

Employee vs. Contracted Labor

Contract Labor is a very tempting – and very dangerous – area for small businesses. The payroll tax payments can quickly get a business into serious trouble with the IRS, so most small businesses hope to cut their tax burdens by trying to make almost everyone a contractor. Unfortunately, the IRS has a very difficult list of 20 points which they use to determine whether or not it should reclassify contractors as employees and hit you for the back taxes (plus heavy penalties and interest, compounded daily). Depending on the auditor, you only have to meet a few of the requirements (not all 20) to be in trouble. The 20 factors are:

Instructions: If you tell a worker when, where and how to perform the work, the worker is probably an employee.

Training: If you exercise control over the means by which the result is accomplished (i.e. teaching the worker to do it your way), then the worker is probably an employee.

Integration: When the success or continuation of a business depends on the performance of certain services, the worker performing those services is subject to a certain amount of control by the owner, and therefore assumed not to be independent.

Services rendered personally: If the services must be rendered personally, the employer controls both the means and the results of the work (as opposed to you subcontractor sending any of his or her employees).

Hiring, supervising and paying assistants: Control is exercised if the employer hires, supervises and pays assistants. In other words, you cannot contract for management.

Continuing relationship: An ongoing relationship between the worker and the employer indicates that an employer-employee relationship probably exists, as opposed to an occasional transaction between the parties.

Set hours of work: The employees work the times an employer dictates, true contract laborers come and go as they wish.

Full time required: If the worker devotes full time to your business, you control the worker's time, and thus he or she is probably an employee. An independent contractor is free to work for others (including competitors).

Doing work on the employer's premises: Control is indicated if workers do their thing at your location.

Order or sequence set: Control is indicated if a worker must perform services in the sequence set by the employer, rather than in any order the worker chooses.

Oral or written reports: If you require regular reporting to you on the progress of the work or job, then that worker is probably an employee.

Payment by the hour, week or month: A time-based calculation of pay points towards an employee relationship, provided this method is not simply a convenient method of making installment payments towards a lump sum agreed in advance for the job. Independent contractors usually get paid by commission or piece rate.

Payment of business and/or traveling expenses: Employees are reimbursed for their out-of-pocket expenses, Independent contractors set their prices to reflect that this is simply an expense to them (a cost of doing business, like rent or phone).

Furnishing tools and materials: If you supply significant tools, materials for the job and/or other equipment, an employee-employer relationship probably exists.

Significant investment: To be independent, a worker should invest in his or her own facilities and equipment. Employees rarely have a significant amount of money tied up in items needed to earn money (such as rent, tools, etc).

Realization of profit or loss: If the worst your worker can do by not showing up for work is to earn zero, then there is a high probability that the worker is an employee. You as a business owner can earn quite a bit less than zero due to continuing expenses, whether or not you collect for your efforts. If your worker does not have the same situation, the worker is not independent.

Working for more than one firm at a time: If the worker obtains revenue from a variety of people throughout the year rather than relying almost exclusively on you, then the worker can be classified as an independent contractor. Billing to you (and others) and a local occupational license (if required in your area) help support this position.

Making services available to the general public: The worker can usually be considered independent of your business if he or she makes services available to the general public (including some of your competitors) on a regular and consistent basis.

Right to discharge: If you can fire the worker, that worker is probably an employee. If you must resolve a contract dispute, and the worker has the right to insist on someone you don't like doing the work anyway, then the worker is probably an independent contractor.

Right to terminate: If there is no contractual penalty for failure to complete a task, then the worker may be an independent contractor.

If you still truly believe you have contractors who are not employees, you should document the relationship as best you can. You may also want to consider applying to the IRS for a private letter ruling that might "bless" their contractor status.