

INDEPENDENT CONTRACTOR OR EMPLOYEE?

By
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"How can I make the people that work for me independent contractors rather than employees?" This is a question that is frequently asked by the owners of small businesses and increasingly in the midst of the current Great Recession, large businesses, as well. Business owners are aware that classifying a worker as an independent contractor, instead of an employee, can result in significant savings for their business. In the case of independent contractors, the business avoids the accounting burdens of withholding income and FICA taxes from compensation paid to the worker and is not required to pay unemployment taxes, worker's compensation premiums, and any costs related to health insurance, pension plans, and other fringe benefits provided to its employees. The business also avoids the cost of complying with the laws and regulations governing these items and the liability exposure for failing to do so that accompanies them. Additionally, the worker may prefer to be an independent contractor in order to be able to fully deduct, on their individual income tax return, expenses that are incurred in the course of performing services for the business.

Given the benefits of doing so, why would a business not treat all its workers as independent contractors? Mainly, because of the serious consequences that could result if the Internal Revenue Services ("IRS"), or a court, determines that a particular worker is an employee, not an independent contractor. If the IRS were to make such a determination, the business would be required to pay the employer's portion of FICA and unemployment taxes, plus penalties and interest, and may be required to pay up to the full amount of the worker's portion of income and FICA taxes, plus interest, for the compensation paid the worker during the time period in question. In addition, all "responsible persons" (e.g., directors and officers) in the business could be held individually liable for a penalty of 100% of any unpaid withholding taxes for such compensation.

With the recent reintroduction of the Employee Misclassification Prevention Act in Congress and the proposed addition of \$25 million dollars in next year's federal budget for a Department of Labor "Misclassification Initiative", employers can expect increased scrutiny by the federal government on whether workers have been incorrectly classified as independent contractors by their employers. The IRS has already announced a program to audit 6,000 businesses over the next three years in industries thought to have a high incidence of workers misclassified as independent contractors. Although the industries publically singled out by the IRS for special attention do not include insurance, with the budget deficit at an all time high, any employer who reports using a significant number of independent contractors is a likely target.

In addition to the adverse tax consequences of the misclassification of a worker as an independent contractor, if a court were to determine that a particular worker is an employee, not an independent contractor, the business would be subject to claims that the worker was entitled to receive health, retirement, and other fringe benefits provided to its employees and could end up having to pay such benefits out of its own revenues. If such a worker was injured on the job, the business would be liable for at least the amount of compensation and other benefits the

worker would have received if he or she had been covered by worker's compensation insurance and may be subject to greater liability for pain and suffering and punitive damages, plus penalties for failing to provide worker's compensation coverage for the worker.

Thus, it is easy to see why a business owner should be extremely careful when deciding whether to treat a particular worker as an independent contractor, instead of an employee. A mistake in characterizing a worker as an independent contractor, instead of an employee, could be quite expensive to the business and the owner personally.

In general, whether a worker is an employee or an independent contractor is determined using the "common law" definition of employment. Under the common law, the relationship of employer/employee exists when the employer has the right to direct and control the time, place, and manner of the performance of services by the worker on behalf of the employer. A worker is an independent contractor, if the employer is only concerned with the results of the worker's efforts and has no, or very little, control over the manner, method, or means by which, or the time at which, those results are achieved. For example, if a homeowner hired someone to replace the roof on his or her home and the homeowner's only involvement was an inspection of the roof after completion of the work done, the person hired by the homeowner would be an independent contractor. If the homeowner hired a crew of workers, purchased the roofing materials, and directed and supervised their work, the crew would be considered employees of the homeowner. Most employment situations fall in the gray area between the two extremes illustrated by this example.

To supplement the "common law" definition of employment, the IRS has developed guidelines to determine whether a particular worker is an employee or independent contractor. Those guidelines focus on three main areas: Behavioral Control, Financial Control, and Structure of the Relationship. The factors used by the IRS in examining these three main areas, as they might apply to a producer for an insurance agency, are discussed in detail below.

However, before reviewing those factors, it is important to remember that the classification of a worker as an independent contractor or employee is based on the actual circumstances of that worker's employment relationship with the business, rather than any written agreement that may exist between the worker and the business. In other words, the IRS, or a court, can ignore the contents of any such written agreement if the actual circumstances of the employment relationship are not consistent with those contents. Therefore, merely having a written employment contract that states the worker is an independent contractor does not guarantee that the IRS, or a court, will accept that characterization of the employment relationship.

The discussion below of how the factors used by the IRS to determine the nature of an employment relationship focuses on the normal employment relationship between a producer and a property and casualty insurance agency and reveals why it is likely that such a relationship would be classified by the IRS as an employer/employee one in most instances:

BEHAVIORAL CONTROL

1. Type of Instructions Given - If the agency gives a producer instructions about how, when, and where the producer is to work and with whom, this would indicate employee status. Ordinarily, an agency does give such instructions to its producers and would not want to relinquish its right to do so to any significant extent.

2. Degree of Instructions – If the agency gives a producer detailed instructions about how, when, and where the producer is to work and with whom, this would indicate employee status. The degree of instructions on these topics given to producers usually varies from agency to agency, but the more detailed the instructions given the more likely the producer would be considered an employee.

3. Training - If the agency provides training to a producer, this would indicate employee status. If the training provided is of a periodic ongoing nature, this is considered by the IRS to be strong evidence of employee status. In the case of producers with no previous experience, such training would normally be provided by the agency and may also be provided to any producer who switches or expands from personal to commercial lines or vice versa. In many instances, agencies also provide periodic ongoing training to producers to help them maintain their skills and knowledge. If the agency pays the cost of such training by outside providers, this is the same as if the agency itself provided the training, especially if the agency selects the outside training programs.

4. Evaluation System - If the agency has a procedure for evaluating the performance of its producers that is based on how the producer performs his or her job, this would indicate employee status. If the evaluation procedure focuses on the end results of the producer's performance, this would indicate independent contractor status. Most agencies are probably more concerned with how many sales its producers make than with how they make the sales. This would indicate independent contractor status for such producers.

FINANCIAL CONTROL

1. Method of Payment - If a producer is paid a salary or other fixed amount of compensation on a hourly, weekly, or monthly basis, that would indicate employee status. Most producers are paid on a commission basis, and thus, this factor would indicate independent contractor status for such producers.

2. Unreimbursed Expenses - If the agency pays a producer's business, travel, and other expenses, that would indicate employee status. This factor is subject to wide variation among agencies and thus, the employment relationship could probably be structured to require a producer to pay his or her own business expenses in most instances.

3. Significant Investment - If the agency provides business facilities, such as an office, office supplies, and other materials for use by a producer in performing services on its behalf,

this would indicate employee status. Most agencies do provide office space, supplies, and other materials for a producer's use. However, the employment relationship could probably be structured to permit a producer to work out of an office in his or her home or at some location other than the agency's offices. A potential problem with such an arrangement would be the necessity of the producer paying for the expense of setting up and operating such an office.

4. Opportunity for Profit or Loss - If a producer is not subject to a risk of economic loss as a result of the performance of services for the agency, that would indicate employee status. A producer that was being compensated on a draw against commissions basis (where repayment of excess draws was actually required) and/or was required to pay for the expenses referred to paragraphs 2 and 3 above would have such a risk. However, whether such an employment relationship could be implemented would depend on a case by case analysis of the producer's financial condition and prospects for success.

5. Services Available to the Market - If a producer makes his or her services available to the general public on a regular basis, that would indicate independent contractor status. But if a producer works for only one agency and can not place business elsewhere without the agency's permission, that would indicate employee status. This is almost always the case and would be difficult, if not impossible, to change.

STRUCTURE OF RELATIONSHIP

1. Written Contracts - If the producer has a written contract that says he or she is an independent contractor this is helpful, but does not control the final determination of independent contractor status. That determination will be made based on how the producer and agency actually work together in light of all the other factors mentioned.

2. Benefits - If the agency provides the producer with insurance coverage of any kind (life, health, disability, E&O), retirement plans, paid vacations, or other "fringe benefits", that would indicate employee status. This will vary from agency to agency, but the more such benefits a producer is required to pay the full cost of, the more that producer will appear to be an independent contractor.

3. Services Provided as Key Activity of Business - If a producer is being used to perform normal business functions, the performance of which would largely determine the success of the agency's business, that would indicate employee status. Producers are an integral part of, and essential to, the success of an agency.

4. Permanency of the Relationship - If the relationship existing between the producer and the agency is of an indefinite and continuing nature, that would indicate employee status. Producers usually work continuously for an agency on an "at will" basis for an indefinite time. This practice would be difficult, if not impossible, to change.

This article is not intended to provide “legal advice” on the issues discussed in it. It is only for information purposes. The reader should seek advice from an attorney who is knowledgeable in this area of the law about their specific situation before acting. For other articles of interest to insurance agencies and agents, please see the website of Joyner & Burnette, P.C., at www.decaturlaw.com.

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