Abstract: In today's belt-tightening economy, some businesses are replacing downsized workers with independent contractors (ICs) to eliminate the costs of maintaining full-time employees. But just because your company considers workers as ICs doesn't mean the IRS will. This article offers guidelines to help companies observe the distinction between *supporting* and *controlling* the way an employee works, and a sidebar warns that companies must be careful to protect the tax-qualified status of their benefit plans when reclassifying ICs as employees.

Are your independent contractors truly independent?

In today's belt-tightening economy, some businesses are replacing downsized workers with independent contractors (ICs) to eliminate the costs of maintaining full-time employees. But just because your company considers workers as ICs doesn't mean the IRS will. It's critical that you understand IRS guidelines to ensure your ICs truly are independent, or they could be much more costly than you bargained for.

Get clear

Companies use ICs because they can get the service without the overhead. Employment laws don't require you to pay them overtime or minimum wage — or provide them with mandatory employee benefits — as is required for regular employees. Moreover, you don't need to withhold and pay federal, state, Social Security (FICA) and Medicare taxes on behalf of ICs.

But making the distinction between an IC and an employee can be tricky. And if you incorrectly classify an employee as an IC, the IRS could hold you liable for the taxes that should have been paid or withheld for that worker, and penalize you for not doing so. Let's look at an example to help drive home this important point.

ABC Corporation added several ICs to its telemarketing center. The workers signed agreements stating they'd work for a certain fee and be responsible for paying their own FICA, unemployment and workers' compensation taxes.

Unfortunately, ABC made the mistake of integrating the ICs into the company, including allocating them office space and using company managers to oversee their work. ABC thought the signed agreement protected them, but the IRS considered it hollow because, in nearly every way but compensation, the company treated the ICs as employees.

As a result, ABC had to pay the ICs back employment taxes and the value of health insurance, 401(k) and other benefits for the period they worked. And ABC had to pay those costly IRS penalties.

Avoid trouble

The distinction between employee and IC typically is determined by the amount of *control* the company has over the way in which the individual works and by the *support* given to that individual. To steer clear of IRS trouble, explain your desired results to the IC and provide a deadline, but leave the how, when and where the work is done to the IC. And be sure that the individual uses his or her own transportation, equipment and supplies.

Here are several other guidelines to help protect your ICs' independent status:

Require invoices. ICs should give you a total cost estimate for their work, rather than just an hourly or monthly rate. Ask them to submit invoices on completion or a series of invoices if the work takes more than a month or two. At year end, file a Form 1099-MISC for each IC to whom you paid at least $600 during the year.

Look for professional operations. ICs should have their own workspace and resources. Like other professional businesses, they should market their services and carry business insurance. Use ICs who work for other companies besides yours. Otherwise, if his or her tax return includes only one Form 1099-MISC, the IRS might challenge his or her IC status.

Be mindful of industry norms. The IRS knows that some industries hire ICs more than others. For example, builders often hire independent carpenters, electricians and other tradespeople. If your industry doesn't typically use ICs, diligently follow the basic control and support rules as well as those regarding invoicing and hiring professionals.

Finally, consult an employment law attorney to develop a policy for hiring ICs, and have him or her prepare work-for-hire contracts for use with all ICs.

Go by the book

Using ICs can be a cost-saving option for your company, particularly during this tough economic climate. But take precautions to ensure your independent contractors are truly independent. Keep accurate records of all work performed by and money paid to your ICs so that, if their classification is ever questioned, you'll be able to substantiate their status.

Sidebar: Protect your benefit plans

If a benefit plan excludes independent contractors who are later reclassified as employees, they may be entitled to retroactive benefits, which could be costly to your company and even jeopardize the tax-qualified status of your employee benefit plans. For example, if a reclassified employee is entitled to benefits from a 401(k) plan or defined benefit plan, you'd have to retroactively include the worker in the plan, make a retroactive contribution as required under the terms of the plan, and make an additional contribution of annual interest and earnings.

To maintain the plan's tax-qualified status, you'd likely need to correct certain operational failures of the plan, as prescribed by the IRS. And you'd need to rerun nondiscrimination testing for the plans and possibly amend Form 5500 filings. Other benefit plans may also be affected, including Section 125 plans, group health and term life insurance plans, and incentive stock option plans. Be sure to examine the terms of these plans and, if necessary, amend them.