



STRATEGIC USE OF CONSULTANTS

Activity 4: Creating Strong Contracts

Understanding Tax, Labor, and Procurement Laws and Regulations

Background

Head Start and Early Head Start programs that use consultants for specific training and technical assistance purposes must be aware of and familiar with federal and state rules, laws, and regulations that govern relationships between organizations or businesses and consultants. These rules, laws, and regulations are legally binding, and programs must adhere to them. This handout provides introductory information on this topic and features links to further resources related to three regulatory areas that impact business-consultant relationships:

- Taxes
- Labor laws
- Procurement

Please note that for the purposes of this handout, the terms “consultant” and “contractor” are used interchangeably.

Independent Contractor versus Employee

When a program decides to engage an external consultant, the person should be hired as an “independent contractor” and not as an “employee.” This distinction then governs how the consultant is paid, who pays his or her withholding taxes, and whether the consultant is eligible for workers’ compensation. It also has implications for federal and state labor laws and program procurement policies.

The distinction between an employee and an independent contractor is made on the basis of three factors:

- **Behavior.** A business has the right to direct and control how its employees do their work, but it does *not* have the right to direct and control how work is done by an independent consultant. Consultants do not receive detailed instructions on how to perform their job, and they typically do not receive on-the-job training.
- **Finances.** A business can control economic aspects of an employee’s job, but it does *not* have the right to control economic aspects of a consultant’s job. A consultant may have expenses (e.g., office rent, telecommunications, technology) that are not reimbursed by the contracting organization (e.g., Head Start program). A consultant also may work for other organizations.
- **Type of Relationship.** The relationship between a consultant and a business differs from the relationship between an employee and a business. Consultants typically do not receive employee benefits, and the work they perform is time limited.

For more information on these factors, see the IRS Small Business and Self-Employed Tax Center at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/>.

When writing a consultant contract, always seek professional legal and accounting advice to ensure that your program establishes a consultant agreement, not an employment agreement. Please note that the Internal Revenue Service (IRS) has determined that identifying an individual as an independent contractor (or consultant) in a contract is *not* considered proof of contractor status.

To learn more about the legal distinctions between employees and consultants, see Table 1.

Table 1
Employee or Consultant: Making the Distinction

		EMPLOYEE	CONSULTANT
BEHAVIORAL	<i>Type of instruction</i>	Generally receives the following types of instruction: <ul style="list-style-type: none"> • When and where to do work • Tools or equipment to use • Workers to hire • Where to purchase supplies and services • What order or sequence to follow when performing the work 	Generally receives the following types of instruction: <ul style="list-style-type: none"> • Final work products to be developed • Overall timeline for completing the work
	<i>Degree of instruction</i>	Typically receives detailed instruction; the more detailed the instructions, the more control the organization exercises over the worker	Typically is given free rein to plan the work; is given less detailed instruction (employer has given up right to control details of work)
	<i>Evaluation systems</i>	Evaluated on how the work is performed and maybe on the end result	Evaluated on the end result
	<i>Training</i>	Often receives periodic or ongoing training	Typically is not provided with ongoing training
FINANCIAL	<i>Significant investment</i>	Not relevant for Head Start	
	<i>Unreimbursed expenses</i>	Typically receives reimbursement for most costs, including any costs related to travel	Often does not receive reimbursement for some expenses
	<i>Opportunity for profit or loss</i>	Not relevant for Head Start	
	<i>Services available to the market</i>	Generally does not seek out other business opportunities while at the work place	<ul style="list-style-type: none"> • Generally free to seek out other business opportunities, and may advertise his/her services to other organizations • Should not spend significant time doing or soliciting other work while on the job
	<i>Method of payment</i>	Generally guaranteed a regular wage for an hourly, weekly, or other period of time	Generally paid hourly or a flat fee for work



		EMPLOYEE	CONSULTANT
TYPE OF RELATIONSHIP	<i>Written contracts</i>	Keep in mind that how the parties work together, and not the terms of the written contract, is what determines whether the worker is an employee or an independent contractor. Written contracts that state a worker is a contractor do not overrule any IRS determinations.	
	<i>Employee benefits</i>	Typically receives benefits that may include medical and disability insurance, pension plans, and paid vacation and sick days	Does not receive employee benefits
	<i>Permanency of relationship</i>	Expects the relationship to continue indefinitely	Expects the relationship to exist for the duration of a specific project or through a specified time period
	<i>Services provided to business</i>	Provides services that are a key aspect of the business	Provides services that supplement the core work of the business

Consultant Tax Forms

For all employees, programs must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax. However, programs are generally not required to withhold or pay taxes on payments to independent contractors or consultants.

Still, Head Start programs working with independent consultants on a contract basis must be familiar with the following two IRS forms:

1. **Form W-9** is the Request for Taxpayer Identification Number (TIN) and Certification. This form:
 - Is informational and is used to complete Form 1099-MISC (see below)
 - Is completed by the consultant and given to the organization to verify the consultant's name and TIN (generally the contractor's social security number)
 - Does not need to be submitted to the IRS
 - Must be kept in the organization's files for four years after payment to the consultant

2. **Form 1099-MISC** is the form used to report payments from the organization to the independent consultant. This form:
 - Must be provided by the organization to the consultant by January 31 of the year following payment
 - Must be filed with the IRS by February 28 of the year following payment
 - Can be filed electronically or on paper

These IRS Forms can be accessed at [Small Business and Self-Employed Tax Center](#).

Note: If a consultant hires subcontractors to help perform his/her work for a program, the consultant is responsible for the tax filing and reporting requirements for any subcontractors.



Labor Laws and Workers' Compensation Laws

Program leaders that engage independent consultants need to know about and understand applicable federal and state labor laws as well as the rules that govern workers' compensation. Listed below are brief introductions to how labor and workers' compensation laws and regulations impact a program's work with consultants.

Federal Labor Laws

Independent contractors or consultants are *not* covered under the following federal labor laws:

- Fair Labor Standards Act
- Family and Medical Leave Act
- Worker Adjustment and Retraining Act

The following links from the U.S. Department of Labor provide detailed information on federal labor laws and the status of independent contractors/consultants with respect to these labor laws:

- [Summary of the Major Laws of the Department of Labor](#)
- [The Fair Labor Standards Act Advisor](#) (helps employers determine whether or not a worker is legally categorized as an independent contractor)
- ["Who Is an Employee? Determining Independent Contractor Status"](#) from *Flexible Staffing Arrangements: A Report on Temporary Help, On-Call, Direct-Hire Temporary, Leased, Contract Company, and Independent Contractor Employment in the United States* by Susan Houseman (1999)
- [Understanding Employee vs. Contractor Designation](#)
Retrieved from IRS Fact Sheets.

State Labor Laws

Labor laws across states vary widely. Go to State Labor Offices at http://www.dol.gov/whd/contacts/state_of.htm to find and review your state's labor laws.

Workers' Compensation

Laws and regulations that guide workers' compensations also vary across states and can be confusing. A consultant may or may not be covered under the organization's workers' compensation plan—it just depends. Some consultants have their own workers' compensation insurance, and you may ask them to provide a certificate of workers' compensation insurance. In general, a proactive program director will learn in advance of hiring an independent contractor what exactly the laws are in her state and how those laws will affect workers' compensation for any of her hires. Go to State Workers' Compensation Officials at <http://www.dol.gov/owcp/dfec/regs/compliance/wc.htm> to find out more about your state's workers' compensation laws and regulations.

Procurement Regulations and Cost Principles

Grantee agencies are required to establish their own written procurement procedures based on federal standards for purchasing services—including consulting services—as well as supplies and other expendable property, equipment, and real property. The standards for procurement are found in federal regulations 45 CFR §§75.326-335.



Your agency's procurement system may be designed to be more stringent than the federal requirements. Program leaders should follow their organization's procurement guidelines and processes in hiring consultants to provide training and technical assistance. Program leaders should keep in mind that their parent organizations may have a dollar amount "threshold" that determines the procedures they are required to follow for contracting consulting services.

In particular, when contracting for an external auditor, grantees must follow the guidelines described in a 2012 Head Start Information Memorandum [ACF-IM-HS-12-01](#), which requires them to follow their usual procurement procedures in connection with selection of an auditor. Procurement processes must meet the applicable requirements of 45 CFR §§75.326-335.

Additionally, the IM suggests considering, "responsiveness to the request for proposal, relevant experience, availability of staff with professional qualifications and technical abilities, the results of external quality reviews, and price," when evaluating proposals for auditing services. The IM also directs that the governing body must approve selection of the external auditor.

Prior to engaging a consultant, program leaders should review the procurement checklist in Table 2.

Table 2

Engaging Consultants: Procurement Checklist

1. Review your organization's procurement procedures.
2. Check to see whether the anticipated payment for the consulting services meets the dollar amount "threshold" for following your organization's procurement procedures.
3. If the anticipated payment for the consulting services does not meet the dollar amount "threshold" for your organization's procurement procedures, consider whether there are other procurement guidelines or regulations with which you need to comply, such as the following:
 - a. **Appendix II to 45 CFR Part 75 - Contract Provisions for Non-Federal Entity Contracts under Federal Awards.** This section of the Code of Federal Regulations (CFR) concerns the key provisions needed in any contracts awarded by a recipient of federal funding.
 - b. **45 CFR §75.327 General Procurement Standards.** This section of the federal regulations addresses the written standards of conduct governing the performance of employees engaged in the award and administration of contracts.
 - c. **45 CFR §75.327 General Procurement Standards.** Grantee and delegate agencies must ensure that all employees engaged in the award and administration of contracts or other financial awards refrain from soliciting or accepting personal gratuities, favors, or anything of significant monetary value from contractors or potential contractors.
 - d. Based on the federal standard established in **45 CFR §75.328 Competition**, all procurement transactions, regardless of amount, must be conducted in a manner that provides, to the maximum extent practical, full and open competition.

Extend Your Learning

Listed here are additional resources and links to guide your understanding of federal and state laws and regulations that govern how Head Start and Early Head Start programs engage with consultants.

Procurement Standards (45 CFR §§75.326-74.335).

Retrieved from https://www.ecfr.gov/cgi-bin/text-idx?SID=507cfac1519b49a7eb9e0d6fb98dac74&mc=true&node=pt45.1.75&rgn=div5-se45.1.75_1326

These standards lay out the Uniform Guidance for grantees of the Department of Health and Human Services in the area of procurement.

Cost Principles (45 CFR 75 §§75.400-75.477).

Retrieved from <https://www.ecfr.gov/cgi-bin/text-idx?SID=507cfac1519b49a7eb9e0d6fb98dac74&mc=true&node=pt45.1.75&rgn=div5-sp45.1.75.e>

Overview: This section of the *Code of Federal Regulations* highlights the general cost principles that nonprofit organizations need to follow when hiring consultants.

Highlights: Content focuses on cost principles for determining costs of grants, contracts, and other agreements with nonprofit organizations. Nonprofit organizations seeking federal contracts can use these cost principles to meet the requirements associated with the financing of the project they were awarded.

Audit Requirements. (45 CFR §§75.500-520).

Retrieved from <https://www.ecfr.gov/cgi-bin/text-idx?SID=507cfac1519b49a7eb9e0d6fb98dac74&mc=true&node=pt45.1.75&rgn=div5-sp45.1.75.f>

Overview: 45 CFR §§75 Subpart F describes the processes to be used for auditor procurement.

U.S. Small Business Administration. (2012). *Hire a Contractor or an Employee?*

Retrieved from www.sba.gov/content/independent-contractors-vs-employees

Overview: This webpage offers a succinct, bulleted description of how independent contractors differ from employees.

Highlights: This resource explains why the distinction between a contractor and an employee matters and what the tax implications are for either classification.



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