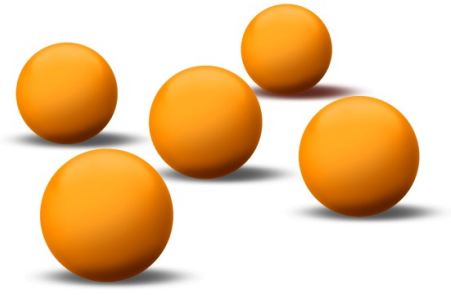


Why, Again, Do You Think that Worker is an Independent Contractor? *By Allen Sullivan*



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If you're reading this article, then you likely own or administer a medical practice of some sort. That practice may have workers of many stripes. Some of those workers may be treated as employees and some may be independent contractors. For example, some home health workers may be paid as independent contractors while others are not. If you help run a hospital, you may have noticed that some hospital doctors are considered contractors yet others are employees. But do you know why they are treated that way? Well, if the IRS or the Alabama Department of Revenue audits your practice, you may need to know why quickly.

The Economics of Worker Classification

Since 2008 many companies have cut costs wherever possible, which often involves using independent contractors whenever possible. Why? Employees are much more expensive than independent contractors. Employees cast many burdens on their employers: health care benefits, minimum wage limitations, fringe benefit costs. None of these issues arise with independent contractors.

In addition to administrative burdens, employees also cost their employers much more in employment tax than independent contractors. You see, all employers must generally pay employment taxes (Social Security, FICA, etc.) of around 7.5% of each employee's salary. There is no similar requirement related to independent contractors; they are responsible for their own employment taxes. Using the national income average of \$43,000, an average employee costs its employer about \$3,700 more than an average independent contractor in tax-related costs alone. Thus, all other things being equal, businesses treating their workers as independent contractors have competitive advantages over those treating similar workers as employees.

Independent Contractor or Employee?

Because the worker classification decision so affects the bottom line, many companies prefer to classify their workers as independent contractors. But what makes one worker an employee and another an independent contractor? In a word: control. If a company has control over how a worker performs his or her job, then that worker is most likely an employee. The substance of the worker/company relationship therefore determines the worker's classification, no matter how the company and the worker decide to define the relationship. That is, you cannot simply label your worker an independent contractor and expect the IRS or some other government agency to take your word for it.

Since 1987 the IRS has used a "20 Factor Test" to determine whether or not a business has control over a worker. Each factor indicates control or a lack of control, and, in turn, either employee or independent contractor status. For example, if you require your workers to attend formal training, then your control indicates employee status. Control is also evident if a worker must work set hours, gets paid by the hour, or can be terminated at any time. On the other hand, if a worker is paid on a per-task basis, does the same type of work for other companies, and provides its own tools and equipment, then the paying company doesn't likely control the worker enough to trigger employee status.

Why Should You Care? Increased Audits

Back in 2009, the Government Accountability Office ("GAO") took the IRS to task for its ineffective enforcement of employment tax compliance. The so-called "tax gap" -- the gap between taxes owed and those actually paid -- was widening at this time, and employment tax issues, like the misclassification of workers as independent contractors, played a significant part. The GAO report estimated that worker misclassification alone accounts for \$1.8 billion of the tax gap. The U.S. Department of Labor estimated additional unemployment insurance revenue losses to be in the \$400 million to \$600 million range.

Soon after the GAO report's release, the IRS responded by announcing a "National Research Program" ("NRP") -- the first of its type since 1984 -- to address issues that surfaced in the GAO report. In reality the NRP was more like a massive audit initiative. The IRS used the NRP to audit 6,000 U.S. companies, targeting broad cross-sections of employers nationwide: corporations and pass-through entities, profitable entities and those in-the-red, and operations large and small. Among other things, these audits analyzed the companies' worker classification decisions.

Armed with NRP data the IRS is identifying noncompliance patterns and using this information to audit others. Will the IRS again target health care companies like they did in the '90s after concluding a similar research project? We don't know yet, but the employment tax world seems to run in cycles, and federal and state governments are under stress to plug widening budget holes.

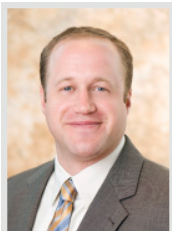
In any event, the IRS clearly plans to intensify its worker classification audits. This audit uptick may also relate to the Affordable Care Act's ("ACA") requirement that companies with 50 "full-time equivalent" employees must offer those employees health insurance. The IRS may worry that ACA-related burdens will tempt more and more companies to attempt illegitimate contractor use. Any companies considering moving to a contractor-heavy workforce because of the ACA, or for other reasons, should therefore evaluate whether those workers may be reclassified as employees in an IRS audit.

Prepare Now

Companies can prepare for government scrutiny by reviewing their own compliance procedures, and perusing contracts with would-be independent contractors. You may be able to avoid many costly penalties by disclosing past missteps to the IRS before an audit.

And if you are audited, then time is of the essence. Establish a proper "chain of command" to ensure that important notices, and their more important deadlines, don't go unaddressed. Additionally, companies need procedures in place that guarantee that outside advisors are notified right away. Involving tax practitioners early in an audit may allow them to narrow the audit's scope, and thereby reduce the costs of defending it. Spending a little time and money now can save a lot of both later.

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