

# How to Manage Independent Contractors

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The Internal Revenue Service (IRS) recently assessed Federal Express with \$319 million in penalties for failing to pay taxes and benefits for drivers whom they called “contractors” but treated like employees. The practice is tempting: According to the U.S. Department of Labor, the cost of hiring a contractor is as much as 30 percent lower than that of hiring an employee. But it’s also illegal — and costly if you get audited.

What does this have to do with a law-abiding manager like you? Well, the legal difference between a contractor and an employee can be tough to determine, and getting it right has just become more important: The IRS will up its vigilance on the issue for the 2007 tax year. In this comprehensive Crash Course, we’ll show you how to classify workers correctly and steer clear of conflicts with Uncle Sam.

## Things you will need:

- Legal fees to keep a tax attorney in the loop and provide a “best practices” guide.
- A few hours to bone up on tax law.
- **IRS Publications:** [Pub 15a](#) gives detailed information on how the IRS classifies workers, with helpful hypothetical examples.
- **IRS Forms:** You can file [Form SS-8](#) for a determination of worker status if you’re not sure how to classify a worker. Workers themselves can also file.
- **HR:** Make sure your human resources manager is well versed on employee classification matters.
- **Rationale:** Have a strong reason, other than cost-cutting, for hiring an independent contractor versus an employee — or else don’t bother.

A yellow sticky note with the text 'step 1' written in black.

## Decide Whether You Need One

**Goal: Learn what contractors can do for you — and when it makes sense to hire one.**

Independent contractors (ICs) are workers who provide their services to the public, usually on a short-term or part-time basis. They work with multiple clients, operate out of their own workplace, have their own tools and equipment, and may have a business license or a company name.

Generally, it makes sense to go the free-agent route when you don't have enough steady work to justify a permanent position. Here are the top three reasons companies hire ICs instead of employees:

**The task requires specialized skills.** You don't have these skills on staff and you won't need them long term.

**Examples:** You bring in an interior designer to redesign your offices or an IT expert to set up a new server.

**The task is short-term.** The job at hand will take a few weeks or months to complete.

**Examples:** You need extra programmers on hand for the launch of your website or an employee is taking a temporary leave of absence.

**The workload fluctuates.** The flow of work is not consistent enough to warrant creating a permanent staff position.

**Examples:** You need an accountant who can put in 180 hours a month during tax season but only 50 hours in June, or you bring in a landscaper to plant every spring, but there's very little for her to do in fall and winter.

## Nitty Gritty

### The Cost of Misclassification

What will it cost you if you get caught misclassifying employees? According to the IRS, back taxes can add up to 41.5 percent of the contractor's payment:

- 15.3 percent Social Security tax (on the maximum amount of wages subject to Social Security tax)
- 20 percent federal income tax
- 6.2 percent unemployment insurance

Penalties and interest may also apply. The IRS has broad latitude to assess penalties depending on whether a business acted with reasonable care or purposeful disregard for tax requirements. In a worst-case scenario, penalties could cause you to lose your business.

step 2

## Learn the Legal Definitions of Contractor and Employee

**Goal: Know the law, so you don't end up breaking it.**

Let's say you've decided that hiring an IC is the way to go. Now you need to make sure the work arrangement won't raise any red flags with the IRS. Just labeling the person a contractor and signing an agreement, for example, isn't enough. According to the IRS, a manager hiring a contractor has the right to control or direct only the *result* of the work — not the method of

accomplishing it. That means the managerial relationship between you and your worker is the IRS's prime concern. Because work situations can vary so widely, the IRS does not publish specific guidelines, but here are the three factors the agency looks at:

### **Behavioral Control**

Who decides where and what time the person works, what tools or equipment they use, or which subcontractors to hire to assist with the work? Who is responsible for training?

**Examples:** An independent trucker **is a contractor** if you hire him to make deliveries using his own truck and he sets his own schedule and hires his own assistants. The driver **is not a contractor** if you give him a daily schedule, a driving partner, and the truck to make the deliveries.

### **Financial Control**

To what extent does the worker have unreimbursed expenses or make services available to the public? Can the worker make business decisions that would affect their profit or loss? Are they paid regardless of whether the work is completed?

**Examples:** A cabinet maker **is a contractor** if she contracts with your company to do a job for a fixed fee. She buys her own materials and tools, and makes a profit only if she has charged you more than her costs. The cabinet maker **is not a contractor** if you buy the materials, rent the tools, pay her regardless of whether the work was completed, or ask her to give up other work opportunities while working for you.

### **Type of Relationship**

What is the relationship between the parties? Are there written contracts describing the relationship? Is the worker provided with benefits or insurance? How permanent is the relationship? How integral are the services to the company's principal activity?

**Examples:** An accountant **is a contractor** if she has her own accounting firm and you and she both sign a contract stipulating that she will provide accounting services to your restaurant for a fixed monthly fee. The accountant **is not a contractor** if your company is an accounting firm and she is a retired employee who is still covered by your workers' comp and disability insurance.

## **Checklist**

### **Gathering Evidence**

To prove that a worker is in fact a separate business entity, many companies have a checklist of documents to require from a new IC. Here's a sample list:

- Signed contract
- Signed W-9 form
- Copy of fictitious or assumed business name statement or application
- Information on how business is structured (sole proprietorship, partnership, corporation, or LLC)

- Business address and phone number
- Unemployment insurance number and Employer Identification Number (if contractor has employees)
- Copies of professional or business licenses
- Contact information for other clients
- Samples of marketing materials (ads, Yellow Pages listing, etc. )
- Business card, professional stationery, invoice form, or website address
- Copies of insurance certificates

step 3

## Know the Risks of Misclassification

### **Goal: Avoid legal problems with the IRS — and your workers.**

By now you know what to expect from the IRS: If they conduct an audit and find you in violation of worker misclassification, you'll owe back taxes and penalty fines. But the danger in misclassification doesn't end there. Workers themselves may take issue with the classification if it denies them rights or benefits they feel they are entitled to.

When the IRS audited Microsoft in 1990, the company quickly agreed to settle and reclassified approximately 600 independent ICs as employees. Though the workers had signed agreements saying they were freelancers, many of them did the same work that was done by employees of the company. They were also supervised and in some cases worked exclusively for the company for as long as 10 years. Microsoft ended up paying millions in back taxes and fines, but that was just the beginning. The reclassified workers — forced to refile taxes, pay interest and penalties, and renege years of business expenses — sued Microsoft to recover benefits they had been denied while classified as ICs, including 401(k) pension benefits and the right to participate in the company's employee stock-purchase plan. The \$97 million settlement ended up costing the company more than the original audit.

Time Warner Inc. had similar problems in October 1998, when the Pension and Welfare Benefits Administration of the U.S. Department of Labor sued the company, charging worker misclassification of hundreds of employees as independent contractors or temporary workers. The misclassification had denied the workers benefits in violation of the Employee Retirement Income Security Act. In November 2000, the two parties announced a \$5.5 million settlement.

Today FedEx finds itself in a similar position. In addition to the \$319 million IRS audit, the company is also fighting more than 50 lawsuits brought by drivers in 36 states. Though hired as ICs, the drivers say that they are managed like employees — the company holds them to specific schedules and customer-interaction policies — and therefore should be entitled to benefits and reimbursement for expenses and lost wages.

## Big Idea

### New for 2007

An increase in the number of people filing as ICs has led the IRS to suspect that companies are misclassifying workers in greater numbers than ever. On November 6, the agency announced that it is upping its vigilance on worker misclassification for the 2007 tax year. Under the new Questionable Employment Tax Practice initiative, tax agencies in 29 states will share information with the IRS to help track down out-of-compliance companies.

Also starting this year, workers will be able to file **Form 8919**, which will allow those who have been misclassified by their employer to pay only their half of the self-employment tax. (ICs pay the whole tax themselves, whereas employees and employers split it.)

The changes are discussed in detail on TaxTalkToday.com's [webcast panel interview](#) with tax experts. Registration to view the archived webcast is free.

step 4

## Take Advantage of IRS Amnesty

**Goal: If you're out of compliance, find out whether you qualify for tax relief.**

One catch-22 with these rules is that when companies realize they've been breaking the rules, they're often reluctant to reverse course for fear of attracting attention. To ease the pain, the IRS has developed a few programs that can help relieve the tax burden for employers who have made classification errors.

**Total Relief:** If you qualify for Section 530 under the Revenue Act of 1978, you will not owe any past employment taxes and you can continue to treat workers as ICs. The three requirements are:

1. You have a reasonable basis for treating a contractor as an employee (i.e., you based your decision on a similar instance in a tax-court case or on what other companies in your industry do).
2. You have treated all similar workers as contractors.
3. You have filed all taxes consistently (i.e., you always filed a 1099 for the contractor).

**Partial Relief:** For companies that don't qualify for Section 530 relief, the IRS will conduct an examination under the 1996 Classification Settlement Program. If they determine that you're eligible, they'll offer you the chance to reach a settlement rather than go to tax court — as long as you agree to get in compliance. Offers include settling for a single year of taxes or 25 percent of one year of taxes, if certain requirements are met.

## **Other Resources**

### **More Help Online**

The IRS website has the following sections on correcting misclassification:

[Tips on How to Correct Reporting of Misclassification](#)

[Classification Settlement Program](#)

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