

Independent Contractors vs. Employees: A Management Dilemma

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One of the more effective ways businesses have added additional capacity to their organization without incurring over head has been through the use of independent contractors.

Traditionally, this avenue has offered employers the opportunity to reduce their labor and administrative costs while at the same time adding specific

skills or capabilities to their organizations. At the same time, independent contractors status has provided both employment flexibility and certain tax benefits to those who have provided their services under this relationship.

Yet despite the benefits, independent contractors can also bring significant liabilities to your business. The three primary areas where your corporation can be exposed through the use of independent contractors are for back taxes and penalties if the IRS should rule that your independent contractor is actually an employee, the legal liability for the actions of your contractors, and their own injuries while on the job.

Exposure Analysis: Tax Liability.

From a tax liability standpoint, the IRS is becoming far more aggressive, concentrating on independent contractors hired to perform functions traditionally performed by regular workers. Even though a written contract may exist, the IRS has often ruled that these independent contractors should be classified as employees, and have claimed for taxes not withheld or paid.

Penalties for a misclassification can be severe. According to the National Technical Services Association, the employer can be fined for all back withholding and social security taxes, plus a 100 percent penalty. In terms of both tax collection difficulties and fraudulent deductions related to independent contractors, the IRS maintains that as much as \$1.5 billion in tax revenues go uncollected each year from this source.

Exposure Analysis: Legal Liability.

In addition to the financial risks, there is also a legal liability exposure associated with work performed by your independent contractors. Theoretically, owners are not responsible for the decisions and choices made by inde-

pendent contractors. Independent contractors should carry the same level of insurance protection as the host company, and it is to this coverage that any injured party would first look to be made whole.

Yet when an independent contractor is negligent, causing injuries or property damage, business owners may become liable for their actions. This is particularly true if the owner retains control over the work being performed or its place of performance. There is growing case evidence that owners are becoming increasingly more responsible for the work performed by independent contractors.

Within our own industry, aviation companies have often utilized independent contractors for flight instructors, charter crews, or professional pilot services, and more recently for maintenance technicians. Again, they have seen the primary benefits of flexible employment, lower employment costs, particularly in terms of social security contributions and workers' compensation premiums saved. The basic problem with all of these relationships is the deep-pocket theory. In the event of a loss caused by an independent contractor, most independent contractors rarely have any insurance coverage of their own, so the plaintiff seeks redress against the next deep pocket in line, your business!

Exposure Analysis - Workers' Compensation.

Independent contractors can truly expose your workers' compensation program. The definition of who is or is not an independent contractor creates such a gray area, that any loss caused or suffered by an independent contractor will more often than not result in a claim under your workers' compensation policy.

Driving this problem is again the deep-pocket theory. In aviation, the traditional contract pilot or maintenance professional almost never carries his/her own workers' compensation program, which not only leaves his or her family exposed and uncovered in case of a loss, but also exposes your operation from two important standpoints. First, your business may be open to a suit from that independent contractor, thus making your business self-insured for the injury as well as additional exposures to fines and penalties all outside of any insurance coverage.

On the other hand, since the independent contractor's family usually has no recourse in the event of a loss, both the courts and the industry have found it convenient to often allow the claim to be filed against your workers' compensation policy. This is usually done by your workers' compensation carrier agreeing to allow you to cover that individual and the loss by adding them to your policy and then paying any back premiums and interest.

All of this creates so many gray areas that it is our strong recommendation unless you can conclusively prove an independent contractor is truly that, you either do not hire them or that you hire them as an employee and cover them under your workers' compensation policy. The potential premium savings possible from stretching the concept of independent contractor are usually far outweighed by the potential exposures to your organization.

Some Independent Contractor Guide lines.

In Florida, Workers' Compensation Law states that the term "employee" does not include independent contractor. Yet over the years, it has become difficult in many instances to determine whether a particular subcontractor will be held by the courts to be an independent contractor or an employee. In the Florida Supreme Court case (Magarian vs. Southern Fruit Distributors, 1941) the court stated that, "it appears generally conceded that no hard and fast rule may be stated to control the determination of the question as to whether one occupies the status of an employee or that of an independent contractor and that each case must stand on its own facts and, therefore, no useful purpose may be served by citing particular cases involving different factual situations." Bottom line, the courts will look at each case individually.

Nonetheless, there are several guidelines you should use to evaluate the potential to have a current independent contractor reclassified as an employee.

In general terms, an independent contractor:

Has the right to direct what, when, where and how his particular work should be done;

Should have a contract, written or oral (preferably written);

Accepts payment by the job at a fixed price rather than on a time basis;

Is engaged in a distinct occupation or calling;

Has the right to hire, fire and supervise his own people;

Has the obligation to furnish necessary tools, supplies and materials;

Has the right to control the progress of his work and accept the final results;

Establishes the pay for his own employees;

Does not have social security deducted nor tax payments withheld from his remuneration;

Works on a specified job-by-job basis;

Performs services for more than one company;

Has a place of business as opposed to working from his home;

Projects the image of an independent contractor to the public;

Has an occupational license if appropriate;

Carries general liability insurance.

No one of these issues alone carries more weight than another - in fact, while a contract between an employer and an independent contractor will be considered by the courts, the determination of the worker's status will be based upon the facts at the time of the injury even if the contract names the worker as an independent contractor.

The particular concern we see for our clients is in ensuring that any independent contractors are clearly defined, particularly as regards their coverage or exclusion from workers' compensation programs. Overall, we recommend against retaining individuals as independent contractors except for those traditional situations such as consultants or temporary administrative help.

If you have independent contractors working for you, you should review those contracts, either verbal or written, to be sure your business is not exposed should a claim arise out of their activities. Given today's litigious society, this is a critical area of exposure, and we will be happy to work with you to ensure these exposures have been adequately identified and managed.

I hope you will feel free to call us if you have any questions on these issues. Without question, this is a complex topic, but like most other risk-related subjects, it can be mitigated through careful identification, planning and management. And again, we believe this is a critical part of our "Professional Client Care" program.