Personnel Notebook

For Your Most Important Resource -- The Human Resource

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INDEPENDENT CONTRACTOR OR EMPLOYEE? WHO'S IN CONTROL HERE?

A few years ago, C.C. Eastern, Inc., a New Jersey trucking company with 14 independent contractor drivers, was served a notice by the National Labor Relations Board (NLRB) that the Teamsters union wanted to conduct an election among the drivers. The Teamsters, of course, wanted to be designated as the official representatives of the drivers against the company.

Eastern claimed that this action was moot as they had no employees driving trucks. The drivers were all independent contractors (ICs) who owned their own rigs and had written contracts for their services and equipment. The company did not require them to provide a specific size or color tractor, the drivers could decide if and when they would provide maintenance and repairs on the equipment and they were not provided any health insurance or employee benefits.

The Teamsters argued that: 1) the drivers were told the order in which the deliveries were to be made, and 2) the company provided an incentive financial bonus that was dependent on the quality of the service.
The NLRB ruled in favor of the Teamsters, thus declaring the drivers to be employees, not ICs. This was a shock to the company, even though the NLRB had been recently voted the "most aggressively anti-employer" Federal agency employers face today.

The implications to Eastern are enormous. They could be required to pay back taxes and penalties totaling tens of thousands of dollars and be required to initiate a myriad of federally mandated regulations, in addition to facing additional Teamster union demands. The company has filed an appeal to the NLRB ruling. But more on that later.

Many organizations and government agencies take a deep interest in the issue of ICs. Beyond unions and the NLRB, the Social Security Administration wants the FICA taxes paid on employees, federal unemployment agents want to see the FUTA taxes paid, and then there's Workers' Compensation and state unemployment compensation agencies who are also standing in that line.
Although all these organizations have a stake in this issue, the real driver in all the current action is the Internal Revenue Service (IRS), and they are really cracking down!

The IRS has a legitimate concern. They know companies like Eastern don't have to pay federal taxes on ICs as they do on employees. They also know the taxes to be paid by the worker are not deducted from the earnings of ICs as they are with employees.

The result is that the IRS estimates that it loses $3.7 billion annually resulting from workers' "misclassifications." In addition, ICs often underpay or avoid payment altogether of their taxes and beyond that, many continue to

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pay taxes annually instead of quarterly as ICs are required to do.

So in 1986, the IRS created the new Employment Tax Examination Program and targeted small businesses (of less than $3 million annual revenues) as the greatest violators. During the first year of operation, they ruled against 92% of all employers they examined on IC classifications. That program is still in full swing and has been gaining momentum.

WHY IS THIS SUCH A HOT ISSUE NOW?

There are many political opinions on this, however, basic demographic changes in the workforce certainly must be recognized as part of the problem.

When downsizing, rightsizing, re-engineering organizations, and early retirement reduces the size of so many companies' workforce, the government loses taxpayers and gains tax users, (i.e., unemployment claims, welfare usage, etc.). However, many of those former employees are also becoming self-employed.

The government, particularly the IRS, wants to reinterpret the regulations to bring more or most of the ICs back into the employee tax base. This could result in a total reinterpretation of what an employee is. But let us start by identifying what an IC is.

WHAT IS AN INDEPENDENT CONTRACTOR?

The most common myth on ICs today is that a company can cut out a segment of the work that they now hire employees to perform and contract it out to someone else. Often to the same workers who now perform the work. At its worst, the company calculates its total cost of wages, benefits, taxes and tools and then convinces an employee to start their own company to perform the work for about 80% of that predetermined cost. In many such cases the worker makes less than they made on wages and sometimes less than minimum wage. This is clearly not what employers in general nor the IRS wants.

An independent contractor is basically someone who operates their own company providing goods or services to clients for fees. However, that broad generic description is too easy to manipulate. Therefore, the IRS has attempted to create a standard. The standard is basically a judgment call often based on appearances, gut feelings and sometimes prejudice.

The decisions made by the IRS depend primarily on whether the employer has the control over both what the worker does and how he/she does it. The greater the control seems to be, the more likely the worker will be classified as an employee.

More specifically, the IRS uses the following 20 "Common-Law" rules as their guidelines. The preponderance of "yes" answers on the more significant questions is used as evidence of an employer/employee relationship. This is usually referred to as the "Right To Control" test.

1. Do you provide the worker with instructions on when, where and how work is performed?
2. Did you train the worker in order to have the job performed correctly?
3. Are the worker's services a vital part of your company's operations?
4. Is the person prevented from delegating work to others?
5. Is the worker prohibited from hiring, supervising and paying assistants?
6. Does the worker perform services for you on a regular and continuous basis?
7. Do you set the hours of service for the worker?
8. Does the person work full time for your company?
9. Does the worker perform duties on

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your company's premises?

10. Do you control the order and sequence of the work performed?
11. Do you require workers to submit oral or written reports?
12. Do you pay the worker by the hour, week or month?
13. Do you pay for the worker's business and travel expenses?
14. Do you furnish tools or equipment for the worker?
15. Does the worker lack a "significant investment in tools, equipment and facilities?
16. Is the worker insulated from suffering a loss as a result of the activities performed for your company?
17. Does the worker perform services solely for your firm?
18. Does the worker not make services available to the general public?
19. Do you have the right to discharge the worker at will?
20. Can the worker end the relationship without incurring any liability?

Based n IRS Revenue Ruling 87-41.

Although much of this seems reasonable, like many federal laws it is too vague, too subjective, open to misinterpretation and the final decision is all too often politically or financially motivated. Companies clearly want something more concrete, simple and logical as a guideline for this enormously affecting decision.

IS THERE ANY OTHER RECOURSE OR APPEAL TO AN IRS DECISION?

Yes. If after applying the 20 Common-Law rules and seeking the advice of a tax consultant, you are still unsure:

- You may file an IRS form "SS-8." On this form you can describe the working conditions of one representative worker and the IRS will make a determination which you must follow in specific detail.
- Examine your records to see if you qualify under Section 530 of the Revenue Act of 1978. Fundamentally, Section 530 "grandfathers" in all workers who have historically been treated as ICs on the basis of industry practice, legal authority, prior audits that did not rule against IC status or when a past company decision shows a reasonable basis for the IC decision.

  Section 530 supersedes the 20 Common-Law rules. If an employer fails to qualify their ICs under Section 530, they may still attempt to qualify under the 20 Common-Law rules.

Remember the C.C. Eastern, Inc. trucking firm that filed an appeal to the NLRB ruling against them? Well, after YEARS in appeal, an unexpected decision by the Circuit Court of Appeals in the District of Columbia ruled in favor of the company, thereby declaring that the NLRB was wrong in its ruling. The court, in fact, chastised the NLRB, a very rare occurrence, for its actions which were thought to be political and prejudiced.

WHAT CAN I DO NOW?

First, use common sense — if it walks like a duck and talks like a duck, it's probably a duck! If the relationship between the company and the worker is clearly an employer/employee relationship, declare them to be an employee and start paying the taxes on your own before the IRS gets in the picture. Otherwise:

- Avoid paying ICs on the same paydays and from the same payroll account as you do employees.
- Contract with established outside suppliers, vendors and contractors who invoice for their services.
- Document the IC relationship with a written agreement.
- File a Form 1099 MISC federal tax form to report all payments to ICs (to all ICs whose annual payments exceed $600).

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- Obtain and familiarize yourself with IRS Regulation 31.3121(d)-1 and IRS manual exhibit 4640-1 and IRS SS-8.

Talk to an attorney who is practiced in labor law or tax law. A counterpoint to consider: in some cases you may not want an IC relationship. For example, if you develop software, inventions, management systems or other proprietary products with an employee, you will most likely have a stronger proprietary claim of ownership. However, when you develop those same products through an IC, it may be that the IC will have the stronger claim of ownership.

NEW GUIDELINES

Over the last few years business and government officials have countered each other with proposals for new legislation (Small Business Legislative Council in Washington, DC, Fax: 202-296-5333) and with new guidelines (IRS Classification Settlement Program of 1996).

The IRS seems to have prevailed with this 1996 Classification Program. After a two-year trial they decided to extend the program and intend to make it permanent. Here's how it works.

If charged with misclassifying employees as ICs, you may debate your case as described in this issue of Personnel Notebook. You should be aware that beyond the IRS' "Right To Control" test, the U.S. Department of Labor uses a slightly different standard relying more on how dependent the IC is on your company for economic survival. This is usually referred to as the "Economics Realities Test" and is sometimes used for Family and Medical Leave Act (FMLA) and Federal Labor Standards Act (FLSA) issues.

If you win your case, you may continue to deal with your ICs accordingly.

If you lose your case and the individuals are declared to be employees, the issue of penalties is then determined. At its worse, the penalties can be back wages, back taxes, financial penalties, interest on overtime pay, workers compensation and unemployment insurance payments.

However, if your company has always filed 1099 forms (reporting the payments made to those ICs), the IRS will only penalize you for one year's taxes. In addition, if your company has consistently treated the workers as ICs and could make a reasonable argument why they should be treated that way, the penalty would be further reduced to just 25% of one year's taxes. And if your company could show a sound basis for the decision to classify them as ICs, such as a standard industry practice or reliance on a court case or professional advice, the IRS could forego any penalty.

Remember, if your IC is declared to be an employee, you will not only have to pay the taxes and provide the benefits, but you may now have to provide Family and Medical Leave, COBRA notification and various termination processes between jobs. In addition, your employee count may then rise to a level where you have to comply with several federal and state regulations that are not required of smaller employers.

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