

Hiring Employees vs. Independent Contractors

Businesses risk running afoul of labor and tax laws for characterizing workers as independent contractors when, under Internal Revenue Service and other tests, they are actually employees.

There are obvious financial advantages to hiring independent contractors rather than full-time employees. For instance, costs of providing health and retirement benefits are saved by hiring independent contractors. There is no employer-paid portion of FICA taxes (i.e., Social Security and Medicare) for independent contractors; and the employer is not responsible for withholding taxes from their wages. Federal and some state employment discrimination statutes do not cover independent contractors. An employer is generally not responsible for providing workers' compensation and unemployment insurance for independent contractors.

However, the penalties for misclassification are severe. A business found to have misclassified an employee as an independent contractor will be required to pay back taxes and penalties. To make matters worse, it may also face a lawsuit from the misclassified worker seeking compensation for being excluded from the provider's employee benefit plans. These costs may more than cancel out any savings that the business previously enjoyed.

Businesses should have a basic understanding of the factors that the Internal Revenue Service (IRS) and courts consider when deciding whether a worker should be classified as an independent contractor or an employee. Although the courts and the IRS have used several different tests to make this determination, they generally give significant weight to whether the hiring party has the right to control the manner and means by which the worker accomplishes his or her tasks. The more control that the hiring party has the right to exercise, the more likely it is that the worker will be deemed to be an employee and not an independent contractor.

If an employer answers "yes" to all or most the following questions about its relationship with a worker, it is likely that the worker should be classified as an employee.

1. Is the worker required to comply with the employers' instructions about when, where, and how he or she is to work?
2. Is the worker required to undergo training or attend meetings?
3. Are the worker's services integrated into the employer's business operations?
4. Must the worker render the services personally?
5. Is there a continuing relationship between the worker and the employer?
6. Does the employer establish set hours for the work?
7. Must the worker devote substantially full time to the employer's business?
8. Is the work performed on the employer's premises?
9. Must the worker perform services in the order or sequence set by the employer?
10. Must the worker make regular oral or written reports to the employer?
11. Is the worker paid by the hour, week or month? An exception would be if this method of payment is a convenient way of paying a lump sum agreed upon as the cost of a job.

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12. Does the employer pay the worker's business and traveling expenses?
13. Does the employer furnish tools or other equipment?
14. Does the employer have the right to discharge the worker?
15. Does the worker have the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability?

If the answers to most of the questions above is "no" and the answer to all or most of the following questions is "yes," it is likely that the worker should be classified as an independent contractor.

1. Does the worker invest in facilities that he or she uses and that are not typically maintained by employees?
2. Can the worker realize a profit or suffer a loss as a result of his or her services in addition to profit or loss ordinarily realized by employees?
3. Can the worker perform more than minimal services for multiple employers at the same time?
4. Can the worker make his or her services available to the general public?
5. Does the worker have the right to hire assistants?

If a business uses an independent contractor, the relationship should be clearly defined in an agreement; and the agreement should reflect the actual relationship between the parties. The business should carefully monitor its relationships with independent contractors to ensure that it does not treat them as employees. In dealing with independent contractors, it is often advisable to consult with an employment law attorney to draft an appropriate agreement and to seek advice on how to avoid liability for misclassifying workers as independent contractors.