THEME: INDEPENDENT CONTRACTOR vs. EMPLOYEE

By John W. Day, MBA

ACCOUNTING TERM: Independent Contractor

An individual who contracts with an entity to perform a service independent of the entity's management and control is considered to be an Independent Contractor (IC). The contractor is not considered an employee and therefore, is responsible for his/her own taxes.

FEATURE ARTICLE: Defining An Independent Contractor

If you are in business now or planning to be, there is a good chance that you will have to deal with the issue of Independent Contractor (IC) vs. Employee either sooner or later. The business community and the IRS have been playing a cat and mouse game around this subject for many years. The reasons are clear. Businesses can save money by hiring an IC because they are not responsible for collecting and paying any taxes. In addition, they can hire this "expert" to come in and complete a specific job. This means they don't have to train their own employees and keep them on the payroll when the job is done. This can be a great solution for employers whose staffing demands fluxuate with the workload. Since these ICs are non-employees, they are not entitled to any company benefit programs. You can see why businesses are looking for these cost saving opportunities.

The Internal Revenue Service (IRS) sees nothing wrong with hiring ICs as long as they are legitimate ICs. Therein lies the rub – in many cases it is not a clear black vs. white situation. The lay of the land can become fuzzy and gray. In an attempt to remedy the ambiguities, the courts and the IRS have developed a set of twenty factors or questions that an employer or worker can use to determine IC status. However, there are no fixed rules or regulations that stipulate which factor or combination of factors must be met in order to be classified as an employee or an IC. Each case is evaluated on its own facts, many in front of a jury. The following is a summary that was printed in an IRS publication:

Employee or Independent Contractor	
a quick guide	
Employee	Independent Contractor

1. Instructions	
Employees comply with instructions about when, where, and how work is to be performed.	Contractors set their own hours and do the job in their own way.
2. Training	
Employees are trained to perform services in a particular way. They are required to take correspondence courses and attend meetings. Other methods also indicate that the employer wants the services performed in a particular way.	Contractors use their own methods and receive no training from the purchaser of their services.
3. Integration	
Services of an employee are merged into the business. Success and continuation of the business depends upon these services. The employer coordinates work with that of others.	The success and continuation of the business aren't dependent on services provided by a contractor.
4. Services Rendered Personally	
Services must be rendered personally. An employee does not engage other people to do the work.	Contractors are able to assign their own workers to do the job.
5. Hiring, Supervising, Paying	
An employee hires, supervises and pays workers at the direction of the employer (i.e.: acts as foreman or representative of the employer).	Contractors hire, supervise and pay the other workers as the result of a contract. A contractor agrees to provide materials and labor and is responsible for the results.
6. Continuing Relationship	
An employee continues to work for the same person year after year.	Contractors are hired to do one job. There is no continuous relationship.
7. Set Hours of Work	
An employee's hours and days are set by the employer.	Contractors are masters of their own time.
8. Full Time Required	

An employee normally works full time for an employer.	Contractors are free to work when and for whom they choose.
9. Doing Work on Employer's Premises	
Employees work on the premises of an employer; or on a route, or at a site, designated by the employer.	Contractors work off an employer's premises and use their own offices, desks, and telephones.
10. Order or Sequence Set	
An employee performs services in the order or sequence set by the employer. Salespersons report to the office at specified times, follow-up on leads, and perform certain tasks at certain times.	Services are performed at a contractor's own pace. Salespersons work their own schedules and usually have their own offices.
11. Oral or Written Reports	
Employees are required to submit regular oral or written reports to the employer.	Contractors submit no reports.
12. Payment by Hour, Week, Month	
Employees are paid by the employer in regular amounts at stated intervals.	A contractor is paid by the job on a straight commission.
13. Payment of Business and/or Travel Expenses	
The employer pays employees' business and/or travel expenses.	Contractors take care of their own expenses and are accountable only to themselves for expenses.
14. Furnishing of Tools, Materials	
An employer furnishes tools, materials, etc.	Contractors furnish their own tools, etc.
15. Significant Investment	
An employee has no significant investment in the facilities used to perform services.	A contractor has a real, essential and significant investment.
16. Realization of Profit or Loss	
An employee cannot realize a profit or loss by making good or bad decisions.	Contractors can realize a profit or suffer a loss as a result of their services or decisions.

17. Working for More than One Firm at a Time	
An employee usually works for one employer at a time.	An independent contractor works for a number of persons or firms at the same time.
18. Making Services Available to the General Public	
An employee does not make services available to the general public.	Contractors have their own offices and assistants. They hold business licenses, are listed in business directories, maintain business telephones, and otherwise generally make their services available to the public.
19. Right to Fire	
An employee can be discharged at any time.	Contractors cannot be fired so long as product results meet contract specifications.
20. Right to Quit	
Employees can quit their jobs at any time without incurring liability.	Contractors agree to complete a specific job and are responsible for satisfactory completion; or they are legally obligated to make good for any failure.

You can get a pretty good idea what you are up against by using the twenty factors as a checklist. There is a form called an SS-8 that you can send to the IRS requesting a determination of IC or employee status if you are not sure. I don't recommend doing that as you might as well send in a letter that says, "PLEASE AUDIT ME".

When recording an IC expense on your books you can use one of several categories, whichever is appropriate. Here is short list of possibilities:

Contract Labor
Commissions
Outside Services
Consulting

Your general journal would look like this:

DESCRIPTION	DEBIT	CREDIT
Contract Labor	200.00	
Cash		200.00
Payment to J. Jackson		

For further information directly from the Internal Revenue Service click here:
http://www.irs.gov/businesses/small/article/0,,id=99921,00.html

QUESTION: What Risks Are Involved In Hiring An Independent Contractor?

Obviously it depends on the situation. Many small businesses hire someone as an IC to determine whether they want to hire that person full time as an employee. The IRS would frown on this approach, but the risk is minimal if it is a low paying job and the IC status doesn't last long. The risk is that the employer will become responsible for the employment taxes of the worker if recharacterized from IC to employee. This includes penalties and interest for failure to pay these taxes, and for failure to file the payroll tax returns. It is also important to keep in mind that if the state you live in has income and payroll taxes you could be assessed for those taxes, plus penalties and interest. The federal taxing authorities normally communicate with their colleagues at the state level.

Usually, the feds won't go back further than three years due to the statute of limitations, however, if you have several workers making good money that are re-characterized, you could be faced with a huge liability. I have personally seen two small companies have to go out of business as a result of these types of audits. You may find some relief if you can locate your IC workers and get them to prove that they paid their taxes. Any assessed tax to you cannot be recovered from the worker.

It could get worse if you have a retirement plan in place. The plan could be retroactively disqualified which could cause all vested accrued benefits to become fully taxable for employees enrolled in the plan.

TIP: Strategies For Business Owners

Whenever a business hires an IC, the first thing to do is have the individual sign a W-9 form. This should be done before any work is started. This is the due diligence form where the worker is verifying that his/her address and social security number are correct. Without this form, the business can be fined $50 if this information turns out to be incorrect.

Second, the business should have a written contract with the worker stating what exactly the worker will be doing, how long the job is expected to take, how much money will be paid for doing the job, and that the worker is solely responsible for his/her own taxes.

Third, as much independence as possible should be given the worker in areas such as hours worked, supervision on the job, and the location where the work is to be performed.

Fourth, the worker should be required to provide his/her own tools, supplies, training, and transportation.

Fifth, the worker should receive from the business a 1099-Miscellaneous form that is also sent to the IRS reporting how much was paid to the IC. This has to be done by January 31 of the following year.

Even with these minimum measures, the IRS may not agree with you. You have to keep in mind that the deck is stacked in favor of the IRS and their tendency, in gray areas, is to rule in favor of employee status. Why? It is because they have the opportunity to collect more money, which, whether you believe it or not, happens to be the guiding principle of the IRS.

John W. Day, MBA is the author of two courses in accounting basics: Real Life Accounting for Non-Accountants (20-hr online) and The HEART of Accounting (4-hr PDF). Visit his website at http://www.reallifeaccounting.com to download his FREE e-book pertaining to small business accounting and his monthly newsletter on accounting issues. Ask John questions directly on his Accounting for Non-Accountants blog.

