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Classifying Workers: Know the Rules and Risks

Businesses are responsible for paying payroll taxes for Social Security, Medicare, and unemployment for their employees, but not for independent contractors. And when using contract workers, employers avoid related expenses such as workers' compensation insurance and other benefits. Instead, contractors pay self-employment taxes and cover their own work-related expenses.

For this reason, hiring independent contractors often makes sense for small businesses running on thin margins. However, it's important to be aware that a complex web of tax and employment laws determines how workers must be classified. And misclassifying workers can be a costly proposition, even if it's unintentional.

At last count, more than 10.5 million people, or roughly 6.9% of U.S. workers, were independent contractors. This figure excludes those who supplement their primary job with freelance work.

Source: U.S. Bureau of Labor Statistics, 2018



Multiple Tests Apply

Contractors are hired to deliver a certain result; how and when they get the work done is generally up to them. Employees are subject to much more employer control, but they are also eligible for worker protections such as wage and hour laws.

The IRS uses a three-part test based on whether the worker has behavioral and financial control, and the type of relationship with the employer (including the permanence). Under the federal Fair Labor Standards Act (FLSA), worker status is determined by an “economic reality” test that is similar, but not identical. Complicating matters, some states have rules that are stricter than the federal guidelines.

If your business is audited and the IRS or a state agency decides that one or more independent contractors were truly employees under the law, you might have to pay back taxes with interest, fines, and penalties. You also run the risk of being sued by misclassified workers.

Employee or Independent Contractor?

When hiring an independent contractor, there should always be a written agreement that specifies the project scope, payment, and other terms. Unfortunately, having a signed contract that says a worker is a contractor may not be enough, especially if any one of the following distinctions suggests otherwise.

1. Employees work according to a schedule defined by the business. Contractors set their own hours.
2. Employees receive regular paychecks through the payroll process. Contractors submit invoices and are treated as vendors under accounts payable.
3. Businesses provide equipment, supplies, and training for their employees. Contractors rely on their own knowledge and use their own tools.
4. Employees perform core business functions. Contractors typically provide supplemental services.
5. The work relationship between employers and employees is normally considered continuous or permanent. Contractors work on a temporary basis and typically have multiple clients.

Keep in mind that any contractor who works primarily for your business for a long period of time looks a lot like an employee. You shouldn't hesitate to consult a qualified legal professional if you have questions about worker classification.

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