

EMPLOYEE OR NOT AN EMPLOYEE?

19. July 2010 By Steve Palazzolo

So things seem to be picking up a little in the economy? At least that is what we keep reading and hearing. What is pretty clear is that employers are very reluctant to start hiring again. Productivity, sales, and profits might be rising, but employment isn't. Instead, it looks like employers are filling staffing needs with temps and independent contractors. But before you go off and retain a bunch of independent contractors, be sure you know what you are getting into.

Last year, the IRS announced that it would audit 6,000 companies to determine if they were misclassifying employees as independent contractors. see <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=anpR2t09GieU> This came on the heels of a 74-page GAO report on employee misclassification.

So why does the IRS care? Because there is money (or overhead) in hiring independent contractors. Lots of money. Companies that hire real independent contractors don't withhold taxes for them, withhold social security, pay benefits, or pay other expenses like unemployment and workers' compensation premiums or pay the company's normal share of these same taxes. The GAO report estimated that for 1984, the last year any statistics were compiled on misclassification, the federal government lost about "\$1.6 Billion (in 1984 dollars)" in tax revenue.

States don't like employee misclassification either. According to the Bureau of National Affairs, Daily Labor Report, FedEx Ground Package System Inc. has just agreed to pay the Commonwealth of Massachusetts over "\$3 million" to settle a misclassification suit involving drivers. According to BNA, the settlement pays \$1.3 million for state taxes, \$689,000 for workers' comp., \$442,000 for unemployment, and the balance for an educational fund and into the commonwealth's general fund.

So, how do you know who should be an employee and who should be an independent contractor? You have to look at least three places. Lets start with the IRS. At <http://www.irs.gov/businesses/small/article/0,,id=99921,00.html> you can find what the IRS considers important when determining if a worker is an employee or an independent contractor. The IRS looks at three primary areas: First, what they call "behavioral control"-things like who decides when and where the work is done, who supplies the tools, and how the work is sequenced. The more detailed the instructions on how to accomplish the task, the more likely you have an employee. Second, what they call "financial control,"-things like can the worker lose money on the job, can the worker sell his or her services to others in the market, and does the worker need to make a significant investment. Again, the more risk the company takes on, like paying by the hour rather than the job, the more likely it is you have an employee.

Finally, the IRS looks at the “type of relationship.” Is there a written contract, does the worker get benefits from the company, and how permanent is the relationship. The more permanent, the more likely you have an employee.

Next, you need to see what the Department of Labor has to say about employee misclassification. The DOL enforces the Fair Labor Standards Act, and they care about misclassification because they want workers to get at least the minimum wage and overtime. In Fact Sheet #13 (available at <http://www.dol.gov/whd/fact-sheets-index.htm>), the DOL, relying on decisions by the Supreme Court, looks at whether the work is an “integral part of the principal’s business,” the “permanency of the relationship,” the worker’s “investment,” and the company’s “control” over how the work is performed, among other things.

Finally, you need to look and see if your state has any rules. Some have very strict and complex rules and some don’t have any at all (so you will just follow the federal rules).

Misclassifying employees can be an expensive proposition. Not only can you be liable for the taxes that you should have paid, you can also be liable for the employee portion of any taxes, penalties (like the IRS’ 100% penalty), interest, fees, and unpaid benefits. So be careful how you classify your workers.