers found the test difficult to apply.



IRS Revises Standards

A few years ago, the IRS moved to a simpler set of standards. The agency's emphasis shifted toward compiling worker-status evidence under three main questions:

- How much behavioral control does the employer exercise over the worker?
- What financial control does the employer have over the worker?
- How do the worker and employer view their work arrangement?

Within those main categories are 10 questions that IRS auditors now focus on to determine a worker's status. These include eight of the original 20 factors:

1. Did you train the worker to perform the services for you?
2. Did you give the worker instructions on where, when and how the work is to be performed?
3. Is the worker protected from losing money as a result of providing services to your company?
4. Is the worker prohibited from providing services to the public at large?
5. Do you pay for the worker's business expenses?
6. Does the worker provide services to your company on an ongoing basis?
7. Do you pay the worker by the week, month or hour?
8. Are the services the worker provides essential to running the company?

The last two factors were added in 1997:

1. Does a written contract exist that describes the relationship the parties intend to create?
2. Does the business provide the worker with employee-type benefits?

In addition, under the Small Business Job Protection Act of 1996, the burden of proof is now on the IRS to prove that the individual in question qualifies as an employee.

Also, be aware that not all states and courts apply the same standards in determining whether workers are employees or independent contractors. "State unemployment compensation statutes take a very narrow view because the purpose is to provide relief for people in unfortunate circumstances," says Eric Dreiband, a Chicago lawyer. So a contractor's unemployment compensation might be charged to your account if your business severed the relationship, leaving the contractor out of a job.

Preventive Steps

The most important safeguards are to maintain accurate records and follow the rules on Form 1099s. If 1099s were mailed on time and filed properly, you may be able to avoid retroactive payroll taxes even if an auditor reclassifies your contractors as employees.

Under so-called "Section 530" tax relief, employers are immune from back employment taxes on misclassified employees as long as they can prove that: (1) they had a reasonable basis for treating workers as independent contractors; (2) they regularly filed a Form 1099 for each worker; and (3) they consistently classified all workers with similar jobs as independent contractors. The tax liability is limited to one year for employers who misclassify workers.



Here are some other tips to keep your contractor relationships on the right side of the law:

- Enforce your rules uniformly. For example, if some telemarketers are classified as employees and others as contractors, you will need a well-documented reason for doing so.
- If you send some contractors 1099s, send them to all outside workers to whom you paid more than \$600 the previous year.
- Have independent contractors acknowledge in writing that they are not covered by your benefits plan.
- Have an accountant certify your worker classifications.
- Compose a formal contract for outside workers. It should include the work to be done, the length of the agreement and the amounts to be paid. It should also state that no benefits will be provided and that the contractor is responsible for paying state and federal taxes. You may also want them to sign an acknowledgment that they have complied with business licensing requirements and maintain their own employment records.
- Require outside contractors to provide their own equipment and supplies.
- Allow them to choose their own work schedules within a general time frame.
- Don't supervise their work beyond expected standards of quality.
- Let independent contractors decide whether to hire assistants.
- Don't withhold taxes.
- Don't provide an expense account.
- Avoid downsizing employees out of a job, then rehiring them as independent contractors to perform the same function. The IRS takes a dim view of that action.

The following is a sample letter of agreement between a disaster recovery company and an independent contractor (agreement should be signed and dated by both parties):

Sample Contractor's Agreement

"XYZ, Inc. (hereafter referred to as XYZ) hereby agrees to pay Jane Jones a flat fee of \$1,500 (one thousand five hundred dollars) per month for a period of one year to engage the services of Jane Jones as a consultant to XYZ in the area of public relations and to act as a representative of XYZ in that area. The 12-month period of this agreement commences on June 1, 2003, and terminates on May 31, 2004, unless extended by written agreement by both parties.

"XYZ will pay the \$1,500 fee on or before the first of each month. In addition, XYZ agrees to reimburse Jane Jones for reasonable expenses incurred while acting as a consultant to or representative of XYZ, up to a maximum of \$300 (three hundred dollars) per month. Reasonable expenses include such items as phone, fax, photocopier, postage, local transportation and the cost of local business meetings. XYZ is not liable for expenses incurred by Jane Jones for rent, taxes, insurance or salaries. Reimbursement of expenses is to be paid by XYZ within 15 days of receipt of an itemized expense report. Reimbursement of expenses in excess of \$300, or expenses incurred outside the Minneapolis metro area, require prior approval by XYZ.

"Jane Jones agrees to commit the equivalent of one day a week per month for the 12 months of this agreement to working as a consultant to and/or representative of XYZ in the area of public relations. During any given month, the specific apportioning of this time within that month is at the discretion of Jane Jones except insofar as XYZ may identify a specific need for these services at a given time.

"As a consultant and representative, Jane Jones agrees to use her knowledge and contacts to increase the awareness of and promote the use of XYZ's magnetic tape restoration and disaster recovery services within the archival community. As a representative of XYZ, it is agreed that Jane Jones does not have the authority to commit XYZ to a contract or in any way obligate XYZ to a third party.

"The specifics set forth in this letter have been agreed to by XYZ and Jane Jones and are binding on both parties."

