

Ten Independent Contractor Mistakes That Can Cost Big

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As a full time tax lawyer for over 30 years, I sometimes forget what it is like to be a client and to face the complexity of the law from a business person's viewpoint. Business people must make many decisions, and it is not always possible to stop the flow of business and seek tax or other legal advice. Yet certain fundamental areas have enormous tax and legal implications both immediately and for many years into the future.

I can't think of a better example of this phenomenon than the decision whether to hire someone as an employee or an independent contractor. This is not only a tax decision, but involves elements of labor and employment law, ERISA and employee benefit laws, workers' compensation, and unemployment insurance law. And the list goes on.

In fact, it is hard to think of a more consequential business decision. Yet paradoxically, the question whether to hire someone in one capacity or the other often gets virtually no attention from advisers. Sadly, it gets even less from business people themselves. That can be a huge problem causing staggering tax and other liabilities down the road.

If it were a one-time or immediate problem, it would not be so serious. However, an even larger problem is that little attention is generally paid to this decision down the road. Once you hire someone in

any capacity, you understandably focus on business objectives. Whether the arrangement works out well or it does not, you tend not to revisit fundamental questions such as whether they should be an independent contractor or an employee.

Businesses can avoid major landmines if they consider these topics from time to time. You should do so when additional workers are brought on, when the tenure and nature of the relationship changes, when the tasks expected of the worker expand or contract, or when other terms and conditions of the work change. The worker's role may morph into something quite different from what it was at the inception of the relationship. That can impact the status of the worker as an independent contractor or employee.

Here are the top ten mistakes I see committed by companies—and even by advisers—in using workers they believe are safely “independent contractors” but who may actually turn out to be reclassified as employees.

1. Not Having A Written Contract

This one is inexcusable yet I see it frequently: simply failing to have any kind of written agreement for independent contractors. It is a recipe for disaster. Sure, if you hire a plumber for a one-time toilet fix one afternoon and pay him \$200, I would

not worry that he is an employee.

But you would be surprised at how many businesses have regular and long-term workers—on their premises or off—paid month after month and year after year as independent contractors without a written contract. Don't do it! You are almost doomed to fail in any dispute over the status of that worker, no matter how strong your independent contractor facts.

The taxing, labor and employment, and insurance authorities expect you to have a written contract that states that the worker is an independent contractor and will be paid as such with no tax withholding, no benefits, etc. Plainly, such a contract does not by itself mean the worker is really an independent contractor. But if you don't have a written contract, you are likely to lose.

Plus, you may even have a dispute with the worker himself. If he later claims he thought he was an employee, what will you point to?

2. Treating Similar Workers Differently

It is perfectly OK for a business to have some employees and some independent contractors. But it is not OK to have one worker selling shoes on an independent contractor basis and another similarly situated worker doing the same thing as an employee.

Suppose you have some employee messengers and some independent contractor messengers (or sales people, computer programmers or what have you).

The risk of treating people differently is that the people you are trying to treat as independent contractors may be reclassified as employees. In effect, you set yourself up for that by having the two differently classified workers for ready comparison by the IRS, state tax authorities, labor or employment agency, or other authority. They all look for this tell-tale sign.

You need to make significant distinctions between the two types of workers. Some companies are able to have two groups of workers do essentially the same type of work—such as independent contractor sales agents and employee sales agents. But if you walk this tightrope you must be very careful and you will need professional help.

3. Providing Tools and Supplies

One of the hallmarks of independent contractors is that they are required to supply their own tools, equipment and supplies. As with just about everything else in the contractor vs. employee characterization realm, this is not dispositive by itself. However, it is certainly something reviewed in making a thumbs-up or thumbs-down decision.

After all, independent contractors are classically independent business people or professionals. It makes sense that they would bring their own ladder, shovel, or paint brush. If you purport to have independent contractors but supply a desk, chair, computer, software, and telephone—everything they need—how convincing is it? As this example

suggests, this problem may be biggest with office work.

Still, it can arise in virtually any setting. In this age of high technology, it is not even easy to determine exactly what will be regarded as tools, supplies, and equipment. The safest bet may be to make sure you don't provide anything. But that can be impractical. For possible ways around this conundrum see #5 below.

4. Reimbursing Expenses

Another red flag is the extent to which you reimburse workers for their business expenses. If they work late, do you pay for their dinner or a taxi? If they need special paper for the report they are producing, do you provide it or reimburse them?

There is no bright line saying you can't cover the expenses of an independent contractor, but doing so can suggest the worker is an employee. Classically, all such items are supposed to be factored into the price you are paying the independent contractor for a finished product. As a result, reimbursements and reimbursement policies are likely to be reviewed if you get into a worker classification dispute.

You might think you are doing yourself a favor and being a nice guy by covering such items. The reality is that you may be making the line between your employees and your independent contractors murkier. For ideas to address this, see #5 below.

5. Paying By the Hour

How you pay someone is about as fundamental a work variable as you can get. And it can be one of the most fundamental indicators of whether a worker is an employee

or an independent contractor. Classically, you pay a contractor for a job, like putting a pool in your backyard, repairing your computer system, or putting in a break room at your office. In contrast, you classically pay employees by the hour or by the week.

Yet it is surprising how many businesses don't think about this issue, much less explore ways to package it. There is no rule saying that you can't pay an independent contractor by the hour. After all, that is how most lawyers bill time to their numerous clients.

But when you have alternatives, paying by the hour can be unwise. Consider whether you can come up with a payment regimen that fairly covers all the elements going into the work and yet that is independent contractor-like in scope. Ideally, a project fee or success fee is more consistent with independent contractor status than an hourly rate.

Furthermore, you may be able to address any tool, equipment and supply issues, and even expense reimbursements, as part of the payment formula you devise. As the discussion of those topics noted (see #3 and #4 above) you don't want to provide items that are employee-indicators. Yet if an independent contractor worker arrives at the job site with no hammer, understandably, you may want to provide one.

The answer may be to do so but to charge back the worker for the item provided. You could have the charge subtracted from his invoice at the end of the week. You may find that a little creative thinking with independent contractors will get you to the same place economically but

may appear vastly better viz. the likelihood independent contractor treatment will be upheld.

6. Failing To Have Consistent

Forms And Documents

The fact that you call someone an independent contractor does not make it so. An “employee lounge” sign in your office does not mean only employees can go there. The fact that you pay a worker based on a time card and then issue a check and paystub does not make him an employee. But all these things add up.

And sometimes, after all, something is what you call it. So consider if you should have an “Employee File” for each employee and use a different name for independent contractors. Consider if independent contractors should turn in an “invoice” not a time card. Consider whether independent contractor discipline should be handled in exactly the same way as employee discipline. Usually changes in terminology or substance can be made that may not impact your business but that may help bolster independent contractor treatment.

7. Over Supervising

With an independent contractor you are paying for a product or result. With an employee you are paying for him to do what you ask, whatever that might be. With employees you control not only the nature of the work, but the method, manner, and means by which they do it.

This control factor is the most over-arching of the points I will make here. It is also the most over-arching way in which you can

end up in trouble with workers you believe are independent contractors but who might be ruled otherwise. How much do you check in with workers, monitor what they are doing, or make suggestions? How frequently must they check in with you and report how and what they are doing?

Be very careful with supervision and control. The mere fact that an independent contractor must provide a weekly progress report on how the installation of the new laundry room in your house is going does not mean the builder is an employee. But if the report involves constant tweaking and redirecting of the effort, it might be otherwise.

Note that the important inquiry is not merely whether you are exercising control over the method, manner, and means by which the worker is doing the job. It can even be fatal if you have the legal right to do this even if you don't exercise it. For that reason, be careful what your contract and other documents say about reports, supervision, and the like.

8. Requiring Set Hours

One of the classic signs of employee status is a time clock or 9 to 5 office hours. In contrast, with independent contractors you should normally pay for the result, not exactly when or how they do it. That does not mean you can't have some control over the hours an independent contractor works.

For example, the fact that you tell your building contractor he can't work on your kitchen remodel past 7 p.m. does not make him an employee. Nevertheless, it is surpris-

ing how many businesses don't even consider which workers need to be on a set schedule and which workers don't. Consider whether you can allow workers to complete work on their own schedule as long as they meet applicable deadlines. That can help show they are independent contractors. Conversely, it can be telling if you dictate a 9 to 5 and full time schedule.

9. Prohibiting Competition

Many businesses using independent contractors require full time work, prohibit competition, or do both. Neither of these points is likely by itself to be dispositive of an independent contractor versus employee characterization battle. However, both of these points are inconsistent with independent contractor treatment.

For that reason, it pays to consider whether you need such rules and why. Optimally, if you are paying for a particular result—such as selling a minimum dollar volume of goods each month—you should stick to that target. Don't focus on how long the worker may take to do it or where else they may work during the same period. Those details are arguably irrelevant.

Since requiring full time work and/or no competition will be viewed as more employee-like in nature, consider whether it is a good idea to dictate these terms. Always bear in mind the paradigm case: an independent contractor like a lawyer or plumber serving many clients or customers. If you are worried about the worker giving away your business methods or intellectual property to a competitor, make those concerns

explicit. Focus on prohibiting the worker from disclosing your property. That may accomplish your major goal and may be cosmetically much more pleasing.

10. Attempting The Impossible

If you cannot possibly keep your influence and direction over workers to a minimum, cannot possibly let them come and go as they please, can't allow them to work part time and for other companies, and can't abide the thought that they may make some of their own decisions, is it realistic to even try to treat them as independent contractors? Probably not. In that situation, even if you apply some of the points noted here, you may be asking for trouble—either immediately or down the road—if you don't just admit it to yourself and face facts.

That may mean simply treating the workers as employees. Sometimes cutting corners ends up costing you way more money in the long run than if you had done it right in the first place. I have seen that occur over and over with independent contractor issues.

Alternatively, you could at least apply this principle in stages, such as by focusing on particular types of workers or even time periods. For example, you could engage in a kind of triage to help limit your exposure. Plainly, it is technically wrong to suggest that all short term workers are independent contractors.

However, you could try independent contractor status for short term workers and those you are trying to evaluate. If you tried working with someone on an independent contractor basis for three months as a

kind of evaluation period, that might keep them out of your health plans, payroll processing and employment tax returns, and even workers' compensation and unemployment insurance rolls.

If they work out well, you could bite the bullet and treat them as employees. If they don't, you could figure that even if such workers are recharacterized as employees, your financial exposure should be fairly limited. For example, if you "fire" such a worker after two months, will he qualify for unemployment benefits?

The object of this kind of approach would be to limit your exposure. At least the big picture would be better because your long term workers would be employees. Even if you end up losing a worker status dispute later, the employment tax or other liabilities for short term workers should be fairly limited. In contrast, if you are aggressive with independent contractor treatment and don't take some of the steps I advocate here, you could have potentially staggering liabilities. Remember, hogs sometimes get slaughtered.

Conclusion

Above all, evaluate what you are trying to do, what is realistic to expect, and whether you or your clients are being reasonable. Don't make this a static or one-time process. Like an annual medical checkup or annual visit with your estate planning lawyer over the terms of your will, evaluate your workers, their status, duties, and treatment periodically. The more frequently you do it the less likely it will be that you

have major problems to address.

Finally, don't do it all yourself. Professionals can often cut through what seem to be impenetrable problems and suggest solutions. The optimum time for that is before there is a lawsuit, audit, or investigation. Don't wait. ■

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