Overview Of Independent Contractors



WHAT IS AN INDEPENDENT CONTRACTOR?

Independent contractors, or ICs, are people who contract to perform services for others, but don't have the legal status of employees. Because many employment laws and tax rules that cover employees don't apply to ICs, businesses can save time, money and headaches by hiring ICs instead of employees. ICs may call themselves by a variety of names – freelancers, consultants, the self-employed, entrepreneurs or business owners.

WHAT ARE THE BENEFITS OF HIRING INDEPENDENT CONTRACTORS?

Businesses can usually save money by hiring ICs instead of employees. In addition to salaries or other compensation, employers generally have to pay additional expenses for employees, including:

- federal payroll taxes, including a 7.65% Social Security tax and a usually small (.08%) federal unemployment insurance tax
- state unemployment insurance premiums
- workers' compensation insurance premiums
- employee benefits, such as health insurance, paid vacations, sick leave, retirement benefits and life or disability insurance, and • office space and equipment.

These expenses add at least 20% to 30% (often more) to payroll costs. For example, if you pay an employee $10 per hour, you will probably pay another $2 to $3 per hour in employee expenses. You incur none of these expenses when you hire an IC. So even though ICs are often paid more per hour than employees doing the same work, they may still cost less.

In addition, when you hire ICs instead of employees, you have reduced exposure to some types of lawsuits, such as those alleging job discrimination or wrongful termination.

Finally, and most importantly for many firms, ICs provide a level of flexibility that can't be obtained with employees. You can pay an IC to accomplish only a specific task, allowing your business to get specialized expertise for a short period. You need not go through the trauma (not to mention potential severance costs and lawsuits) of laying off or firing – when the IC's job is finished, the relationship is over. Moreover, an experienced IC can be productive immediately,

eliminating the time and expense involved in training employees.

WHAT ARE THE RISKS OF HIRING INDEPENDENT CONTRACTORS?

Despite the advantages, many businesses are wary of using ICs because they have heard about or experienced the consequences of misclassifying as ICs workers who are, legally, employees. And it's true that the consequences can be economically devastating. A business must pay the IRS all back taxes owed, with interest, plus a penalty of 12% to 35% of the tax bill.

Audits by state agencies are even more common than IRS audits. State audits most frequently occur when workers classified as ICs apply for unemployment compensation after their services are terminated. An investigation by your state unemployment compensation agency will ensue, and you will be subject to fines and penalties if it determines that workers whom you classified as ICs should have been classified as employees for unemployment compensation purposes.

Another major disadvantage of hiring ICs is that they can sue you for negligence if they are injured on the job. This is something employees covered by workers' compensation normally cannot do.

WHEN DO WORKERS QUALIFY AS INDEPENDENT CONTRACTORS?

Most people who qualify as independent contractors follow their own trade, business or profession

– that is, they are in business for themselves. This is why they are called "independent" contractors. They earn their livelihoods from their own independent businesses instead of depending upon an employer.

Examples of ICs are professionals with their own practices, like doctors, lawyers and accountants. For example, dentists who have their own practices are independent businesspersons offering dental services to the public; although you pay your dentist for work, he or she is not your employee.

However, a worker doesn't have to be a professional to be an IC. A person you hire to paint your office or mow your lawn can be in business for him or herself and qualify as an IC.

HOW DO GOVERNMENT AGENCIES DETERMINE WHETHER WORKERS ARE ICS OR EMPLOYEES?

There is no single, clear-cut test for classification. Different legal tests for determining worker status are used by various government agencies, including:

- the Internal Revenue Service
- state unemployment compensation insurance agencies
- state workers' compensation insurance agencies
- state tax departments
- the United States Labor Department, and • the National Labor Relations Board.

Each of these agencies is concerned with worker classification for different reasons, and has different biases and practices. Each agency normally makes classification decisions on its own and need not consider what other agencies

have done, which means that one agency can find that a worker is an IC while another decides that he or she is an employee. It's also possible, though rare, for a worker to be deemed an IC in one state and an employee in another.

WHAT TEST DOES THE IRS USE TO DETERMINE WHETHER WORKERS ARE ICS OR EMPLOYEES?

Under the IRS test, workers are employees if the people they work for have the right to direct and control the way they work – including the details of when, where and how they do their jobs.

In contrast, the companies that hire them do not control ICs. The hiring company's control is limited to accepting or rejecting the final results an IC achieves.

The IRS looks at a number of factors when determining whether a worker is an employee or an independent contractor. The agency is more likely to classify as an independent contractor a worker who:

- can earn a profit or suffer a loss from the activity
- furnishes the tools and materials needed to do the job
- is paid by the job
- works for more than one client company at a time
- invests in equipment and facilities
- pays his or her own business and traveling expenses • hires and pays assistants, and
- sets his or her own working hours.

On the other hand, the IRS is more likely to classify as an employee a worker who:

- can be fired at any time by the hiring company
- is paid by the hour
- receives instructions from the hiring company
- receives training from the hiring company
- works full time for the hiring company
- receives employee benefits
- has the right to quit without incurring liability, and
- provides services that are an integral part of the hiring company's day-to-day operations.

WHAT TESTS DO AGENCIES BESIDES THE IRS USE TO DETERMINE WHETHER A WORKER IS AN EMPLOYEE OR AN INDEPENDENT CONTRACTOR?

State workers' compensation, unemployment compensation and tax agencies use various tests to determine worker status. Many use the same sort of test as the IRS (a "right of control" test), but emphasize different factors from the IRS's. Others use an "economic reality" test that focuses on whether a worker is economically dependent upon a hiring company– this means that those who work for more than one company at a time are more likely to be classified as Ics.

Many state unemployment compensation agencies use a special statutory test, also called the ABC test. This test focuses on just a few factors:

whether the hiring company controls the worker on the job

whether the worker is operating an independent business, and

where the work is performed – that is, whether the hiring company or the worker gets to decide where the work is done.

SHOULD COMPANIES HAVE FREELANCERS AND CONSULTANTS SIGN WRITTEN INDEPENDENT CONTRACTOR AGREEMENTS?

Absolutely. Using a written agreement avoids later disputes by providing a written description of the services the IC is to perform, when they are to be performed and how much the IC will be paid.

A written IC agreement can also help establish that a worker is an independent contractor. Although an agreement by itself is never enough to make a worker an IC, it will help show the IRS and other agencies that both you and the worker intended to create a hiring company-independent contractor relationship, not an employer-employee relationship. IRS training materials state that where all the other factors are evenly balanced, a written IC agreement may tip the scale to the IC side. But remember, an IC agreement is only useful if it's obeyed. It will be useless if you treat a worker like an employee.

WHAT ABOUT INTELLECTUAL PROPERTY OWNERSHIP?

When you hire an IC to create a work of authorship such as a computer program, written work, artwork, musical work, photographs or multimedia work, you need to be concerned with copyright ownership.

The copyright laws contain a major trap for unwary hiring companies. The hiring company will not own the copyright to the IC's work unless it obtains a written assignment of copyright ownership. An assignment is simply a transfer of copyright ownership. You should obtain an assignment before the IC starts work. This assignment should be included in the IC agreement.

There are exceptions to this rule. Certain specially commissioned works by ICs are considered to be works for hire to which the hiring company automatically owns all copyright rights. If the work an IC creates falls into one of nine special categories, the hiring company will own the work as long as there is an agreement to this effect. Both you and the IC must sign a written agreement stating that the work is made for hire. Again, this should be included in the IC agreement.

These nine work-for-hire categories include:

- a contribution to a collective work – for example, a work created by more than one author, such as a newspaper, magazine, anthology or encyclopedia
- a part of an audiovisual work – for example, a motion picture screenplay
- a translation
- supplementary works – for example, forewords, afterwords, supplemental pictorial illustrations, maps, charts, editorial notes, bibliographies, appendixes and indexes
- a compilation – for example, an electronic database
- an instructional text
- a test
- answer material for a test, and an atlas.

It should be noted that federal investigations of misclassification of independent contractors is on the rise and in addition several states have implemented laws that impose significant penalties for violations.