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Feature: A Risky New Trend: Replacing Employees with Independent Contractors

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A Risky New Trend: Replacing Employees with Independent Contractors

In the midst of a sour economy, some organizations have opted to rehire some laid-off employees as independent contractors. But this practice is fraught with risk, and it is becoming riskier now: The IRS is planning an audit crackdown early next year. Here is what you need to know before you hire independent contractors in lieu of employees.

By **Adriana R. Midence**

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In this recession, budget constraints have forced many employers to lay off some of their most valuable employees. Rather than lose key workers, however, many employers are exploring alternative hiring arrangements. One popular alternative is to hire laid-off employees to perform their same jobs as independent contractors. Such a strategy, however, is not without risk. Misclassifying an employee as an independent contractor can result in significant costs to an employer, including back-owed taxes and penalties.

Another economic reality—declining tax revenues and climbing unemployment claims—is prompting the IRS and state taxation agencies to uncover businesses improperly treating their workers as independent contractors.

In September, the IRS announced it will audit 6,000 random employers beginning in February 2010 to determine whether employees are being misclassified as independent contractors. Similarly, many independent contractors are suing their former employers, alleging they were misclassified as independent contractors and denied overtime wages and other benefits.

In recent years, the IRS targeted FedEx Corp. for classifying its ground-service delivery drivers as independent contractors and sought over \$300 million in fines and penalties. In the 1990s, the IRS audited Microsoft Corp. and questioned whether certain freelance software programmers and other workers were properly classified as independent contractors.

More recently, cable installers for Comcast Corp. have sued the company, alleging they were improperly classified as independent contractors and denied overtime pay and benefits. Even nightclub owners are not immune from litigation, as evidenced by a class action filed in Massachusetts by exotic dancers alleging misclassification.

In reality, all employers, no matter the industry, should be cautious of replacing their workforce with independent contractors. Employers that simply rehire laid-off employees as independent contractors without fundamentally restructuring the company's relationship with its workforce will likely be an easy target for such audits and litigation.

The decision to hire any independent contractor, especially an independent contractor who previously worked as an employee of the company, should be made in consultation with an attorney. The following is intended to help

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Feature Contents

- 1. The Independent Contractor Question**
The use of independent contractors in place of employees has been on the rise in the U.S. for years and continues to stir debate over its impact on worker protections. Congress has recently taken a renewed interest in the subject with the arrival of a Democratic majority, with one representative calling the misclassification of employees as contract workers 'a national problem with implications for federal laws and our federal coffers; a problem we must solve.'
 - 2. Seven Costly Myths About Managing Contract Workers**
Businesses can be led to believe they are saving costs by classifying workers as independent contractors instead of employees. Ultimately, this could be costly.
 - 3. Court Rules for FedEx in NLRB Case**
The court's majority opinion cited drivers' abilities to operate multiple routes, hire substitute drivers without FedEx's permission and sell routes as well as their contract as reasons for ruling they are independent contractors.
 - 4. TOOL: IRS Information on Using Independent Contractors**
The IRS provides employers with a resource page containing information on properly determining whether workers are independent contractors or employees. Here are some highlights from it, including a 160-page IRS training manual on determining independent contractor status.
- Similar Documents**
- [Independent Contractor vs. Employee: Get It Right](#)
 - [The Independent Contractor Question](#)
 - [Seven Costly Myths About Managing Contract Workers](#)
 - [The Hiring Process: A Primer of Legal Do's and Don'ts](#)
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facilitate, and not replace, such a discussion.

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Who qualifies as an independent contractor?

Determining whether a worker can be properly classified as an independent contractor requires an individualized analysis of the relationship between the company and worker. In addition to adhering to federal tax regulations, complying with the specific requirements in your state is equally critical to avoiding misclassification liability.

But because the federal tax ramifications of misclassifying an employee are typically the most feared and the most severe, this article will focus on the guidelines set forth by the Internal Revenue Service. According to the IRS, an individual qualifies as an independent contractor if the employer has the right to control or direct the result of the work of the individual, but “not the means and methods of accomplishing the result.” Similarly, the IRS explains that an individual is really an employee if the employer controls “what will be done and how it will be done.” In applying these guidelines, the IRS will typically consider the overall relationship between the parties, with specific attention paid to the behavior of the parties and their financial relationship. There are several facets of a working relationship that the IRS will consider in applying these guidelines. For example, when considering the overall relationship of the parties, the IRS may consider:

1. Whether the individual performs work that is distinct from the employer’s business or work that is part of the regular business of the company.
2. Whether the individual performs a service that requires a special skill.
3. The length of time the individual will perform services for the employer.
4. Whether the individual determines his or her own work schedule.
5. Whether the individual is required to devote all of his or her time to the employer.
6. Whether the individual and employer can terminate the relationship at any time.
7. The permanence of the working relationship.

Similarly, when evaluating the behavior of the parties, the IRS will consider how certain responsibilities are divided among the worker and employer. For example, the IRS may consider:

1. Whether the company provides extensive training to the individual prior to commencement of work.
2. Who supplies the instrumentalities, tools and the place needed to perform the work.
3. Whether the individual performs his or her work under the direction and supervision of the employer.

Finally, when evaluating the financial relationship between the parties, the IRS may consider:

1. The individual’s personal financial investment in the equipment or materials required by the work.
2. The individual’s opportunity for profit or loss depending on his or her managerial skill.

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3. The method of payment between the parties, in particular whether payments are calculated by time worked or jobs performed.

Why hire independent contractors?

There are many financial benefits to properly hiring independent contractors instead of employees. In an employee-employer relationship, an employer is responsible for withholding federal income taxes, paying Social Security and Medicare taxes (the FICA tax), withholding the employee's share of FICA taxes and paying federal unemployment taxes.

Depending on the state, employers may also be responsible for withholding state income taxes, paying state unemployment taxes, paying or withholding state disability insurance contributions and providing workers' compensation insurance. Employees are also protected by federal and state wage-and-hour laws, entitling them to (among other benefits) overtime pay, and typically receive benefits such as health insurance, paid vacation, sick leave and retirement contributions. Finally, employees are protected by federal and state anti-discrimination statutes.

By contrast, an employer can avoid all or most of these obligations and potential liabilities if an individual is properly classified as an independent contractor. Independent contractors are responsible for paying their own taxes, including self-employment taxes, which cover both the employer and employee share of FICA taxes. Typically, independent contractors are responsible for their own insurance and not are not entitled to the protections of federal and state wage-and-hour laws. They also do not receive any of the benefits typically provided by an employer to an employee. Finally, independent contractors are not protected by many federal and state anti-discrimination statutes.

Naturally, there are several reasons the IRS, state taxing authorities and workers prefer the employee classification. First, classifying more individuals as employees maximizes payroll and unemployment tax revenue by ensuring that the employer deducts such taxes on a regular basis before paying the employee. Second, classifying individuals as employees allows tax agencies to collect tax money from a single employer, rather than several individual independent contractors. Third, employees receive more benefits than independent contractors, such as health care and retirement contributions, which decrease government expenditures in the long term. As a result of this preference for employees, the penalties for misclassifying an employee as an independent contractor are quite severe.

Depending on the circumstances, an employer that fails to properly deduct and withhold federal taxes may be liable for penalties equal to 20 to 40 percent of the unpaid tax liability. Moreover, an employer that fails to properly pay overtime to or provide benefits for employees who have been misclassified as independent contractors may be liable for back-owed wages, reimbursement of unpaid benefits and various penalties set forth in federal and state wage-and-hour statutes. Finally, many states have recently passed independent contractor legislation aimed at increasing awareness of worker misclassification and increasing the penalties—in some states to include criminal penalties—on employers that misclassify workers.

How to protect your company

Without a clear test to help employers determine whether a particular worker qualifies as an independent contractor, employers considering hiring new or previously laid-off workers as independent contractors should consult an attorney.

In addition to helping an employer properly classify its workers, consulting an attorney can help protect employers from tax liability in the event the IRS decides that workers should have been classified as employees.

The IRS has enacted a safe harbor provision that shields an employer from

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liability for back taxes, interest and penalties in the event the IRS reclassifies an independent contractor as an employee. To qualify for this protection, however, an employer must demonstrate:

1. That all similarly situated workers were also classified as independent contractors.
2. That the employer consistently filed all required tax returns for all prior relevant periods.
3. That the employer had a reasonable basis for treating the employee as an independent contractor, such as relying on a court opinion, IRS ruling, a prior employment tax audit, a longstanding, recognized industry practice, or advice from a qualified accountant or lawyer.

Notably, federal lawmakers have recently proposed legislation that would limit the availability of this safe harbor. Additionally, this safe harbor applies only to federal tax liability and does not shield an employer from liability under state tax laws, wage-and-hour statutes, or anti-discrimination statutes. Therefore, it behooves all employers to properly define and classify relationships with workers at the outset of the relationship. When in doubt, workers should be classified as employees, not independent contractors.

Finally, particularly prudent employers can file with the IRS a [Form SS-8: "Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding."](#) Based on the information provided, the IRS will officially determine the worker's status. While it can take at least six months to get a determination from the IRS, an employer that continually hires the same types of workers to perform certain services

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The information contained in this article is intended to provide useful information on the topic covered, but should not be construed as legal advice or a legal opinion. Also remember that state laws may differ from the federal law.

Adriana R. Midence is an associate at [Elarbee, Thompson, Sapp & Wilson](#). She focuses on defending employers in employment-related litigation, including cases involving alleged discrimination, harassment, non-competition, non-solicitation and trade secrets. To comment, e-mail editors@workforce.com.

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