



# WHITEPAPER: How to Mitigate Risks When Engaging Independent Contractors

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## EXECUTIVE SUMMARY

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Independent contractors have increasingly become an integral part of doing business, offering several benefits from cost savings to staffing flexibility. More and more businesses from various industries are realizing the advantages and increasing the use of contractors.

However, if not done properly, engaging independent contractors can cost your business. With misclassification being the top challenge, audits, liability and co-employment are other risks you may face when hiring contractors. Both federal and state governments are adopting stricter measures to classify workers. The IRS, U.S. Department of Labor, and a growing number of states have collaborated and taken measures to share data to expose companies violating worker classification laws.

While there are risks, it doesn't mean that your organization cannot hire and engage independent contractors. If an organization has the resources, it is possible to create a well-defined program, ensuring all federal, state and local laws are followed. However, this can be a big task to take on, and that's why many companies prefer working with a knowledgeable and experienced staffing partner.

When you work with a well-established staffing company like Stage 4 Solutions, the agency is the primary employer of the worker who will pay wages, withhold taxes, negotiate terms, provide benefits and workers' compensation, and has the right to hire and terminate. In our over 20 years in staffing for primarily contract roles for over a hundred organizations, we have created well-defined policies and procedures that eliminate these risks.

## ABOUT STAGE 4 SOLUTIONS

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Stage 4 Solutions, Inc. is an award-winning, women-owned and minority-owned consulting and interim staffing firm headquartered in Saratoga, CA, with a presence in over 30 states and offices in Boston, MA and Harrisburg, PA. We specialize in serving high tech companies, government agencies and healthcare organizations by providing seasoned professionals for both short term and long term needs across marketing, technology and operations teams.

We bring together the right people, processes and skills to help organizations achieve their performance objectives and meet diversity goals. With a 20-year track record of creating success – we deliver multiple qualified candidates for client review within days and our placement success rate exceeds 99%. We have served over a 100 organizations and have achieved 100% client referenceability.

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## BENEFITS OF ENGAGING CONTRACTORS

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There are several advantages to hiring contractors for businesses, from financial benefits to staffing flexibility. More and more businesses from various industries are realizing the benefits and increasing the use of contractors.

One of the top reasons companies turn to contractors is to meet short-term project and skills needs. In many cases, organizations do not have the right resources with specific skill sets readily available in their teams to complete key projects. Bringing in an expert contractor with the niche required skill will ensure companies meet immediate staffing needs and achieve project goals.

Most of the time, skilled contractors are highly efficient in their work right from the beginning and do not require training, which will help save time and increase productivity.

Unlike hiring employees, companies have the flexibility to hire contractors when they need them for their desired term, depending on critical projects or seasonal needs.

One other reason is the financial benefits. Contractors are not offered benefits that are offered to employees, such as share of employee's taxes, unemployment compensation insurance, workers' compensation insurance, health insurance, 401K, training and many more. They are only paid for the hours worked for the duration of the project.

With all the great benefits, there comes the risks. It is very important to know and understand the definition of an independent contractor under the law and the risks that may arise while engaging contractors. However, there are ways to mitigate risks and achieve efficiency.

## WHAT IS AND ISN'T AN INDEPENDENT CONTRACTOR UNDER THE LAW?

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Using independent contractors has been a common practice that can help companies reduce costs such as payroll taxes and benefits. While it has its advantages, the risk of penalties is on the rise. Both federal and state governments are adopting stricter measures to classify workers. The IRS, U.S. Department of Labor and a growing number of states have collaborated and taken measures to share data to expose companies violating worker classification laws. To prevent penalties and legal liabilities, the first step is to understand what an independent contractor is under the law.

An individual hired by an organization will have one of the two classifications: an employee or an independent contractor. The IRS, in [Topic No. 762 Independent Contractor vs. Employee](#), states that under common law, the relationship between the worker and the company must be examined to determine one or the other. There is really a thin line that distinguishes an employee from an independent contractor. However, it is crucial to get it right to prevent potential legal and financial challenges.



When determining whether the worker is an independent contractor or an employee, evidence of the degree of behavioral and financial control and dependency in the relationship should be considered. What does this mean? For example, if an employer has too much control over how the work is completed, it may cause issues, or if the employer offers even small perks or benefits, that may lead to serious problems. Unfortunately, there is no single nationally accepted definition of an "independent contractor." The interpretation can differ from one case to another.

Let's look at the categories IRS considers when classifying a worker:

### **Behavioral Control:**

IRS would consider a worker as an employee when the company has the right to direct and control the work performed. If the company gives instructions on when and where to work, what tools to use, or how to purchase supplies and services to perform the work, this may indicate a worker is an employee. The degree of instructions is another factor. The more detailed instructions reflect more control over the worker and may indicate the worker is an employee. The evaluation systems to measure the details of how the work is performed can point to either an employee or independent contractor – all open to interpretation. The level of training provided can also be evidence of whether the worker is an employee or not. Independent contractors use their own methods and knowledge and should not require training from the organization.

### **Financial Control:**

If the company provides equipment for the worker to perform the job, this can provide complications. The ability to seek other business opportunities is another consideration. Unlike employees, independent contractors are free to seek out business opportunities. The method of payment is another factor when determining the classification. The financial control aspects provide more clarity compared to behavioral control aspects, as expected.

### **Relationship:**

The third area is the relationship which can be considered the most complex out of all. A written contract can be helpful to outline the relationship between parties, but it's not sufficient. The factors such as perks and benefits, the permanency of the relationship, the importance of services provided for the business are taken under consideration when determining the classification of the worker.

According to the U.S. Department of Labor, Wages and the Fair Labor Standards Act, a worker is entitled to minimum wage and overtime pay protections under the Fair Labor Standards Act (FLSA) when there is an employment "*relationship*" between the worker and an employer and there is coverage under the FLSA. The Wage and Hour Division is responsible for determining whether an employee has been misclassified as an independent contractor and has been denied critical benefits and labor standards protections. There is no single rule or test defining the relationship between a worker and employer.

In addition to federal law, state and local laws should be in consideration. Today, the State of California leads the path when it comes to tightening its policies about the classification of workers. The [Assembly Bill 5](#) (AB5), which took effect on January 1, 2020, introduced the "ABC Test" as a standard to classify workers. The ABC stands for:

*A: the worker is free from control and direction of the hiring entity in connection with performing the work, both under contract and in fact,*

*B: the worker performs work outside the usual course of the hiring entity's business, and*

*C: the worker customarily engages in an independently established trade, occupation, or business of the same nature as the work performed.*

The California [Assembly Bill 2257](#) (AB2257), which revised the State's independent contractor laws, went into effect on September 4, 2020. AB 2257 maintains the framework of AB 5 for worker classification and also expands the exemptions.

Several other states have implemented laws or introduced new bills to tighten measures or add and change worker classification definitions. In addition to California, Connecticut, Delaware, Illinois, Indiana, Massachusetts, Nebraska, Nevada, New Hampshire, New Jersey, Vermont, Washington, and West Virginia are some of the other states that apply some version of the [ABC test](#) to classify workers.

## TOP 4 RISKS WHEN ENGAGING CONTRACTORS

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Independent contractors have increasingly become an integral part of doing business. However, if not done properly, engaging independent contractors can cost your business. While misclassification being the top challenge, we have laid out the top risks you may face when hiring contractors.

### Misclassification

Probably the top risk of independent contractor engagement is misclassification. The risk of misclassification has been on the rise due to the legislation and tightened scrutiny from government agencies. As more employers increase hiring independent contractors without really understanding these definitions and laws, it has become more common for organizations to face liabilities due to [misclassification](#) of an employee vs. an independent contractor. According to [the Economic Policy Institute](#), almost 20 percent of businesses are misclassifying at least one contractor who should be considered an employee. Whether intentional or unintentional, this serious mistake can lead to penalties for the company and lead to unforeseen federal tax charges for the independent contractor. To prevent this, it is important to know the federal, state and local government regulations and create a compliant program to engage independent contractors.

Leading organizations such as Microsoft, Federal Express, Uber and Lyft have had to pay settlements in large amounts due to [misclassification](#) since the 1990s. The federal, state and local governments are taking the worker classification cases very seriously.

Many factors can lead to misclassification, and mismanagement is a common one. Independent contractors are expected to provide services outlined in a Statement of Work or contract and provide deliverables. The company

should not manage and control them as if they are employees and maintain certain boundaries. Mismanagement can also occur when the company provides work equipment or training that employees receive. It's best to outline clearly the detailed deliverables, dates, metrics and other important factors in the contract to avoid mismanagement.

## Liability

Although remote work has been the new norm since 2020, following the Covid-19 pandemic, not all jobs can be performed remotely. If the independent contractors suffer on the job, they would not be covered under the company's workers' compensation insurance policy, making the organization liable. It is important to include insurance requirements in the contracts before starting the work.

## Audits

Several instances can trigger an audit during the engagement with independent contractors. If a contractor files for unemployment, requests classification determination, or a whistleblower at the company reports misclassification, or government agencies believe a contractor is misclassified, the company can get audited.

## Co-employment

Another common problem is co-employment, which occurs when multiple employers have rights and legal responsibilities as an employer. For example, if a worker hired by a staffing agency for a client is on-boarded by the client instead of the staffing agency as if the worker is a permanent employee, this may be considered co-employment.

## HOW TO MITIGATE RISKS

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While there are risks, it doesn't mean that your organization cannot hire and engage independent contractors. If you have the resources, you can create a well-defined program within your organization, making sure you follow all federal, state and local laws. However, this can be a big task to take on, and that's why many companies prefer working with a knowledgeable and experienced staffing partner.

When you work with a well-established staffing company like [Stage 4 Solutions](#), the agency is the primary employer of the worker who will pay wages, withhold taxes, negotiate terms, provide benefits and workers' compensation and has the right to hire and terminate. According to the [U.S. Small Business Administration](#), even when hiring employees temporarily, companies are required to provide certain benefits such as unemployment benefits, workers' compensation, Social Security and Medicare. Your staffing partner should hire the contractors as their W-2 employees and provide at least the minimum benefits.



Your organization will have a contract with the staffing partner, which clearly outlines the scope of work, deliverables, duration and other terms. The staffing agency is responsible for supervising the worker and ensuring the work is done.

If you work with an experienced agency, the misclassification issue can be eliminated.

However, if the staffing agency is unaware of the co-employment risks, you may encounter other issues. Before executing a contract with the agency, you should make sure the agency has processes in place to properly engage independent workers. Not all staffing agencies hire consultants as W-2 employees, and they may prefer C2C (Corp-to-Corp) engagements, which is not an ideal approach to eliminate these risks.

Also, it is a good idea to train your W-2 employees, primarily the managers interacting with independent contractors, so they know the dos and don'ts when it comes to treating contractors to avoid misclassification issues.

If you decide to create your own program without partnering with a staffing firm, it is recommended to conduct internal audits to ensure your processes are compliant, review and update your guidelines and train your employees to reduce the risk of being audited.

## STAGE 4 SOLUTIONS' BEST PRACTICES

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In our over 20 years in staffing for primarily contract roles for over a hundred organizations, we have created well-defined policies and procedures that eliminate the risks mentioned in this whitepaper.

✓ Knowledge of federal and state laws:

Stage 4 Solutions is a registered employer in over 30 states. Our experienced and knowledgeable operations team closely follows and seamlessly adapts to the new regulations introduced by the federal, state and local governments.

✓ Our contractors are our employees:

All of our contractors are W-2 employees with benefits (health insurance, 401K, workers' compensation, unemployment benefits) offered. From the beginning of the interview process, we are the main point of contact for the worker to discuss the terms of the job, salary, benefits, etc. Where applicable, we offer continued employment to our employees beyond one client project.

✓ Clear and detailed SOWs for each engagement:

Our dedicated account managers work with our clients closely to understand their needs and create a clear SOW for each engagement that includes the tasks and deliverables with key dates.

✓ Ongoing communication:

Our account managers are regularly in touch with both the employees and clients. When there is a performance concern, we communicate the issues with our employees to prevent mismanagement.

### **Our Value:**

We bring together the right people, processes and skills to help organizations achieve their performance objectives and meet diversity goals. We are a highly experienced group of professionals with a proven track record of delivering results. With over 50,000 consultants in our network, we are able to match the best consultant(s) to our clients' needs. Our team's experience spans a wide range of expertise across market segments, industries and technologies.

We are dedicated to creating true partnerships with our clients built on a foundation of clear communication, trust and respect. Since our foundation, we have served over a hundred companies, from startups to Fortune 100 companies and adopted this partnership approach and commitment at the core of every engagement.

[Please check out what our clients say about us by clicking here!](#)

To learn more about how we can help you fill critical gaps, please [contact us](#).