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Don't Get Burned By Independent Contracting

By Toddi Gutner | [Business on Main](#)

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Farming out work to independent contractors is a growing trend for businesses of all sizes. Here's what you need to know so you don't get burned by the IRS.

With the unemployment rate stubbornly stuck around 9 percent, many refugees of the recession have turned to launching their own businesses rather than waiting for the perfect job to come along. But successfully starting a company during an economic downturn isn't easy, and keeping costs down is paramount if one is to make it through the first few years.

That's why hiring independent contractors — for virtually all aspects of running a business — is a growing trend. It allows small-business owners to try out workers first before making a significant investment in them in the form of higher wages and benefits, as well as state and federal payroll taxes.

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Indeed, retirement and health care benefits can add 20 to 30 percent on top of salaries, says Bill Nolan, managing partner at the Columbus, Ohio, office of Barnes & Thornburg, a legal services firm. He says he's seen a gradual increase in the use of independent contractors as companies cautiously build staffing back up. Nolan calls it "just-in-time staffing — as you don't want to have a lot of excess staff, and [independent contractors] give you flexibility."

Drawing the line between contractors and employees

But to benefit from this flexible workforce, it's essential to be familiar with the Internal Revenue Service rules governing independent contracting. Without this understanding, you're liable to be on the hook for back taxes, interest, penalties, overtime wages and retirement benefits if you hire someone as an independent contractor but treat him or her like a regular employee.

What exactly do you need to know? Your first stop should be the [small business/self-employed section of the IRS' website](#), which spells out the definition of an independent contractor and the rules that come with hiring this kind of employee.

The IRS uses a checklist to determine if someone is an independent contractor. It boils down to the relationship that exists between the worker and the business, and the degree of control the business owner has over the worker. The degree of control can be broken down into three categories:

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- **Behavioral:** Does the company control or have the right to control what the worker does and how his or her job is performed?

- **Financial:** Are the business aspects of the worker's job controlled by the payer? (This includes things like method of payment, reimbursement of expenses, determining who provides tools/supplies, etc.)

- **Type of relationship:** Are there written contracts or employee-type benefits (e.g., a pension plan, insurance or vacation pay)? Will the relationship continue and is the work performed a key aspect of the business?

If you answered yes to any of the above questions in regard to your independent contractors, you may have some explaining to do to the IRS. Contractors who work alongside full-time employees in the same office, doing the same job and attending the same meetings, look a lot like employees to the IRS.

Unfortunately, there are often gray areas where an independent contractor might look a lot like an employee despite other factors indicating the opposite. When in doubt, it's best to either consult a labor and employment attorney or document each of the situations and the factors that you used to make the determination. That way, you'll have backup should the IRS ever come knocking at your door.

If you're still not certain, you can file a Form SS-8 (Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding) with the IRS. The IRS will review the facts and make a determination for you. Note, however, that it can take at least six months to get a determination.

At the end of the year, inform your accountant of the names, addresses, Social Security numbers and annual earnings of your independent contractors, and have a 1099 sent to them. Your independent contractors will be responsible for paying their own taxes.

For many business owners, independent contractors are worth the extra effort up front. "There is no overhead, no idle time, just productivity," says Tracy Rosen, president of Meeting Street Marketing, a full-service consumer insight and market research firm in Westport, Connecticut, and an avid user of independent contractors. "I think it is a win-win situation."

Done right, it certainly is.

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