

TO EMPLOY, OR NOT TO EMPLOY? STRAIGHT TALK ABOUT INDEPENDENT CONTRACTORS





What's Going On With Independent Contractors?

In 2008, just before the recession, non-employee workers – independent contractors, temp workers, and contract workers – numbered 2.3 million. Since the recession, their numbers have grown. Independent contractors (ICs) can offer a smart way for companies to cut costs and gain competitive advantages. But what are the risks?

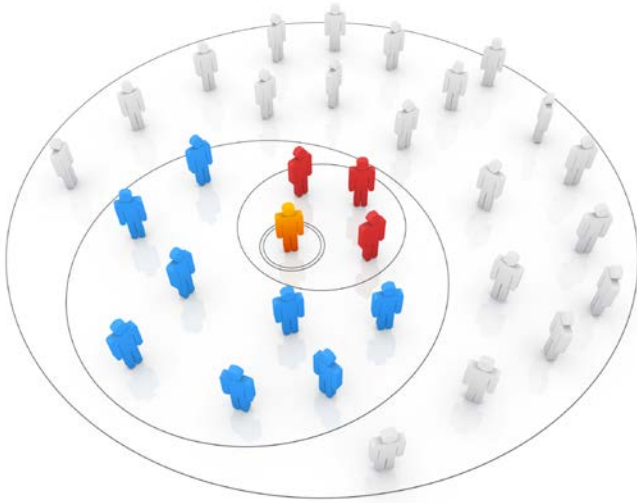


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When an employee is incorrectly classified as an independent contractor, the penalties for the company can be steep:



- Wrongly classified workers have filed and won court cases seeking retroactive employee benefits.
- States like Connecticut have increased fines for misclassifying workers as independent contractors.
- The Internal Revenue Service (IRS) is increasing workforce audits and penalizing misclassification more severely.
- The Patient Protection and Affordable Care Act (PPACA) exposes companies to additional penalties for failure to obtain healthcare coverage based on misclassification – even if workers are misclassified in good faith.
- The Occupational Safety and Health Administration (OSHA) protects whistleblowers who point out PPACA violations.



How can your company work with independent contractors within the bounds of the law?

To start, read through this guide. It will help you avoid misclassifying workers and reduce the risk of misclassification-related penalties. In it you will:

- Discover what independent contractors are and how they differ from employees.
- Learn how the IRS distinguishes independent contractors from employees, and find ways to apply these criteria to your own workers.
- Understand the penalties for worker misclassification and how you can avoid or mitigate them.
- Explore non-employee alternatives to independent contractors that can supply the talent you need in a cost-effective manner with less risk.





What is an Independent Contractor?

An independent contractor (IC) is a worker who is “independent” from your business. They’re not factored into company headcounts, bound by company policies or procedures, or traditionally entitled to benefits.

An IC may be any legal business type – a sole proprietor, a member of a partnership or LLC, or a C-corporation, just to name a few. ICs are typically self-employed or employed by their own business.

ICs are treated and paid like any other vendor or business entity. Your organization does not have to withhold taxes, unless the contractor has failed to provide a valid tax ID number; in these cases, it’s wise to perform what’s known as “backup withholding.” Instead, an IC’s pay is reported annually on Form 1099-MISC, with a copy sent to the IC. The IC files and pays his or her own taxes.

Independent contractors are not contract or temporary workers supplied by recruiting firms. In fact, working with a recruiting firm can help you avoid many of the problems posed by hiring ICs.



What Do Independent Contractors Do?



Independent contractors are hired to perform a specific service for a company. Usually, the service to be performed is explained in a written Statement of Work (SOW) or Independent Contractor Agreement (ICA). The SOW or ICA may also specify the worker's independent contractor status and cover issues like copyright or non-disclosure if they apply.

Unlike traditional employees, ICs require little paperwork to get started: often, a SOW or ICA, an IRS Form W-9 (for tax purposes) and a resume or CV are sufficient.



How does the IRS define Independent Contractors?

The IRS assumes that those who work for an organization are the organization's employees. Independent contractors are considered the exception, not the rule.

The IRS weighs three groups of factors in the independent contractor/employee decision:

1 Behavioral Control

- a. Who controls the worker's daily tasks?
- b. Who controls the time, place, and manner work is performed?
- c. Who trains the worker?
- d. How is the worker evaluated, and on what basis?

2 Financial Control

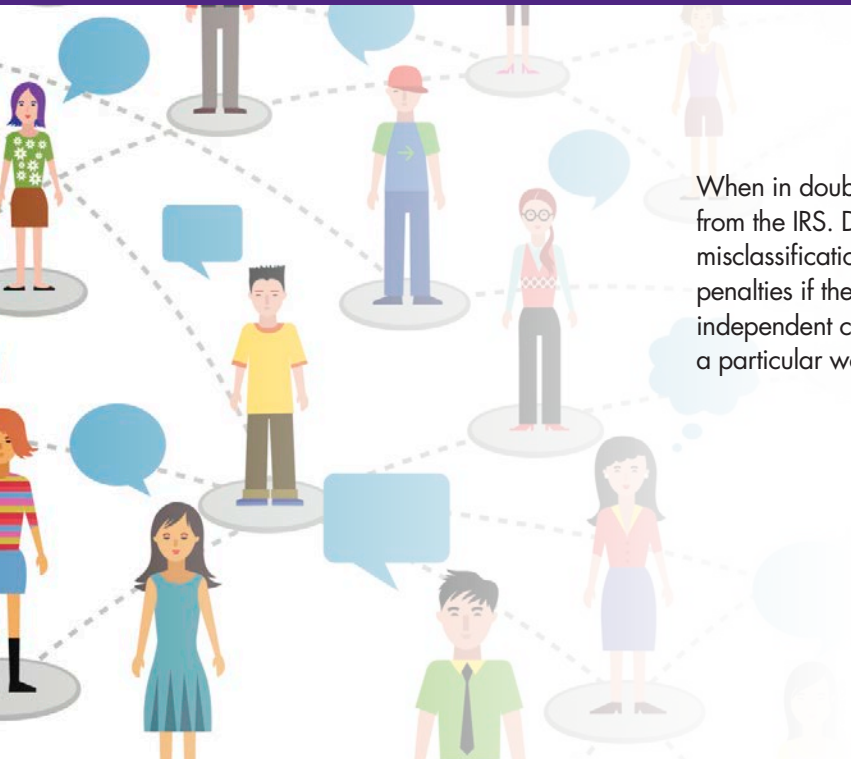
- a. Who controls how the worker is paid, apart from payment for deliverables?
- b. Who decides whether or what expenses are reimbursed?
- c. Who provides tools, supplies, and work space?

3 Type of Relationship

- a. Is there a written contract? What does it say?
- b. Does the worker receive benefits?
- c. Is the relationship specific and project-focused, or indefinite?
- d. Does the worker perform "key activities of the business?"



What if these factors aren't conclusive?



When in doubt, companies may request a determination letter from the IRS. Determination letters provide a “reasonable basis” for misclassification, which can protect your company from some fines and penalties if the IRS later determines you misclassified an employee as an independent contractor. Use Form SS-8 to request a determination about a particular worker.



Best Practices for IC Compliance

1. Be Specific
2. Evaluate Workers
3. Brief Managers
4. Separate Work
5. Communicate



Step 1: Be Specific

The agreement between your company and an independent contractor or should be specific. A vague, open-ended agreement may sound like it creates flexibility, but it also creates trouble: the IRS tends to see workers who are generally available to do daily tasks as employees, not contractors.

In the Statement of Work or Independent Contractor Agreement, specify:

- **The tasks to be performed and/or the deliverables to be provided**, such as “move business’s computing system to new mainframe” or “write whitepaper on our newest product.”
- **The objective performance measures that define “acceptable completion,”** such as “computing system will run smoothly on new mainframe by October 1, 2013” or “whitepaper will contain approximately 2,500 error-free words and be turned in by Tuesday, May 3.”
- **The conditions under which the work will be performed.** For independent contractors, the agreement should state that the IC is responsible for determining when, where, and how to perform tasks or create deliverables.



Step 2: Evaluate Workers

All workers should be evaluated as to their classification as an independent contractor or an employee, based on the three groups of factors used by the IRS. As a rule:

Independent contractors:

- direct their own on-the-job behavior,
- handle their own financial and tax arrangements,
- perform specific tasks for the company,
- are not required to work in any particular place or at any particular time, unless the work – not the business – requires it,
- are evaluated on the basis of their final product alone, not on their means of producing it, and
- are typically paid by the project.

Employees:

- rely on the business to direct their on-the-job behavior,
- rely on the business to handle financial and tax arrangements,
- perform any tasks for the company related to their job descriptions,
- are typically required to do their work at company-directed times and places,
- are evaluated both on the basis of their final products and on their means of producing it, and
- are typically paid by the hour or by salary.



Step 3: Brief Managers

Managers need to clearly understand the difference between the employees and the independent contractors on their teams. Managers who aren't clear on the difference may treat an IC like an employee, giving daily direction or shifting independent contractors to other projects.

The more an IC is *treated* like an employee – even inadvertently – the more likely it is the IRS will conclude that the IC is an employee. Keeping your managers in the loop is essential to not conflating the two types of workers.

1. Explain the difference. Managers need to understand that ICs are not employees. They are present to perform a specific service and are responsible for directing their own work toward that end. Managers may answer IC questions, but should not rely on them to do non-project-specific tasks or to work at specific days, times, or job sites.

2. Get the details. When a manager will work with an IC, have the manager detail the tasks or deliverables expected, where the IC will be used, how long the IC's services will be needed, and what skills the IC should have. Use these details as a guide to creating the IC's Statement of Work or Independent Contractor Agreement.

3. Choose the best worker for the project. Not all projects need ICs – and not all projects benefit from employee focus. Create criteria for deciding whether an IC or a temporary or contract worker is a better choice for each project. An experienced recruiter can help.



Step 4: Separate Work

Independent contractors' work and employees' work should be separated by:

- **Type:** Independent contractors focus on projects, rather than daily business tasks.
- **Tools:** Independent contractors typically use their own tools, unless the project requires the use of tools specific to the business.
- **Management:** Independent contractors are generally self-directed, rather than managed along with other employees.
- **Time:** Independent contractors' work schedules should be based on the demands of the project, not the business's work schedule.
- **Place:** When possible, ICs should be allowed or even encouraged to work away from the business site. When ICs must work alongside employees, separating work by using the other factors becomes even more important.



Step 5: Communicate

Communicating with the independent contractor is key to avoiding misunderstandings as to the nature of the work and the business relationship. ICs should be clear that they are working as ICs, not as employees, and should agree that the IC classification fits what they do.

Some questions to ask while communicating with ICs or potential ICs:

- Who will ensure the IC has the proper insurance coverage, tax filings, and other paperwork completed and filed?
- Who at the business will set up the work relationship with the IC? Who will be responsible for altering this relationship if necessary?
- Does the IC understand that he or she must represent his or her services and deliverables honestly and must perform within the guidelines of the contract?



Penalties for Misclassification



Penalties for misclassifying workers as ICs are steep and getting steeper. States like Connecticut are increasing fines for misclassification, and enforcement at the federal level is increasing.

Tax penalties for misclassification are governed by IRC Section 3509. They include requirements to pay back withholding taxes at increased rates, with double penalties for failures to meet employee reporting requirements that aren't made with "reasonable cause."



What if we made a good-faith mistake?



The IRS offers some relief from penalties if a worker was misclassified in good faith. To qualify, a business must meet three criteria:

- **A “reasonable basis” for treating a worker as an IC.** A “reasonable basis” may be proven through several means, including:
 - Reliance on a court ruling or IRS determination letter that applies to your business,
 - A previous IRS employment tax audit that did not reclassify similar ICs,
 - Evidence that a significant segment of your industry treats similar workers as ICs, or
 - Another reasonable basis, like lawyer or accountant advice.
- **All federal filings treat the worker as an IC, and**
- **The business does not treat similarly situated workers as employees.**

The business may also choose to resolve a misclassification error through the IRS’s Voluntary Classification Settlement Program (VCSP). This program allows businesses to receive partial relief from employment taxes for past years if they voluntarily reclassify ICs as employees for future years.



Healthcare Penalties: Independent Contractors and the PPACA

The Patient Protection and Affordable Care Act (PPACA) adds penalties when the misclassification of workers results in a business failing to offer legally mandated healthcare coverage to its employees – even when that mistake is also made in good faith.

Under the PPACA, any employer with 50 or more full-time or equivalent employees must provide coverage to at least 95 percent of these employees. For businesses that fail to provide this coverage, the penalty under IRC Sec. 4980H(a) for failing to provide coverage kicks in if:

- The employer doesn't cover at least 95 percent of its employees,
- Any full-time employee buys health insurance from a private exchange and receives premium assistance to do so. (Premium assistance is available for households with an income between 100 and 400 percent of the federal poverty level. For 2013 in the contiguous U.S. states, this segment included households making \$23,550 to \$94,200 for a family of four.)

The penalties are steep. The IRS may charge a non-compliant business up to \$2,000 per full-time employee, minus the first 30 employees but including any full-time employees who do have employer-provided coverage. The PPACA defines a "full-time employee" as one who works an average of 30 hours per week – not 40.



Do the PPACA insurance requirements cover independent contractors?



Businesses are not required to provide health insurance coverage to independent contractors. However, because misclassified ICs are added to the overall employee count, misclassification can result in a penalty.

Since the late 1990s, employers have used the “Microsoft fix,” named after *Vizcaino v. Microsoft Corp.*, to avoid paying benefits to ICs by stating that even if they are misclassified they are not entitled to benefits. But this “fix” doesn’t work under the PPACA! If the IRS determines that an independent contractor should be reclassified as a full-time employee, the penalties still apply.

Federal agencies are taking PPACA whistleblowing and enforcement seriously. In early 2013, the Occupational Safety and Health Administration (OSHA) released a 53-page brief detailing how PPACA whistleblowers are protected by OSHA regulations. They cannot be fired for bringing PPACA violations to the attention of regulators.



Wrap-Up: What Should Your Business Do?



Independent contractors are hired to perform a specific service for a company. Usually, the service to be performed is explained in a written Statement of Work (SOW) or Independent Contractor Agreement (ICA). The SOW or ICA may also specify the worker's independent contractor status and cover issues like copyright or non-disclosure if they apply.

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