

## Are Your “Independent Contractors” Really Employees?

Independent contractors who are engaged by an employer for an extended period of time may be treated as employees for tax and benefits purposes. Whether these workers are freelance creatives or employees obtained through a temporary employment agency, if they render services for a single employer at the employer’s place of business under its direct supervision, they will probably be employees, not independent contractors. This conclusion will follow even if the “independent contractor” has entered into an agreement with the employer or the employment agency providing that the individual is not an employee. Under these circumstances, the Internal Revenue Service would very likely determine on audit that such workers are “common law employees.”

The consequences to the employer of reclassifying independent contractors as common law employees include:

1. The employer will be responsible for one-half of the Social Security taxes payable with respect to the employee’s “wages.” This tax is in two components, and the employer’s portion for old age, survivors and disability insurance is 6.2% of compensation up to the annual wage base. The employer’s share of hospital insurance (medicare) is 1.45% of all wages paid.
2. The employer will be responsible for Federal unemployment tax with respect to wages paid to the employee.
3. The employer will be responsible for any failure to deduct income tax withholding from the employee’s compensation. Retroactive assessment of this liability may be mitigated if the employee has properly reported the income for tax purposes.
4. The employer may be liable for any benefits payable to “employees” that were denied to the reclassified employee while he was treated as an independent contractor. These benefits would include retirement plan participation and any group health benefits. Particularly on a retroactive basis, these liabilities can be substantial.

The possible responses to a situation in which an employer has “independent contractors” who are really employees include the following:

- (a) Reclassify the workers in question as employees for purposes of internal payroll and benefits as well as tax reporting. This will entail, among other things, the reporting of worker compensation on IRS Form W-2 rather than IRS Form 1099. Also negotiate a

reduction in cash compensation to pay for benefits, if appropriate. This approach will not affect any liability for past conduct, but should eliminate the employer's exposure for future taxes and benefits.

- (b) Enter into specific agreements that make it clear that the "independent contractor" intends to be treated as an independent contractor for all purposes. This document would include an acknowledgment that the worker has voluntarily elected to forego certain employee benefits and assurances that the worker will properly discharge his tax liabilities as an independent contractor. The agreement should also contain an indemnity running to the employer to protect it from the liabilities enumerated above, to the extent possible. Note that these agreements will not influence the outcome of an IRS audit except possibly in borderline cases. Also, because of the substantial dollar amounts of potential employer liability, the indemnity agreements, even if enforced by a court, may not provide reliable protection.
- (c) Make sure the benefit plans which exclude the independent contractors very clearly provide that the exclusion will apply even if the workers are reclassified as employees. For example, a profit sharing plan could, within the limits of the coverage rules, be amended to expressly exclude from coverage any independent contractor who has been reclassified as a common law employee. This approach can help isolate the benefit exposure from the tax exposure.
- (d) Invoke the IRS administrative procedure for arriving at a settlement of back tax liabilities. Although this approach may result in a better settlement than an audit, a voluntary settlement with the IRS will eliminate the chance of avoiding liability entirely by playing "audit roulette" (that is, doing nothing in hopes that the applicable limitations period expires before there is an IRS audit).

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