Independent Contractor – A Perilous Decision

Now and then, you may need to bring someone onboard to add a special skill, an extra set of hands, a strong back, or provide another short-term need that is not currently within the company. You know that you can find the needed help and decide you will pay for the services as an *"Independent Contractor"* relationship. Your reasoning is simple and logical. It is only for a short time and there is no need to go through all of the administrative expense of putting the person on your payroll. You instruct your staff to bring in the person as a contactor and send an IRS-1099 MISC at the end of the year if it meets the $600 threshold. Simple enough, right? Unfortunately, it is not that easy and flawed decision-making can be expensive. How expensive? Back wages and benefits, overtime pay, employer FICA, along with the fines and other assessments. The long penalty arm can reach back into the past and cause you to remedy all of those who have been misclassified, whether they are still around or not. I learned that from my expert opinion work and saw the potential for bankruptcy more than once from those who did it wrong.

HOW SERIOUS IS THE PROBLEM

Misclassifying an employee as an independent contractor is number eight on the top ten list of mistakes employers make, according the Department of Labor. The Fair Labor Standards Act (FLSA) contains the definition of an "employee" and defines when an employee-employer relationship exists. If an employer tries to circumvent the FLSA and pays the employee as an independent contractor, both the Department of Labor and the Internal Revenue Service have an immediate interest. The IRS announced the employment of additional agents to seek out employers attempting to circumvent their FICA tax obligation by misclassifying employees as contractors. No taxes are withheld, no overtime is paid, and no benefits of employment are offered to contractors. The individual becomes responsible for all of the FICA taxes, based on the IRS Form 1099 provided at the end of the year by the company. Undoing the misclassification can result in back pay and financial penalties.

THE IRS 20-FACTOR TEST

Employers can rightfully classify certain individuals as Independent Contractors, provided they meet a specific criteria. The IRS has issued a list of the criteria. It is commonly called the "IRS 20-factor Test." The 20 factors used to evaluate right to control and the validity of independent contractor classification describes the expected roles of the company and the contractor in order to conclude that a true independent contracting relationship exists.

1. Instructions
2. Training
3. Integration
4. Service rendered personally
5. Hiring, supervising, and paying assistants
6. Continuing relationship
7. Set hours of work
8. Full-time work required
9. Doing work on business premises
10. Accomplishing work in certain order
11. Submission of oral or written reports
12. Method of payment
13. Payment of business or traveling expenses
14. Furnishing tools and equipment
15. Significant investment
16. Realization of profit or loss
17. Work for one entity at a time
18. Offer their services to the general public
19. Right to discharge
20. Right to termination

THE 20-FACTOR TEST EXPLAINED

Looking at each factor specifically, a pattern becomes evident. There must be a separation of power and control that would be expected to appear in the formal agreement between a company and its contractor. The contractor must be a legitimate businessperson and not just a "person looking for work."

1. **Instruction**. If the company directs when, where, and how work is done, this indicates a level of control expected from an employer.

2. **Training**. If the contractor is required to participate in company training programs or is required to undergo individual training to perform the work, then it appears there is an employer-employee relationship. Contractors usually participate in some form of general orientation to the company and specific rules (smoking, access to confidential areas, location of restrooms, etc.), and that is all.

3. **Integration**. If the work of the Contractor is significant to the success of the business, then it appears the presence of the Contractor is essential to the business and the relationship appears to be an employer-employee relationship.

4. **Service offered personally**. If the Contractor must always be the person who performs the work and may not assign work to any of his/her staff, then it appears a level of control exists that would suggest there is an employer-employee relationship.

5. **Hiring, supervising, and paying assistants**. If the company hires, supervises, or pays the staff of the contractor, then it suggests the Contractor is in an employer-employee relationship.
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6. **Continuing Relationship**. A continuous relationship between a company and a Contractor indicates a possible employment relationship. However, an independent contractor arrangement can involve an ongoing relationship for multiple, sequential projects, rather than simply doing repetitive work over and over again that is usually done by employees.

7. **Set hours of work**. When a Contractor is assigned specific days or hours, the level of control suggest an employer-employee relationship exists. Obviously, the employer is able to negotiate the expectation of time commitment during the negotiation of the engagement contract.

8. **Full-time work required.** Requiring the Contractor to work full time for the business supports a finding of an employment relationship.

9. **Doing work on business premises**. Requiring someone to work on company premises—particularly if the work can be performed elsewhere—indicates a possible employment relationship.

10. **Doing the work in a certain order**. If the company demands the work be performed a certain way or in a certain sequence, then it appears the control is not balanced and an employment relationship exists.

11. **Submission of written or oral reports.** If the Contractor is required to submit written or oral reports in the same way as the company employees would, then it appears the employer is in control and an employment relationship exists.

12. **Method of payment**. Payment on commission, a fee schedule, or at project completion, is more characteristic of independent contractor relationships. When the payment is made by the hour or week, in the same way as employees, the Contractor relationship is questionable.

13. **Method of payment**. Independent contractors typically bear the cost of their own travel and business expenses, and build the cost is in their fees. They may negotiate expenses and how they are paid, as part of the engagement agreement. Submitting an expense report, as employees do, may compromise the employer-contractor relationship.

14. **Furnishing tools or materials**. Companies typically furnish all materials, tools, and equipment to their employees. Assuring that Contractors provide their own resources supports an independent contractor finding.

15. **Significant investment**. The worksite of employees is paid for by the company. Contractors must pay for their own office, vehicle, warehouse, or other facility where they operate their business. Furnishing an office, staff, telephone, computer, and other means to complete the work, will cause the relationship to be questioned.

16. **Realization of profit or loss**. Employees receive a paycheck based on work performed. A Contractor assumes a risk of profit and loss, based on the outcome of the work.

17. **Work for one entity at a time**. When a Contractor works for only one company, the challenge that the relationship is actually an employer-employee relationship will be easy. Contractors have multiple clients.

18. **Offers their services to the general public**. If a Contractor regularly makes services available to the general public, this supports an independent contractor determination.

19. **Right to discharge**. If the company can discharge the Contractor in the same way it discharges employees, then it will appear that an employer-employee relationship exists. Typically, there is specific language in the engagement contract regarding how the relationship ends.

20. **Right to terminate**. An engagement with an Independent Contractor ends according to the engagement agreement. If an employer can "terminate a Contractor at-will" then the relationship will appear to be employer-employee.

THE SAFE HARBOR RULE

If you have reviewed this list and melted into a mild state of panic, you should also know that the tax laws provide what is called a "Safe Harbor" rule, as it relates to employment taxes. You can avoid the Independent Contractor status challenge if you have met the terms of the Safe Harbor Rule.

This rule provides that an individual who has consistently **not** been treated as a common-law employee for any period after 1977 will not be reclassified as an employee if you, the employer, have filed all required federal tax returns, including information returns (Forms 1099-MISC), and if you had a reasonable basis for not treating the individual as an employee. Human Resources Managers look at consistency and past practice as a basis for decisions as to how to classify a worker. In other words, if you have always treated a certain worker as an independent contractor and properly filed the corresponding tax returns, you may be in the clear.

What is a "reasonable basis" for not treating someone as an employee? You may use three factors:

1. judicial precedent, published rulings, technical advice, or a letter ruling you received from the IRS,

2. a past audit by the IRS in which there was no assessment for the treatment, for employment purposes, of workers holding positions substantially similar to the position held by the worker in question, or

3. long-standing, recognized practice of a significant segment of the industry in which the individual works (for example, most workers in a specific occupation in your industry are treated as independent contractors by employers).

OTHER LIABILITIES

Some employers choose to put the worker on Independent Contractor status to avoid responsibility for any work-related injuries the worker may have during the assignment. That is not a valid reason. There have been many judicial decisions made throughout the country that have found that the company is responsible for work-related claims for illness or injury when the Contractor has no Worker's Compensation Insurance. Few employers want to risk that liability.

The same situation exists when there is a charge of discrimination, including sex harassment. Companies are not immune to claims made against their Independent Contractors. As the employer, you can be certain that the company will be charged, or at least listed as a "party-defendant," when there is a legal charge against a Contractor for inappropriate conduct against an employee of the company where an engagement is in progress. Historically, there have been claims that a co-employment relationship exists between the company and the Independent Contractor, and both are liable.

The potential for liability for actions of Independent Contractors over which there is limited or no control may be the most important deciding factor, regardless of the 20-Factor Test.

As you may have already concluded, the decision is classify a worker as an "Independent Contractor" is not simple. It is, in fact, complex. Some employers rely on their HR staff, their accounting staff, and their outside advisors, to assure they will not be in conflict with the law. When in doubt, the safe thing to do is to get an expert opinion or place the worker on the payroll, both to avoid the tax issues and other potential liabilities.

Nancye Combs is President of HR Enterprise, Inc. in Louisville, KY and a nationally respect authority in Human Resources and Organizational Development. She is the endorsed Human Resources consultant for five major trade associations, and consults with manufacturing and distribution trade association members throughout the world. Nancye has four decades of practical experience in human resources and executive management. She is called a voice of authority and, speaks, writes, and offers expert witness testimony on management issues. She is the Bellarmine University instructor for more than 1,100 human resources professionals seeking to become nationally certified by the Human Resources Certification Institute. She is also a member of the MREF faculty for those who are seeking to become a Certified Professional Management Representative (CPMR).

This is a business management advisory and is not designed to substitute for the services of a competent legal advisor. It is not specific to the laws of any state in the U.S. Nancye can be reached at:

Nancye M. Combs, AEP•SPHR
HR Enterprise, Inc.
P.O. Box 6507 • Louisville, KY 40206-0507
Office (502) 896-0503 • Personal (502) 419-6413 • FAX (502) 896-0033
e-mail: nancyecombs@aol.com