

Avoiding the Misclassification of Workers in the Small Business

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Years ago, I was an "independent contractor" (IC) scuba instructor for a local dive store. The store only employed a handful of staff in sales and management, and the rest of the support crew, including instructors and the equipment repair tech, were labeled "ICs."

Independent contractor staffing makes tremendous sense for small businesses, such as dive stores. Recreational scuba tends to be seasonal, and the demand for staff such as instructors and boat captains fluctuates during the year. Like any business, success in dive retailing requires managing overhead and cash flow, and there is a large and ready contingent of qualified instructors and boat captains who do not seek permanent gigs in the scuba industry but are eager to affiliate with a dive store to ply their training.

The decision whether to staff with employees or ICs hinges on a number of practical issues. Store owners are able to exercise more control over the actions and methods of employees than ICs. Employees also tend to be more committed to the store's image and business objectives than ICs. On the other hand, ICs can be brought in to help for short periods and then let go without hard feelings or legal issues, as long as both parties honor their end of the agreement. And ICs do not require the same care and feeding as employees, such as benefits and training. The dive industry requires both types of worker to serve its customers.

But aside from these practical issues, there are other more important considerations with regard to employee vs. IC staffing, and big headaches can develop by blurring the distinction between these classifications. Problems can include a variety of unexpected liabilities from a number of sources related to taxes, insurance and lawsuits, even when the business owner believes he or she is doing everything right. Simply labeling your contractor instructors "ICs" and issuing 1099 forms are not enough to avoid the pitfalls of worker "misclassification."

What is an Independent Contractor?

The definition of IC can vary from state to state. I believe it's basically summed up in a legal case on the subject in North Carolina. According to the court, here's the definition of an IC:

The person employed:

- is engaged in an independent business, calling, or occupation;
- is to have the independent use of his special skill, knowledge, or training in the execution of the work;
- is doing a specified piece of work at a fixed price or for a lump sum or upon a quantitative basis;
- is not subject to discharge because he adopts one method of doing the work rather than another;
- is not in the regular employ of the other contracting party;
- is free to use such assistants as he may think proper;
- has full control over such assistants; and selects his own time.

As with nearly all legal rulings on this subject, these factors are simply guidelines; none are final and not all factors have to be present. The problem is, as with many aspects of the law (much to the chagrin of business people), this is not black and white. Gray areas exist when you try to define an employee and an IC.

Having explained that there is blur even in a purely legal sense, legal rulings tend to emphasize "control" as the most important factor in determining whether a worker is an IC or employee (I will discuss this more fully below). What's nice in determining worker status for federal tax purposes, is that you can let the IRS decide whether a worker is an employee by filing a Form SS-8, "Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding." The IRS will decide for you based on a 1987 revenue ruling and although the decision won't have legal authority, it will provide you with useful guidance. You can access the form on-line at <http://www.irs.gov/pub/irs-pdf/fss8.pdf>

Please bear in mind that IRS rules and guidelines only relate to federal tax liability. There are other issues, which I will get into, and you may require additional interpretation based on your situation. If you have concerns whether you are properly classifying your instructors or other staff, I would advise that you visit your certified public accountant (CPA) or tax attorney first.

Taxation Issues

As you know, an employer must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment taxes on wages paid to an employee. An employer does not withhold or pay any taxes to independent contractors. If you misclassify someone and not withhold and pay the required taxes, it can lead to significant tax liability, and you may be held responsible for back employment taxes for that worker, including penalties for late payment.

Revenue Ruling 87-41 provides several scenarios to illustrate the difference between an employee and an IC. For example, in a dive center employing an IC scuba instructor, possible red flags that could indicate misclassification of an IC (meaning he may have to be classified as an employee) include:

- The IC instructor works full-time at the store.
- The store management supervises the IC instructor's activities.
- The IC instructor reports to the store owner or manager, and receives regular progress reports.
- The IC instructor is required to sign a non-compete clause; i.e. he cannot work for a competing dive operator for six months after he stops working for the store.
- The store can fire the IC instructor, even if he is complying with the terms and conditions of his agreement with the store to provide services.
- The IC instructor has been working at the store for a long time, with no definite ending date. (Have your attorney review your standard IC instructor contract, or have him draft it if you are not using one.)
- The store provides the IC instructor with a significant amount of equipment and supplies necessary to perform the job.
- The store pays the IC instructor based on the time worked, rather than a fixed amount per class or student trained.

Remember, the list above contains the danger signs that you may have misclassified a worker as an IC when he or she is actually an employee. We've talked about "control" as a defining issue. As you can see, each of these factors indicates that the store exercises some degree of control over the IC instructor.

How do businesses get in trouble for misclassification of employees? The IRS is one sure route. The IRS is aware that employers prefer to treat workers as independent contractors to avoid paying fringe benefits and payroll taxes. In addition to liability for unpaid taxes, a business which misclassifies its worker can be liable to the worker for denied medical, dental, vision and life insurance benefits, and paid leave, including vacation time, holidays, sick leave and military leave. It is not only the business that can suffer by misclassification. The IC who is reclassified as an employee can lose his business tax deductions. Everyone has a stake in this issue.

Workers' Compensation Insurance

It's not just the IRS and tax issues that you have to worry about with regard to classification. Most states have a Workers' Compensation Act, which requires employers with a certain number of employees or more to maintain workers' compensation insurance. Businesses that are subject to the act must comply with its provisions, which include carrying workers' compensation insurance, or receive stiff penalties. The employee vs. IC issues loom large in this area of the law, which has its own definitions of employment and employee, which, in turn, may be state-specific. For example, in North Carolina, an employer is not subject to the state Workers' Compensation Act, unless three or more employees are regularly employed in the same business. An IC is not an employee, thus, is not covered by the act. Unfortunately, if the IC is misclassified, it can become a problem, particularly if an injured IC or her attorney attempts to file a workers' compensation claim. It is also a problem if that IC, who is really an employee, puts you over the threshold that requires you to have workers' compensation insurance on all of your employees.

Then There's the Liability

Generally, an employer is not liable for torts committed by an independent contractor, but an employer can be liable for torts committed by its employees in the scope of their employment. Torts include acts that cause injury -- intentional acts, such as battery, or careless acts, such as negligence. So for example, if the employee hits someone in the dive store parking lot while driving the store van to the office supply store, the injury occurs in the scope of employment. If an IC hits someone with his van in the dive store parking lot on his way to the office supply store, arguably, that injury occurs outside the scope of employment.

The misclassification of your ICs could create headaches if a court finds that the IC should have been considered an employee, and that your business is liable for his misconduct or negligence.

It is important to note that there are situations where an employer may be liable in tort without regard to the existence of an employer-employee (contractual) relationship. This includes selecting an incompetent IC.

Other Issues

Another issue worth mentioning is "dual classification"; that is employees who serve the business as ICs for limited purposes. An example might be a dive store employee whose full-time job is bookkeeper, but who the store classifies as an IC for her service as a part-time scuba instructor. This can be tricky. The recognition of dual classification depends on the jurisdiction and the situation; for example, whether the matter relates to workers' compensation vs. a tax liability claim. If you have questions, particularly in complicated

circumstances such as these, regarding your classification of employees, I always encourage you to contact your attorney or CPA, as appropriate.