

# Employee vs. Independent Contractor

Five Strategic Options to Mitigate the Risks  
of Worker Misclassification and Help Your  
Company Achieve Independent Contractor  
Compliance

By: Walter Branam



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Contingent Workforce Management & Compliance Solutions

## Introduction

*The Independent Contractor model is good for the company and good for the IC.*

Here's a scenario that plays out every day in today's workplace: Imagine that you just hired a highly skilled, experienced, and motivated Independent Contractor (IC) for a project. There isn't anyone in your company with the skills to do the job and you know the IC will cost much less than a full time, payrolled employee. It looks like you made a smart business decision that will get a vital project completed while saving the company money.

All is well. Or, is it?

Permanent employees come with Social Security, unemployment insurance, workman's compensation insurance, health insurance, dental, matching 401(k), life insurance, overtime pay, protection against discrimination, and an endless list of other fringe benefits, protections and operational costs that are commonplace in the United States. The IC model allows you to secure the exact skill set you need while avoiding the costs and obligations, and the issue of what to do with the worker after the project is completed. The IC will make more income, can claim business expenses denied to employees, and has the freedom to accept other lucrative jobs while still serving your company. The Independent Contractor Model is good for the company and good for the IC. The model reflects the individual, entrepreneurial spirit that has made America great, and appears to be good for everyone involved.

Until something goes wrong.

## Independent Contractor Risks

*Most worker misclassification settlements do not become public, as the companies involved elect to settle with the auditing agency to avoid the negative PR, management distraction, and legal expenses.*

There are significant risks when using IC's that many companies never consider until it is too late. The possible hazards are endless. A few common examples:

- The IC is injured on the job
- The IC decides he/she is missing out on the benefits offered your employees
- The IC believes he/she is not being treated fairly
- The IC doesn't perform to expectations and is terminated
- The IC completes the job successfully and leaves, then files for unemployment insurance benefits
- A government regulatory agency knocks on your door and questions the consultant's classification

Each of these events, along with a host of others, can trigger a 20-20 hindsight evaluation by a regulatory agency (or a judge) of your decision to classify the worker as an IC instead of an employee. If you didn't do it right in the beginning, or if you guessed, gambling that nothing would go wrong, your company could be facing a very large unplanned liability when the honeymoon between you and your IC is over.

When you made the decision whether the contractor was an employee or an IC, your criteria might have been based upon the wishes of the parties and what was financially sound and practical for a successful project. However, the courts, the IRS, and the state enforcement agencies use a different set of criteria to decide who is an Employee and who is an Independent Contractor.

Today's regulatory and tax enforcement environment is riddled with complexities and hazards for organizations using IC's. In California there are at least three government agencies that are interested in the proper classification of workers: the Internal Revenue Service (IRS), the Employment Development Department (EDD) and the Department of Industrial relations (DIR). Each of these three agencies has the responsibility for ensuring accurate worker classification. They are diligent in their work and when they find errors in classifying workers they will charge your company with back taxes, penalties, interest, and fines.

These agencies have Memorandums of Understanding with one another – contracts to share information about companies found to be "Out of Compliance." When this information is shared, the results of a state tax audit can also become the basis for an IRS tax assessment, greatly multiplying your unplanned liabilities. It is not unusual for the combined tax assessments to be several millions of dollars.

Another category of potential exposure is civil class action lawsuits filed by disgruntled workers. In a typical case, workers who signed on willingly as IC's later decide the grass is greener on the other side of the fence, opening the gate for a class action lawsuit. If the court decides your company didn't do it right, the unplanned liability resulting from these actions can be very costly. Even if the company eventually wins through a series of appeals, the time, energy and cost of fighting these lawsuits drains time and resources, and distracts top management from core business activities.

No company is exempt from this phenomenon. In recent years such giants as FedEx, UPS, Albertsons, Ralphs, Vons, Microsoft Corporation and Allstate Insurance Company have all been subject to class action lawsuits related to the misclassification of their workers. These are only the well known examples – most never become public as the companies involved elect to settle with the auditing agency to avoid the negative PR, management distraction, and legal expenses. To find more examples, simply use your favorite search engine to look up "Independent Contractor Class Action Lawsuits." You will find hundreds. You will also find law firms that encourage workers to instigate lawsuits. These law firms prominently list their successes as credentials.

## Independent Contractor Compliance

*Each of the various state and federal agencies have their own laws, rules and case histories for determining who is an employee or an independent contractor..*

The challenging business environment is further aggravated by the rules for determining who is an employee or an independent contractor. Each of the various state and federal agencies have their own laws, rules and case histories for determining who is an employee or an independent contractor. Originally, the IRS had the 20 Factors Test which was recently changed to the Three Categories of Evidence. In addition, each state has its own set of rules which means your company may be governed by a range of rules in different locations. Depending on where you are doing business it may be the "ABC Test" or the "Common Law Test." California's EDD, which runs one of the most aggressive programs in the nation, has One Primary Factor, plus Ten Secondary Factors when deciding who is an employee or IC. Each of the factors takes on a different weight depending on the profession being considered. Finally, both federal and state laws have statutes that make exceptions to the common law rules or the ABC Tests.

The numerous rules can also be weighted differently depending on the reason the worker's status is being questioned. The threshold or "bar" defining an employee is set either higher or lower for different programs. For example, if a worker has been injured on the job he/she will more likely be considered a "covered employee" than the same worker

## Your Independent Contractor Compliance Options

*Each option offers varying degrees of risk mitigation and cost savings.*

reviewed during an audit by the IRS for the purpose of income tax withholding. The Employee/IC threshold for unemployment insurance coverage is different than either the IRS or a worker's injury case. So it is possible for the same worker to be an IC for one agency and an employee for another. Once one agency has held a worker to be an employee the others are more likely to agree; however, if an agency holds a worker to be an IC the others will still rigidly and independently apply their own set of rules.

If the status question has arisen because of a civil class action law suit, where disgruntled workers sue their employer for such grievances as overtime, business expense reimbursement, co-employment benefits and rights, sexual harassment or discrimination – the judge may ignore the government administrative rulings and use his/her own criteria.

Independent Contractor compliance can be both a frustrating and confusing issue. The companies who do not address the issue risk becoming involved in a lengthy and expensive legal battle that may end in a large unplanned liability and forced changes to their business model.

But it doesn't have to be that way. It is possible to engage contractors and work successfully in this complex and highly regulated environment if you make the right choices before you hire your IC.

Your company has five options when confronting the issue of Independent Contractor compliance. Each offers varying degrees of risk mitigation and cost savings:

### **OPTION #1:**

#### **Continue to roll the dice, playing the odds that nothing will go wrong.**

This strategy will most likely create problems for your company in the long term. The IRS reports the United States loses more than \$35 billion per year in non-withheld income taxes and unpaid employment taxes due to the misclassification of independent contractors. Their stated goal is to close this "tax gap." As a result, numerous federal and state agencies have made it a priority to collect this money by launching aggressive audit campaigns in companies, big and small, who use independent contractors. Eventually, either a state or federal agency will knock on your door. If you haven't taken the proper steps to insure you're doing it correctly you could be facing a large unplanned liability.

**OPTION #2:**

**Hire and/or train an in-house expert whose primary responsibility is to stay on top of, and be able to apply, the federal and state laws and rulings for Independent Contractor compliance.**

This is a full-time, highly technical position that requires seasoned expertise. One of the options within this category is to use a former IRS or state auditor who specializes in this area of law, but good ones who know their business and make the transition to the private sector are hard to find. Some companies use an in-house paralegal or legal staff for this work, but many attorneys do not specialize in this area and don't find it interesting, so they don't keep up on the recent rulings and trends. Having a full-time in-house expert is only cost effective if you are making these decisions on a frequent basis.

**OPTION #3:**

**Keep an outside law firm, specializing in labor law, on retainer to help you make the decision.**

This option provides an expert to help you make the right determination. However, most of the time you have to make this decision quickly in order to bring in the talent and get the project off the ground. Law firms are generally not set up to handle quick turnarounds and may slow down your HR or procurement decision cycle. In addition, engaging an attorney each time you want to select an IC will be expensive and is usually not a long-term solution for a growth company.

**OPTION #4:**

**Utilize an Employee Leasing or Temporary Staffing firm.**

Firms providing contingent workers for temporary projects are a viable option as long as the firm protects you from the inherent risks in this model. These firms typically recruit, conduct background screening, hire, place and pay the consultant in your company. Many of these firms train the workers, set the wage rates, withhold taxes, and provide account management and cost tracking to help you stay in budget. These firms also provide liability insurance and workers' compensation coverage, which will protect you from down-stream claims and significantly mitigate your employment risks. Usually these firms primary expertise is temporary staffing, so IC qualification is not a core capability.

You still control the employee's work during the assignment, but for all other purposes, including discrimination and harassment claims, the staffing firm is responsible for the consultant. The down-side to this arrangement is that many highly skilled consultants (the ones you really need for your project) really are qualified IC's and will not work as an employee and do not want to be associated with a staffing

firm. In addition, the pay and benefits packages offered by most staffing firms may not be robust enough to attract or retain top-level talent. Although this option provides the safety you desire it may not provide the IC expertise you need.

**OPTION #5:**

**Hire the services of a third party vender that provides everything: an objective IC compliance and risk assessment, IC oversight and project management services, and comprehensive contingent employee pay and benefit services for those who do not qualify as an Independent Contractor.**

These firms may provide talent search (if needed) but specialize in screening and background checks, placement, management services and budget tracking. They may also offer scrutiny and risk assessment similar to a state or federal tax audit, so you can mitigate risk and make sound business decisions for classifying and on-boarding your contractors. They will build a compliance file for each Independent Contractor so that in the event of an audit you are fully prepared to defend your company.

The best of these services companies stay abreast of current trends and have their own full-time, up-to-date, experts for both the federal and state Employment-IC laws. If the contractor does not qualify as an IC they tell you. If you want to take the risk, that's your decision. If you don't want the risk they will give you options. They usually provide this service quickly and at a very small cost. If you regularly utilize IC's, consultants, and contingent workers this is the recommended option for most companies.

## Conclusion

The use of leased, temporary and other contingent workers has grown in the past decade as both employers and workers seek greater flexibility in their working arrangements and face more aggressive competition in the global economy. Many of these workers are bonafide Independent Contractors. However, these non-traditional workers can create a host of legal and practical problems if you do not take the proper steps to protect your company.

**About the Author**

Walter Branam has over 30 years of experience working with The State of California's Employment Development Department (CA EDD) in labor and tax audits. As a former Tax Auditor, Tax Administrator, facilitator of the CA EDD's first Taxpayer Rights Advocate Program, and designer of the CA EDD's Settlement Program his knowledge of the Federal and State employment laws, regulations, and audit criteria provides valuable insight into how to prevent worker misclassification. Walt brings his compliance expertise to the private sector as the in-house Worker Classification and Employment Tax Compliance Specialist at Collabrus Inc.

## About Collabrus

*Collabrus provides:*

*Contingent Workforce optimization, risk mitigation and cost control.*

Collabrus provides clients with a comprehensive suite of contingent workforce management services designed to optimize your workforce spend and mitigate risk. Services include professional-level pay and benefits for contract employees, worker qualification and contract administration for Independent Contractors, and end-to-end outsourced managed solutions. Our tailored programs enable you to make the contingent workforce a key asset in your overall talent strategy.

Collabrus solutions include:

- **Compliance and Risk Mitigation** – The unique Collabrus evaluation process is a combination of Web-based tools and expert review to ensure 1099 compliance. Since not all individuals or vendors qualify to be legally called “Independent Contractors,” Collabrus helps clients implement procedures to eliminate the risk associated with utilizing contractors. This often involves working with the vendors to achieve compliance, or moving them to our payroll solution whereby Collabrus becomes the employer-of-record.
- **Professional-Level Payroll** –Collabrus pay services and benefits packages are tailored to meet the needs of your highly skilled contract workers and consultants, on a nationwide basis.
- **Contingent Workforce Managed Services** – Collabrus builds personalized programs that enable clients to manage all aspects of their contractor workforce – Independent contractors (1099), staffing suppliers, and W2 workers – using a combination of web-based technology and high touch services.

For more information:

**Collabrus, Inc.**  
111 Sutter Street, Suite 900  
San Francisco, CA 94104  
415-391-1038  
www.collabrus.com

**Alicia Gousis**  
VP, Business Development  
agousis@collabrus.com  
415-288-1826 x222