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Risks Associated With Using Independent Contractors

(A white paper by David L. Woody – Zaetric Business Solutions, LLC)

Independent contractor risk overview

Using independent contractors makes good business sense. Among many benefits, use of independent contractors can free professional staff for mission-critical responsibilities and enable short-term use of specialized resources, which may not be available normally. However, by improperly structuring and managing the relationship between the company and its independent contractors, companies may unwittingly expose themselves to potential legal and financial risks. Companies can face back taxes and possible fines if an Internal Revenue Service (IRS) audit determines the contractor is actually being treated as an employee. Additionally, contractors can sue for back benefits and other findings in certain circumstances if it can be proved that they were treated as employees. Some steps businesses can take to guard against these kinds of risks are:

- Evaluate your current use of consultants and develop policy and procedures for managing consultants
- Train management staff in the risks associated with employing independent contractors
- Develop business systems for managing and controlling consultant-related documentation
- Review consulting contract language, evaluate for risk and implement risk reduction measures
- Hire only properly insured consulting companies and do not hire individual consultants direct
- Routinely audit your consultant management methods to assure conformance to policy and procedures

What is an employee?

According to the IRS, a person is considered an employee if the company has the right to determine what the individual should do, and how, when and where they should do it. For employees, company is responsible for:

- Federal & State Income Tax Withholding
- Social Security
- Medicare Taxes (FICA)
- Unemployment Taxes or Worker's Compensation Insurance

What is an independent contractor?

One definition of an independent contractor is; a person who exercises an independent employment, contracts to perform work according to his/her own methods and is subject to his/her employer's control only as to end product or final result of his/her work. There are, however, other considerations:

- There is no precise legal definition of an independent contractor.
- Each state, the federal government and agencies have their own criteria for determining Independent contractor status
- Courts analyze the facts of each particular case, with the greatest significance given to:
 - The company's 'right of control' over the worker;
 - Whether the company carries indemnity or liability insurance for the worker;
 - Whether the individual works exclusively for the company, or is permitted to work for others at the same time; and
 - Whether the parties have a written agreement, which defines the status of the worker

IRS independent contractor test

The IRS formerly used what has become known as the "Twenty Factor" test. Under pressure from Congress and from representatives of labor and business, it has recently attempted to simplify and refine the test, consolidating the twenty factors into eleven main tests, and organizing them into three main groups: behavioral control, financial control, and the type of relationship of the parties. Those factors appear below, along with comments regarding each one (source: IRS Publication 15-A, 2004 Edition, page 5; available for downloading from <http://www.irs.gov/pub/irs-pdf/p15a.pdf>).

Behavioral control

Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of—

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- Instructions the business gives the worker. An employee is generally subject to the business' instructions about when, where, and how to work. All of the following are examples of types of instructions about how to do work:
 - When and where to do the work
 - What tools or equipment to use
 - What workers to hire or to assist with the work
 - Where to purchase supplies and services
 - What work must be performed by a specified individual
 - What order or sequence to follow

The amount of instruction needed varies among different jobs. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. A business may lack the knowledge to instruct some highly specialized professionals; in other cases, the task may require little or no instruction. The key consideration is whether the business has retained the right to control the details of a worker's performance or instead has given up that right.

- Training the business gives the worker. An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

Financial control

Facts that show whether the business has a right to control the business aspects of the worker's job include:

- The extent to which the worker has un-reimbursed business expenses. Independent contractors are more likely to have un-reimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur un-reimbursed expenses in connection with the services they perform for their business.
- The extent of the worker's investment. An employee usually has no investment in the work other than his or her own time. An independent contractor often has a significant investment in the facilities he or she uses in performing services for someone else. However, a significant investment is not necessary for independent contractor status.
- The extent to which the worker makes services available to the relevant market. An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.
- How the business pays the worker. An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when a commission supplements the wage or salary. An independent contractor is usually paid by a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.
- The extent to which the worker can realize a profit or loss. Since an employer usually provides employees a workplace, tools, materials, equipment, and supplies needed for the work, and generally pays the costs of doing business, employees do not have an opportunity to make a profit or loss. An independent contractor can make a profit or loss.

Type of relationship

Facts that show the parties' type of relationship include:

- Written contracts describing the relationship the parties intended to create. This is probably the least important of the criteria, since what really matters is the nature of the underlying work relationship, not what the parties choose to call it. However, in close cases, the written contract can make a difference.
- Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay. The power to grant benefits carries with it the power to take them away, which is a power generally exercised by employers over employees. A true independent contractor will finance his or her own benefits out of the overall profits of the enterprise.
- The permanency of the relationship. If the company engages a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that the intent was to create an employer-employee relationship.
- The extents to which services performed by the worker are a key aspect of the regular business of the company. If a worker provides services that are a key aspect of the company's regular business activity, it

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is more likely that the company will have the right to direct and control his or her activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

The IRS's 'right of control' test has been applied in a variety of contexts. An important element often present in the case law where the courts have found 'control' is the ability of the employer to dictate not only the result, but also the process (or methods) the worker uses to produce his or her result.

What can happen?

If the IRS determines that, under their guidelines, an Independent Contractor is an employee, the company may be responsible for: (applicable governmental agencies named after each point)

- All uncollected social security, unemployment and additional taxes (Various state labor agencies & IRS)
 - Penalties and interest (IRS)
 - Additional wages/overtime, (Department of Labor)
 - Possible wrongful termination suits or immigration violations, (Various state labor agencies, courts & Immigration and Naturalization Service)
- NOTE: On age discrimination suits there is no cap on punitive damages***
- Affirmative action violations (Office of Federal Contract Compliance Programs)
 - Pension, 401k and medical and dental benefits (Employee Retirement Income Security Act)

Situations indicating caution

The follow situations suggesting caution when managing independent contractors:

- Large number of Independent Contractors
- W2 employment of Independent Contractors
- Contracting with individuals instead of legal entities
- Poorly executed contracts or agreements (or no contract)
- Long term temporary and part-timers
- Use of former employees, especially just after they have left the company
- Downsizing environments with disgruntled employees calling the IRS

In conclusion

Companies that improperly use and manage independent contractors risk having their contractors redefined as employees by the IRS, government or courts unless policies and procedures for using independent contractors are carefully structured and followed. If redefined by the IRS or the courts as employees, independent contractors may become eligible for employee rights and benefits, while the company may face fines or other significant commercial obligations. It is critical that companies have operating policies in place to reinforce the Independent Contractor's status and minimize risk.

Courts have ruled that companies were exercising right to control and determined that contractors were employees when the company:

- Had the right to supervise the details of the operations
- Required sales people to collect accounts on behalf of the company
- Provided the worker with a company car and/or reimbursement for some or all expenses
- Restricted the worker's ability to work for other companies, or jobs (i.e., required full-time efforts)
- Required the worker to call on particular customers
- Provided the worker with insurance and Workers' Compensation benefits
- Deducted income and FICA taxes

A good risk mitigation strategy should include a thorough analysis of your current operating policy, procedures and methodology regarding the use and management of independent contractors.

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