



EMPLOYER BULLETIN:

Are you properly classifying independent contractor workers?

HIRING INDEPENDENT CONTRACTORS. In 1989 and 1990, the Internal Revenue Service investigated Microsoft's employment records and decided its "freelance" employees were not independent contractors, but "employees" of the company. Three years later, a group of "freelance" employees brought a class-action lawsuit against Microsoft seeking participation in the company's stock purchase plan and they sued for full benefits. The class-action suit settled out of court for \$97 million in unpaid compensation. This landmark case illustrates that merely naming an employee an "independent contractor" or having him sign an agreement designating him as such, does not make him one under the law.

Typically, independent contractors are hired to complete specific projects. Employers often save money by hiring an independent contractor as opposed to an employee to complete discrete tasks. Employers save money from not having to pay payroll taxes, unemployment premiums, workers compensation premiums, employee benefits, as well as a decreased exposure to liability in certain types of lawsuits. However, as illustrated by the Microsoft case, failure to properly classify an employee can result in liability not only to the individual(s), but also from state and federal agencies, including the IRS, state unemployment and workers compensation offices, and the U.S. Department of Labor. Each of these offices has a different set of standards for determining independent contractor status and its own method of regulating that status.

WHAT IS AN INDEPENDENT CONTRACTOR UNDER MICHIGAN LAW? Michigan courts have applied an "economic-realities" test in determining whether an individual is truly an "independent contractor" for purposes of civil liability. This test includes four basic considerations: (1) whether the

employer has the right to direct or control the worker's duties; (2) how wages are paid (i.e., 1099 Misc Form); (3) whether the employer has the right to hire, fire and discipline; and (4) whether the individual's performance of the duties is an integral part of the employer's business toward accomplishment of a common goal. This test considers the totality of the circumstances in which the work is performed. No single factor is controlling over the situation, and other factors may be considered on a case-by-case basis. For tax purposes, the IRS has established a list of 20 factors to assist employers in determining worker status under the code.

WHAT CAN EMPLOYERS DO TO PROTECT THE COMPANY WHEN HIRING INDEPENDENT CONTRACTORS?

The employer should include language in all of its policies and benefit plans specifically excluding coverage for all independent contractors and contingent workers. This would include stock options, vacation, sick time, health insurance and retirement plans. Further, ensure there is a formal written agreement between the employer and the independent contractor which explains the degree of control the company will have over the independent contractor, the specific tasks to be performed, where and how such tasks will be performed, how compensation will be paid, that there will be no benefits, the extent of the employer's authority to hire, fire or discipline, and that the independent contractor must obtain his/her own worker's compensation and other appropriate insurances.

WHAT HAPPENS IF A COMPANY MISCLASSIFIES AN INDEPENDENT CONTRACTOR?

If the IRS finds an employee has improperly classified an individual, it may assess a civil penalty equal to 100% of the total amount of tax evaded, a civil penalty of \$50 for each W-2 form which was not filed, interest on

past due tax payments, an amount equal to 1.5% of wages not reported, and 20% of the workers share of FICA that was not withheld. Further, criminal penalties and fines may be imposed.

At the state level, penalties for misclassification include: exposure for unpaid taxes, penalties and interest, wage and overtime payments, and past due workers compensation and unemployment charges. Further, an employer could also be exposed to employment related lawsuits. Audits and investigations at the state agency level occur more frequently because workers classified as independent contractors file for unemployment compensation upon completion of their work and this information is shared between the state agencies.

SEEK ADVICE ON HANDLING INDEPENDENT CONTRACTORS.
If you plan to, or have been working with independent contractors, allow us the opportunity

to help protect your company's workforce by ensuring you are meeting federal and state guidelines and limiting your potential exposure for misclassification. Please contact John Below (313-259-8597) or Heather Ptasznik (313-259-8586) to determine what solutions are best for your company.

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IRS SAFE HARBOR LAW

In 1997, the IRS passed a Safe Harbor law in order to assist companies correctly determine independent contractor status. There are three requirements:

(1) the employer must file all required 1099-MISC forms with the IRS which reports all payment made to the workers in question; (2) the employer must treat the workers involved and others doing substantially similar work as independent contractors; and (3) the employer must have a reasonable basis for treating the individual as an independent contractor. This can be satisfied by: (a) showing it is common practice in the industry to treat such worker as an independent contractor; or (b) obtaining a letter from an attorney or accountant stating the workers qualify as an independent contractor; or (c) showing in a previous IRS audit the status of similar workers was not questioned; or (d) obtaining a copy of a court decision or IRS ruling that similar workers qualified as independent contractors. However, an employer may be denied protection of this defense if it inconsistently classified employees doing the same work or failed to file the appropriate tax forms consistent with an independent contractor.