

# HIRING AND MANAGING INDEPENDENT CONTRACTORS

## AVOIDING THE COSTLY MISTAKES OF MISCLASSIFICATION



### Abstract

The hiring and managing of independent contractors has become one of today's most pressing issues for employers, with business ramifications for years to come. Learn best practices for working with independent contractors while protecting your business.

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# Hiring and Managing Independent Contractors

This white paper focuses on one of today's most pressing business and legal issues: the hiring and managing of independent contractors. This issue has exploded in importance with the downsizing of companies, the creation of the virtual company, the increase in the use of consultants and temporary or leased employees, and the formation of strategic relationships. The question most employers ask is whether or not an independent contractor can be considered an employee for tax and liability reasons. The simple answer is that they might be viewed as employees.

This report reviews the definition of what is and is not an independent contractor, and follows with an analysis of various liabilities associated with the different status classifications and how employers can avoid misclassification claims.

## What Is an Independent Contractor?

According to the Internal Revenue Service:

*"The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done."*

## What Is an Employee?

According to the Internal Revenue Service:

*"Under common-law rules, anyone who performs services for you is your employee if you can control what will be done and how it will be done. This is so even when you give the employee freedom of action. What matters is that you have the right to control the details of how the services are performed."*

## Factors

These definitions are representative of most federal and state statutes, most of which specifically direct courts and agencies to construe workers' compensation laws, unemployment compensation laws, wage and hour laws, and other labor laws liberally. The purpose is to extend benefits to persons who arguably come within their scope. The Internal Revenue Service (IRS) and other agencies will cut through any independent contractor agreement they believe is a subterfuge for denying employee status.

The following is a list of factors derived from guidelines used by the IRS, state employment development offices, and the courts in helping to determine whether someone is an independent contractor or an employee. While the most significant factors are shown at the top, each worker is viewed on a *case-by-case basis*, based on each agency's or attorney's agenda, to ultimately determine whether or not the person is an independent contractor. In some industries some of these factors are weighted more heavily than in others.

The most significant factors are as follows:

1. **Control.** This is the single most important factor. As an employer, you can tell an independent contractor what job you need to have done and the results you expect, but not when to work on it or how to do it. It is a question of the extent to which the company exercises control over the details of the work being performed. To what degree has the company provided the worker with instructions or training?
2. **Distinct occupation.** Is the worker a skilled artisan, tradesperson, or businessperson who has special training, experience, and education? Is the worker professionally licensed and insured?
3. **Supply of resources.** Who supplies the necessary equipment, place of work, and other resources necessary for the worker to perform the job? Does the worker have an office at your company, at home, or somewhere else? Who pays expenses? What investment does the independent contractor have in his or her business?
4. **Custom in the locality.** Is the work usually done under the direction of an employer or by a specialist without supervision? How are similar workers treated by other companies in your industry or community?
5. **Length of work and method of payment.** Independent contractors are generally paid for the job done and not the hours worked. Method of payment, whether by time or the job, is a significant factor as is the worker's obligation to devote a set number of hours to the work to be performed every week. (Remember, just because someone gets paid a commission doesn't make him or her an independent contractor.)
6. **Integration of the worker's job functions into the business.** Is the worker's job required to be performed on an ongoing basis for the company as part of its regular business? Is there a continuing business relationship? If so, the relationship is likely that of an employee. This is where it is best to lease the worker from a temp agency.
7. **Conducting or attempting to do business elsewhere.** To what degree does the worker have his or her own business location, business stationery, licenses, and advertise to the public? Is there freedom to work for another company at any time? Are there 1099s from other companies?
8. **Eligibility for firing.** An independent contractor cannot be fired so long as a result that meets the specifications of a contract is produced. Likewise, the independent contractor cannot simply leave the job at any time without incurring liability.
9. **Opportunity for profit or loss.** Does the worker's profitability relate to personal business management skills, or is it guaranteed as with any wage? Do they receive bonuses or penalties based on certain performance benchmarks?
10. **Existence of employees.** How are the people the independent contractor supervises classified? Are they treated as the independent contractor's employees? How are their wages paid? Is there workers' compensation coverage for them?
11. **Belief of the parties.** The independent contractor relationship should be spelled out in writing. The IRS is giving greater weight to contractual arrangements.
12. **Clear communication of eligibility provisions for employee benefits.** In the wake of the *Vizcaino v. Microsoft* case, courts may be more willing to disregard an independent contractor agreement altogether if benefit eligibility has not been clearly spelled out within the plan itself, and communicated to all workers — employees and independent contractors alike.

There are more factors, but those above are by far the most critical.

## Why Hire Independent Contractors?

There are many benefits for classifying a worker as an independent contractor. They include the avoidance of various payroll deductions, such as FICA, FUTA, state withholding, federal withholding, state disability taxes, workers' compensation, and unemployment insurance. Independent contractor status eliminates the cost of overtime, accident, life, and health insurance, and pension and profit-sharing benefits. It also eliminates the cost of managing payroll functions, which can be significant. For example, a \$50,000 employee costs over \$4,000 just in FICA and FUTA withholdings alone. The overtime rate would be approximately \$37 per hour. Standard health benefits would cost \$350 per month or more. When totaled, the difference between the classification of that worker could be \$10,000 or more per year. There are also benefits associated with personnel law compliance, flexibility, specialization, etc.; however, the downside of misclassification can be substantial.

## Misclassification Can Be Costly

If an agency decides you have misclassified that \$50,000-per-year employee, you will not only have to pay the \$4,000 in FICA and FUTA, but you'll also have to pay sanctions of 1.5 percent for not withholding federal income taxes (\$750); a sanction for failure to withhold the employers' share of Social Security taxes, which is 20 percent of 7.65 percent of \$50,000, or \$765. In addition, if the IRS determines that the withholding was willful, the sanction for failing to withhold the income taxes can be equal to the highest rate that would apply to a single person with one exemption, approximately 30 percent of the \$50,000, or \$15,000. The sanction for willful failure to withhold the employee's share of Social Security payment (FICA and FUTA) can total over another \$7,000. As you can see, the costs of misclassification can be substantial.

Misclassifying an employee may also result in significant penalties under the Affordable Care Act (ACA). Under the ACA, employers may be subject to "failure to offer" penalties of \$2,000 per year times the total number of full-time employees (minus the first 30 full-time employees) if misclassification results in a failure to offer coverage to 95 percent of those deemed to be the company's full-time employees and just one such individual obtains subsidized exchange coverage. Employers may also be subject to "insufficient coverage" penalties of \$3,000 per year for each misclassified full-time worker who actually obtains subsidized exchange coverage because the employer coverage is either unaffordable or does not provide minimum value.

According to the IRS, there are millions of misclassified independent contractors, costing the government as much as \$30 billion in lost revenue. According to an IRS study of 1,200 instances in which employers claimed the work was done by independent contractors, more than 90 percent of the contractors were reclassified as employees. The average back-tax bill for guilty employers is approximately \$3,000 per employee, with some employer liabilities easily exceeding \$100,000. During a recent set of IRS audits, the average misclassification assessment was more than \$68,000 per employer. And, this does not include state taxing penalties and other exposures of significance.

From our findings, most complaints are brought to the attention of agencies when a single employee files a claim, usually one who has been terminated or not paid taxes. Once the agency has been alerted to the treatment of an employee as an independent contractor, it will not only look to see how other employees at the company have been treated, but also notify other agencies that have an interest in the classification issue. Soon a number of agencies are ready to assess fines, and an attorney may be ready to serve your business a class-action lawsuit.

Often, entrepreneurs and small businesses will hire secretaries or assistants and try to label them independent contractors to avoid paying workers' compensation and payroll taxes. Other companies will lay off employees and

then hire them back as consultants to perform essentially the same tasks they were doing when they were employees. This is, very simply, a formula for disaster.

For example, assume the secretary or assistant causes an automobile accident while doing work for the company. Assume that, as a result of this accident, he or she is disabled and unable to go back to work. Also assume people in the other car are hurt. Under this scenario, the company will be sued for the negligence of the “independent contractor” under the theory that the status is a subterfuge because the employer at all times retained control over work performance, etc., and thereby more properly should have defined him or her as an employee for liability purposes.

Since the employee is now unemployable, unemployment and workers’ compensation claims are likely to state the individual should have been classified as an employee. If the independent contractor is found to be an employee and the company does not have workers’ compensation coverage, then the company can be exposed to payments that its carrier would normally make if it were insured (e.g., physical therapy, vocational rehabilitation). In addition, the company will also be penalized by the state. This exposure alone can easily exceed \$100,000.

Then, because the company classified the independent contractor as such, it may have created an argument for its insurance company to deny insurance coverage. Using the company’s own classification, the insurance company can claim that the independent contractor is not covered under the company’s liability insurance — only employees are.

Next, because of a newly difficult financial position, it is likely the independent contractor will not be able to pay all taxes when they become due and will claim it is the fault of the employer for not withholding sufficient wages, including the 7.65 percent payment required for Social Security, spurring the IRS and other agencies to become involved. There is also the inevitable claim for overtime, which can go back for two or three years and may include double damage penalties.

**This is not an unlikely scenario.**

In fact, this example was drawn from actual cases. In the end, on top of being sued by a third party, the company is penalized by the IRS, state taxation authorities, workers’ compensation authorities, and required to pay workers’ compensation benefits out of its own pocket — benefits its carrier would normally have made.

The status of someone as an independent contractor or employee has further repercussions, including, but not limited to, licensing statutes, permit requirements, antidiscrimination statutes, laws governing minimum wages, maximum hours, overtime, and employment of minors, workers’ compensation, labor relations, insurance law, as well as the responsibility for the torts created by the worker in the scope or course of the contract. For workers’ compensation and tort liability purposes, independent contractors and leased or temporary employees may have “dual employment status,” meaning they are considered both your employee and someone else’s.

A worker’s status as an employee can also affect whether or not he or she is covered by your insurance or pension and profit sharing plans. This may result in breach of fiduciary duty claims, ERISA (Employee Retirement Income Security Act) violations, as well as penalties for failing to include the employee in any benefit plan.

## IRS Determinations

The IRS provides a manual as guidance to auditors for determining whether a worker is an independent contractor

or an employee. In the past, the IRS has been reluctant to accept the designation of an independent contractor; however, this may be changing in light of today's business realities. Some of the highlights of the guidelines are as follows:

1. The IRS is giving more weight to written contracts that designate the worker as an independent contractor. While contracts in and of themselves are not sufficient to determine a worker's status, the IRS now states that if the evidence is so balanced that a judgment could be made either way, a written contract may be one way to resolve the issue.
2. In the past, the "time and place" of work were important issues for the IRS in determining a worker's status. If the work had to be done at a certain time, the IRS usually interpreted that as evidence of "control" and, therefore, concluded the worker would be considered an employee. The IRS now allows that some work, by its nature, must be performed at a certain place and a certain time. This would have no impact on a worker's status.
3. The IRS now recognizes that by advertising a service to the public, a worker demonstrates that he or she is an independent contractor. These advertisements need not be in the newspaper or yellow pages, but can be by word of mouth, personal networking, etc.
4. The manual now makes distinctions between "suggestions" and "instructions." Instructions to a worker are considered evidence that a worker is an employee. However, the IRS now accepts that "suggestions" to a worker, which may or may not be followed, could be construed as evidence that a worker is an independent contractor.
5. The IRS acknowledges that having a worker wear a uniform will not weigh heavily in determining a worker's status.

Some provisions in the IRS manual make it more difficult for professionals, such as accountants, engineers, and consultants to claim independent contractor status. They are as follows:

1. The manual states that being paid an hourly wage is generally sufficient evidence to warrant a finding of employer-employee status, even though hourly wages are how most professionals such as accountants and consultants are paid.
2. The IRS ruled that making a significant investment in business facilities is evidence of independent contractor status. However, the IRS does not consider items that also have a personal use, such as computers, to be a significant investment.

A company can usually avoid a penalty for misclassification if it had a "reasonable basis" for that classification. The manual states a "reasonable basis" can be gained by consulting an attorney or accountant with expertise in the area.

Technically, this manual is not a policy statement by the IRS, but most attorneys and accountants are assuming that the manual accurately reflects the IRS' position on the subject.

## Liability for Independent Contractors

One of the upsides to using independent contractors is that you are generally not liable for their actions unless you have negligently hired them or, in the alternative, they are involved in "inherently dangerous" work. For example, security guards work in "inherently dangerous" work. If one of those security guards negligently injures someone, you can be held responsible along with them. In certain states you may face responsibility for the acts of unlicensed contractors. For example, in California, a party who hires an unlicensed contractor becomes the statutory employer of the contractor's workers and therefore legally liable for their actions.

An important distinction is that workers' compensation coverage covers employees, not independent contractors. Therefore, you can be subject to direct liability for injuries to these workers. For example, if an independent contractor

gets hurt on the job, you may not be protected by your workers' compensation liability policy and that independent contractor may sue you directly. Again, it is important to make sure any independent contractors have insurance coverage for any of their possible torts as well as workers' compensation coverage for any of their employees.

## Statutory Employees

Statutory employees occupy a middle ground between independent contractors and regular employees. Statutory employees are treated as employees for taxation purposes, but also have the opportunity to file Schedule C's and allow for business-related deductions. Occupations considered statutory employees include full-time life insurance salespeople who primarily work for one insurance company, certain drivers, traveling salespersons, and home workers who work on a contract or piecework basis, in their own homes, or in the homes of others. (Remember, FedEx and other employers have been fined for misclassifying their drivers as independent contractors. This is a tricky area and professional advice is recommended.) Again, they are entitled to deduct their business expenses on Schedule C, but must still pay income taxes on their net income since their employers are not required to withhold income taxes from their pay. The employer does, however, pay their self-employment tax (FICA).

## *Vizcaino v. Microsoft Corp.*, Setting the Stage for Today's Cases

In 1989 and 1990, the IRS conducted audits of Microsoft Corporation and found that a number of workers had been misclassified as independent contractors when they were in fact full-fledged employees with Microsoft, at least for tax purposes. Despite having signed agreements stating they were independent contractors, these workers worked on teams with regular Microsoft employees; they shared the same supervisors; they sometimes performed identical functions; they worked similar hours; they had admittance cards just like the regular employees; they worked at Microsoft-owned facilities; and they had access to the same office equipment and supplies as regular employees did.

Microsoft agreed to reclassify these workers as employees. This prompted a number of these misclassified employees to file a class-action lawsuit against Microsoft, to recover what they argued were wrongfully withheld benefits, including those accruing from an employee stock purchase plan and a 401(k) plan.

In *Vizcaino v. Microsoft*, the Ninth Circuit Court held that independent contractor agreements notwithstanding, the workers were indeed "common law employees" and were entitled to the benefits. Although the IRS reviews the practices of each business independently, this case has impacted how employers classify their workers, and how they administer benefit plans.

In the *Microsoft* case, even though the workers had signed independent contractor agreements, the court held that the wording of the benefit plans was ambiguous with respect to which workers were full-fledged employees and which were independent contractors. In essence, the court disregarded the agreements and focused on the wording of the plans.

In light of this and court decisions since this case, employers need to review eligibility criteria for participation in all benefit plans to assure the plans provide a legal basis for excluding independent contractors or contingent workers. All contractual agreements with independent contractors should include specific waivers of participation in employee benefit plans. Moreover, such a waiver must not be dependent on the worker's status as an independent contractor or contingent employee, because that status itself may be called into question when other facts are considered.

In addition, all benefit plans must contain a clause clearly stipulating that contingent workers are not eligible for the benefits. This clause and the clause in the independent contractor agreements may be worded as “mirror-images” of each other; that is, they may refer the reader back to the appropriate clause in the other document.

Finally, all this needs to be clearly communicated to all workers, regular employees and independent contractors alike. Unless this communication has taken place, the presumption may be that a firm’s independent contractors were unaware that they were not entitled to employee benefits.

## Misclassification Protection Checklist

- Do not have independent contractors go through the same hiring process you use for employees. For example, do not use a job application.
- When you hire independent contractors, temporaries, or outsourced employees, make sure to request a resume and interview them, check their references, and conduct background checks.
- Make sure your agreement is in writing. Be sure to address the essential factors set forth above, including the issues of control, place of employment, tools to be utilized, etc., in the agreement. Be sure it contains “work for hire” language. Have the final draft reviewed by an attorney.
- Pay attention to the wording of all benefit plans, including health, vacation and sick leave, profit sharing, stock purchase plans, pension plans, and 401(k) plans, particularly with respect to which workers are eligible for the plans and which workers are not. Insert a clause into each plan that specifically excludes independent contractors. Then make sure these changes are reflected with a “mirror image clause” in the agreement you ask these workers to sign. Consult an attorney as to the proper wording of these clauses.
- Obtain a business card, advertisement, brochure, business license, and 1099 from the independent contractor and retain them in your files.
- File an IRS 1099 form for the independent contractor’s wages.
- Keep the independent contractor’s file separate and apart from company personnel files.
- If in doubt, obtain an advance IRS classification ruling by filing form SS-8.
- Obtain proof of workers’ compensation insurance coverage and general liability coverage from the independent contractor and save it, or make sure they are covered under your policy.
- Obtain proof of an employer identification number (EIN), and use it on all payments to the independent contractor.
- Make sure the independent contractor invoices you for payment.
- Make sure the independent contractor is not reimbursed for expenses and that they pay for them directly.
- Do not allow independent contractors to hold themselves out as company employees. Their names should not appear on company letterhead, brochures, business cards, or other materials unless it is specifically indicated that they are an independent contractor, independent representative, affiliate, etc.



- Consider having independent contractors provide you with indemnity against any form of claim by any agency or third party related to their scope of services. It is cautioned that any form of indemnity provision may be declared void as a matter of public policy should the individual, in fact, be found to be an employee and not an independent contractor.
- Consider using a leased or temporary employee from an established agency.
- Remember, you cannot fire an independent contractor unless they breach the contract.
- Be aware that a number of state courts are beginning to allow independent contractors to bring claims for wrongful discharge, sexual harassment, etc., despite the fact that they are not "employees." You may consider having independent contractors sign Equal Employment Opportunity policies, provide them with sexual harassment prevention information, safety training, etc.
- Do not micro-manage or direct an independent contractor's work.
- Do not give independent contractors employee benefits (vacations, holidays, etc.)
- Make sure to include independent contractors in any safety training programs. You cannot delegate workplace safety responsibility to third parties.
- Lastly, if you know you have misclassified an independent contractor, you may be able to take advantage of frequent federal and state amnesty programs. They typically require you to pay the taxes owed and penalties are waived. Contact the IRS, your Employment Development Department or other taxing authorities about these programs.

## Conclusion

When you review the risks and benefits of hiring independent contractors, you may find that it actually costs less to hire an employee than an independent contractor. In many instances, you have someone whose work you can control, who you can train and insure, and provides you with peace of mind for very few extra dollars per hour. An employee may also have a greater sense of loyalty and commitment to your company.

This report is provided with the understanding that we cannot provide a wide audience with specific legal, technical, or other professional service or advice relating to hiring employees versus independent contractors. Additional information relating to this topic is available in the ThinkHR compliance library and from our ThinkHR Live Hotline advisors.