

Independent Contractor Definition and Requirements

Complying with how the IRS determines employees vs contractors

By Jim Everett, Think180 – March 2009

"If a contractor works like an employee, and is treated like an employee..."

Independent Contractor status and reporting to the IRS comes into sharp focus when a client directly engages an individual worker, or consultant, to perform work on a project, or in a continuing role. It can also be a concern when engaging a smaller provider (such as an LLC), where a number of people are assigned full-time to a client, and work onsite.

In larger outsourcing contracts, specific workers allocated to the client by the provider are typically employees of that provider, or of a 3rd party whom the provider has engaged. The client does not pay the worker, but pays the provider for the work against the contract and agreement. If the provider is incorporated, or defined as a company by the IRS, then their status and conditions are (normally) the legal responsibility of the provider.

Even if dedicated workers allocated by the provider work full-time on a client site, and the client pays the provider for their time by the hour (as for staff supplied by an agency), the employment, legal and taxation requirements remain the responsibility of the provider or the agency, rather than the client. There are exceptions, but this is the general rule.

IRS Requirements

The IRS uses criteria to determine if a vendor or individual is classified as an independent contractor or is deemed to be an employee of the client. These are in IRS Publication 15-A "Employer's Supplemental Tax Guide". The IRS also uses Form SS-8 to determine if a vendor is an Independent Contractor or an employee. Links to these are at the end of this article.

Common Law Factors

People (including sole proprietors and partnerships) with an independent trade, business, or profession, who offer their services in the commercial marketplace, are generally independent contractors and not deemed to be client employees, depending on the facts in each case.

A general rule is an individual is an independent contractor if the client has the right to control or direct *only the result of the work* and *not the means and methods of accomplishing the result*. Under common law, anyone who performs services may be deemed an employee if the client has the right to control what will be done, *where* it will be done and *how* it will be done.

Simplified Process

In 1996, the IRS simplified its previous ("20 Questions") IC qualification test, and IRS auditors now determine whether a hiring firm has the right to control a worker, based on the three factors outlined below.

Behavioral control – directing how the work is done, through direction, training or other means. This includes specifying what tools or equipment the individual should use, who they can hire to help them, where they buy materials, or what services (such as travel) they use.

Financial control – how much the provider/contractor has invested in being ready to perform; whether the client reimburses most expenses; if the work is done on client premises with client facilities; if the provider has other clients; the nature of payment schedules (tied to deliverables versus hours); and whether the provider can make a profit or loss.

Type of relationship – if written contracts are based on deliverables and service levels rather than an employment; whether there is exclusivity; what other benefits are provided; if the contract is open-ended or has permanency, or if it is for a finite period; and the extent to which the provider is integrated with client business.

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Avoid Exposure

The defining case that brought this into awareness in the business world was in early 1990s. Microsoft battled the IRS and was held accountable for large numbers of independent contractors, that the IRS deemed to be employees and required Microsoft to back retroactive benefits, plus fines.

How can clients avoid exposure and risk of costly surprises from IRS audits? Limit exposure and ensure resources you engage are independent.

- The provider is incorporated, or at least an LLC
- Provider has invested in their own business
- Provider has other clients and actively markets their services
- Not all work is done on client premises
- Provider uses their own equipment
- Payment is by milestones, project completion, or agreed service levels
- Agreements specify deliverables and a finite duration
- Workers are not directed by the client how to do the work
- Expenses are not reimbursed (travel may be an exception)
- Provider does not receive training from client in order to do the work
- No benefits are paid other than agreed fees for work delivered

Alternative (*and this is important*)

Engage contractors through an approved agency.

This way, contractors may work like employees – onsite, be directed, use client facilities, be dedicated to client, have no fixed completion, be measured on behaviors as well as deliverables.

Individuals can be assigned as contractors to a client as a resource, providing the agency has hired the contractor as their own employee, or the contractor signs an employment agreement with the agency.

The agency meets all IRS reporting and taxation obligations, and pays the required benefits to the individual. The client is responsible to ensure this.

Get it in Writing

A contract or agreement with the provider should be completed which clearly defines the work and sets out:

- scope of the work, including a finite duration
- measurable milestones
- standards and timelines
- payments based on milestones and service levels

Any changes to the scope of work after the agreement is signed must be reflected in an addendum, and signed by both parties.

Reference Materials

IRS materials

Tax Topic 762 - Independent Contractor vs. Employee
(<http://www.irs.gov/taxtopics/tc762.html>)

Publication 1779 - Independent Contractor or Employee
(<http://www.irs.gov/pub/irs-pdf/p1779.pdf>)

Publication 15-A for 2008
(<http://www.irs.gov/pub/irs-pdf/p15a.pdf>)

Form SS-8, Rev Nov 1996 – (<http://www.irs.gov/pub/irs-pdf/fss8.pdf>)
<http://www.irs.gov/businesses/small/article/0,,id=99921,00.html>

"Working with Independent Contractors" (NOLOPress.com) by Attorney, Stephen Fishman – good reference book detailing these requirements, along with documents, forms and the IRS training manual developed for its auditors (included in PDF on CD).

<http://www.nolo.com/product.cfm/ObjectID/EF0DE668-BA17-48AF-B7634507589AA51D/111/159/>

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Disclaimer

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