



INDEPENDENT CONTRACTORS

This Legal Lines provides an overview of the issues surrounding employing an independent contractor:

- Employee vs. Independent Contractor
- The Initial Contract for the Services of an Independent Contractor
- How Much Authority Should You Give an Independent Contractor?
- Useful Internet Resources Regarding Independent Contractors

Employee vs. Independent Contractor?

The difference between the employee and independent contractor categories hinges on the amount of control and direction your organization exerts over the worker in various situations. Generally the more control your organization exerts over a worker, the more likely that worker is an employee and not an independent contractor.

The Federal Test

But what determines control or direction? Courts and the IRS are looking for facts that indicate the level of control and independence the worker has in the work they perform for the organization. The table below summarizes the types of facts that authorities use to make the distinction between an employee and independent contractor.

Behavioral Control	Financial Control	Relationship of the Parties
<ul style="list-style-type: none"> • Instructions the organization gives the worker regarding where, when and how to do the work involved. • Amount of training the organization gives the worker 	<ul style="list-style-type: none"> • The extent to which the worker has unreimbursed business expenses. • The extent of the worker's investment. • The extent to which the worker makes his or her services available to the market. • Whether the worker can make a profit or loss off the project. 	<ul style="list-style-type: none"> • Written contracts describing the relationship the parties intend to create. • Whether the organization provides the worker with employee-type benefits. • The permanency of the relationship. • The extent to which services performed by the worker are a key aspect of the regular business of the organization.

Source: *Employer's Supplemental Tax Guide*, IRS Publication 15-A, January 2004.

All of these factors are looked at as part of a “bigger picture.” No one factor is more significant than the others, and the same factor can be interpreted differently in different situations. This makes it important to keep all of them in mind when creating the independent contractor relationship.

If you are unsure whether a relationship is (or will be) considered an independent contractor relationship, you can request a determination from the IRS. To do so, you must complete Form SS-8 and provide a number of attachments. The IRS will evaluate the information, and provide you with a response. This formal determination is not required, but can be helpful when you are entering into a relationship that has conflicting factors.

The State Test

Michigan law also has a multi-factor test to determine whether a worker is an employee or an independent contractor. Similar to the federal standard, the law says that if a person performs service under the "direction and control" of another person, then there is an "employer-employee" relationship.

While the factors are similar, they are not precisely the same. Among the factors considered by the state are:

1. Whether the employer will incur liability if the relationship terminates at will;
2. Whether the work performed is an integral part of the employer's business;
3. Whether the employee depends upon the wages for living expenses;
4. Whether the employee furnishes equipment and materials;
5. Whether the employee holds himself out to the public as able to perform the same tasks;
6. Whether the work involved is customarily performed by an independent contractor; and
7. The factors of control, payment of wages, maintenance of discipline, and the right to hire and fire employees.

What Does it Mean to You?

Your responsibilities will differ depending on whether you are working with an “employee” or an “independent contractor.”

	Employee	Independent Contractor
Taxes & Withholding	Must withhold income tax, social security, Medicare, and unemployment taxes on employee’s wages	The independent contractor is responsible for paying his or her own income and self-employment taxes
Benefits	Must offer employee benefits (health, leave, training, etc.) consistent with your employee handbook, employee policies and other internal procedures	No employee benefits to independent contractors
Workers’ Compensation	Must maintain workers’ compensation insurance for your employees	Independent contractor is responsible for maintaining his/her own workers’ compensation insurance
Liability	May be liable for any wrongful acts of your employee	Generally, you are not responsible for the wrongful acts of an independent contractor

The Initial Contract for the Services of an Independent Contractor

There are many steps to establishing a successful relationship with an independent contractor or consultant. Much of the preliminary work (establishing your needs, defining the project, assessing your ability to work with a contractor, etc.), is often done without any interaction with those outside your organization. The request for proposal, bidding, and interview process is crucial to ensuring that you choose a contractor who is right for your organization. But the work of defining the relationship doesn’t end there.

A carefully drafted contract with your chosen contractor is essential. It makes sure that both client and contractor understand the client’s needs, the contractor’s skills, and their mutual responsibilities. It clarifies issues of oversight, payment and evaluation. It provides guidelines for conduct throughout the relationship. And although the presence of a contract does not guarantee that an independent contractor relationship has been established, it is one of the many factors that federal and state agencies will consider in testing whether the worker has been properly characterized. The key consideration in any contract is that **you understand and agree to all terms before you sign it.** Employment/consulting contracts that are poorly drafted or do not represent your best interests can lead to many headaches in the future and possibly litigation. Seek review of any contract that you feel you do not fully understand.

There are several forms a contract can take. It may look like a traditional contract, with numbered clauses. In some circumstances it may be an engagement letter, and include all of the above information in a letter format (this is especially common with

attorneys and accountants). In other cases (usually with architects), it may be in the form of a prepared booklet. All of these are valid, and are equally binding.

Regardless of the form of contract, attachments, exhibits and addenda are commonly included. They are part of the contract, and are binding as well. If using attachments and exhibits will help clarify the intent and content of the contract, use them!

The content and form of a contract will vary depending on the parties and their needs. There are, however, key provisions that must be present for the contract to truly do its job. At a minimum, the contract should include:

1. An identification of the parties, their names and addresses.
2. A detailed description of the services to be provided, including standards for performance.
 - Should include responsibilities of the Contractor and Client, as well as joint responsibilities.
 - Should be detailed enough that an outsider, with no background of the parties or the project, would be able to determine who is responsible for each aspect of the project.
 - Standards may be based on industry norms, or tailored to the particular project.
 - Should also include any statement of warranty for work.
3. A timetable for completion of key tasks or products, including the start date and ending date of the agreement, and key benchmarks.
4. A description of fees (project based or time based), procedure for expense reimbursements, and/or payment schedules and method of payment.
 - If the fee is to be based on time, a projection of the hours necessary should be included whenever possible.
5. A statement of which out-of-pocket costs will be paid by the contractor, and which will be paid (or reimbursed) by the client.
6. A statement of whether or not the contractor is authorized to use subcontractors.
7. The type, format and frequency of reporting requirement of both parties.
8. The names and contact information for the lead contacts for both contractor and client.

9. The procedures for changing the scope, payment arrangements, or other aspects of the consulting relationship (including the names of the people authorized to make such changes).
10. A clause addressing liabilities and indemnification, including insurance requirements.
11. The conditions and procedures for canceling the contract.
12. A clause addressing confidentiality policies – what each party’s existing policy is, and what the policy will be for this contract.
13. A clause addressing ownership of materials produced under the agreement.
 - Who will own the materials? Who can use them? For what purposes?
14. A statement of the employment status of the contractor in relation to the client (“shall be an independent contractor”).
 - **Remember!** This is not determinative, only a factor.
15. Whether mediation, arbitration or other dispute resolution is required.
16. Dated signatures of persons authorized to execute the agreement.

There are also many other standard provisions which will likely be included (which state’s law is applied, where notice should be sent, etc.). These 16 are those which are most crucial to governing the independent contractor relationship, and many are also the ones which must be the most carefully tailored to the individual project.

How Much Authority Should You Give an Independent Contractor?

Mishaps and accidents are not the only unexpected complications that an organization may encounter when working with contractors. Particularly when working with a contractor who has specialized expertise and significant roles, it may be tempting to give them a great deal of authority. In doing so, you may be opening the door to problems in the future.

A nonprofit must be cautious about how much authority it gives to its contractors. Often, it can be hard to decide how much authority you should give to a contractor. In order for the contractor to do his or her job effectively, contractors may need to have the ability to take some actions on the nonprofit’s behalf. Your organization should carefully decide what decisions and actions the contractor should have control of. You should also be sure that the contractor understands and agrees to these limits.

As a general rule, there are certain types of decisions that the organization should be sure it has the “final word” on:

- Decisions that will have a significant financial impact on the organization
- Decisions that will significantly change the timeline of a project
- Decisions that waive one or more requirements under an existing contract
- Decisions that will cause the organization to incur debt
- Decisions that will create joint ventures or other long-term relationships

This list is not all-inclusive, and there is no “magic formula.” The extent of a contractor’s authority must be determined on a case-by-case basis. But thinking about these key characteristics may help you determine what level of authority you are comfortable giving to your contractor.

How Do I Make Our Contractor’s Authority Clear?

The theory of “agency” is what gives one person the legal ability to act on behalf of another. One way to minimize the likelihood that your organization will find itself in an unintended agency arrangement is to include express language in your contract stating that no agency is created. In addition, you should be careful to make clear to third parties who is and is not authorized to act on your behalf, if there is the potential for any uncertainty.

If you have reason to believe that a contractor is allowing others to believe that he or she has more authority than he or she really does, you should talk to the contractor to make your expectations clear. You should also contact anyone you think may believe your contractor has the authority to act on your behalf, and clarify the relationship. A phone call is a good start, but written notice is essential if you want to avoid unintended liability in the future. This is particularly important where a contractor has acted outside of his or her authority, and you want to “put the world on notice” that he or she is not authorized to do so.

Useful Internet Resources Regarding Independent Contractors

IRS Publications

Independent Contractor or Employee, IRS Publication 1779 (December 1999).
<http://www.irs.gov/pub/irs-pdf/p1779.pdf>

Employer's Supplemental Tax Guide, IRS Publication 15-A (Revised January 2004).
<http://www.irs.gov/pub/irs-pdf/p15a.pdf>

Nolo Press

Hiring Independent Contractors
<http://www.nolo.com/lawcenter> (Choose "Independent Contractors" from browse menu)

Volunteer Accounting Service Team of Michigan

The Michigan Nonprofit Management Manual, Fourth Edition (2003)
<http://www.vastmi.org/pages/manual.cfm>

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