

## **Schmidt: Cutting costs by using independent contractors is risky**

by Commentary

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Despite recent news that the economy may have finally bottomed out, businesses small and large continue to look for ways to reduce costs. One method has been to retain independent contractors in lieu of employees and to reclassify current employees as independent contractors. For example, a recent SurePayroll Contractor Index says small businesses' use of independent contractors reached a record peak due to the current economic climate.

This strategy, however, can land companies in hot water. Oftentimes, individuals or classes of individuals are not properly classified as independent contractors, leading to abuses both to the federal and state government, as well as to the individuals. In fact, according to recent IRS data, employers have misclassified more than 3 million workers.

From the government's perspective, misclassification results in unpaid federal, state and local tax withholding, as well as unpaid Social Security and Medicare contributions. By misclassifying an individual, companies also avoid paying unemployment insurance and workers' compensation premiums. For workers, misclassification means they will be excluded from coverage from virtually all antidiscrimination and wage/hour laws, resulting in the potential loss of monetary relief and benefits.

While 2007 was a watershed year - including IRS data-sharing agreements with 29 state work-force agencies to share and monitor employment tax examinations, and the formation of a New York State Joint Enforcement Task Force on Employee Misclassification - recent initiatives from all government branches highlight the ongoing need for proactive compliance.

Currently, federal and state agencies are stepping up efforts to audit companies and recoup (with penalties and fines) the monetary losses sustained due to misclassification. This year alone, the New York State Task Force charged two contractors with criminal penalties arising out of fraudulently misclassifying employees as independent contractors to evade unemployment insurance fund obligations.

Legislatures have also increased their focus on this issue. More than a dozen states including New York have either enacted or proposed legislation setting rules for classifying independent contractors in certain industries and providing for steep financial penalties in the event of noncompliance. On July 30, Rep. Jim McDermott, D-Wash., introduced federal legislation to define classification rules. Finally, courts have addressed the issue in a number of industries, including transportation, brokerage and medical. For example, a recent case in the Court of Appeals in New York determined that a physician with privileges on a hospital medical staff should have been deemed an employee rather than an independent contractor.

So, what should your business do? While you can never completely eliminate the possibility of a lawsuit or agency audit, there are ways you can minimize the potential for future liability:

**Understand the thumbnail factors to distinguish employees from independent contractors.** For example, the IRS has largely moved away from its prior 20-factor test, instead favoring a more simplified test that focuses on the degree of behavioral and financial control the company can and does exercise over the individual, and the parties' own views and perceptions of their work relationship. (For more information on IRS standards, visit [www.irs.gov/newsroom/article/0,,id=173423,00.html](http://www.irs.gov/newsroom/article/0,,id=173423,00.html).)

**Conduct internal audits to ensure individuals (or classes of individuals) are properly classified as independent contractors.** It is important to look not only at a particular job title or written position statement defining job duties, but also at the actual day-to-day functions being carried out by the individuals.

**Maintain a well-documented file setting forth the criteria relied upon by the company,**

**and the reasons the workers are classified as independent contractors instead of as employees.** In light of the IRS' apparent focus on the parties' own views of their relationship, the company should also make sure that the proper written agreements are in place detailing the terms of the relationship, and acknowledging the independent contractor status.

**Consider opting for a responsible third-party leasing organization to provide workers.**

In such cases, the workers will be deemed employees of the leasing organization, which in turn would withhold taxes, make the appropriate unemployment and workers' compensation payments, and also perhaps provide various other employee-like benefits. The worker can continue to provide services to your company, while minimizing your company's potential exposure in an audit or lawsuit.

Before you classify or hire a worker as an independent contractor, it is vital to ensure your cost-cutting strategy isn't going to cost your business.

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