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THE CLASSIFICATION OF SERVICE PROVIDERS AS "CONTRACT WORKERS" RATHER THAN "EMPLOYEES": IMPLICATIONS AND GUIDELINES FOR SMALL BUSINESSES

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ABSTRACT

Small businesses can reap a variety of benefits by classifying some of their workers as "contract workers" rather than "employees." However, there are significant risks involved as well. This article explains the issues and regulations involved in such a classification, gives some examples, and then provides the small business owner, manager and advisor with a series of guidelines to increase the likelihood of correct classification, maximum benefit and minimum risk to the company.

INTRODUCTION

About five million Americans work for companies, but are not employees of those companies (Uchitelle, 1996). These workers are "contract workers," also known as "independent contractors." Under the law, a contract worker independently agrees with an employer to perform services for that employer for a fee. Unlike an employee, the contract worker is considered self-employed, performs his or her work with minimal direction and greater flexibility, receives none of the supplementary benefits an employee might receive, and is responsible for paying his or her own income and social security taxes.

Largely because of this flexibility and the relief from providing benefits and from withholding and paying taxes, this alternative to employment appeals to employers, who have been using it in greater and greater numbers. The growth of contract workers has been explosive in the 1990's and is expected to continue well into the next century (Wolfe, 1996).

The rise of the use of contract workers is part of a larger and growing shift in the basic structure of American business and work. In recent years, in response to competitive and financial market pressures, a large number of companies have moved to make their operations more lean and efficient through downsizing and outsourcing (Anderson, 1997; Greising, 1998). And one specific mechanism to achieve these goals has been the use of contract workers rather than employees (Braff, 1997; Houseman, 1997). While downsizing most often leads to the outright elimination of jobs and employees, employers motivated by the potential cost savings of "contract worker" classification may also replace terminated employees with less expensive contract workers. One recent study indicates that almost thirty percent of terminated employees are being replaced by contract workers ("Temps forever," 1997).

The apparent advantages to the employer are clear. The costs of withholding and recording income taxes can be avoided, since this responsibility now falls on the contract worker. The employer need not contribute to social security/medicare taxes (7.65% from the employer on the first $68,400 in wages in 1998) nor to Federal and state unemployment and workers' compensation insurance (these tax rates vary by state). Minimum wages, overtime pay and ERISA benefits can be ignored. Medical and other benefits need not be provided. Since the worker is not an employee, he or she can not join a union (as per the Labor Management Relations Act). And the worker can be released at any time with no notice or severance costs.

These advantages might seem especially appealing to a small business owner, as the administrative costs of collecting taxes and providing benefits for employees are more onerous to a firm with few employees than to a large company, where these costs can be spread out over many employees.

Yet there are many potential dangers involved in the utilization of contract workers. As the use of such workers has grown, the Internal Revenue Service and other federal and state agencies have moved to scrutinize such use more carefully. These agencies' concerns are justified. The IRS estimates that (1) more than half of all contract workers are misclassified, (2) one in seven employers are guilty of misclassification, and (3) such misclassification results in a loss of $4.1 billion a year in unpaid tax revenues (Cohen, 1997).

Therefore, the IRS and state income tax agencies are carefully auditing companies which utilize contract workers. When it is determined that contract workers should in fact be regular employees, these workers can be reclassified, and the employer then can be liable for the payment of the various back taxes, and sometimes for other employee benefits as well, such as health insurance and pension plan contributions (Jenero & Mennel, 1997). And because the IRS sees small firms as more likely to escape its routine audits, it has established a special unit to scrutinize companies with less than $3 million in net worth. Most of these IRS audits are the result of complaints from dissatisfied workers, and an estimated ninety percent of such audits result in a reclassification from "contract worker" to "employee."

Thus it is especially important for small business owners to understand the pros and cons of using contract workers, to understand the laws governing such use, and to have guidelines for their own personnel policies. The dollar costs resulting from a reclassification of employees can be very substantial for a small business with a minimal financial cushion to deal with unexpected major expenses. Being ordered by the IRS to pay several years of back Social Security, Medicare and unemployment taxes for a number of workers can run into thousands of dollars, more than many small firms can raise (Bernardi, 1997). In fact, the contact worker issue, and especially the IRS governing regulations, topped small business owner concerns among those who attended the 1995 White House Conference on Small Business (Readers Views, 1996). It is the purpose of this article to provide a discussion of the contract worker issue and the laws surrounding it, and to offer a series of guidelines to assist a small business owner in dealing with this issue.

THE LAWS AND REGULATIONS

The laws and regulations which determine whether a worker should be classified as an employee or as a contract worker are not cut and dry. If they were, the issue would be simple, and there would not be a large percentage of misclassified contract workers. Rather, there is a huge "grey

area" which allows companies to both willfully and unintentionally classify workers incorrectly as contract workers.

Basically, the IRS currently relies on a twenty-factor test to determine whether the employer maintains sufficient control over a worker for an employer-employee relationship to legally exist. Specifically, Revenue Ruling 87-41 covering Section 530(d) of the Revenue Act of 1978 set up these twenty factors. That ruling (in lengthier wording than the following) asks whether the worker or "service provider" (IRS, 1987; Davis, 1993; Jenero & Mennel, 1997):

1. Must comply with the employer's instructions about the work (and what amount and level of instructions are given)
2. Receives training from or at the direction of the employer (also what amount and level)
3. Provides services that are integral to the employer's business (i.e. part of the basic activities of the firm rather than peripheral support services)
4. Provides services that must be rendered personally (rather than by someone else assigned or employed by the worker)
5. Hires, supervises and pays workers for the employer
6. Has an ongoing relationship with the employer (a permanent position rather than a short-term or occasional one)
7. Follows set hours of work (rather than hours largely of the worker's choosing)
8. Works full time for the employer (rather than part-time and/or for more than one employer)
9. Does the work on the employer's premises (rather than the worker's premises)
10. Does the work in a sequence set by the employer (rather than one set by the worker)
11. Submits regular reports to the employer (so that the employer is always aware of the worker's performance rather than being informed only occasionally)
12. Receives payments of regular amounts at set intervals (rather than occasionally when billed by the worker)
13. Receives payments for business and/or travel expenses from the employer (rather than the worker absorbing such expenses)
14. Relies on the employer to provide tools and materials (rather than the worker providing these)
15. Lacks a major investment in resources for providing services (i.e. the employer provides such resources)
16. Can not make a profit or loss from the services (i.e., the employer solely takes the financial risk of profit or loss)
17. Works for one employer at a time
18. Does not offer the services to the general public (but rather just to the employer)
19. Can be fired by the employer (as an employee, rather than working under a service provider contract with provisions for both termination by either party and recourse for non-compliance by either party)
20. May quit work at any time without incurring a liability (again, without contractual recourse)

(There is no implied ranking of importance to the sequence or numbering of the factors.)

These twenty factors relate to the more general question of "who controls what work is done and how the work is done?" The more the answers to the twenty questions indicate the independence of the worker, the stronger the classification as "contract worker." Conversely, the more the

answers indicate that the employer has the right of control and direction over the worker and the work's details, means and results (even if that right is not fully exercised), the more likely the correct classification of the worker should be "employee."

Furthermore, these twenty factors relate to the concept of a "common law employee." In other words, while there is no concrete legal definition of an "employee" (versus a "contract worker"), these twenty factors cover the range of common law meaning. Not all twenty factors need indicate an "employee" or a "contract worker" classification; some factors can be more or less important, or even irrelevant, depending upon the context of the work and the company. Industry norms are also a factor; if contract workers are frequently utilized in an industry, firms in that industry are more likely to have their "contract worker" classifications upheld.

There are some additional regulations that affect these IRS rulings and the possible resulting financial penalties to a small business. In particular, Section 530 of the Revenue Act of 1978 and the subsequent Small Business Job Protection Act of 1996 provide more uniform standards in the classification of workers and make the regulations more "user-friendly" toward employers. For example, in certain situations, when the employer makes a prima facie case for "independent contractor" status, the burden of proof shifts to the IRS to prove that the workers are "employees." Also, these regulations and modifications can, in some instances, offer some tax liability relief to small businesses whose contract workers are reclassified as employees. But the conditions under which such assistance and relief can be obtained are complex, and they provide both benefits and disadvantages to the employer. Furthermore, the current agenda in Congress is to make the IRS itself more "client-oriented," and possible future directives and regulations may offer other benefits to employers involved in job classification issues. Because of the complexity of these new regulations and modifications, it is suggested that an interested small business owner, manager or advisor consult an accountant or attorney for further information (Jackson, 1997; Krawczyk, 1996; Mason & Brozovsky, 1997).

Also, there is a U.S. Senate bill (105th Congress, 1st Session, S.473) that would amend and simplify the existing twenty-factor IRS test. If this proposed amendment to the current IRS regulations were to be passed, a service provider would be considered a contract worker if criteria #1, #2 and #3 or #3 and #4 below were satisfied:

1. The service provider can realize a profit or loss from the work
2. The provider has his or her own place of business, or works with his or her own equipment
3. There is a written contract which stipulates that the provider will not be treated as an employee
4. The provider is a corporation or a limited liability company and does not receive the benefits the service recipient's employees receive.

As of Spring 1998, this bill was still in committee and had not reached the floor of the Senate. While passage of this bill (or something similar) might reduce the current uncertainty in defining a "contract worker," and interested small business owners and advisors can monitor the progress and possible passage of this bill in Congress (http://thomas.loc.gov/home/thomas.html)a sizable "grey area" will still exist, as will penalties for incorrect worker classification, even if current IRS guidelines are amended.

EXAMPLES

As previously noted, the vast majority of Internal Revenue Service audits result in a reclassification from "contract worker" to "employee." This is because in most cases the facts (as evaluated by the "Twenty-Factor Test") clearly support "employee" status. However, some job classification audits deal with more complicated situations. In these cases, the IRS rulings are less predictable in advance and often not even easily comprehendible after they are issued! As an illustration, several recent Internal Revenue Service rulings on such complicated cases are provided here.

Example #1

Employer #1 engaged workers as sales representatives selling insurance and other financial products. These workers were required to obtain and maintain all necessary licenses, were allowed to solicit sales anywhere they were licensed, and had a written contract with the employer stating that they were contract workers. The contract was not for a specific period of time and allowed for termination by either party. The workers had the right to determine hours and schedule of work activity. Although the workers received extensive product and sales training, actual day-to-day instructions to the workers were minimal. Furthermore, the employer required each worker to maintain an office outside his or her home and to pay all the expenses associated with maintaining that office. The workers were paid on a commission basis.

Example #2

Employer #2 hired an individual who had previously retired from the firm to review the firm's delivery of services, identify bottlenecks and recommend solutions to problems which he found. When previously an "employee" of the firm, he had engaged in similar activities. Now he worked under a written contract as a "contract worker," to be paid a set amount per day for a period not to exceed 150 days. The worker received minimal training, was reimbursed for expenses, and was supervised only on an informal basis yet was directed where and when he would perform his services. Also, he was required to attend staff meetings, was provided helpers when needed, was provided all equipment and supplies by the firm, and received no benefits.

Example #3

Employer #3 contracted with various retailers to deliver their products to the retailers' customers. Employer #3 then contracted with workers to perform these delivery services, assigning each worker to a specific retailer. Merchandise was loaded onto the vehicles by the retailer in the order in which it was to be delivered. The workers, who were engaged to work full-time in this capacity, received up to a week of on-the-job training prior to performing these services, and they received instructions from the employer regarding the type, size and color of the vehicle, which the workers were required to purchase or lease. The workers did not own or lease any vehicles prior to their association with the firm. Furthermore, the firm provided instructions as to how to perform the delivery services, and representatives of the firm occasionally rode with the workers to insure that the workers' services were being performed in accordance with the firm's standards. A written contract classified the workers as "contract workers" and they were paid a percentage of the delivery charge paid by the retailers' customers.

Example #4

Employer #4 operated a country club comprised of two 18-hole golf courses, a golf pro shop, and other related recreational and social facilities. The worker was engaged as the Director of Golf, with duties delineated in a written contract. These duties included responsibility for golf cart rental services, practice range operation, golf shop operation, golf club storage and repair, golf instruction and clinics, and golf tournaments and related events. The contact required him to employ sufficient staff to conduct these operations; this staff was paid by the employer and financial records of these activities were to be made available to the employer. The Director of Golf received a base salary plus a percentage of the gross receipts from the golf cart rentals, all income from any lessons and clinics he taught, and a percentage of the Pro Shop's net profits. The Director of Golf worked under the direct supervision of the employer's General Manager, who was an employee of the Country Club. The Director of Golf was required to purchase all inventory to be sold in the Pro Shop, but he did not pay any rental to the employer for the shop and other golf facilities. Although the Club's members could pay the Director of Golf directly for lessons and clinics, most chose to pay to the Club, which then paid those amounts over to the Director of Golf. If members failed to pay for these services, the Director of Golf received nothing. Here too the written contract stipulated that the worker was a "contract worker."

Clearly, these four examples of employer-worker relationships fall into the "grey area" discussed above. All four involve a mixture of the "Twenty Factors," some indicating that the worker is an "employee" and others indicating that the worker is a "contract worker" or "independent contractor." These four situations were but a few of the many in 1997 in which a worker or workers filed a complaint with the Internal Revenue Service, claiming that they were incorrectly classified by their employers as "contract workers" or "independent contractors." In these four cases, the IRS weighed the various twenty factors to determined which way the balance tilted, and ruled that in Example #1 and Example #3 the workers were correctly classified as "independent contractors;" and that in Example #2 and Example #4 the workers were incorrectly classified and should be classified as "employees." In examples #2 and #4, the workers were reclassified and entitled to a variety of prior benefits, with the employer liable for paying back taxes and some other benefits. The fact that the IRS rulings in these four examples were difficult to predict illustrates how important it is for small business owner/managers to understand this broad issue of job classification, and the need for guidelines to assist in job classification. Even after several readings of these four examples, the tilt of the weight of the "Twenty-Factor Test" toward "independent contractor" in #1 and #3, and toward "employee" in #2 and #4 is at best subtly comprehendible (#1: IRS TAM 9736002; #2: IRS PLR 9707019; #3: IRS PLR 9738015; #4: IRS TAM 9717001).

NON-FINANCIAL ISSUES

The objective of this article has been to primarily focus on the financial risks inherent in the misclassification of workers. This is the issue raised at the 1995 White House Conference on Small Business, and what most polls indicate to be of prime concern to small business owners/managers ("Readers Views," 1996). Still, it is also important to consider the non-financial issues. In choosing to hire and/or classify workers as "contract workers," the employer risks weakening worker motivation and performance. A contract worker who believes that he or she should correctly be classified as an "employee" may still accept or remain in the contract worker position because of financial need for the job, but may at the same time perceive that the employer is taking advantage of him or her. In such situations, motivation and performance may

suffer, quality of work may be lower, and employer-worker communication and relations may deteriorate. These non-financial risks of misclassification (whether the misclassification is true or only perceived as such by the worker) must also be carefully considered and weighed when initial job classifications are being determined.

GUIDELINES FOR SMALL BUSINESS OWNERS

In light of the above discussion and examples, a number of guidelines are offered to small business owners or managers who either currently utilize contract workers, or who are considering the use of such workers (Chvisuk, 1996; Davis, 1993; Jenero, 1997; Robinson, 1996):

1. Any arrangement to use one or more contract workers should be spelled out in a written contract. Such a contract should clearly delineate the responsibilities of the worker and the benefits that the position provides. The use of relevant items from the IRS Twenty-Factor listing can strengthen the clarity of the contract worker status. However, the existence of such a written contract does not guarantee IRS acceptance of the contract worker status. It is the *practice* which matters most, not just what is written on paper.

2. Other business documents must be consistent with the contract. For example, be sure that the term "employee" is not used to describe contract workers in promotional literature aimed at the firm's customers.

3. Utilize contract workers whose characteristics support this classification. For example, workers with their own business identities and with other clients are more likely to be accepted as contract workers by the IRS.

4. As an employer is required to file federal W-2 forms with the IRS for regular employees, federal 1099 forms are required for contract workers. Failure to file promptly might jeopardize a contract worker classification. (Check with an accountant or attorney to determine the current minimum dollar requirement for filing 1099 forms.)

5. Firms utilizing contract workers should periodically conduct a self-audit to confirm the validity of the classification. Basically, the IRS Twenty-Factor listing can be used as the audit checklist. If few or none of the requirements for a contract worker are supported by the workers' situations, the employer should either reconsider the classification or should modify the relationships with the workers to meet the classification. Conversely, in some cases, a self-audit might indicate that some workers or positions currently classified as "employees" in the firm might in fact be eligible for contract worker status.

6. Employers should monitor all contract worker situations for any changes in responsibilities, supervision, work days or hours, etc. As a company grows, there may be a tendency to utilize contract workers in additional tasks, and this could lead to more work time and additional supervision from the employer, jeopardizing the contract worker status.

7. Some employers and supervisors may have a tendency to increase the amount of direction and control over workers over time. To maintain contract worker status, those in supervisory positions must consciously work to avoid exercising too much direction.

8. All company employee benefit plans should be designed so that those groups of employees covered and not covered are clearly identified, and so that the plan administrator has high discretionary authority to determine eligibility. If some of the company's contract workers were subsequently reclassified, this would reduce the possibility that they would be entitled to past benefits.

9. Employers should recognize that the classification of workers as "contract workers" when the situation falls into the "grey area" previously discussed may lead to lower levels of morale, work quality, communication and other measures of performance by these workers. The savings in costs gained by "contract worker" classification may be more than offset by these lowered work outcomes resulting from "contract worker" classification, even if classification is valid.

10. Employers should consider the use of temporary workers rather than contract workers. Temporary workers are generally considered the employees of the temporary agency, which is thus responsible for IRS filing, etc. The use of temporary workers therefore shifts the burden of classification away from the employer.

11. Finally, the issue of "contract workers" versus "employees" is complex and, as discussed earlier, currently under review in a U.S. Senate committee. Employers would be wise to consult an expert for advice and to determine whether any modifications have been made to the laws, regulations, and the "twenty-factor test" before classifying a new group of workers, or reclassifying an existing group.

CONCLUSIONS

The classification of some workers as "contract workers" or "independent contractors" rather than "employees" can provide a variety of financial and non-financial benefits to a small business owner/employer. Yet the risks of having such a classification overturned by the IRS or another agency are substantial, with the potential of being highly damaging or even possibly lethal to a small firm with limited financial resources. While small business owner/managers should not rule out the utilization of contract workers, they should fully understand the requirements for contract worker classification, and should engage in management practices to support such classification if used.

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