

Abstract: Independent contractors are playing a bigger and bigger role in our economy. But the federal government still has a vested interest in ensuring workers aren't misclassified as independent contractors when they're really bona fide employees. This article reviews the key factors used by the IRS to determine worker status.

Beware the ongoing risk of employee misclassification

We live in an increasingly specialized society. As such, there's a growing subset of the workforce with distinctive skill sets that can perform high-quality services. Through independent contractor relationships, companies are able to access these services without the long-term entanglements of traditional employment.

And yet, risk remains. Classifying a worker as an independent contractor frees a business from payroll tax liability and allows it to forgo providing overtime pay, unemployment compensation, and other employee benefits. Also, independent status takes an individual off the company payroll, where an employee's share of payroll taxes, plus income taxes, is automatically withheld.

For these reasons, the federal government views misclassifying a bona fide employee as an independent contractor as forcing a square peg into a round hole.

Key factors

The IRS has long been a primary enforcer of proper worker classification. When assessing worker classification, the agency typically looks at the:

Level of behavioral control. This means the extent to which the company instructs a worker on when and where to do the work, what tools or equipment to use, whom to hire, where to purchase supplies and so on. Also, control typically involves providing training and evaluating the worker's performance. The more control the company exercises, the more likely the worker is an employee.

Level of financial control. Independent contractors are more likely to invest in their own equipment or facilities, incur unreimbursed business expenses, and market their services to other customers. Employees are more likely to be paid by the hour or week or some other time period; independent contractors are more likely to receive a flat fee.

Relationship of the parties. Independent contractors are often engaged for a discrete project, while employees are typically hired permanently (or at least for an indefinite period). Also, workers who serve a key business function are more likely to be classified as employees.

The IRS examines a variety of factors within each category. You need to consider all of the facts and circumstances surrounding each worker relationship.

Protective measures

Once you've completed your review, there are several strategies you can use to minimize your exposure. When in doubt, reclassify questionable independent contractors as

employees. This may increase your tax and benefit costs, but it will eliminate reclassification risk.

From there, modify your relationships with independent contractors to better ensure compliance. For example, you might exercise less behavioral control by reducing your level of supervision or allowing workers to set their own hours or work from home.

Also, consider using an employee-leasing company. Workers leased from these firms are employees of the leasing company, which is responsible for taxes, benefits and other employer obligations.

Before and during

Sometimes a company engages an independent contractor with short-term intentions only to gradually integrate the person into its staff, creating a risk of employee misclassification. Our firm can help you review the pertinent factors and use protective measures before *and during* an engagement.

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