

## Top 10 Mistakes With Independent Contractors

By Robert W. Wood

Robert W. Wood practices law with Wood & Porter in San Francisco (<http://www.woodporter.com>) and is the author of *Taxation of Damage Awards and Settlement Payments* (4th ed. 2009), *Qualified Settlement Funds and Section 468B* (2009), and *Legal Guide to Independent Contractor Status* (5th ed. 2010), all available at <http://www.taxinstitute.com>.

Most lawyers have at least some idea about the differences between independent contractors and employees. Yet lawyers and their clients commit surprisingly fundamental mistakes in this area, often affecting the extent to which their independent contractor arrangements are defensible. Wood reviews what he considers the top 10 mistakes made with independent contractors.

This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

Copyright 2011 Robert W. Wood.  
All rights reserved.

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 to seek tax or other legal advice. Yet some fundamental areas have enormous tax and legal implications both immediately and for many years thereafter.

I can't think of a better example of this than the decision whether to hire someone as an employee or independent contractor. This is not only a tax decision; it 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 little attention from advisers and even less attention from business people themselves. That can be a huge problem, causing staggering tax and other liabilities down the road.

If it were just 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 later. Once you hire someone in any capacity, you understandably focus on business objectives. Regardless of whether the arrangement works out well, you tend not to revisit fundamental questions such as whether the worker should be an independent contractor or employee.

Businesses can avoid major pitfalls if they reconsider these topics from time to time. They should do so when additional workers are brought on, the tenure and nature of the relationship changes, the tasks expected of the worker expand or contract, or 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 affect the worker's status as an independent contractor or employee.

Here are the top 10 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: companies 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 and pay him \$200, he probably won't be considered an employee. But you would be surprised at how many businesses have regular and long-term workers — on or off their premises — paid month after month, 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 stating that the worker is an independent contractor and will be paid as such with no tax withholding, no benefits, and so on. 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 performing a job on an independent contractor basis and a 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, etc.). The risk of treating people differently is that the workers 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, the labor or employment agency, or other authority. They all look for this telltale 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 nearly everything else in the contractor versus employee characterization realm, this is not itself dispositive. However, it is certainly something reviewed in making a determination.

After all, independent contractors are classically independent business people or professionals. It makes sense that they would bring their own ladder, shovel, or paintbrush. 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, the problem may be biggest with office work.

Still, it can arise in virtually any setting. In this age of high technology, it is not easy to even determine exactly what will be regarded as tools, supplies, and equipment.<sup>1</sup> The safest bet may be to ensure you don't provide anything. But that can be impractical. For possible ways around this conundrum, see No. 5, "Paying by the hour."

**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 those items are supposed to be factored into the price you're 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're doing yourself a favor and being nice by covering those items. The reality is that you may be obscuring the line between your employees and your independent contractors.

**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 independent contractor. Typically, you pay a contractor for a job like installing a pool in your backyard, repairing your computer system, or putting in a break room at your office. In contrast, you typically 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 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 but is still independent-contractor-like in scope. Ideally, a project fee or success fee is more consistent with independent contractor status than an hourly rate.

Further, 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 Nos. 3 and 4 above), you don't want to provide items that are employee indicators. Yet, if an independent contractor arrives at the jobsite with no hammer, you may understandably want to provide one.

The answer may be to do so but to charge 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 appear vastly better in terms of upholding independent contractor treatment.

**6. Failing to have consistent forms and documents.** That you *call* someone an independent contractor

<sup>1</sup>See Robert W. Wood and Christopher A. Karachale, "Home Workers: Employee Status Hidden in Plain Sight," *Tax Notes*, Jan. 25, 2010, p. 531, 2010-241, or 2010 TNT 16-17.

does not make it so. An “employee lounge” sign in your office does not mean that only employees can go there. When you pay a worker based on a timecard and then issue a check and pay stub that does not itself make him an employee. But all those things add up.

And sometimes, after all, something is actually 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” rather than a timecard. Consider whether independent contractor discipline should be handled exactly the same way as employee discipline. Usually, changes in terminology or substance can be made that scarcely affect your business but may help bolster independent contractor treatment.

**7. Over-supervising.** With independent contractors, you are paying for a product or result. With employees, you are paying for them to do what you ask, whatever that might be. You control not only the nature of the work, but also the method, manner, and means by which they do it.

This control factor is one of the most important points I will make. It is also the most likely way in which you can end up in trouble with workers you believe are independent contractors but who might be ruled otherwise. How often 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, the builder might be viewed 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 merely *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 set office hours. In contrast, with independent contractors you should normally pay for the result, not based on exactly when or how it is achieved. That doesn’t mean you can’t have some control over the hours an independent contractor works.

For example, telling your building contractor he can’t work on your kitchen remodel past 7 p.m. doesn’t make him an employee. Nevertheless, it is

surprising how many businesses don’t even think about 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 both. Neither of these points is itself likely to be dispositive in an independent contractor versus employee characterization battle. However, both are inconsistent with independent contractor treatment.

For that reason, it pays to contemplate whether you need those 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 takes to do it or where else he 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 those terms. Bear in mind the paradigmatic case: an independent contractor, like a lawyer or plumber, serving many clients or customers. If you’re 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 be cosmetically much more pleasing.

**10. Attempting the impossible.** If you can’t keep your influence and direction over workers to a minimum, can’t 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 in the future — if you don’t just face facts.

That may simply mean hiring the workers as employees. Sometimes cutting corners ends up costing you far 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 those 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're aggressive with independent contractor treatment and don't take some of the steps I advocate here, you could have 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 a regular medical checkup or an annual visit with your estate planning lawyer over the terms of your will, periodically evaluate your workers' status, duties, and treatment. The more frequently you do it, the less likely you will 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.