

Co-Employment Risk

Definition

Strictly speaking, *co-employment* is the situation in which two legally distinct employers have an employer-employee relationship with the same person. More broadly, *co-employment risk* is when a corporation may be liable for misclassifying a worker as an independent contractor when the worker is actually being treated like an employee.

The largest and most well-publicized case was against Microsoft which settled its case in December 2000 for \$96.9 million. Presumably, if Microsoft was willing to settle for this amount, its potential liability was much, much larger.

Clearly co-employment risk is a big, big issue!

Consequences of Misclassifying a Worker

The consequences of incorrectly classifying a worker as an independent contractor are primarily financial.

Financial costs can be imposed by the Federal Government, the State Government, by the worker (often in class action lawsuits) or by all of them. The most significant costs:

1. If the Feds go after the corporation, the company would be liable for:
 - a) Fines (can be up to 100% of the employment tax due, depending on level of culpability)
 - b) All federal income tax not withheld
 - c) All social security taxes not withheld
 - d) Unemployment insurance tax of 6.2%

None of these amounts may be collected from the worker.

2. If the State of California (for example) goes after the corporation, the company would be liable for:
 - a) Fines
 - b) All state income tax not withheld
 - c) All unemployment insurance tax not paid, plus 10%, plus interest
 - d) All disability insurance tax not paid, plus 10%, plus interest
 - e) Penalty of \$10,000 for failure to provide workers' comp insurance coverage

None of these amounts may be collected from the worker.

3. If the worker sues (typically as a class-action lawsuit) the lawsuit usually includes the following claims:
 - a) Any overtime owed (and because the corporation did not maintain time records, the worker's records would be used to calculate the overtime); in California overtime is owed for work in excess of 8 hours in a day or 40 hours in a week or both



- b) Failure to provide the required meal break and rest periods; minimum penalty of 1.5 hours of pay and of course, if this would result in the employee having worked over 8 hours in a day, then overtime has to be added
- c) Tort liability for any work related injuries suffered by the employee; plus 10% added on to any worker's comp award, plus attorney's fees related to the tort liability
- d) Creative plaintiff's attorneys can also add claims for unfair business practices under some State statutes, claims for the worker's incurred medical costs (due to the corporation's failure to provide health insurance), and related claims based on the corporation's failure to provide various fringe benefits.
- e) The worker's attorney's fees for bringing the lawsuit.

In theory, the corporation and/or the particular managers can also be held criminally liable for misclassifying the individual. Most of the wage hour laws make various violations a misdemeanor although it is very rare for anyone to be criminally charged. And, of course, in all of these situations, whether civil or criminal, the corporation will incur large litigation defense costs.

Common Law Guidelines for Contractor vs Employee

For federal tax purposes the usual common law rules are applicable to determine whether a worker is an independent contractor or an employee. Under the common law, you must examine the relationship between the worker and the business. All evidence of the degree of control and independence in this relationship should be considered. The facts that provide this evidence fall into three categories – Behavioral Control, Financial Control, and the Type of Relationship of the parties.

Behavioral Control covers facts that show whether the business has a right to direct and control what work is accomplished and how the work is done, through instructions, training, or other means.

Financial Control covers facts that show whether the business has a right to direct or control the financial and business aspects of the worker's job. This includes:

- The extent to which the worker has unreimbursed business expenses
- The extent of the worker's investment in the facilities or tools used in performing services
- The extent to which the worker makes his or her services available to the relevant market
- How the business pays the worker, and
- The extent to which the worker can realize a profit or incur a loss

Type of Relationship covers facts that show the type of relationship the parties had. This includes:

- Written contracts describing the relationship the parties intended to create
- Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay
- The permanency of the relationship, and
- The extent to which services performed by the worker are a key aspect of the regular business of the company

For more information, refer to [Publication 15-A](#) (PDF), *Employer's Supplemental Tax Guide*, or [Publication 1779](#) (PDF), *Independent Contractor or Employee*. If you want the IRS to determine whether a specific individual is an independent contractor or an employee, file [Form SS-8](#) (PDF), *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*.



20 Questions for Correctly Classifying a Worker

Because of co-employment risk many corporations are afraid to contract directly with independent consultants or contractors unless the worker can show proof that he or she is a legitimate independent business. Often independent consultants are screened using a 20-point checklist established by the IRS as a guideline in determining whether or not a contractor can legally be paid on a 1099 instead of a W-2. The checklist is an aid in determining whether the corporation has control, or the "right of control", over the worker's job performance. The greater the control exercised over the terms and conditions of employment, the greater the chance that the controlling entity will be held to be the employer. The right to control (not the actual exercise of the right) determines the status of the worker as an independent contractor or employee.

The 20-point IRS checklist is only a guideline. Compliance with the checklist does not guarantee that a person is correctly classified. There is no one single homogenous definition of the term "employee." Most agencies and courts typically look to the totality of the circumstances and balance the factors to determine whether a worker is an employee or an independent contractor. Ultimately, the decisive factor is whether the corporation had the ability, whether or not exercised, to control the worker's job performance. In general, it is the corporation's burden to establish that the worker was not an employee because a finding of independent contractor status is not favored by the courts. Nonetheless, compliance with the 20-point IRS checklist can increase the likelihood that a worker will be found to be an independent contractor, and for that reason, corporations will often require that an individual satisfy all, or most of, the requirements of the checklist before classifying the worker as an independent contractor.

These are the 20 factors from the IRS checklist that the courts will usually review in determining whether a worker is an employee or an independent contractor.

1. Must the individual take instructions from your management staff regarding when, where, and how work is to be done?
2. Does the individual receive training from your company?
3. Is the success or continuation of your business somewhat dependent on the type of service provided by the individual?
4. Must the individual personally perform the contracted services?
5. Have you hired, supervised, or paid individuals to assist the worker in completing the project stated in the contract?
6. Is there a continuing relationship between your company and the individual?
7. Must the individual work set hours?
8. Is the individual required to work full time at your company?
9. Is the work performed on company premises?
10. Is the individual required to follow a set sequence or routine in the performance of his work?
11. Must the individual give you reports regarding his/her work?
12. Is the individual paid by the hour, week, or month?
13. Do you reimburse the individual for business/travel expenses?
14. Do you supply the individual with needed tools or materials?
15. Have you made a significant investment in facilities used by the individual to perform services?
16. Is the individual free from suffering a loss or realizing a profit based on his work?



17. Does the individual only perform services for your company?
18. Does the individual limit the availability of his services to the general public?
19. Do you have the right to discharge the individual?
20. May the individual terminate his services at any time?

The Typical Compliance Process

Since establishing compliance can be a tedious and time-consuming administrative process, many corporations have hired third-party companies to handle the compliance process for them. These third parties screen the prospective contractors to determine if they have the business structure, insurance coverage, and other things to ensure that they are not putting the corporation at risk for co-employment. In addition to the 20 questions listed above, these third-party companies typically ask for evidence of the following in order to build “a compliance file”.

- Articles of Incorporation (if applicable)
- Articles of Organization (if applicable)
- Business License (If applicable)
- Fictitious Business Name Statement/DBA Filing (if applicable)
- Advertising/Marketing Collateral
 - Business card, website, letterhead, brochure, trade magazine advertising, etc.
- Proof of three (3) other clients (within last 9 months)
 - Invoice, contract, statement of work, etc.
- Proof of ongoing business expenses
 - Profit & loss statement, evidence of leased/rented office space, tools and equipment, etc.
- Taxpayer Identification Number (FIEN, SEIN, Social Security Number as it applies to the business structure)
- Proof employees are paid on W-2 and evidence of Workers Compensation per the statutory limits (if applicable)

Many corporations are also demanding that every independent consultant have the following minimum insurance coverage:

- General Liability Insurance (\$1,000,000)
- Professional Liability Insurance (“Errors & Omissions”) (\$2,000,000)
- Employers Liability as a part of Workers Compensation (\$500,000)
- Business Auto Liability Insurance (\$1,000,000) if driving on behalf of the corporation

Inability by the independent contractor or small business to provide any or all of these documents may result in a non-compliant evaluation recommendation by the third party. Conveniently enough, the worker can still do the work, provided the individual becomes a “payrolled worker” (paid on a W-2) by the third party company that handled the compliance screening process.

One of the primary benefits of PrōKo Consulting is that we handle the compliance process and furnish the necessary documentation and insurance coverage so that:

- a) The independent consultant does not need to deal with it
- b) The independent consultant can keep their sole proprietor/1099 status
- c) The independent consultant does not have to renegotiate his or her rates, and
- d) The corporation does not have to pay a 10-25% mark-up to the third party provider.

