



Tread Carefully With Contract Workers

Trying to dodge payroll taxes, insurance, and other outlays by classifying workers as independent contractors can get you into hot water

By Lucy Sutherland | July 28, 2006

Skyrocketing labor costs are prompting more businesses to hire independent contractors, and it's no surprise: ICs – who alleviate the need for payroll taxes, insurance, and other outlays mandated for employees – can save businesses up to 30 percent per worker, according to the U.S. Department of Labor.

But before you hire an IC, it's important to know the legal and financial risks. Being aware of how much control you have over your workers will help you to properly classify them as either ICs or employees on your tax returns.

If you misclassify an employee, you may face steep penalties and back taxes, most likely from the IRS or your state unemployment agency, according to Los Angeles tax consultant Eva Rosenberg. "The penalties may cause you enough heartache to shut down your business," Rosenberg says.

To make matters worse, no less than 20 state and federal laws hold businesses in the crosshairs for misclassification, including laws for taxes, unemployment compensation, workers compensation, and health benefits, according to an analysis by Columbus, Ohio labor lawyer D. Lewis Clark.

Clark says it's not surprising that many business owners throw up their hands, indulge in wishful thinking, and hire an IC without making sure they're protected. "You can get bogged down by all the (legal) tests," he says.

But the good news, say Clark and Rosenberg, is that classifying a worker correctly isn't a thorny process for most businesses. A good first step is to look at the IRS "Common-Law" test, which lists 20 factors many government agencies use to determine if a worker has enough independence to be considered an IC. Publications 1779 and 15-A, available on www.irs.gov, are user-friendly overviews of these factors.

Classification can seem onerous, says tax professor Joseph Newpol of Bentley College in Massachusetts, because most working relationships have elements of both independence and control. But the more

control you have over a worker, Newport says, the more likely you'll be treated as an employer – rather than a client – by the IRS and other government agencies.

If a contractor is heavily monitored, doesn't have other clients, is using your equipment or performing core operations similar to those of your employees, you as a business owner are at risk, says Waltham, Mass. employment lawyer Mark Burak.

Paying ICs by the project, as well as keeping licenses, business cards, proposals, and contracts supporting a worker's independent status will work in your favor if the IRS decides to investigate you, Rosenberg says.

Keith Hall, a tax expert for the National Association for the Self-Employed, says most audits stem from complaints filed by ICs who are confused about their status. Once they realize they are ineligible for benefits at a state unemployment office, or receive a tax bill from the IRS that they didn't anticipate, an IC can file a complaint stating they were unfairly treated. One complaint against you, Hall cautions, can spur an investigation.

Hall says that aside from understanding how much control you have over an IC, communicating with ICs to make sure they understand their status can help to insulate you from tax and other legal liabilities.

"If you can have good communication with the worker, then most of the issues will resolve themselves," Hall says.

KEY POINTS

- ▶ Follow these steps to protect yourself from a government audit:
- ▶ Instruct an IC to fill out a W-9 form. Then file the form with IRS to request a tax identification number for the IC.
- ▶ File a 1099-MISC form with the IRS to document your use of an IC.
- ▶ Understand employment laws governing use of ICs in your state, which can be stricter than federal laws.
- ▶ Draw up a contract prepared by a lawyer and signed by you and the IC, which spells out the client/vendor relationship.
- ▶ If the work of an IC is too similar to what your employees are doing, consider hiring a contractor through a reputable temp agency, which protects you from tax and other liabilities.
- ▶ Organize and streamline payroll activities with a low-priced, small-business-friendly payroll service such as Paychex or PayCycle.