

## **Should I use an independent contractor or hire an employee?**

As a business owner, you have options when it comes to getting things accomplished. But like most things in business, you have a lot of options. In some cases you must decide whether to hire an employee or utilize an independent contractor. Each category can perform important functions within an organization, but you also have to do some due diligence. Laws have been designed to favor employee status for workers and are particularly stringent in California. You must follow them carefully when deciding how to classify someone. In the end, you need to make the decision that is right for your business.

### **Independent contractors are business owners**

First, you must realize that independent contractors are business owners. They work for clients and try to grow their business. As such, an independent contractor usually provides a specialized service. You might utilize an independent contractor to manage your books or provide marketing services but you would not want to hire a bookkeeper, and also have that person serve as your administrative assistant. You want to utilize their level of expertise in a way that best suits your business, makes economic sense and meets strict independent contractor classification rules. You can generally expect to pay an independent contractor at a higher rate than an employee because you are seeking those specialized skills and offsetting the business expense they incur rather than you.

### **Independent contractors conduct specific tasks**

Given that independent contractors have specialized skills, you must also realize they are often contracted with to complete specific projects. A contractor could, for example, design collateral material for your business or invoice clients. You would not want them managing a particular area of your business, because you cannot have day-to-day oversight of independent contractors. You need to identify work that can be completed independently without supervision.

### **Independent contractors get paid through invoice**

In most cases, you pay people for their time through a paycheck or an invoice. An independent contractor owns a business and invoices you for work performed. You cut a check to the person or their entity directly. The fee can be project based or by the hour. This is different than someone who works for a temporary agency. You pay the temporary agency through an invoice, but the person is given a regular paycheck by the temp agency.

### **Independent contractors are responsible for taxes**

Like any other business owner, an independent contractor pays taxes directly to the government. It's important to collect a W-9 form from the contractor if you pay them more than \$600 during the

calendar year. In the beginning of the following year the contractor will receive a 1099 form that states the annual amount earned.

### **Hiring an independent contractor can have risks**

Unfortunately, some employers have abused the independent contractor rules. They have misclassified people as contractors for a number of reasons, but in general, it is to save money. That means government regulators are paying attention and making sure employers are not misclassifying people. The IRS has an entire page devoted to the subject, because it is “critical that business owners correctly determine whether the individuals providing services are employees or independent contractors.”

The IRS is generally concerned about the amount of control you have over a person when determining whether he or she is an independent contractor or employee. Businesses must be careful, because the fines for violating the statute are high. Civil penalties can run between \$5,000 and \$15,000 for each violation. If a pattern of misbehavior is established, an employer can see penalties between \$10,000 and \$25,000 per violation. The risks of misclassifying for California employers are even greater. In addition, legal fees can be high if the case goes to court.

### **Strict contractor laws in California**

California has one of the strictest laws in the country when it comes to utilizing independent contractors. Labor advocates have argued that some businesses were taking advantage of the independent contractor rule to reduce the need to provide required benefits to employees and decrease employer taxes in order to reduce overhead costs. Now, for a company to engage someone as an independent contractor, it must ensure compliance with the new AB5 law. The law went into effect Jan. 1, 2020 and codifies precedent established in a California Supreme Court ruling in 2018 which required businesses to start following what is termed the ABC test. Most importantly, it expanded the rule beyond just wage hour cases to include class actions, is retroactive and narrowly allows defined exceptions.

Key examples of allowed exceptions are licensed professionals such as attorneys, doctors, architects, engineers, accountants and investment advisers. Professional service contracts for marketing, human resources and graphic design are still allowed but they must also meet further specific requirements. Business to business written contracts are excepted for entities that are organized in a legally recognized form (i.e. sole proprietor, partnership, LLC, or corporation) but they also must still meet the “economic realities test” set forth in the 1989 Borello case.

### **Should I still use independent contractors?**

Yes, this is still an important way for businesses to successfully get specialized skills to get certain work done in their business. However, to be sure you are properly utilizing independent contractors

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in your business it is recommended you talk with an attorney or a human resource consulting company to be sure you are classifying correctly.