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## Employee vs. Independent Contractor: The Pitfalls of Too Little Knowledge

By Michael R. Polk, Sagebrush Consultants, L.L.C.

*This article was prepared using a variety of texts on the subject and through discussions with legal sources. The author is not an authority on the subject, but as an employer who hires both employees and independent consultants, has learned much through study and practical application. Information provided here is to help professionals better understand the subject from the perspective of its application within the CRM field. For verification and further information, consult the references cited and other works on the subject as well as your CPA or attorney.*

### INTRODUCTION

Those of us who are employers or others who work at high levels within CRM companies probably hire and deal with independent contractors in everyday business. They are those individuals, whether they be archaeologists, historians, architects, geomorphologists, soil specialists, paleontologists, even CPAs or electricians, who work by themselves. These individuals are not a part of a larger company, or directly affiliated with other entities. They work for themselves and, as such, can be referred to as "Independent Contractors (or Consultants)". An excellent, concise definition is found in Johnson (1999:17-1):

An independent contractor is a person who does work for another, pursuant to a written or oral, express or implied contract, and who is in control of how he does the work, the methods he uses in the work, who furnishes his own tools, assistants and employees, and who is not subject to the control of his employer except as to the finished job. An

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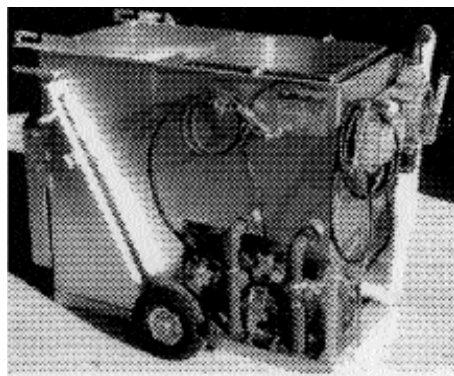
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## Employee vs. Independent Contractor..

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independent contractor is not an agent, and he is not an employee.

An independent contractor can be a valuable asset. Few companies can afford to hire employees to cover all of the tasks necessary to successfully operate a business. In the field of CRM, not to mention business in general, there are always specialized tasks requiring expertise which is not always possessed by a particular company's employees. Independent contractors can often fill these important roles.

That said, there are some companies which value such contractors to the point that they regularly hire them to fill most, if not all, positions in their company that may be more properly filled by employees. In the short run, such practices may save an owner money, since hiring of employees requires payment of a portion of a worker's Social Security and Medicare taxes, withholding of state and federal income taxes and keeping records and reporting this information. Often, there are benefits paid to employees and long-term commitments made. There are no employment taxes or Social Security to be paid to independent contractors, few or no benefits to deal with and, usually, no long-term commitments. However, aside from ethical and professional drawbacks presented by such a wholesale practice, it can be in blatant violation of Federal and State tax laws. Many CRM companies, especially small ones, have successfully practiced this way for some time. Part of their "success" at such methods may be due, in part, to their small size and limited income levels which do not attract the attention of tax auditors. It also could be because their practice has not been reported.

## INTERNAL REVENUE SERVICE GUIDELINES

At face value, independent contractor arrangements appear simple enough. And, there are many legitimate situations in which contractual relationships with such individuals is perfectly acceptable and in the best interest of business. However, fairly widespread abuse of the practice of hiring independent contractors in the field of business has led the Internal Revenue Service (IRS) to rigidly define the practice and to enforce through the tax laws exactly what represents an "Independent Contractor" and what represents an "Employee". You misunderstand or disregard these definitions at your own peril as a business owner.

The main difference between an Employee and Independent Contractors is: "...that independent contractors have the right to control not only the outcome of a project, but also the means of accomplishing it. Problems arise because some workers fall into a gray area, creating the danger of misclassification" (Steingold 1999:11/2). In order to help employers better understand how to classify workers, the IRS developed what it calls "Common-Law Rules"(Internal Revenue Service 2000).

According to the IRS, in order to properly classify a worker as either an Employee or an Independent Contractor, the litmus test is in understanding the relationship between the worker and the business. In order to classify, one must demonstrate the nature of control and independence exhibited by the business and the worker. The IRS lists three categories that provide this evidence: **behavioral control**, **financial control**, and the **type of relationship**.

**Behavioral Control** refers to: "...whether the business has a right to direct and control how the worker does the task for which the worker is hired...". Employees are generally given instructions about when, where, and how to work. Independent consultants operate much more autonomously, though, obviously they must follow instructions of how a job needs to be completed.

**Financial Control** refers to: "...whether the business has a right to control the business aspects of the worker's job...". Employees have few, if any, unreimbursed business expenses. Independent contractors are likely to have such expenses. An independent contractor is free to seek out business opportunities. Also, and a very important difference, unlike an employee, an independent contractor can generate a profit or incur a loss.

**Type of Relationship** includes, among other things, such items as the presence of written contracts (common for independent contractors); whether the business owner provides the worker with employee-type benefits (common for employees); and, generally, a company makes a longer-term relationship with employees, and a shorter-term one with independent consultants. See the IRS publication for more detailed discussion of this test, along with "Industry Examples" showing when and where hiring of employees or independent contractors are more appropriate.

## CONSEQUENCES OF MISCLASSIFICATION

The "test" described above is what the IRS deems appropriate for identifying and classifying workers. From their perspective, it is safer and neater for businesses to hire employees. Of course, the government also has more control over the flow of tax monies from individuals in such a classification. In order to help encourage proper compliance with the tax laws in this area, the IRS has, over the last decade or so, been very diligent about investigating the use of independent consultants. Misclassification of workers has potentially severe drawbacks. If you are audited and found to have misclassified workers, penalties can be severe. Steingold writes (1999:11/4):

If you classify a worker as an independent contractor when the worker should have been treated as an employee, you can be required to pay:

- the employer's and employee's share of Social Security and Medicare contributions;
- income tax that should have been withheld from the employee's wages, and ;
- federal unemployment tax.

You also may be liable for the employee's state income taxes that should have been withheld, as well as unemployment compensation taxes. And, if

the worker is injured on the job, you may have to pay worker's compensation benefits because you didn't cover the employee under your company's workers' compensation policy.

Of course, such penalties can be compounded with fines if an employer is found to have deliberately classified workers as independent contractors merely to increase profits or avoid legal liability and the paperwork associated with employment of workers. Another aspect of this whole subject, beyond IRS rules, which could add to the misery of those who may be identified as improperly utilizing workers as independent contractors has to do with contracts themselves. If federal contracting is involved (perhaps state contracts as well), such practices could be deemed violations of the Service Contract Act as well as other requirements stipulated by the Labor Department or other agencies.

In my observations of the CRM field over the last several decades I have observed quite a lot of use and abuse of the "independent contractor" method of hiring. I know of a company which regularly classifies all of its workers as independent contractors, despite the fact that they use company equipment, and are told how, where, and when to work. It is, obviously, not something that has disappeared. There are still many companies which practice this, just as there are many CRM practitioners who don't buy professional liability, general liability or even workers' compensation insurance! As I introduced this article, you practice such things at your own (and your workers') peril. For those of

us who value our careers and see ourselves as legitimate business people, proper classification of workers is just part of the cost and practice of doing business.

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## MESSAGE FROM THE PRESIDENT

*Kevin Pape, President*

Over the course of the next 5 to 10 years we will see an unprecedented change in the landscape of the CRM industry. Through historical coincidence CRM firms and their owners and senior managers belong to a cohort forged by passage of the National Historic Preservation Act in 1966, but more importantly, the 1979 amendment that granted rule-making authority to the Advisory Council. Thus, the majority of today's well-established CRM firms were born almost two decades ago as entrepreneurial responses to needs and market niches created by these legislative actions.

Consider what we have accomplished over the past two decades. We have made extraordinary efforts to build our businesses. Most of us were ill-prepared for the job, but we persevered. We constructed organizational frameworks, developed staffs of professional CRM consultants, and delivered on promises to balance the needs of our clients with professional responsibilities to the resources. And in the process we have created an entirely new industry. We've accomplished some truly good things, and for many of us our businesses represent our proudest achievements.

And now, by dint of our common origin, we are soon faced with an entirely new but similarly awesome challenge: how to extricate ourselves from this thing that we've devoted our lives to creating. In many ways this new challenge presents us with as many risks and rewards as we faced in building our businesses. So it's very important that we recognize the kinds of decisions that will be required as we begin to think about our exit strategy.

And it's equally important that we acknowledge the changes that will occur in our industry as individual firms go through this succession planning process over the next 5 to 10 years.

At first glance, succession planning and the process of disengagement may seem largely vague and open ended. But in the end there are really only four exit choices from which business owners have to choose. In something of a descending order of preference the options are: (1) sell to company insiders; (2) sell the business as a going concern; (3) liquidate the business and sell the assets; and (4) file for bankruptcy. So, how do these choices stack up?

The advantage of a sale to company insiders has to do with the fact that key employees know the business from the inside and have a stake in its ongoing success. This is important if one of your priorities is to carry on your business traditions. However, recognizing that the sale of your company involves transfer of assets as well as transfer of control, it's often the case that company insiders do not always have the financial means to purchase the company outright.

For an insider sale there may be a strong incentive to develop flexible terms such as an earnout provision, a consulting arrangement, or a non-qualified pension plan. These options can be tailored to parallel the granting of increasing control of the company. An Employee Stock Ownership Plan or ESOP can be a complex but beneficial solution to this problem. ESOPs are qualified retirement benefit plans in which the major invest-

ment is securities of the employer's company. Benefits of the ESOP option derive from the fact that you give employees a vested interest in your business, thus promoting productivity and a commitment to the long-term success of the company.

To sell the business as a going concern involves marketing to one or the other of two types of buyers: the financial buyer or the strategic buyer. The financial buyer is typically interested in your cash flow. For them the sale is an investment transaction and their decision will be based on close scrutiny of your potential profitability. It's doubtful that firms in our industry will attract many financial buyers. The strategic buyer, on the other hand, is interested in how your business fits into their own long-range business plans. These buyers might include your competitors, a similar company that wants to expand into another region, or a company in a related business whose management sees advantages in adding the types of services you offer. It seems likely that many CRM firms will look to buyers in this category.

Maybe you can't find a buyer, you run out of time, or you just don't want the trouble associated with structuring the sale of your company. You certainly have the option of liquidating and taking what you can get for the remaining assets. Since this option is limited to net gain from outstanding receivables and the sell-off of office equipment, your returns will be low so you'd need another source of income established for retirement. Finally, there is a fourth choice. Bankruptcy is an option to consider in the event that debts continue

to mount as your business ages. If the intention is stay off creditors and dissolve the business, then you would consider filing Chapter 7, known as Liquidation.

How will these changes cause a shift in the landscape of the CRM industry? The shift will come about as a result of broad based and relatively coincident changes in personnel and corporate control. We can predict that at least two new patterns will emerge in the CRM industry. First, senior personnel, whose numbers have been extremely static in the job market for the last several years, will begin to consider new employment opportunities. This will come about as some firms close their doors and others change corporate culture under new leadership. Second, there will be some consolidation in the CRM industry as firms go through mergers and acquisitions driven by the interests of strategic buyers. And finally, there will be more opportunities for junior staff to advance as the old guard shuffles off this mortal coil.

In the end, what's most important is that we collectively recognize the changes that are on our horizon; that we carefully define our priorities for the future of our companies; and that we take the time to develop thoughtful and deliberate plans to ensure an orderly and successful exit.



## NOMINATION COMMITTEE

*Cory Breternitz, Chair*

The ACRA Nominations Committee, chaired by Past-President, Cory Breternitz, is now accepting nominations from the membership for Board Members and Officers to be elected this fall and begin serving their terms at the Annual Meeting in Phoenix this November. Nominations are being solicited for candidates to fill five Board Member positions. The positions that are opening are to be filled by representatives from three large-sized companies, two medium-sized companies, and two small-sized companies. The board members whose terms expire this fall are: large-sized companies, Don Weir, Duane Peter, and Tom Wheaton; medium-sized companies; Chuck Niquette and Cory Breternitz; and small-sized companies, Mike Polk and Patrick O'Bannon. Each of these individuals have the option to run for reelection. Please submit nominations directly to Cory Breternitz at Soil Systems, Inc., preferable via email at [cobrdssi@aol.com](mailto:cobrdssi@aol.com). We need to have at least one more candidate than we have slots to fill, or at least this would be the ideal situation. Ballots need to be sent out in early September so that the votes can be tallied and the winners notified prior to October 1. This will give the new Board Members at least 30 days to make arrangements to attend the fall Board Meeting the Thursday before the Annual Conference, which will be held in Phoenix during the first weekend in November.

Nominations also are being solicited for two officers to be elected this fall. The two officer positions are President-Elect, and Vice President. The ACRA bylaws state that only current Board Members can vote for officers, but that nominations for officers can come from the membership. An individual does NOT have to be a sitting Board Member to be an officer.

This is your opportunity to get your name on the ballot and participate in the decision-making process for the organization. Board Members must attend two board meetings a year. The fall Board Meeting is scheduled to coincide with the Annual Meeting. The spring Board Meeting is usually sponsored by an ACRA member company and is held any time between early February to late March. Board Members are expected to attend these Board Meetings at their own (i.e., company's) expense. Board Member terms are for three years and are staggered.

I hope that you will consider running for one of the open Board Member positions and/or one of the open officer positions, or at least nominate someone else for one of these positions. Please submit nominations as soon as possible so that we can conduct the elections in a timely manner.



## CONFERENCE COMMITTEE

*Cory Breternitz, Chair*

The Sixth Annual ACRA Conference will be held November 2-5, 2000, in Phoenix, Arizona. The conference is being sponsored by Soil Systems, Inc. (SSI), and will be headquartered at the historic San Carlos Hotel, in downtown Phoenix. The San Carlos Hotel built in 1928, is in the Italian Renaissance style and listed in the Historic Hotels of America Guide. It was the first high-rise, fully air-conditioned, hotel with an elevator in Phoenix. It was the place to stay among the Hollywood stars of the 1930s and 1940s. Clark Gable, Marilyn Monroe, Mae West, Spencer Tracy, and Carol Lombard are listed in the guest register. There is an Italian restaurant, coffee shop, and Irish pub attached to the hotel.

Downtown Phoenix has experience extensive urban renewal in the past 15 years and there is plenty of shopping, restaurants, bars, museums, and art galleries within walking distance of the hotel. Movie theaters, the Herberger Theater, the Art Deco Orpheum Theater, America West Arena, Bank One Ballpark, and the historic City Hall and Downtown Post Office buildings are all within four blocks.

The conference program is still being finalized and is dependant on final commitments from some surprise speakers and participants. However, we can outline the basics of the conference schedule.

Thursday, November 3, is being reserved for an all-day ACRA Board Meeting to be held in the Senator Room at the San Carlos Hotel. Remember that the ACRA Board Meeting is open to all ACRA Members.

Friday, November 4, is reserved for workshops and tours. The workshops are all focusing on business-related topics. Workshops are planned on human resources dos and don'ts, managing technology, how to incorporate and plan for changing technology in our businesses, marketing, how to better sell our services and market our image. We also are working on some walking tours of historic downtown buildings and some of the older historic neighborhoods close to the hotel.

Saturday, November 5, will be the Plenary Session and afternoon break out sessions. Saturday's activities will be held at the Arizona Club on the 37<sup>th</sup> and 38<sup>th</sup> floors of the Bank One building across the street from the San Carlos Hotel. This venue provides an awesome view of downtown Phoenix and the surrounding mountains. The Arizona Club has one large room that can accommodate the conference, and several smaller rooms for afternoon break-out sessions. The Arizona Club will provide a breakfast and lunch on Saturday.

Saturday afternoon will be the ACRA Awards Ceremony and a general session for the assembled masses hosted by the ACRA President, Kevin Pape. This session was initiated at last year's conference and is an excellent opportunity for the members to provide input. The Phoenix Conference will have a session presented by David Dempsey of Piper, Marbury, Rudnick & Wolfe, LLP, in Washington, D.C., who will explain once and for all, the legal ins and outs of the Service Contract Act. This is the time to get answers to all those questions you have have regarding this complex legal issue. We are still working to fit Mr. Dempsey into the schedule.

Last but not least, there will be festivities on Friday and Saturday nights. We are working on some spectacular culinary feasts, perhaps with music, and a bus ride (short!) to an on-going excavation project/historic site(s), and perhaps a spectacular Arizona sunset thrown in for free!

Details of the conference costs, registration, local sites and activities, and a complete conference program will be available in early September. We are working on a shuttle bus to and from the airport; however, the hotel is only 8 to 12 minutes from SkyHarbor Airport.

Direct any questions to Cory Breternitz, Soil Systems, Inc., 1121 North Second Street, Phoenix, Arizona 85004; 602-253-1938; Fax 602-253-0107; E-mail [cobrdssi@aol.com](mailto:cobrdssi@aol.com).

## LEGISLATIVE UPDATE

*by Nellie Longworth, Consultant*

### **You Are Interested in Watching the Committee Action on Your Own Computer?**

Congress has been in recess since the beginning of August and will not return until after labor Day, but when they return you can watch the committee action on your computer by going to the web site:

<http://energy.senate.gov>, (no "www"), then to "hearings," then to "committee schedule," and finally to "instructions." You must have real video software to receive the live webcast of the committee session.

### **CARA Bill Faces Competition in Getting a Senate Floor Vote**

After celebrating the Energy and Natural Resources Committee's 13-7 vote to report HR 701 to the floor, the difficulty in getting the Senate to schedule a vote on the measure in the last month of the 106th Congress has begun to set in. Majority Leader Trent Lott (R-MS) supports the measure and has stated "we will try to schedule it in September." In his weekly press conference, he noted that time was running out and that the competition with FY01 appropriations bills and favored trade status for China might leave a CARA vote on the back burner.

One of the hurdles to bringing HR 701 to the Senate floor is the prospect of damaging amendments from those strongly opposed to "end running" the appropriations process as well as those concerned about federal land acquisition. Certain senators are so opposed to the bill that they mention a filibuster which would kill all chances of enactment this year.

On the positive side, the numbers still remain favorable for the bill to pass the Senate. In response to those who claim this is an extravagant federal land grab, it is argued that the measure simply takes the receipts obtained from the extraction of our nation's nonrenewable resources and uses them to provide a predictable flow of revenue to the programs that conserve, preserve, and protect our natural and cultural resources, parks, and wildlife.

Should CARA pass the Senate, cultural resource advocates will be encouraged to lobby members of the House/Senate conference committee to authorize \$150 million annually for the Historic Preservation Fund in the Senate bill as opposed to the \$100 million included for the HPF in the House-passed bill.

### **Religious Land Use Bill Clears Both House and Senate**

As predicted, Sen Orrin Hatch (R-UT) took advantage of the last day before recess to move S. 2869 - the Religious Land Use and Institutionalized Persons Act (RLUIPA) - through both Senate and House without a single dissenting vote. The bill passed the Senate under Unanimous Consent after Hatch convinced his colleagues that the measure would protect the right of assembly for religious groups from governmental interference. This interference targets locally enacted zoning and historic preservation ordinances. Such a standard gives preference to the desires of the religious community over all other groups and individuals who must abide by the locally enacted measures. The impact of S. 2869 sets the stage for inappropriate development and probably the demolition of historic churches and structures.

Upon Senate approval last week, the measure was taken immediately to the House which rubber-stamped the Senate action "without objection." The bill is now cleared for White House action and most believe that President Clinton will sign it into law.

S. 2869 was introduced in the Senate on July 13, 2000, and never had hearings or committee approval. Like its predecessor, the Religious Freedom Restoration Act (RFRA) in 1993, the measure will be challenged in the courts and will make its way to the United States Supreme Court where it will probably be overturned on the same Constitutional principles as RFRA in 1997.

## Senate Tax Bill Introduced by Sen. Robb (D-VA) Includes a Scaled down Historic Homeowners Tax Credit

On July 26th, Sen. Robb introduced S. 2936, a measure "Creating New Markets and Empowering American Act of 2000" which brings together a number of previously introduced measures that would "strengthen and revitalize low and moderate income areas across America."

The bill contains three New Markets initiatives designed to attract and expand new capital into low and moderate income areas and requires mandatory funding for Round II Empowerment Zones. (EZs) It creates 9 new EZ's (7 urban, 2 rural) and 40 Renewal Communities (32 urban, 8 rural) as agreed to between President Clinton and House Speaker Hastert (R-IL). It includes incentives for low-income housing, home ownership and a trimmed down Historic Homeownership Assistance Act (limiting the 20% credit to \$20,000 per rehab) but retaining the mortgage certificate program as introduced in S. 664. It further includes provisions that increase private activity bond caps to \$75 per capital, authorizes HUD transfer of unoccupied and substandard housing to local community development corporations, offers relief to trade-affected communities, and improves tax credits for computer equipment and software donated to schools in Enterprise Zones, Enterprise Communities, Indian Reservations, and Renewal Communities.

Sen. Robb was joined by Senate Minority Leader Tom Daschle (D-SD), Clinton Chief of Staff John Podesta and presidential economic advisor Gene Sperling in the introduction of S. 2936. The show of Administration support for community revitalization tax bills led to the passage of similar legislation in the House, although that measure did not include the Historic Homeownership provisions.

Tax bills remain controversial at this time. The President threatening vetoes to measures eliminating the marriage penalty and estate taxes. How the politics of an election year will play out is a favorite Washington topic, with many suggesting that, like a year ago, no new tax breaks will become law during the last month of the 106th Congress.

## Contracting Legislation Raises Concerns

Concern has arisen in the governmental contracting community that includes architects, archaeologists, preservationists, engineers, and other related professions about two measures introduced in Congress this year. HR 3766, introduced by Rep. Wynn (D-MD) and S. 2841 introduced by Sen. Robb (D-VA) - both titled "Truthfulness, Responsibility, and Accountability in Contracting Act" - call for freezing the award of government contracts to outside sources when the agency currently performs such functions except when a dreary, long process concludes that outsourcing includes a public-private competition and an actual savings of federal government dollars.

Calls to staff this week note that both bills have only been introduced and referred to their respective subcommittees to date. There have been no hearings nor are any scheduled. Considering that Congress must complete action on a number of FY01 appropriations and granting China favored nation status before recess in early October, it almost would be impossible to foresee a scenario that would bring these measures to a vote. While one could point to the action on the religious land use measure that received congressional blessing in one day, one would find hearings on similar issues over the past two years and an accumulation of cases that supported the need for such legislation.

A look at the 193 co-sponsors in the House of Representatives shows support from 177 Democrats, 15 Republicans and 1 Independent. Such little GOP support in a Republican Congress further suggests the unlikelihood of any action this year.

*Prepared by Nellie L. Longworth, Consultant, for ACRA subscribers who agree that, without prior written permission from NLL, they will not post weekly or special reports on paper or any computer network, homepage or bulletin board accessible by any entity or individual other than its members, officers, directors, board members, staff, and any others listed above. ACRA may, however, make "fair use" of the weekly news or special reports or periodical newsletters and may rewrite or paraphrase and distribute information contained in them. Credit N. Longworth, Consultant.*

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### ACRA's Members-Only Listserv

ACRA now has an online discussion group just for members. "Membersonly" is a listserv that operates much the same way as ACRA-L, with the exception that it is only available to ACRA members. Its purpose is to offer the board, members, and the executive director a venue to share the latest news from ACRA; promote dialogue between members on current issues; and enable members to post announcements or inquiries.

To subscribe to the list, a member must contact ACRA's Executive Director, Tom Wheaton. Once you have supplied Tom with your e-mail address, he will subscribe you to this list. Contact Tom at 770-498-5159 or e-mail: [tomwheaton@newsouthassoc.com](mailto:tomwheaton@newsouthassoc.com).

### 2000 ACRA EDITION SCHEDULE

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### ACRA Edition

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This publication's purpose is to provide members with the latest information on the association's activities and to provide up-to-date information on federal and state legislative activities. All comments are

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