

Independent Contractors: Frequently Asked Questions

The distinction between an employee and independent contractor is an important one, especially because working with an independent contractor generally relieves employers of certain obligations, such as requirements relating to employment taxes, minimum wage, overtime, benefits, and workers' compensation insurance. Determining whether a worker is an employee or independent contractor is a common point of confusion among employers. In this Tip, you will read answers to some of the most frequently asked independent contractor questions.

INDEPENDENT CONTRACTORS: FREQUENTLY ASKED QUESTIONS

Working with an independent contractor generally relieves employers of certain obligations, such as requirements relating to employment taxes, minimum wage, overtime, benefits, and workers' compensation insurance. As such, some employers may improperly use the classification to avoid expenses that result from hiring regular employees. In recent years, federal government enforcement agencies have been focused on recouping those dollars.

Given heightened enforcement, employers need to be acutely aware of the narrowly defined criteria for independent contractor status. However, determining whether a worker is an employee or independent contractor can be complex and is a common point of confusion among employers. The following are some of the most frequently asked questions related to independent contractor classifications:

Q: WHAT ARE INDEPENDENT CONTRACTORS?

A: In general, independent contractors are self-employed individuals in an independent trade, business, or profession who offer their services to the general public under a contract or agreement. However, whether workers are independent contractors or employees under federal or state law depends on the facts in each case. In general, the determination is based on the degree of control the business has over a worker. The more control the business has over the individual, the more likely that individual will be perceived as an employee and not an independent contractor.

Q: WHAT ARE THE PENALTIES FOR MISCLASSIFYING EMPLOYEES AS INDEPENDENT CONTRACTORS?

A: Federal and state enforcement agencies have made worker misclassification a top priority, and the consequences for misclassification can be significant. In addition to owing back pay, overtime, and benefits to a misclassified worker, the employer may be ordered to pay back taxes, interest, and fines. In some states, employers that intentionally misclassify a worker may also face criminal charges or stop-work orders.

Q: HOW DO I DETERMINE IF A WORKER IS AN EMPLOYEE OR AN INDEPENDENT CONTRACTOR?

A: A worker is presumed to be an employee unless he or she meets specific criteria; the specific test used depends on the purpose. For example, the Internal Revenue Service (IRS) uses a Common Law Test to determine whether a worker is an employee for federal tax purposes. There are also other tests, including those used by the Department of Labor, the Equal Employment Opportunity Commission, and several states. While each test is slightly different, there are some common elements. Each looks at: (1) whether or not the business has the right to control the worker; (2) whether the worker's services are an integral part of the business; (3) the permanency of the relationship; and (4) the worker's investment in facilities, equipment, and tools. You should carefully review each test and consult legal counsel before classifying any individual as an independent contractor.

Q: WHAT IS THE IRS COMMON LAW TEST?

A: The IRS Common Law Test is the most commonly used test for determining independent contractor status. It has three parts that examine factors related to behavioral control, financial control, and the type of relationship between the business and the worker (covered below).

Q: WHAT FACTORS ARE CONSIDERED WHEN LOOKING AT BEHAVIORAL CONTROL?

A: The first part of the IRS test examines whether there is a right to direct or control how the worker does the work, including the type of instruction given (e.g., when and where to do the work, what equipment to use, what order or sequence to follow, etc.); the degree of instruction (detailed instructions indicate the worker is an employee); evaluation systems (measuring how the work is performed rather than the end result is an indication of a employee/employer relationship); and training (which indicates the employer wants the job done in a particular way and is strong evidence of an employer/employee relationship).

Q: WHAT FACTORS ARE CONSIDERED WHEN LOOKING AT FINANCIAL CONTROL?

A: The second part of the IRS test looks at factors that show whether the company has a right to direct or control the financial and business aspects of the worker's job, such as how the business pays the worker and the extent to which the worker has unreimbursed business expenses. When compared with employees, independent contractors are: more likely to have unreimbursed business expenses; make significant investments in tools and facilities; make their services available to other businesses; realize a profit or loss; and are more likely to be paid a flat fee or on a "time and materials" basis.

Q: WHAT FACTORS ARE CONSIDERED WHEN LOOKING AT THE NATURE OF THE RELATIONSHIP BETWEEN WORKER AND EMPLOYER?

A: The third part of the IRS test looks at facts that show how the worker and business perceive their relationship, such as whether there is a written contract describing the relationship, the extent to which the worker is available to perform services for other businesses, the permanency of the relationship, the extent to which services performed by the worker are a key aspect of the business, and whether or not the worker is entitled to employee-type benefits.

Q: IS THERE A SET NUMBER OF IRS FACTORS THAT MUST BE MET TO CLASSIFY A WORKER AS AN INDEPENDENT CONTRACTOR?

A: No. Under the IRS test, there is no set number of factors that must be met, and no one factor stands alone in making the determination. An employer must weigh all factors and take into account other applicable tests when determining whether an individual is an employee or an independent contractor.

Q: I GAVE WORKERS A 1099. DOES IT MEAN THEY ARE AUTOMATICALLY INDEPENDENT CONTRACTORS?

A: No. A common misconception is that a worker's classification is determined by whether a Form 1099 or Form W-2 is provided to them at the end of the year. The reality is the classification determination must always be made on the basis of whether the worker meets the specific criteria for an independent contractor established by the applicable federal or state law.

Q: CAN I LAY OFF EMPLOYEES AND BRING THEM BACK AS INDEPENDENT CONTRACTORS?

A: As mentioned above, if the requirements of federal and state tests for independent contractors are not met, the worker is an employee, regardless of how you characterize the relationship. Simply reinstating an employee and calling him or her an independent contractor is not going to change his or her status as an employee. Unless the nature of the relationship changes so that it satisfies the tests, the worker would still be your employee.

Q: CAN A WORKER WAIVE HIS OR HER RIGHT TO BE CONSIDERED AN EMPLOYEE AND OPT TO BE A CONTRACTOR?

A: No, a worker cannot waive his or her employee status through a contract or otherwise. Again, the specific criteria of the independent contractor tests must be satisfied to classify a worker as an independent contractor. Otherwise, the worker is an employee, no matter what a contract or waivers says.

Q: HOW LONG CAN AN INDEPENDENT CONTRACTOR WORK FOR ME?

A: While there is no specific limit, a continuing relationship between the business and worker is considered an indication of an employer/employee relationship. Since the relationship can change over time, if and when contracts are renewed or extended, review whether the worker still qualifies as an independent contractor.

Q: WHAT ARE MY OPTIONS IF I HAVE APPLIED THE TESTS AND I AM STILL UNSURE WHETHER A WORKER IS AN EMPLOYEE OR INDEPENDENT CONTRACTOR?

A: When in doubt, seek legal counsel or err on the side of caution and classify the worker as an employee. You may also request an official determination from the IRS using Form SS-8. Keep in mind, however, that it ordinarily takes at least six months to get an IRS determination.

Q: WHAT ARE THE PAPERWORK REQUIREMENTS FOR INDEPENDENT CONTRACTORS?

A: If you've made the determination that the person you're paying is a bona fide independent contractor, you should have the contractor complete IRS Form W-9. This form can be used to request the correct name and Taxpayer Identification Number of the worker. The Form W-9 should be kept in your files for four years for future reference in case of any questions from the worker or the IRS. Additionally if you paid a bona fide independent contractor \$600 or more for services provided during the year, you need to complete IRS Form 1099. A copy of the Form 1099 must be provided to the independent contractor and IRS.

CONCLUSION:

Federal and state laws establish the criteria for classifying workers as independent contractors. Employers should carefully review and apply appropriate tests before classifying any individual as an independent contractor. Independent contractor relationships should also be reviewed periodically to determine if reclassification is necessary.



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