

Misclassifying Independent Employees as Independent Employees ...

One of the Most Expensive Mistakes

By Elena Fawkner

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Misclassifying Employees as Independent Contractors ... One of the Most Expensive Mistakes of Them All

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The time comes for every successful home-based business owner when one person can no longer do it all. In the early days of your fledgling business you accepted that not only were you CEO, CFO, COO, secretary, treasurer and marketing director, you also had to be laborer, receptionist, janitor, chief cook and bottlewasher. That is simply what you have to do when starting out. In fact, I'll bet you worked harder in your "little home business" than you ever did in your former life as corporate whatever, right? But now the time has come. You have successfully taken your business past the initial, maddeningly slow, frustrating start-up phase to the point where you're seeing some growth ... so much growth in fact that you're finding it near impossible to keep all the balls in the air.

The time has come to hire some help. OK, but what kind of help do you need? If it's a secretary/receptionist, that's easy. You go out and hire yourself a competent employee. But what if it's someone to carry out specific projects such as designing a website for a good customer you just can't service within the timeframe the customer needs? What if it's someone to create a marketing program to launch your business to the masses? What if it's a bookkeeper to handle your accounts payable, receivable and everything else in between? The difference between these types of activities and our secretary/receptionist example is that the former are all specific projects whereas the latter is not.

When considering whom to hire for your project work, you have a choice ... hire a full-time or part-time employee or hire an

independent contractor. By the time you include all the add-on costs of hiring an employee (in addition to wages or salary you need to add on federal and state payroll taxes, social security tax, federal unemployment insurance tax, state unemployment insurance, workers' comp premiums and employee benefits, not to mention shelling out for office space and equipment), hiring an employee becomes a relatively expensive option compared to hiring an independent contractor to do the same work. The add-on costs of hiring an employee usually add about 30-40% to the bill. In other words, if you pay your employee \$10 an hour, you'll really be paying \$13 - \$14 an hour once you include all the add-on expenses.

In contrast, although you usually pay an independent contractor more than an employee, that cost will still be less than an employee with the add-on expenses. You may pay an independent contractor \$12 an hour without any additional charges. Sound good? Well, read on. It's not as easy as it looks.

WHAT IS AN INDEPENDENT CONTRACTOR?

So, what is the difference between an employee and an independent contractor anyway? Quite simply, an independent contractor is someone who contracts with someone else to provide specified services for a set price on terms and conditions outlined in the contract.

For example, let's say you hire a gardener to mow your lawn and get rid of weeds once a week. Your contract (whether written or not) is that Joe Gardener will arrive at your house on Friday morning, mow your lawn, get rid of weeds and generally tend to your garden. In exchange, you agree to pay Joe \$40 for this service each week. Joe supplies his own lawnmower, hedge clippers and weeding tools. Joe decides what time he arrives and how long the job takes (within reasonable parameters). You do not supervise Joe in his tasks or dictate to him how they are to be done. Joe is an independent businessperson and you treat him accordingly. The final product is either to your satisfaction or it isn't. When he's finished, you pay him if you're satisfied with the end result and you don't pay him if you're not.

Contrast this with an employer/employee situation. Let's say you own the business Joe's Gardening Service. You employ three employee gardeners to perform services for your business. As the gardeners' employer, you pay them a fixed wage and you withhold taxes, unemployment insurance and various other benefits from their wages to remit to the appropriate government agencies. In addition, you provide your employees with the tools and equipment they need to perform their work. You tell them what to do and supervise them while they're doing it. At the end of the job they get paid by you whether your customer is satisfied with the job or not. In other words, although your customer may not pay you (the independent contractor) because she is dissatisfied

with the work performed by your employees, you must still pay your employees because they are not independent contractors - they are your employees and are entitled to be paid a fixed wage. If you are dissatisfied with their work, you can fire them but you can't decide whether to pay or withhold their wages based on the end result of the particular project.

ADVANTAGES OF INDEPENDENT CONTRACTORS

= Cost

As mentioned above, the main advantage of independent contractors versus employees is cost. You can get the same or better service from independent contractors for a lower hourly rate than you can from employees because you don't have to incur all the add-on expenses that go along with hiring employees.

= Equipment and Materials

In addition, you don't have to provide office space or materials and equipment to independent contractors. As independent contractors (who may also go by the terms "freelancers", "consultants", "self-employed", "business owners" etc.) are self-employed business people, they have their own "tools of the trade". If they're website designers, they have their own office space, computer and printing equipment. If they're gardeners, they have their own lawn mower, whipper-snipper, wheelbarrow and pruning shears.

= Legal Liability

At law, an employer is vicariously liable for the torts of his or her employees. This means that if you hire an employee gardener who accidentally runs over your customer's pet cat in the driveway of her home when the customer had made it clear that your employees are always to park in the street, in addition to suing your employee for negligence, she can also sue you, the employer, as you are vicariously responsible for the acts of your employees. (And, by the way, this applies whenever your employee is acting within the scope of employment, whether under your express instruction or not. If your employee has a car accident when traveling between jobs and his negligence at least partially caused the accident, you're responsible to the same extent as the employee.)

This is generally not the case with an independent contractor unless the independent contractor has been engaged to perform an inherently dangerous activity (such as blasting) or you have attempted to delegate to your independent contractor a non-delegable duty (such as keeping a rental property you own in good repair for the benefit of the tenant).

In addition to minimizing legal liability for torts, hiring independent

contractors also minimizes your liability for other types of lawsuits such as wrongful termination or job discrimination.

DISADVANTAGES OF INDEPENDENT CONTRACTORS

There are two main disadvantages to hiring independent contractors versus employees.

= Misclassification

Far and away the most serious disadvantage is if you misclassify employees as independent contractors. Merely labeling a worker as an independent contractor is not enough. They must actually be an independent contractor.

If you do misclassify an employee as an independent contractor, you must pay the IRS all back-taxes owed, plus interest, plus penalty (12% - 35% of the total tax bill).

Also, you expose yourself to an increased risk of state audits when your terminated independent contractor files for unemployment benefits. Never mind that you and your independent contractor intended that there be no employer/employee relationship, many's the disgruntled independent contractor who unilaterally decides to recategorize the relationship as one of employer/employee when the spectre of unemployment benefits raises its pretty head. In such situations, you'd better be able to protect yourself by proving that the arrangement was for an independent contractor and not an employee.

= Legal Liability

Unlike an employee who is limited to workers' compensation benefits, an independent contractor can sue you for negligence if they're injured on the job. That's what liability insurance is for though.

DETERMINING WHETHER JOE IS EMPLOYEE OR INDEPENDENT CONTRACTOR

Unfortunately, as far as the various government agencies are concerned, there is not one single test that determines whether Joe is your employee or an independent contractor. Even more difficult, it is quite possible that for the purposes of one government agency Joe is considered to be an independent contractor while for another he is treated as an employee.

= The IRS/Common Law "Control" Test

The IRS follows the common law "control" test for determining whether someone is an employee or independent contractor. This test looks

at 20 factors as being indicative (and only indicative) of whether the person is an employee or independent contractor. The test basically involves a balancing of these factors -- which way does the scale tip?

Here are the IRS factors:

1. Whether the worker can earn a profit or suffer a loss from the activity (if so, the more likely it is that the worker is an independent contractor).
2. Whether the worker is told where to work (indicative of employee status).
3. Whether the worker offers his or her services to the general public (indicative of independent contractor status).
4. Whether the worker can be fired by the hiring firm.
5. Whether the worker furnishes the tools and materials needed to do the work (indicative of independent contractor status).
6. Whether the worker is paid by the job or by the hour (independent contractors are more likely to be paid by the job; employees by the hour).
7. Whether the worker works for more than one firm at a time (indicative of independent contractor status).
8. Whether the worker has a continuing relationship with the hiring firm (indicative of employee status).
9. Whether the worker invests in equipment and facilities (indicative of independent contractor status).
10. Whether the worker pays his or her own business and traveling expenses (indicative of independent contractor status).
11. Whether the worker has the right to quit without incurring liability (indicative of employee status).
12. Whether the worker receives instructions from the hiring firm (indicative of employee status).
13. Whether the worker is told how to perform the work (indicative of employee status).
14. Whether the worker receives training from the hiring firm (indicative of employee status).
15. Whether the worker performs the services personally.
16. Whether the worker hires and pays assistants (indicative of independent contractor status).
17. Whether the worker sets his or her own working hours (indicative of independent contractor status).
18. Whether the worker provides regular progress reports to the hiring firm.
19. Whether the worker works full-time for the hiring firm (indicative of employee status).
20. Whether the worker provides services that are an integral part of the hiring firm's day-to-day operations (indicative of employee status).

It is important to note that none of the above factors are, of themselves, determinative. The IRS will balance all of the factors to determine which side of the equation is favored.

= Other Agencies

The other government agencies with which you need to be concerned are:

1. Your state Unemployment Compensation Board.
2. Your state Workers' Compensation Insurance Agency.
3. Your state Tax Department.
4. Your state/federal Department of Labor.

Unfortunately each state agency varies in its approach to determining whether a worker is an employee or independent contractor. Many states' agencies use a statutory test focusing on just a few of the "control" test factors. You should therefore find out the factors that your state's agencies take into account before hiring any independent contractors. Most of this information will be available on the agency's website. If not, call them and get them to send you information about their policies.

PROTECTING YOURSELF

OK, so you know the difference between an independent contractor and an employee, you know the advantages and disadvantages of hiring independent contractors and you know the dangers of misclassification. How do you protect yourself?

= Independent Contractor Agreement

First and foremost, arm yourself with the IRS' control test factors and the tests used by the various government agencies in your state. Once you have that information, you can structure your arrangements with your independent contractors accordingly. These arrangements should be reduced to writing, in the form of an independent contractor agreement.

An independent contractor agreement should contain a description of the services the independent contractor is to perform, by when they are to be performed and the amount the independent contractor is to receive in return for satisfactory service.

This agreement can be very helpful evidence in proving that the worker's status was independent contractor rather than employee. Although such an agreement is insufficient by itself (if you nonetheless treat the independent contractor as an employee the agreement will be worthless for this purpose), if the factors weighed by the IRS under the control test are evenly balanced, an independent contractor agreement may well tip the scales in your favor.

= Screening

Before hiring an independent contractor, put him or her through a few hoops first. It's a good idea to prepare some form of questionnaire to extract the sort of information you would need to be able to prove in support of your argument that the worker is, in fact, an independent

contractor and not an employee. Examples of such information (courtesy of the NOLO website - <http://www.nolo.com>) include:

1. Whether the worker has formed a legal entity for his or her business.
2. Whether the worker has filed a fictitious business name (also known as a "DBA" or "doing business as").
3. The worker's business address and telephone numbers.
4. The number of employees employed by the business.
5. Whether the worker has any professional or business licenses.
6. References from other business for whom the worker has performed services as an independent contractor.
7. How the worker markets his or her business.
8. Whether the worker maintains an office separate from his or her home.
9. A description of the equipment and facilities the worker owns and will use in the project.
10. Whether the worker has business cards and stationery etc..
11. A listing of the types of insurance coverage the worker has for his or her business.

Request documents that evidence the responses to the above questions. For example, get copies of fictitious business name statements, professional and business licenses; references; business cards and stationery and insurance policies.

At the end of the day, whether you hire an employee or an independent contractor is a decision for you and your business. If you feel you can adequately protect yourself against an allegation of misclassification then, by all means, follow the independent contractor route if that makes most sense to you. But if you don't feel confident in managing the relationship to protect yourself from such a charge, for your own peace of mind, you may be well advised to hire an employee even if that is more expensive up-front. After all, if you get it wrong, you'll be paying those additional costs anyway in the form of back-taxes (and interest and penalties to boot).

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