



Managing in the New Era of Free Agent Talent

How to Get the Workforce You Need While Complying with the Law

As employers shift to more independent contractors and fewer full-time workers, they face a growing challenge. Whether they are called free agents, freelancers, consultants or just-in-time workers, these contingent workers have one important thing in common. Under state and federal laws, they must meet the proper independent contractor classification tests to be classified as independent contractors, otherwise they will be considered employees. Independent contractors are classified differently than employees under workplace laws and regulations. If businesses misclassify them, a common occurrence, those employers face significant risks and severe penalties.

While using independent contractors is not new, the recession has accelerated the practice. Most employers want to reduce costs and maximize flexibility. By using ICs, they can tap into specialized talent quickly and efficiently without adding long-term obligations. Even as the recession turns around, economic pressure will continue to drive the trend.

Fully half of the new hires during the economic recovery will be independent contractors, consultants and other temporary workers, according to employment law firm Littler Mendelson. The arrangement has grown in popularity among workers as well. Many like the variety and entrepreneurial challenge of being ICs, while others, feeling burned from layoffs, feel a measure of security in having more control. Still others, including parents, retirees returning to the workforce, students and people who simply thrive on new challenges, like the autonomy and work-life balance.

Truly Independent?

The Essential Differences between Employees and Independent Contractors

The test of whether an individual is an employee or an independent contractor is typically based on three aspects of the engagement: financial control, behavioral control and the formal relationship between the individual and the company. Businesses must weigh all these factors when determining whether a worker is an employee or independent contractor. Each case is decided on its specific facts but these guidelines outline the important elements:

Behavioral: Does the company control or have the right to control what the worker does and how the worker does his or her job?

Financial: Are the business aspects of the worker's job controlled by the payer? (These include things like how the worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)

Type of Relationship: Are there written contracts or employee type benefits (i.e. pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?

The relationship between the worker and the business must be examined carefully. In short, if you have behavioral control and financial control, the person is likely to be an employee, not an independent contractor.

Source: IRS.gov Tax Topic 762 -- Independent Contractor vs. Employee

Classification is King

The independent contractor solution is ideal from many points of view, but it only works if the issues of compliance and employee classification are addressed right from the start. Organizations must adhere to specific state and federal laws and regulations regarding taxes, management and supervision, unemployment insurance, discrimination and workers compensation, among other issues. Even the most seasoned professionals agree that classification can be complex.



Also, the same economic realities that have made ICs an attractive option for businesses have inspired cash-poor federal and state governments to step up enforcement of labor laws. If the person engaged as an independent contractor doesn't legally qualify for that status, the business can face devastating consequences. The employer is responsible for all back taxes plus penalties of 12 to 35 percent. They might also be liable for workers compensation, unemployment, stock options, overtime, provisions of the Americans with Disabilities and Family and Medical Leave Acts, not to mention the negative publicity, lost productivity, legal costs and even criminal penalties that such cases can generate.

Governments take a substantial hit from employee misclassification. The U.S. Treasury estimates a \$345 billion "tax gap," the result of employers who under-report, underpay, or don't file employee taxes. Misclassification is rampant. The Internal Revenue Service estimates that as many as half of the 10 million or so independent contractors in the U.S. should properly be classified as employees.

The list of companies that have run afoul of classification rules includes some of the nation's largest employers, including Microsoft, FedEx, RCN, Comcast, Time-Warner, UPS, Hewlett-Packard and Allstate Insurance.

Enforcement Efforts Increasing

Investigations into alleged misclassification can be triggered by a high volume of 1099s coming from the company or a worker having a single 1099 in a calendar year. State audits often take place when so-called independent contractors apply for unemployment compensation when an engagement ends. In some cases, they may file a wrongful discharge, unpaid overtime, workers compensation or other claim. Companies that lay off and then engage the same workers as independent contractors in the same calendar year can also trigger audits when the contractors file their taxes with 1099s and W-2 forms from the same company.

Legal actions against employers who misclassify their independent contractors will only increase, as governments dig deep for new revenue. Beginning in February 2010, the IRS launched a plan to randomly audit 6,000 employers over the next three years. The U.S. Department of Labor is slated to receive \$1.7 billion; as part of this effort it will add 670 new investigators in 2010.

Both houses of Congress are also considering legislation to strengthen compliance detection and enforcement through two similar bills, both called the Taxpayer Responsibility, Accountability, and Consistency Act. The bills would increase fines for misclassification, allow individuals misclassified as independent contractors to petition the IRS to determine if their classification is correct, and amend the tax code's safe harbor provisions (which protects employers' classification of independent contractors in certain cases).

Get It in Writing: Documentation to Prove Independent Contractor Status

There are a variety of ways to show that an independent contractor is properly classified. Supporting documents can help to make the case:

- A business license or certificate from the state or city
- A Tax Identification Number (FEIN)
- Corporate status
- A Doing Business As (DBA) declaration
- Proof of other clients
- Advertising and marketing materials



States Take Action

On the state level, enforcement efforts continue to escalate, as government officials struggle to pay the bills. Several have already passed laws strengthening employee classification rules and ramping up enforcement. Numerous states are considering or have enacted laws focused on stepping up enforcement, including New Jersey; New York; Connecticut; Iowa; New Hampshire; Illinois; Michigan; Minnesota; Maryland; Colorado; Massachusetts; and New Mexico.

In one case, the Illinois Department of Labor levied a \$328,500 fine against a Chicago contractor after discovering that the contractor had misclassified 18 of its employees as independent contractors.

The Classification Conundrum: What's A Company to Do?

So what can companies do to get the workforce they need while staying on the right side of the law? They must put compliance front and center by creating a company-wide program and then enforcing it. One critical requirement is that the plan be comprehensive and not piecemeal.

It's also important to involve the whole organization, including human resources, procurement, legal and tax professionals. Many companies also engage the services of a workforce compliance specialist.

While skilled professionals are needed in many cases and especially if companies are facing an audit, these guidelines and best practices can help in establishing an IC compliance program:

- **Educate on the law:** The first step is education; know the law. If you can't tell what distinguishes an independent contractor from an employee, you are not ready to hire one. (See Sidebar: *Truly Independent?*) You should also review state and federal legislation and enforcement initiatives. This is truly an area where ignorance is not a defense.
- **Conduct an operational analysis and risk assessment:** Next, a thorough analysis and risk assessment can help identify any gaps in compliance processes, areas for improvement and auditable issues. Whether your organization embarks on its own review or engages with a third-party organization that specializes in independent contractor compliance, the assessment should include a review of all existing independent contractor relationships across the organization.

Wherever possible, assess quantifiable risks and determine the dollar cost of any current violations. Misclassifying is typically very expensive to correct, particularly if it involves IRS penalties. The costs can easily run into millions of dollars for larger companies. If any violations are uncovered, get professional help ASAP and address them immediately. It's always better to be proactive, rather than reactive, when dealing with the IRS and other government agencies.

- **Develop a comprehensive IC compliance plan:** Based on the analysis, you should waste no time in developing a comprehensive plan for dealing with independent contractors, customized to your industry and your workforce needs. Given the complexity, many organizations engage with a company that specializes in contingent-workforce compliance and has the resources to stay abreast of changes in employment and labor law, and compliance issues.

Whoever executes the plan, it should include a screening mechanism as well as detailed questionnaires for ICs and the individuals in your organization who are engaging with them. Also, be sure you have a written agreement with the contractor that clearly spells out the terms of the relationship; services to be performed; method of payment; and an acknowledgement that the IC will pay all relevant taxes, among other critical information. The plan should also include a system for creating, collecting and storing documents. In the event of an audit, companies must often spend countless hours and hundreds of thousands of dollars locating or recreating records to be used as part of a defensible audit.

- **Train across the organization:** Once the plan is in place, all personnel who are responsible for independent contractor relationships must undergo thorough training to ensure that they will carry out the plan. This training should encompass every department that touches independent contractors, including human resources, procurement, payroll, accounting and tax. Managers should also understand IC protocols and limits.
- **Update business systems and technology:** At the same time, you need to develop and implement technology to create and monitor your independent contractor compliance plan. It should also be a tool for staying current on changes in state and federal law and enforcement.
- **“Free Agent W-2 Worker”:** If you are set on an individual who does not qualify for independent contractor status, one solution is for that person to become a “free agent W-2 worker” under contract with your company through a staffing or contingent workforce management company.

Good Advice: Look to the Professionals

Independent contractor classification and compliance is challenging and typically requires the service of professionals, including:

- Workforce compliance specialists can assess your current situation and develop a comprehensive plan for the management of an entire contingent labor population while helping to mitigate the current and future risks related to misclassification. Some companies choose this route because the compliance specialists can manage the entire process, including risk assessment and audit support, vetting and engaging ICs, and taking care of payment and billing administration. This is helpful for companies that don't have the capabilities to apply the various state and federal tests or the time to become contingent workforce compliance experts. Workforce management providers can often support IC compliance management across borders, allowing you access to specialists in local markets across the globe.
- A tax attorney who is familiar with contractor classification issues can help assess your risk of an audit on a consulting basis, while maintaining the protection afforded by attorney-client confidentiality rules. An attorney can also help mitigate penalties, while you manage the daily activities related to independent contractor engagement and administration.
- An accountant who understands the law and is familiar with the latest initiatives of the IRS can enhance the process on a consulting basis. In some cases, the accountants are retained by the attorneys so that their advice is protected by attorney-client privilege.

It's No Time for Business As Usual: Compliance Now

If this seems like a lot to get right, there are qualified professionals who can help, especially in cases where auditable risks are already identified (See Sidebar: *Good Advice*.)

Changing workplace dynamics demand that companies step up and take action – before compliance issues get out of hand and cost and complications mount. If independent contractors are even a small part of your business strategy, it's vital to get your plan and your personnel up to speed. Otherwise, it's a good bet that business will proceed as usual and push compliance out of sight—until a problem arises.