

2008 Employment Law Update

Test yourself:

Are you classifying your independent contractors correctly for the IRS?

Hint: Answering “yes” to many of these questions suggests an employer-employee relationship.

- Are instructions given to the worker concerning where, when and how to perform the work? Are hours set for the worker? *A true independent contractor controls how the work is performed.*
- Are hours set for the worker? *A true independent contractor sets their own hours.*
- Is all the work done on the company's premises? *Independent contractors typically perform some or all of the work off-site.*
- Are periodic progress reports not required? *It is appropriate to require independent contractors to provide periodic progress reports; however, the process is rarely this formal with employees who are subject to ongoing supervision.*
- Is payment made at periodic intervals and in fixed amounts, rather than a lump sum at the completion of a task? *Independent contractors are typically paid on the basis of work performed (i.e., project completion or milestones, not on a regular weekly or bi-weekly basis like employees).*
- Will the worker earn a regular wage as long as they remain working? *If an independent contractor is paid an hourly rate, they should still have some opportunity for profit/loss (i.e., amount withheld to be paid upon completion).*

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Independent Contractors: Assessing the Risk

Are you classifying a worker as an independent contractor to accommodate an individual's preference? Have you ever wondered whether this classification would hold up to IRS scrutiny?

A determination by the IRS that your “independent contractors” are really your company's employees has significant consequences, including liabilities for unpaid taxes, overtime compensation, benefits, and hefty fines. Workers in the information technology and pharmacy/medical fields have attracted particular attention from the IRS and other governmental agencies. In addition, workers who have essentially chosen independent contractor status may later claim that they were really employees, perhaps to seek workers' compensation benefits if they are injured on the job, to file a claim for unemployment benefits, or to claim a right to participate in company benefits such as stock option plans.

How does the IRS determine whether classification as an independent contractor is correct or incorrect? They look at a variety of factors, which are described at the end of this article. You may want to ask yourself these questions with respect to individuals

currently classified as independent contractors, whether working directly with your company or through an agency.

Courts may also apply an “economic realities” test (i.e., is the worker dependent on one company for their livelihood or is the worker able to freely move about and work for other companies?) From a practical standpoint, this is known as the “yellow pages” test: If the independent contractor markets their services to multiple prospective clients through various advertising means (yellow pages, direct marketing, Internet, etc.), classification as an independent contractor will likely be upheld. Ask yourself, “Does the worker have business cards, a website, a corporate identity, or d.b.a.?” If you answered no, there is a risk that the worker will be re-classified as an employee.

A good first step to reducing the risk of misclassification is establishing standards for approving independent contractor status: If an individual wishes to be classi-

- Does the worker have business expenses or travel expenses reimbursed? *Typically, independent contractors are responsible for their own expenses.*
- Are most of the resources used to perform the services (computer, phones, etc.) provided to the worker free of charge, with no significant investment by the worker? *True contractors typically are responsible for providing their own equipment and supplies.*
- Is the worker restricted from offering his/her services to the general public? *An independent contractor should be free to offer their services to others.*
- Is the worker prevented from performing the same or similar services for other companies at the same time? *Independent contractors should be allowed to work for more than one client at the same time; however, an IC agreement can be narrowly tailored to avoid a conflict of interest (e.g., restricting their ability to provide the same or similar services to a direct competitor).*
- Is the person trained by an employee on how to complete the work? *A true independent contractor is hired for skills and expertise, and is not trained by the client.*
- Do employees supervise, help or assist the individual in the performance of their duties? *A true independent contractor performs the work themselves or delegates to their own employees, not to company employees.*
- Is the relationship continuing or indefinite? *In general, independent contractor relationships are on a project basis or for a defined period of time.*
- Is the person able to quit at any time, with or without notice, without substantial negative effects such as being sued on a contract? *The status of an independent contractor is different than that of an at-will employee. However, it is generally acceptable to provide that either party may terminate the agreement with a specified period of notice to the other party (e.g., two weeks).*

fied as an independent contractor, they must meet the standard. For example, your standard might include incorporation, a FEIN (Federal Employer Identification Number, for tax purposes), business card or other marketing material, and whether the individual has worked as an independent contractor at least once in the preceding 12 months. Also consider the type of work that will be performed. If it is the same type of work that is currently being performed by employees, use caution in approving independent contractor status and try to distinguish the work (particularly the level of supervision) as much as possible.

Next, establish procedures that govern the independent contractor relationship. Have a written agreement that clearly specifies the independent contractor status, and that also states the contractor is responsible for paying all

applicable taxes and cannot participate in any benefit plans offered to company employees.

Try to pay by the project and not by the hour, and do not reimburse for business or travel expenses. Do not provide the independent contractor with equipment or supplies and try to have them perform work off-site using their own resources when possible. The written agreement should specifically address the supervision and control issues, e.g., state that the independent contractor is responsible

for determining the manner of performing the work and he or she is responsible for providing progress reports to your company.

Finally, remember the “if it walks like a duck ...” test. Take care not to treat independent contractors as employees. This includes requiring or allowing them to fill out an employment application, attend an employee orientation, sign an acknowledgment of receipt of employee handbook or other policy acknowledgment, attend company events, receive holiday bonuses or gifts, etc. Limit their access to premises and company systems

(e.g., keys to the facility, network access, company voicemail, e-mail), and do not allow them to have sign-off authority or to supervise staff. Allowing these types of activities will bolster a finding of employee status as opposed to a true independent contractor status.

From an administrative standpoint, have the contractor complete a W-9 form for tax reporting. In California, companies must report amounts that are paid to independent contractors to the Economic Development Department if the amount paid in the contract exceeds \$600.

Workers classified as IC's in the pharmacy/medical and technical fields have attracted particular attention from the IRS.