From the desk of Vladimir Turkeltaub, MS, CPA, EA

The future of independent contracting

It is not an exaggeration. Every week I get involved in a conversation similar to the following one with one of my clients: 'I just hired an employee. She will work part-time. I am not sure for how long she will stay with the company. Maybe she will not fit in and I will let her go soon. I have already paid her several times'. The only part that changes is the number of times this person has been paid. I always struggle with the right words that I should use to explain the proper approach to a new hire.

Before I can even think of the correct overture something inside me pushes the words out: 'And have you withheld the required taxes?' I knew the answer beforehand. Most of my clients do not differentiate between an employee and an independent contractor (IC). They think it terms of the cash-flow: I pay somebody to do the work - this person is my employee.

I am sure that before hiring anybody every small business estimates whether it can afford a new hire. The problem is that a business owner always starts and ends with the base salary. The owner almost never realizes that the compensation of an employee and the cost of an employee to the business are two different amounts. The actual cost even if the company does not provide any benefits is usually 15% higher than the base salary. This does not include the, sometimes outrageous, premiums for Workers' Comp that could be as high as 30% of the salary. Additionally, ICs are not subject to minimum wage, overtime, or workers' compensation requirements.

When faced with these extra costs business owners intuitively opt for an IC and not employee status. The savings that end up in the owners' pockets are too big a temptation to be passed by.

What follows next in the conversation is my boring explanation about the laws, departments of labor, FICA taxes, audits, penalties, etc. I can see the eyes of my client rolling in boredom as she knows the answer: 'All other business owners that I talked to do it that way.' At this point I am usually lost. My thoughts rush between two options: I either lose a client now if I insist on proper payroll or I will lose the client later when the department of labor comes with an audit and fines my client for using ICs instead of employees. I gingerly insist trying to convince the client to do the things the right way. And I know that the client has a trump card: 'And you of course charge extra for running my payroll?' – she asks. I have been beaten in my own consulting game. I capitulate!

Yes, she is right. A lot of employers manage to get away with using ICs. The government at all levels does not have enough resources to audit everybody. The audit process can drag for years and the results are never certain. Moreover, the definition who can be classified as an IC is also very vague. It used to be a twenty-factor test. Then it became a ten-factor test. There are fewer factors but not less confusion. IRS specifically stated that there is no one factor that by itself defines if a person should be treated as an IC. To add to this confusion some states have their own rules which, like in New York and California, are stricter than the federal ones. And then

there is a very simple test: A person should be an employee if she performs a job that is part of the "usual course" of the company's business. Period!

Where does it leave us? In courts. Here are a few cornerstone cases that addressed the issue we are discussing.

One of the oldest cases goes back to 1947 where the employer compensated coal unloaders as independent contractors. Those employed worked only when the work was available and were paid by the number of platforms unloaded. The court decision was to classify those employed as employees.

The most advertised case was settled in California between FedEx and their drivers who worked as independent contractors. Just a few facts to consider. These drivers owned the trucks and some of them had their own employees. Still FedEx lost and was required to retroactively treat these drivers as employees.

The latest case, also in California, involved short-term engagements with workers who were treated as ICs. The court applied "usual course" test described above and concluded that companies like Uber or Lyft will have hard time proving that their drivers are ICs. This decision might be a boon for the constructions industry where specialized trades could be treated as ICs. But who said that the courts cannot expand or change their decision?

Positions of both parties to the discussion are clear: federal and state governments do not want to lose tax revenue; independent contractors are trying to leverage their status to generate tax savings for themselves. An IC is not subject to the Social Security and Medicare taxes paid by the employer. The employer does not incur any payroll related state taxes such as disability and unemployment. These are direct saving to the employers. In addition, an IC is also entitled to deduct business related expenses from her IC income. That decreases the taxable mass of the ICs and, thus, further decreases the tax cash flow to the government agencies.

One might argue that being an employee has certain advantages including such fringe benefits as health insurance, retirement plans, employer sponsored education, etc. and that if everything is done by the book there should not be any tax saving. I would agree with this assessment. However, most of us think in terms of their pocketbook today and even a month from today seems to be a very distant future.

Small businesses take their chances in classifying their workers as ICs. Some win, some lose. But in a very competitive economy most of them do not have a good choice but to gamble.