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BW SMALLBIZ -- HIRING

## The Road to Independents

**Contractors can give you a cheap and flexible workforce, but beware the IRS potholes**

By Anne Field

After a special promotion led to a big surge in traffic last May, one of Michelle Madhok's Web sites came crashing down. Frantic, Madhok tried to contact the Webmaster for SheFinds.com, which posts shopping and fashion advice for women. But the Webmaster was an independent contractor. It took Madhok an entire day to find him, and she missed a huge marketing opportunity. "That was a very, very, very tense 24 hours," says Madhok, whose New York company, White Cat Media, also runs MomFinds.com.

Contractors are a fact of life for many entrepreneurs, and for good reason. A lot of companies have staffing needs that vary by season. Entrepreneurs in specialized fields such as graphic design and software development often want to use their high-priced help only sparingly. Companies save on more than wages, too. Employers don't pay state or federal payroll taxes when they hire contractors, and they don't have to shell out for benefits.

Yet precisely because they're not on staff, independent contractors present vexing management challenges. They're not likely to feel the same commitment a regular employee does, and they typically have other clients. "You're not their priority," Madhok says. "Often, they just don't have the same sense of urgency you do. Or you simply can't track them down." You'll also have to pay close attention to Internal Revenue Service rules covering who can be classified as a contractor. The IRS simplified its rules in 2006, but make no mistake, they are still confusing. And missteps can be costly. Business owners who incorrectly identify a worker as a contractor may be liable for back taxes, interest, and penalties as well as overtime wages and retirement benefits. A recent ruling by the Vermont Supreme Court may further spread the taxman's snares: The court ruled that the owner of a home-based sweater company could not treat her knitters as independent contractors because she provided them with fabric and patterns.

Still, when hired for the right tasks—and with close attention to the IRS requirements—contractors can save your company money while adding flexibility to your workforce. That's why Madhok continues to rely on them for everything from Web design to writing articles for her \$500,000 company. Says Madhok: "I couldn't run my business without them."

### **ON STAFF—OR NOT?**

Whether the smarter hire would be a contractor or an employee comes down to a few key issues. Most important is workload. "You have to decide how much time you need somebody," says Louis Barajas, a small business consultant in Santa Fe Springs, Calif. "If you don't have enough work to keep a person busy most of the time, you might consider using a contractor." That could describe a bookkeeper who comes in once a week or a computer troubleshooter. Sometimes, though, you'll be better off hiring a part-timer. Kathy Bowman Atkins, a human resources consultant and president of Lattitude Group in Greensboro, N.C., says: "If the work is needed on an ongoing basis and involves various and sundry tasks—say, an administrative assistant who comes in two days a week—consider a part-time employee instead of a contractor."

Also determine whether the job to be done is central to your business. The 45 employees of Junosource, a \$2.5 million San Bruno (Calif.) provider of loan processing and underwriting services for mortgage brokers, are responsible for such jobs as managing loans and addressing compliance issues, while the company's 10 contractors help with information technology, accounting, and other financial functions. "Employees do jobs that are key to delivering our service," says CEO Raghu Krishnaiah. Some positions also require considerable training, and Junosource hires staffers for those jobs to protect its investment.

You may also opt for a contractor if you need highly skilled workers and you can't foot the bill for full-timers. Three years ago, Assen Vassilev and Stanley Gyoshev founded New York-based Lessno.com, an online seller of discount plane tickets. Among the 15 independent contractors they hired were prominent researchers from Harvard, Cornell, and Massachusetts Institute of Technology who developed and fine-tuned the algorithms used in Lessno's software. "We call them when we need heavy lifting in technical areas," says Vassilev. "It means access to talent we wouldn't be able to afford otherwise."

Your needs also may change over time. Vassilev and Gyoshev originally used a contractor to oversee and maintain the \$3 million company's Web site. But they soon decided that the task was too important for anyone whose loyalties were spread across a number of clients and made it a staff position.

Just because you want to call someone an independent contractor, though, doesn't mean the IRS will agree. Before opening his three spas, Bruce Schoenberg, CEO of Oasis Day Spa in New York, consulted the IRS to see whether the people he'd hired, massage therapists and estheticians among them, could be considered contractors. But partly because he set their hours, the IRS "told us that almost everyone was an employee," he says. Without exception, you should seek advice from a lawyer before basing a business plan on contractors.

### **FINE SCREEN**

The most efficient and reliable way to find dependable contractors is to get references from employees and people you've worked with. When that's not possible, careful screening is essential. Brook Jay, president of All Terrain, an 18-employee, \$3.5 million Chicago event-marketing company, hires hundreds of contractors to hand out free samples and demonstrate products. Her managers conduct face-to-face interviews and ask each candidate to conduct a mock presentation. White Cat's Madhok places ads for writers and Web designers on such sites as Monster.com and Mediabistro.com. To lure dedicated workers, her ads emphasize how much time and resourcefulness the jobs demand. "I almost try to scare them away," laughs Madhok.

Draft a written agreement that describes everything about the contractor's job, from the work you need completed to how you will resolve disputes. Although most states let a boss fire an employee without giving a reason as long as antidiscrimination laws aren't violated, you can't do that with a contractor. So your agreement should cover all potential reasons for termination and the procedure you'll follow. Identify specific occasions at which you can call it quits, say, if the work falls behind schedule. But do not include intermediate steps that you'd typically take with an employee, such as giving a warning. Those might jeopardize the worker's standing as a contractor. And to keep contractors from sharing your secrets with a rival, have them sign a nondisclosure agreement. "A nondisclosure is the single best shield an employer can use to protect the confidentiality of information," says Nancy Cornish, an employment lawyer at Kissinger & Fellman in Denver. The agreement should bar disclosures both during the engagement and afterward. You can try to include a measure prohibiting work for certain competitors, but that restriction might not hold up in court, says Michael Hoffman, an employment attorney at Littler Mendelson in San Francisco. Better to state that contractors can't use any information they acquire in your shop when they're working for anyone else.

### **ARM'S LENGTH**

Managing the contractors you do bring on board is especially tricky because the needs of your business and the strictures of the IRS may pull you in opposite directions. Your contractors may not know your business or how their job fits into the bigger picture, so you'll want to give them considerably more guidance at the beginning of a project than you would a regular employee. But if you don't tread carefully, the IRS could rule that you're exerting too much control and that the contractor is legally an employee. "The contractor needs to be able to decide how best to accomplish a job," says Hoffman. "If a contractor is writing an employee handbook, you can tell that person the subjects you need covered, but not where to get the information." Take particular care with training sessions. Giving contractors instruction tailored to their project is fine; asking them to attend sexual harassment courses or other general sessions is a clear violation of IRS rules.

Once the job is under way, you'll need to keep information flowing to the contractors, but you can't appear to be controlling their time or effort. You will also need to include contractors in staff meetings on their project, but here the IRS has plenty to say. For instance, you can invite contractors to a meeting, but you can't demand attendance whenever you wish unless it is in your agreement. "If you want a contractor at a 9:30 meeting and he tells you he has to be at another client's office, you can't really insist he come," says William Nolan, an attorney with Squire, Sanders & Dempsey, a law firm in Columbus, Ohio. "That's getting a little too employee-like." So note in the contract all the meetings a contractor will have to attend.

You can also invite contractors to off-site gatherings appropriate to their jobs. Lessno asks its contractors to

twice-yearly meetings focusing on a single company operation, such as software development or marketing. Avoid meetings that are more general or that aren't germane to a contractor's assignment. And let contractors stay only for the parts of a meeting relevant to their positions. Similarly, inviting contractors to parties and other events can help them feel like they're part of the team, but you cannot require attendance. And don't play favorites. "If you have 10 contractors doing 10 different things, invite them all," says Nolan. Even little matters count with the IRS when ruling on a worker's status. "If you invite them to a picnic, that's O.K.," says Lattitude Group's Atkins. "But if you give everyone a shirt with the company logo, then don't hand them out to your contractors."

Finally, be careful when critiquing a contractor's performance. Avoid anything that might smack of a traditional evaluation. Instead, focus on service. If you aren't satisfied with the results, you can talk with your contractors about changes you'd like them to make. Or you can hold periodic review sessions with them as long as you restrict the discussion to the issues related to the assignment—not how they're spending their time. "If you call someone in and criticize them for not getting in at 8 a.m. when regular employees are supposed to arrive, that's not acceptable," says Cornish. Those may sound like trivial distinctions, but when dealing with contractors, the devil is in the details—lots and lots of them.