

## Smart Move: Written Project Agreements for All ICs

A client was recently surprised when we recommended that a contractor be classified as one of their employees. The company had executed an IC services agreement with the contractor that specifically stated that he would work as an IC. While that agreement would likely support an IC determination in the event that all other factors balanced out, according to newly-published IRS agent training guides, by itself the agreement could not outweigh other evidence of our client's employer-like control over the worker. An executed IC agreement can help establish a worker's IC status by demonstrating the parties' intent to create a client/IC relationship (and not an employer/employee status), but companies should not rely on an agreement as a substitute for proper vetting of a contingent worker.

Companies definitely should document their relationship with contingent workers in a services agreement. The agreement should be in writing, and it should carefully define each party's respective rights and obligations, and the expected quid pro quo – what work product is to be received by the company and the compensation that will be paid to the contractor. Having an effective IC agreement will prevent later disputes and protects both parties. Such an agreement should clearly state that:

- The worker will have control over the methods by which the work will be accomplished, not the company.
- The IC will be responsible for paying all income and self-employment taxes due on the project fees.
- The company will not provide liability, worker's compensation, health, or disability insurance.
- The company will report all monies paid and issue an annual 1099-MISC to the IC.
- The IC will personally hire and pay any additional workers required to execute the project deliverables.
- All tools, equipment, and supplies required to complete the project will be provided by the IC.
- The IC does not work exclusively for the company and has the right to accept other assignments from any employer.
- The IC is compensated for completing the project and is not paid based on the amount of time required to complete the project.
- All costs for meals, transportation, and uniforms, if required to complete the project, will be paid by the IC.
- The IC is not an employee and, therefore, cannot be fired or laid-off. S/he can only be terminated for non-performance under the contract.
- The company will not set the IC's work hours; it will only specify a start and end date for the project.
- The company will not reserve office space on its premises for use by the IC on a regular basis.

IC agreements are also essential for the company to establish its ownership rights to intellectual property assets. While works produced by an employee within the scope of his or her job are automatically designated as "works made for hire" under the Copyright Act, that legislation does not

apply to works produced by ICs. To establish its copyright, a company must have a written agreement in effect at the time the IC produces the work, or the parties can execute a written assignment of ownership rights after the fact. The agreement should also assure the company that creative works produced by the IC do not infringe on the intellectual property rights of any third party or violate any laws.

Other issues that can be covered by an IC agreement include provisions for confidentiality and non-disclosure of proprietary information and, if the IC has access to customer lists, a non-solicitation provision. Finally, an effective IC agreement may include provisions establishing jurisdiction for any dispute, injunctive relief for breach of contract, and arbitration as the preferred venue for disputes.

## **What You Don't Know About Worker Misclassification Can Hurt You**

Companies have been increasing their use of contingent workers for the last decade, but the current economy has accelerated the trend as companies hold off on hiring full-time employees until customer demand drives more revenue. While, certainly, a lot of those companies have hired ICs in the past, many are engaging ICs for the first time and may not be aware of the risks they are taking on. It's easy to see the cost savings from using ICs, but just because a worker is called an IC doesn't mean s/he is an IC. Over and over, we see clients who have been penalized severely because they didn't fully understand state or federal regulations regarding ICs. Most acted on false information that has been reported regarding ICs. Here are a few of the "myths" surrounding IC compliance of which you need to be aware.

*Regarding IC compliance, all contractors are the same when it comes to tax reporting regulations.*

### **The Facts:**

Make no mistake: all contractors are NOT the treated alike under tax reporting requirements. In the IRS' opinion, ICs are self-employed business people with the option of forming any type of business entities they choose, including corporations, LLCs, sole proprietorships, and more. The nature of that business entity can affect how a company reports payments to the IC. Likewise, each company is free to establish whatever work relationship they choose with the IC. Understanding that all ICs are not the same can help you avoid fines and legal disputes.

*Complying with the IRS' Worker Status test meets all worker misclassification requirements.*

### **The Facts:**

While the IRS is the most visible enforcer of worker classification, their regulations only cover employer tax reporting. A number of other federal and state agencies have authority to govern workers and employers, and each has requirements that must be met. As examples, under the Employee Retirement

Income Security Act (ERISA), the federal laws that regulate employee benefits, a 12-factor test is used to distinguish employees from ICs; the Immigration Reform and Control Act (IRCA) applies a 7-factor test; the Fair Labor Standards Act considers “economic realities” test, and the Equal Employment Opportunity Commission (EEOC) looks at whether the company or the worker has the "right to control the means and manner of the worker's performance.” Each agency can assess penalties in the own right.

*By complying with federal IC classification regulations, you can avoid any liability for misclassification.*

**The Facts:**

The complex and subjective nature of IC compliance regulations do not provide a specific guidance for employers and admit as much. An employer can follow or not follow any factor described in the regulations and still be found in compliance or as non-compliant. The government and courts determine classification based on the totality of the work relationship, and on common law case history that defines workers who perform services under an employer’s control and direction as common law employees. If the worker meets the common law definition of employee, s/he will be considered an employee by the courts.

*If the company and worker execute an employment agreement that clearly states that a worker is an IC, then taxing authorities will classify the worker as an IC.*

**The Facts:**

Although the intent of the parties as expressed in an IC agreement is considered by tax authorities and the courts, it is not persuasive in the face of contradictory aspects of the actual work relationship. This is particularly true when a company seeks to convert employees to IC status without changing the actual circumstances of their jobs.

*The IRS determines worker status based on a list of 20 Factors.*

**The Facts:**

There is some truth in this rumor. The IRS did issue a list of 20 Factors, but it discontinued the use of those factors in determining worker status several years ago. Today, they use a new process that examines three aspects of the worker/employer relationship – behavioral control, financial control, and the type of relationship. Relying only on the older, 20 Factors standard will potentially expose companies to costly fines and penalties for worker misclassification by IRS or state tax auditors. Taxing authorities have stepped up enforcement of employer compliance as they struggle to balance budgets with shrinking revenue. If you don’t want to get caught up in their problems, classify your workforce according to the new rules and guidance.

*Worker’s compensation insurance policies protect companies from liability for workplace injuries to all workers, including ICs.*

**The Facts:**

ICs are not covered by worker's compensation policies that base premiums on a percentage of wages paid, and companies can definitely be sued for work-related injuries to ICs, such as those that result from negligence, defective equipment, and other causes.

*Classifying executive officers as independent contractors, rather than as company employees, is an acceptable business practice.*

### **The Facts:**

While many companies have segregated their executives as ICs from other employees, usually to provide the executive with a more beneficial compensation package, the government can deny the classification if it insulates the executive from "corporate responsibility."

### **Conclusion**

As financially beneficial as hiring ICs can be, companies need to carefully vet contractors to ensure they meet the requirements to be classified as ICs. Yet, classification is a complex and subjective determination that requires more expertise than most companies can justify. ICsimplify is the cost effective IC compliance solution that can protect your company and assets from potential fines and penalties for misclassification.

## **Don't Invite a Worker Classification Audit of Your Company**

Numerous state and federal taxing authorities have announced plans for increased enforcement efforts of worker classification compliance. One announcement, regarding an IRS National Research Program, describes how more than 5,000 employers will be randomly chosen for audit. Admittedly, you won't be able to control whether your company is included in that random number; however, most of the other enforcement actions will target employers that have, somehow, attracted scrutiny. How did you keep from doing that? Here are some common "red flags" that will trigger an audit of your company.

*An Independent Contractor (ICs) will file for unemployment benefits against your company*

Because ICs are not employees, companies do not deduct taxes or benefit premiums from payments to them, and they are not covered by those benefit programs. That won't stop an IC, however, from filing for state unemployment benefits anyway after his or her project is finished. When that happens, the state is required to investigate, which can trigger a more comprehensive audit.

*Bringing back a former employee as an IC*

It is not uncommon for companies to bring ex-employees back on board for a short period to take advantage of their knowledge and experience of the company's operations. If the worker only recently

(the same tax year) left the company and is now being classified as an IC, taxing authorities will see two tax filings – one as an W-2 employee and the second as a 1099 IC. Obviously, a worker can't be both an employee and an IC for the same company, so this is a huge red flag to the tax authority.

And, in most of those cases, the resulting audit is well deserved. The returning employee is very likely performing the same tasks s/he did as an employee – perhaps, even finishing up a project started during his or her tenure with the company – and is subject to the same control and the same working relationships as when s/he was an employee. Also, in most cases, the ex-employee is not truly set up as an independent business. Taxing authorities usually catch the discrepancy and will reclassify the worker as an employee and penalize the company with back taxes, plus interest, and fines.

#### *Unreported 1099 income by ICs*

Not much you can do to prevent this. Some ICs are just not going to report the 1099 income you've paid to them, whether intentionally or by mistake. When that happens, tax authorities will initially pursue the IC. If that IC refuses to acknowledge receiving the income, the agency will have no choice but to audit your company to see who is lying. This would be fine, if only the audit stopped there. Often it doesn't.

#### *Form SS-8: A formal request by the IC to have the IRS review the worker classification*

The Form SS-8 is submitted by a worker to the IRS requesting an official determination of the worker's status – i.e. whether s/he is an IC or an employee. There could be many reasons why an IC would file the SS-8, but the most obvious is to gain access to the benefits offered to regular employees, such as health insurance, stock options, retirement plan contributions, overtime pay, vacation pay, and more. If the IRS determines that the worker should have been classified as an employee, it will assess back taxes, penalties, and even fines, which can be costly, but with that determination in hand, the newly-designated employee can file a civil suit to collect those benefits retroactively. In a worst case scenario, the ruling may apply to an entire class of workers at the company and amount to a huge settlement cost or even bankrupt the company.