

Hiring Independent Contractors

By Stephen Fishman

There are many benefits to using independent contractors -- cost savings, reduced liability, flexibility in hiring. But workers aren't independent contractors just because you say they are. Here's what the IRS has to say about the matter.

The late Supreme Court justice Potter Stewart once said that he couldn't define what pornography was, but he knew it when he saw it. Many business owners and legal experts believe that IRS and other government auditors take this same haphazard approach in determining whether workers are independent contractors (ICs). They're at least half right. There is no single test used to determine when workers are and are not ICs. Instead, various legal tests are used (or at least paid lip service to) by courts and government agencies to determine worker status.

The result is a legal morass that confuses and frightens many hiring firms. The only way to successfully wade through this legal thicket is to spend some time learning how these government agencies go about classifying workers. If you fail to do so, you leave yourself vulnerable to government auditors who are only too happy to reclassify ICs as employees and impose assessments, penalties and fines on you as the employer.

The IRS 20-Factor Control Test

The IRS has developed a list of 20 factors to measure control under the so-called "common law test." (IRS Rev. Rul. 87-41.) This IRS test has been very influential on other government agencies and courts. Arguably, it is the single most important IC test, since federal payroll taxes are a substantial financial burden on hiring firms and IRS penalties for misclassifying workers can be huge.

All your relationships with ICs should be structured with these 20 factors in mind. Unfortunately, however, it is often difficult to come up with a conclusive answer about whether a worker is an IC or employee simply by using this unwieldy 20-factor test. That's because no one factor is dominant and some factors may be more important than others in certain cases. Also, it's not necessary for all or even a majority of these factors to show lack of

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control for a worker to be considered an IC. The bottom line is that, on balance, the factors showing lack of employer control must outweigh those that do indicate control.

1. Making a profit or loss

Employees. Employees are typically paid for their time and labor and have no liability for business expenses.

Independent Contractors. In addition to the gain or loss ordinarily realized by employees, ICs can earn a profit or suffer a loss as a result of the services being performed.

ICs are entrepreneurs. They make money if their businesses succeed, but they risk going broke if they fail. Whether ICs make money depends on how well they use their ingenuity, initiative and judgment in conducting their business.

2. Work on specific premises

Employees. Employees must work where their employers tell them, usually on the employer's premises.

Independent Contractors. ICs are usually able to choose where they will perform their services.

Work at a location specified by a hiring firm implies control by the firm, especially if the work could be done elsewhere. A person working at a hiring firm's place of business is physically within the firm's direction and supervision. If the person can choose to work off the premises, the firm obviously has less control.

3. Offering services to general public

Employees. Employees offer their services solely to their employers.

Independent Contractors. ICs offer services to the general public, since they are independent businesspersons.

4. Right to fire

Employees. An employee typically can be discharged by the employer at any time.

Independent Contractors. An IC's relationship with a hiring firm can be terminated only according to the terms of their agreement.

If you have a right to fire a worker at any time any reason or for no reason at all, the IRS will likely conclude that you have the right to control that worker. The ever-present threat of dismissal must inevitably cause a worker to follow your instructions and otherwise do your bidding.

5. Furnishing tools and materials

Employees. Employees are typically furnished all the tools and materials necessary to do their jobs by their employers.

Independent Contractors. ICs typically furnish their own tools and materials.

The fact that a hiring firm furnishes tools and materials, such as computers and construction equipment, tends to show control because the firm can determine which tools the worker is to use and, at least to some extent, in what order and how they will be used.

Sometimes ICs have to use a hiring firm's tools or materials. For example, a computer consultant may have to perform work on the hiring firm's computers. The fact that the tools are provided in such a situation should be irrelevant.

6. Method of payment

Employees. Employees are usually paid by unit of time.

Independent Contractors. ICs are typically paid a flat rate for a project.

The fact that a worker is paid by unit of time (by the hour, week or month) strongly suggests an employer-employee relationship. This is because the hiring firm assumes the risk that the services provided will be worth what worker is paid. To protect its investment, the hiring firm demands the right

to direct and control the worker's performance. In this way, the hiring firm makes sure it gets a day's work for day's pay.

Payment by the job or on a straight commission generally indicates that the worker is an IC. In many professions and trades, however, payment is customarily made by unit of time. For example, lawyers, accountants and psychiatrists typically charge by the hour. Where this is the general practice, the method-of-payment factor will not be given great weight.

7. Working for more than one firm

Employees. Although employees can have more than one job at a time, employers can require loyalty and prevent employees from taking some alternative jobs.

Independent Contractors. ICs usually have multiple clients or customers. This is very strong evidence of IC status because these people are usually free from control by any one of the firms.

8. Continuing relationship

Employees. Employees have a continuing relationship with their employers. (One of the main reasons businesses hire employees is to have workers available on a long-term basis.)

Independent Contractors. ICs generally work on one project and then move on.

9. Investment in equipment or facilities

Employees. Employees generally have no investment in equipment or facilities.

Independent Contractors. ICs have an investment in the equipment and facilities appropriate for their businesses.

This factor includes equipment and premises necessary for the work, such as office space, furniture and machinery. It does not include tools, instruments and clothing commonly provided by employees in their trade, nor does it include education, experience or training. A worker who makes a significant investment in the equipment and facilities to perform services is more likely

to be considered an IC. By making such a financial investment, the worker risks losing it if the business is not profitable.

On the other hand, lack of investment indicates dependence on the hiring firm for tools and facilities and is another hallmark of an employer-employee relationship.

Some types of workers typically provide their own inexpensive tools. For example, carpenters may use their own hammers and accountants their own calculators. Providing such inexpensive tools doesn't show that a worker is an IC. But a worker who provides his or her own \$3,000 computer or \$10,000 lathe is more likely to be an IC.

10. Business or traveling expenses

Employees. Employees' job-related business and traveling expenses are paid by the employer. To be able to control such expenses, the employer must retain the right to regulate and direct the worker's actions.

Independent Contractors. ICs typically pay their own business and travel expenses. Of course, some ICs typically bill their clients for certain expenses. For example, accountants normally bill clients for travel, photocopying and other incidental expenses. This does not make them employees, since their clients do not control them.

11. Right to quit

Employees. An employee may normally quit the job at any time without incurring any liability to the employer, even if it costs the employer substantial money and inconvenience. They work "at will."

Independent Contractors. An IC is legally obligated to complete the work he or she agreed to do. If they don't, they are liable to the hiring firm to make good any losses caused.

12. Instructions

Employees. Employers have the right to give their employees oral or written instructions that the employees must obey about when, where, and how they are to work.

Independent Contractors. ICs need not comply with instructions on how to perform their services; they decide how to do their work on their own.

You can have trouble evaluating this factor because there is no requirement that instructions actually be given. You must focus instead on whether you have the right to give them. Even though you have not given a worker instructions, the IRS could conclude that you have the right to do so and view this factor as indicating employment status.

If someone has an independent business and you are just one client or customer among many, it's likely you don't have the right to give the worker instructions about how to perform the services. Your right is usually limited to accepting or rejecting the final results.

Note that you may give an IC detailed guidelines as to the end results to achieve. For example, a software programmer may be given highly detailed specifications describing the software programs to develop; or a building contractor may be given detailed blueprints showing precisely what the finished building should look like. Since these relate only to the end results to be achieved, not how to achieve them, they do not make the programmer or building contractor employees.

13. Sequence of work

Employees. Employees may be required to perform services in the order or sequence set for them by the employer.

Independent Contractors. ICs decide for themselves the order or sequence in which they work.

This factor is closely related to the right to give instructions. If a person must perform services in the order or sequence set by the hiring firm, it shows that the worker is not free to use discretion in working, but must follow established routines and schedules.

Often, because of the nature of the occupation, the hiring firm either does not set the order of the services or sets them infrequently. It is sufficient to show control, however, if the hiring firm retains the right to do so.

14. Training

Employees. Employees may receive training from their employers.

Independent Contractors. ICs ordinarily receive no training from those who purchase their services.

Training may be done by teaming a new worker with a more experienced one, by requiring attendance at meetings or seminars, or even by correspondence. Training shows control because it indicates that the employer wants the services performed a particular way. This is especially true if the training is given periodically or at frequent intervals.

ICs are usually hired precisely because they don't need any training. They possess special skills or proficiencies that the hiring firms employees do not.

15. Services performed personally

Employees. Employees are required to perform their services on their own. That is, they can't get someone else to do their job for them.

Independent Contractors. ICs ordinarily are not required to render services personally. They may hire their own employees or even other ICs to do the work.

Ordinarily, when you hire an IC, he or she has the right to delegate all or part of the work to others without your permission. This is part and parcel of running a business. For example, if you hire an accountant to prepare your tax return, the accountant normally has the right to have assistants do all or part of the work under his or her supervision.

Requiring someone you hire to perform the services personally indicates that you want to control how the work is done, not just the end results. If you were just interested in end result, you wouldn't care who did the work; you would simply make sure the work was done right when it was finished.

16. Hiring assistants

Employees. Employees hire, supervise and pay assistants only at the direction of their employer.

Independent Contractors. ICs hire, supervise and pay their own assistants.

IRS auditors will usually be very impressed by the fact that a worker hires and pays his or her own assistants. This is something that employees simply

do not do, and it is strong evidence of IC status because it shows risk of loss if the worker's income does not match payroll expenses.

17. Set working hours

Employees. Employees ordinarily have set hours of work.

Independent Contractors. ICs are masters of their own time; they ordinarily set their own work hours.

Obviously, telling a worker when to come to work and when to leave shows that you have control over that worker.

18. Working full-time

Employees. An employee may be required to devote full-time to the employer's business.

Independent Contractors. ICs are free to work when and for whom they choose -- and usually have the right to work for more than one client or customer at a time.

Requiring a worker to devote full-time to the workplace indicates that you have control over how much time he or she spends on your job and practically restricts that worker from working elsewhere.

19. Oral or written reports

Employees. Employees may be required to submit regular oral or written reports to the employer regarding the progress of their work.

Independent Contractors. ICs are generally not required to submit regular reports; they are responsible only for end results.

Submitting reports shows that the worker is compelled to account for individual actions. Reports are an important control device for an employer. They help determine whether directions are being followed, or whether new instructions should be issued.

Note that this requirement focuses on regular reports that enable an employer to keep track of employees' day-to-day performance. It's quite common for ICs to make infrequent interim reports to hiring firms when they

are working on long or complex projects. Such reports are typically tied to specific completion dates, timelines or milestones written into the contract.

20. Integration into business

Employees. Employees typically provide services that are an integral part of the employer's day-to-day operations.

Independent Contractors. ICs' services typically are not molded into the hiring firm's overall business as one integrated operation.

Integration in this context means that the workers are a regular part of the hiring firm's overall operations. In the IRS's view, the hiring firm would likely exercise control over such workers because they are so important to the success of the business. On the other hand, ICs generally have special skills that the hiring firm calls upon only sporadically.

Other Factors to Consider

Besides the 20 factors that the IRS applies, here are some of the other major factors that courts and government agencies use in determining worker status:

1. Skill required to do the work

Employees. Workers whose jobs require a low level of skill and experience are more likely to be employees.

Independent Contractors. Workers with job requiring high skills are more likely to qualify as ICs.

2. Worker benefits

Employees. Employees usually receive benefits such as health insurance, sick leave, pension benefits and paid vacation.

Independent Contractors. ICs ordinarily receive no similar workplace benefits.

3. Tax treatment of the worker

Employees. Employees usually have federal and state payroll taxes withheld by their employers and remitted to the government.

Independent Contractors. ICs ordinarily pay their own taxes.

4. Intent of the hiring firm and worker

Employees. People who hire employees normally intend to create an employer-employee relationship.

Independent Contractors. People who hire ICs normally intend to create an IC-hiring firm relationship.

5. Custom in the trade or industry

Employees. Workers who are normally treated like employees in the trade or industry in which they work are likely to really be employees.

Independent Contractors. Workers who are normally treated like ICs in the trade or industry in which they work are likely to really be ICs.

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