1099 Compliance:
Avoid worker misclassification and save your company from financial disaster.

Highlights include:

- FedEx and Microsoft’s Misclassification Legal Battles
- Factors to Determine Independent Contractor Status
- Potential Employer Liability
- What You Can Do to Protect Your Company
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Executive Summary:

For much of our recent business history, the workforce in the United States has been predominantly comprised of full-time employees who receive long-term employment benefits, with many employees remaining employed by the same company for much of their careers. However, a new trend has emerged within the past 20 years: a contingent workforce of independent contractors has permeated companies across the country in almost every industry.

Generally speaking, company management has welcomed independent contractors, due in large part to expected, perceived or realized cost savings. In addition, the use of independent contractors oftentimes allows the company to be fluid in terms of the size of the workforce, allows the company to decrease amounts paid for employment taxes and employee benefit plans, and permits companies to be exempt from obligations relating to traditional labor law.

Despite these beneficial surface effects of utilizing independent contractors, the ballooning use of the independent contractor workforce has the potential to create significant exposure for companies that misclassify independent contractors due to a lack of understanding of what constitutes an independent contractor versus an employee.

Although many companies are aware that misclassification of an employee as an independent contractor might result in increased tax liability, this liability is only the outer edge of a deeper problem. Liability for taxes and unpaid benefits, as well as a host of other related problems, can be devastating. The potential liability associated with misclassification of workers even has the capacity to collapse a business.

Proactive third-party audits provide real value by helping organizations understand and mitigate risks involved in the misclassification of workers as independent contractors. To give the reader a perspective on this issue, a brief study of Federal Express Corporation (FedEx) and related cases offers insight into how problematic this issue is in today's business world and what your organization can do to minimize exposure to this very real risk.

A. FedEx: The current “poster child” for independent contractor misclassification.

On Dec. 22, 2007, the Internal Revenue Service delivered the latest bad
The IRS determined that FedEx owed approx. $319 million in back taxes for 2002. Bear in mind that this amount has the potential to multiply as additional tax years are evaluated.

FedEx's policy of treating its FedEx Ground/Home Delivery drivers as independent contractors has been under attack at the state and federal level for several years; the IRS and Massachusetts rulings are only the latest. Class action lawsuits alleging that the FedEx Ground/Home Delivery drivers have been misclassified have multiplied across the country, with more than 50 lawsuits consolidated in a federal court in South Bend, Ind.

The class certification on the FedEx case in Indiana was determined on Oct. 15, 2007, which entitles the case to proceed as a class action involving 14,000 current FedEx Ground/Home Delivery drivers across the nation, as well as upwards of more than 10,000 former drivers.

The legal setbacks for FedEx were also felt in California in December 2007, when the California Supreme Court issued its decision in the case of Estrada v. FedEx, upholding an appeals court ruling that found FedEx Ground/Home Delivery drivers were misclassified as independent contractors.

On March 25, 2008, in a ruling by U.S. District Court Judge Robert L. Miller, the number of states permitting class actions against FedEx expanded to 20. The states involved include Tennessee, home to FedEx's corporate headquarters, as well as Pennsylvania, home of FedEx Ground/Home Delivery.

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FedEx is not the first high-profile company to find itself in this predicament. The previous “poster child” for worker misclassification issues is Microsoft Corporation. In the late 1980s, Microsoft employed approximately 1,000 workers who were categorized as independent contractors. The workers signed an agreement that confirmed they were independent contractors and as such, were not entitled to participate in Microsoft benefit programs. The IRS audited Microsoft for the 1989-1990...
tax year and found that the workers who were classified as independent contractors were truly employees. This finding was due to the fact that Microsoft either did, or had the ability to exercise direction and control over the services the workers performed.

As a result of this finding, Microsoft agreed to comply with payment of employment taxes on behalf of the workers for the specified tax period and even hired some of the workers as employees; however, this step backfired on Microsoft as a group of these misclassified workers, now employees, demanded benefits that they would have received for the period they were classified as independent contractors.

Microsoft denied the employees' claims, asserting that the independent contractors had signed away their rights to company benefits in their independent contractor agreements. As a result of the denial of entitlement, eight of the employees sued Microsoft (*Vizcaino v. Microsoft*) for the right to participate in benefit plans. In December 2000, Microsoft agreed to settle the suit for $97 million.

As seen from the Microsoft case, the focus on this issue is not something that is new. Rather, the above cases illustrate what appears to be a growing worker misclassification legal trend.

The issue has even reached the congressional level of government. In May 2007, the House Committee on Ways and Means held a hearing on the effects of misclassifying workers as independent contractors. The hearing partly focused on a report stating that the U.S. Department of Labor (DOL) is missing opportunities to address issues of misclassification. Part of the solution to this problem was stronger oversight responsibilities by the DOL. The increased focus on misclassification by federal and state agencies should be a concern for any company or industry that uses independent contractors as part of its workforce.

**C. Factors to Determine Independent Contractor Status**

Scrutiny of the classification of independent contractor versus employee stresses “control” of the worker, specifically control over the manner and means of the worker’s performance of his or her services. True independent contractors are skilled and qualified experts in their field who perform services without being subject to control over the manner and means in which services are performed.

Employees, on the other hand, typically lack specific skills and are frequently instructed and trained on how their work is to be performed, including company designated hours of work, rate of work, and the place and nature of work. Problems occur when control over the results of the work (indicative of an independent contractor relationship) overlap with
control over the manner and means of performance of the work (indicative of an employee relationship).

When these lines merge or become fuzzy, an independent contractor relationship may fall under the microscope of various interested parties, including the National Labor Relations Board; state agencies that administer workers' compensation or unemployment compensation; the IRS (as in the FedEx and Microsoft cases); the independent contractors themselves; plaintiff lawyers; union organizers; and more. When these groups identify a company that may be misclassifying workers, they will allege an employee relationship, as opposed to an independent contractor relationship.

Some factors looked at include a) if the company is exerting or has the right to exert control over the worker's time and work schedule, including lunch and rest breaks b) if the company's employees assist the alleged independent contractors to perform their work and c) if the company has control over the worker's methods for performing their work, for example, how to complete a task as opposed to only being concerned with the end results.

Additionally, attacks on purported independent contractor status arise when the contractor is provided training by the company; when the worker works only for one organization as opposed to multiple companies; when the worker does not have his or her own business; when the worker doesn't supply his or her own tools and equipment; when the worker is given paid leave or paid vacation; when the worker can be terminated at will; and when the worker doesn’t have any business opportunity to earn profit or suffer losses.

Depending on the circumstances and factors, it is possible that a state or federal agency (or a court or other reviewing body) could conclude that an employer-employee relationship exists, as opposed to an independent contractor relationship that may have been originally intended.

D. Potential Liability

Federal and state agencies are losing millions of dollars in tax revenue each year due to worker misclassification. Similarly, increased audits by government agencies put companies that misclassify workers at risk for hefty fines and penalties.

Oftentimes, federal and state agencies as well as plaintiff attorneys attack independent contractor worker misclassifications, alleging liability or claims for:

1. Back taxes, including employer and employee contributions.
2. Benefits that would have been provided to the workers if they had been an employee (health insurance, stock options, vacation, sick leave and other benefit programs).

3. Pension contributions or profit sharing that the previously classified independent contractor did not receive.

4. Fines from federal and state agencies, including interest.

5. Past liability asserted by third parties for acts of employees while they were independent contractors.

6. Intentional misclassification of workers as independent contractors (in which punitive or triple damages are available in some instances).

7. Union organization efforts.

No one expects the challenges surrounding proper worker classification to go away any time soon; FedEx is forecast to be only one of many in an expected upswing of these types of cases.

E. What can you do to protect your company?

Worker misclassification issues are here to stay. It is an issue that requires a multitude of perspectives to look at the current use and circumstances of independent contractor relationships, and requires solid independent contractor analysis expertise.

Many employers do not know what processes are in place for classifying their workers or just how many independent contractors are providing services to their company. The first step to protection is taking a closer look into company worker classification policies. While some basic steps can be taken to ensure appropriate classification, understanding the complexity of worker classification is generally not a core competency of many businesses.

The following is a list of steps that can be taken to help ensure proper worker classification:

1. **Apply government guidelines.** Various federal and state tests can be applied during an audit. Make sure to follow guidelines as completely and consistently as possible when engaging an independent contractor. Many guidelines that agencies use when executing an audit are public information and can be found on an agency’s Web site; however, these guidelines can be confusing or ambiguous.
2. **Use independent contractors that have an established business.** Engage contractors that perform services for multiple unrelated clients. Identify and select independent contractors that have a documented history of providing services. Request items that indicate an established business such as licenses, references, marketing materials and proof of insurance.

3. **Use independent contractors that provide services not integral to your core business.** Do not engage contractors to perform the same or similar services as your regular employees. Engaging contractors to perform the same work functions as existing employees is indicative of staff augmentation, rather than a specialized and defined project for contract.

4. **Create and execute appropriate contracts with each independent contractor for each engagement.** Enter into a contractual agreement that clearly explains the intended relationship of the parties. It is best to have an expert review the contract for compliance with regulatory guidelines. Contracts should be constructed to describe a business-to-business engagement and should not include employer-employee language that suggests governance or supervision. The contract should be accompanied by a comprehensive statement of work that outlines the deliverables and financial agreement. Non-disclosure agreements and other intellectual property protection should be included in the contract process.

5. **Address worker classification for each and every project.** Even independent contractors with a documented history of providing business-to-business services can be improperly classified based on the project scope and definition.

6. **Maintain audit files to support classification decisions.** All qualified independent contractor classifications should be supported through documentation of the evaluation process and through the materials collected to support the classification. In the event of an audit, companies are accountable for supporting the classification of an independent contractor.

7. **Do not engage a former W-2 employee of your company on a 1099 basis.** Companies commonly make the mistake of engaging a previous W-2 worker as an independent contractor. This poses risk, since these individuals often return to perform the same or similar tasks as performed in their previous employee roles. It is safest to engage an independent contractor that has an established business and performs services for multiple clients.
8. **Outsource assistance.** A comprehensive 1099 classification program requires resources and expertise. The changing regulatory landscape, the number of auditing agencies and new precedent-setting cases make 1099 compliance a difficult path to navigate. Outsourcing with 1099 compliance experts can provide compliance confidence without the worry of risk, and alternative employment options for non-qualified independent contractors.

With a seasoned leadership team recognized as subject matter experts, Secure Talent has the technical knowledge to identify independent contractors from employees and the experience to identify potential pitfalls within business processes.

While Secure Talent does not offer its clients legal advice, the company does help clients make well-informed decisions and can discuss potential issues with outside legal advisors. Further, Secure Talent works with companies to find innovative answers to eliminating the misclassification issue and to take the necessary steps to help protect companies from attack. Taking a proactive approach to this issue, before problems arise, is the key to keeping your company safe.

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