



The 1099 Time Bomb: Avoiding the Perils of Misclassifying Independent Contractors

By Don Phin, Esq.

This article will focus on one of today’s most pressing employment liability and business issues: the potentially dangerous consequences of misclassifying independent contractors as employees. The article will:

- ◆ Explain why this issue has become so prevalent in recent years
- ◆ Discuss the landmark case that put this issue on the “radar screen”
- ◆ Describe a case study demonstrating the enormous potential costs of misclassification
- ◆ Provide detailed guidelines for determining who is an independent contractor
- ◆ Offer specific steps to avoid misclassification errors

Why Has this Issue Exploded Recently?

There are four major reasons why the issue of independent contractor misclassification has become especially prevalent in recent years.

Corporate Downsizing

The wave of corporate downsizing that began in the early 1980s recession and has continued to the present day has produced a marked increase in the use of consultants and temporary

and leased workers. Throughout this period, companies have sought to lower: (1) fixed salary costs that continue, despite downturns in the business cycle and consequent reduced need for labor, and (2) ever-rising employee benefit costs—especially those involving health insurance. In many corporations that have undergone significant downsizing, it has become almost typical for these firms to rehire their former employees as consultants.

The Free Agency Trend

Admittedly, the majority of the impetus propelling the use of consultants and temporary and leased workers has been “involuntary,” in the sense that most people prefer a stable job with a single employer. However, there is a significant minority of individuals who prefer the flexibility of temporary/consulting positions as well as the benefits of being one’s own boss. Moreover, this trend has also been fueled by women who require both time at home to raise a family as well as an income—needs that are often met by working as an independent contractor rather than as an employee.

Virtual Companies

The explosion of the Internet, beginning in the mid-1990s, touched off a wave of Internet-based businesses whereby people could work from home, despite the fact that the actual company

for which they worked or the company's corporate headquarters was located thousands of miles away. Such persons may technically have been employees of the Internet companies. But by virtue of their remote locations and consequent lack of employer control over their day-to-day activities, they began to take on characteristics of independent contractors.

A Stepped-Up IRS Agenda

As the country's annual budget deficit and national debt climb skyward, the Internal Revenue Service (IRS) as well as state and local taxing authorities are stepping up their agendas in an effort to collect millions, if not billions, in unpaid taxes. The question these agencies usually ask is *whether or not an independent contractor can be considered an employee for tax and liability reasons*. The simple answer is that if they can, they will be!

***Vizcaino v. Microsoft Corp.* and Its Implications for Employers**

In 1989 and 1990, the IRS conducted audits of Microsoft Corporation and found that a number of its workers had been misclassified as independent contractors, when they were, in fact, full-fledged employees, at least for tax purposes. Despite having signed agreements stating they were independent contractors, these workers (1) collaborated on teams with regular Microsoft employees, (2) shared the same supervisors, (3) sometimes performed identical functions, (4) worked similar hours, (5) had admittance cards just like regular employees, (6) worked at Microsoft-owned facilities, and (7) had access to the same office equipment and supplies as the company's regular employees.

Reclassification: What Triggered the Lawsuit

When Microsoft agreed to reclassify these workers as employees, it prompted a number of the misclassified employees to file a class action lawsuit against Microsoft. The suit aimed to recover what the workers argued were wrongfully withheld benefits, including those accruing

from an employee stock purchase plan and a 401(k) plan.

The Court's Holding

In this case, the Ninth Circuit Court held that the signed independent contractor agreements notwithstanding, the workers were indeed "common law employees" and were thus entitled to the benefits accruing to employees in comparable positions. The court found that although the workers had signed independent contractor agreements, 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 signed agreements and focused instead on the eligibility wording of the benefit plans.

What the Case Has Meant for Employers

Although the IRS reviews the practices of each business independently, from the time this case was decided it has had important implications in three areas.

Eligibility Criteria. In light of this decision, 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.

Clear Statement of Ineligibility for Benefits. 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 direct the reader back to the appropriate clause in the other document.

Communication Requirements. Finally, the extent to which specific classes of people are eligible/ineligible for benefits 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.

The Costs of Misclassification: A Case Study

Most complaints alleging misclassification are brought to the attention of federal and state agencies when a *single* worker files a claim; usually one who has been terminated and/or has not paid any of his or her own taxes, such as Social Security 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 will also *notify other agencies* that have an interest in the classification issue. Before you know it, you will not only have a number of agencies ready to assess fines but also an attorney knocking on your door serving a class action lawsuit!

Layoffs Followed by Rehire as Independent Contractor: A Recipe for Disaster

Very often, entrepreneurs and small businesses will hire secretaries or assistants and try to label them independent contractors to avoid paying unemployment, workers compensation, benefits costs, and payroll taxes. In other cases, companies will lay off employees and then rehire them as consultants to perform essentially the same tasks they were doing when they were employees. This is, very simply, a formula for disaster.

A Misclassification Scenario with a Costly Outcome

Assume the following facts: (1) the secretary or assistant causes an automobile accident while doing work for the company, (2) is disabled as a result of the accident and cannot return to work, and (3) people in the "other" car are also hurt. Under this scenario, the company—rather than

the so-called independent contractor—will be held liable for the negligence of the secretary/assistant, under the theory that his or her independent contractor status is merely a subterfuge to disguise an employer-employee relationship. In reality, because the employer at all times *retained control* over work performance, the person was an employee, for whose actions the employer is ultimately held liable.

Uninsured Claims for Workers Compensation and Unemployment Compensation. Since the employee is now unemployable, he or she makes claims for both unemployment compensation and workers compensation. Investigation required by such claims reveals that the individual should have been classified as an employee. Assuming the so-called independent contractor is actually found to be an employee and yet the company does not have *workers compensation* coverage for that person, the firm can be exposed to liability payments that its insurer would ordinarily have made if it were insured (e.g., weekly payments for lost wages, physical therapy, vocational rehabilitation, payments for permanent disability). In addition, the company will also be penalized by the state. This exposure alone can easily exceed \$100,000!

Uninsured Claim for Automobile Liability. Then, because the company classified the worker as an independent contractor, it may have created an argument for its insurance company to *deny insurance coverage*. Consequently, the insurer can assert that the independent contractor is not covered under the company's liability insurance; *only employees are*. That's what you call "shooting yourself in the foot"!

Liability Claim by Worker for Employer Failure To Pay Withholding Taxes. Next, the worker is now likely to be in a difficult financial position, one in which he or she is unable to pay all of the accrued withholding taxes when they become due. The worker will then attribute this failing to the employer for not withholding sufficient wages, including the 7.65 percent payment required for Social Security. Next will come the IRS and "friends." Also inevitable under these circumstances is a "wage and hour" claim, in which the worker will allege that he or she was

wrongfully denied overtime pay. Such a claim can reach back for 2 to 3 years and may also include double damage penalties.

State and Federal Penalties. If a state or federal agency decides you have misclassified that \$50,000-per-year employee, you will not only have to pay the \$4,000 in Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes but you will also be liable for sanctions amounting to 1.5 percent of the worker's salary for not withholding federal income taxes (\$750). In addition, there will be a sanction for failure to withhold the employer's share of Social Security taxes, which is 20 percent of 7.65 percent of \$50,000, or \$765. Moreover, 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!

Misclassification Costs: The Big Picture. According to the IRS, there are millions of misclassified independent contractors, costing the government as much as \$30 billion in lost revenue. A recent IRS study of 1,200 instances in which employers claimed that work was done by independent contractors resulted in more than 90 percent of the contractors being reclassified as employees. The average back-tax bill for guilty employers is approximately \$3,000 per employee, with some employer liabilities exceeding \$100,000. During a recent set of IRS audits, the average misclassification assessment was more than \$68,000 per employer. It should be recognized that this does not include penalties assessed by state taxing authorities.

What Is an Independent Contractor?

The following is a list of factors derived from guidelines used by the IRS, state employment development offices, and the courts to help determine whether someone is an independent contractor or an employee. While the list has been weighted with the most significant factors

at the top, each worker is viewed on a case-by-case basis and is also affected by each agency's or attorney's agenda in ultimately determining whether a person is an independent contractor. In some industries, certain 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! The key determinant of independent contractor status is the degree to which the company has provided the worker with instructions or training. 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. Ultimately, determining independent contractor status is a question of the extent to which the company exercises control over the details of the work being performed.
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? The greater the extent to which these factors apply, the higher the likelihood the individual will be considered an independent contractor.
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 for the number of 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. So 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, it sounds like an employee-employer relationship. To avoid having the person designated as an independent contractor, under such circumstances it is generally 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 option to advertise to the public? Is there freedom to work for another company at any time? Does the person receive 1099s from other companies?
8. **Eligibility for firing.** An independent contractor cannot be fired as long as he or she produces a result meeting the specifications noted in a contract. Likewise, the independent contractor cannot simply abandon 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 is the case with wages received by an employee? Does the person 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? Who provides workers compensation coverage for them?
11. **Belief of the parties.** The independent contractor relationship should be memorialized in writing. The IRS is giving greater respect to contractual arrangements.

12. **Clear communication of eligibility provisions for employee benefits.** In the wake of the *Vizcaino v. Microsoft* case discussed earlier, 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 additional factors, but those above are by far the most critical.

Protecting Yourself from a Misclassification Claim

A company can protect itself from a misclassification claim by doing the following.

- ❑ Don't have independent contractors go through your "typical" hiring process used for employees. For example, don't have them fill out a job application.
- ❑ Reduce your agreement with the independent contractor to writing. Use the sample **Independent Contractor Agreement** (which can be downloaded at <http://portal.hrthatworks.com/NewsletterPDFs/IndContrAgmt.pdf>). Make sure you address the essential factors set forth above, including the issues of control, place of employment, tools to be utilized, etc., in the agreement. Verify that 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 **Independent Contractor 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 form from the independent contractor, and retain these items 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 number SS-8.
- ❑ Obtain proof of: workers compensation insurance, automobile liability, general liability coverage, and employment practices liability (EPL) coverages from the independent contractor and save such proof. Alternatively, make sure they are covered under your policy for these liability exposures. Readers who seek detailed information regarding EPL coverage issues relating to independent contractors should refer to Bob Bregman's article in the Winter 2006 issue of *EPLiC* titled "Independent Contractors under EPLI Policies: Understanding the Exposure and Arranging Coverage."
- ❑ Obtain proof of an employer identification number (EIN). Use it on all payments to the independent contractor.
- ❑ Make sure the independent contractor invoices you for payment in return for services rendered.
- ❑ Do not reimburse the independent contractor for expenses. Rather, have him or her pay such expenses directly.
- ❑ Call your local IRS office or 1-800-829-1040 to inquire about viewing its video, *Employee or Independent Contractor*, and other materials on this issue.
- ❑ Don't 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, or affiliate.
- ❑ 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.
- ❑ Find out what it would cost to use a leased or temporary employee from an established agency. Then, let the agency worry about the individual's employment status.
- ❑ Remember, you can't fire an independent contractor unless he or she breaches the contract.
- ❑ Be aware that a number of state courts are beginning to allow independent contractors to bring claims for wrongful discharge, sexual harassment, and discrimination, despite the fact that they are not "employees." As a result, consider having them sign Equal Employment Opportunity policy statements and provide them with sexual harassment prevention information and safety training.
- ❑ Don't micromanage or direct their work.
- ❑ Don't give them 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. Although they do require you to pay the taxes owed, penalties are waived under such programs. Contact the IRS, your Employment Development Department, or other taxing authorities about these programs.

Concluding Thoughts

After you perform a detailed cost-benefit analysis, you may find that it actually costs less to have an employee rather than an independent contractor. With an employee, you have someone whose work you can control and who you can train and insure—all for just a few extra dollars per hour. Perhaps most important, he or she will also have a greater sense of loyalty and commitment to your company. *EPLiC*

Donald A. Phin, Esq., has been an employment law attorney since 1983. He developed the HRThatWorks.com program used by agencies and their clients nationwide. Mr. Phin is a highly rated speaker and author of Building Powerful Employment Relationships; LAWSUIT FREE! How to Prevent Employee Lawsuits; and Victims, Villains and Heroes: Managing Emotions in the Workplace. His articles have appeared in The Risk Report, Business Insurance, CFG Update, HR.com, EPLiC, and other industry publications. He can be reached at (800) 234-3304 or by e-mail at don@hrthatworks.com.