

# Focus on Employment Practices

## R/W Industry Faces Greater Scrutiny From IRS

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**I**ncreasingly complex governmental regulations in employment practices have had a significant financial impact on those of us in the right-of-way industry. Gone are the days of the independent contractor. Gone are the days of paying everyone who is living away from home a per diem to cover expenses. Much of the burden of compliance with these regulations has shifted from the individual to the companies involved.

The regulations affecting those who can be treated as independent contractors are in the process of being more strictly defined. According to the January 1996 issue of the *Journal Of Accountancy*, "the Internal Revenue Service has identified the ... independent contractor reclassification issue as a significant compliance challenge." In 1988, the IRS began a nationwide employment tax compliance examination program (ETEP) with the intent of requiring businesses to treat misclassified workers as employees instead of independent contractors. Part of the problem of compliance with the proper classification of

workers has been the IRS's use of a 20-step common law test, which is considered by Senator Kit Bond (R-Mo.) as "a nightmare of subjectivity and unpredictability."<sup>1</sup>

A bill recently introduced in Congress, the Independent Contractor Simplification Act of 1995 (H. R. 1972), may make a fundamental change by defining specifically which workers qualify as independent contractors. If passed, an employer will evaluate the criteria to determine if the worker qualifies as an independent contractor. If the worker does not meet the criteria, he or she must be designated and treated as an employee. In general, under this bill, the criteria to qualify as an independent contractor are as follows:

The worker

- has a significant investment in assets and/or training;
- incurs significant unreimbursed expense;
- agrees to perform the services for a particular amount of time or to complete a specific result;

- is liable for damages for early termination without cause;
- is paid primarily on a commissioned basis;
- purchases products for resale;
- has a principal place of business and does not primarily provide the service in the recipient's place of business or pays the recipient a fair market rent for use of recipient's facilities;
- in the year in question and in subsequent or in preceding years has performed other work for other companies;
- advertises and/or solicits work with other companies;
- has a written contract with company that specifies the individual will not be treated as an employee.<sup>2</sup>

A similar bill has been proposed in the Senate by Senators Don Nickles (R-Okla.) and Kit Bond (R-Mo.), the Independent Contractor Tax Simplification Act of 1996 (S 1610). This bill would set standards for determining who is not an "employee." The worker would not be an employee if he/she:

- is working under a written contract stipulating that he/she will not be treated as an employee;
- has a significant financial investment in the work;
- is substantially independent of the "service recipient."<sup>3</sup>

The intent of these bills is to eliminate gray areas which have allowed companies to hire individuals without treating them as employees. The reason for this change involves the many regulations that affect employer/employee relationships such as the Age Discrimination Employment Act of 1967, OSHA of 1970, ERISA of 1986, ADA of 1990 and the Family Leave Act of 1993. It is clear that their primary function is to assure that all taxes are collected and paid. In fact, the General Accounting Office reported that ETEP audits through 1991 resulted in the reclassification of 338,000 workers as employees and \$468 million in proposed assessments. These assessments were for social security, medicare, FUTA and federal income taxes that should have been withheld or paid had the worker been "properly" classified.<sup>4</sup>

Fortunately, some of the companies which were subject to the ETEP audits avoided severe penalties by falling under "Section 530 Safe Harbor Provisions." However, the IRS used this section as a bargaining tool, agreeing to its applicability only if the employer would agree to reclassify its workers as employees. The Internal Revenue Code section 530 prevents the IRS from retroactively reclassifying workers if the employer has:

- a) not treated the worker as an employee in the past;
- b) consistently treated the worker as an independent contractor on all returns filed (including form 1099);
- c) a reasonable basis (reliance on authority, prior IRS audit, or long-standing industry practice) for treating the worker as an independent contractor;
- d) not treated anyone else holding a substantially similar position as an employee.<sup>5</sup>

These proposed new regulations appear to have strong congressional support and will have a tremendous impact on companies that normally hire individuals as "independent contractors." There will be little room for subjectivity with regard to worker classifi-

cation. Many companies will need to reexamine their relationships with workers and classify many of them as employees. Companies that err in their classification of workers by treating them as "independent contractors" instead of "employees" may have to pay retroactively the payroll taxes that should have been withheld and paid, plus penalties and interest. The cost of noncompliance will be staggering.

The solution to this problem is for companies in our industry either to hire the "independent contractors" as employees or place them with a right-of-way consultant company. Regardless of the choice, one of the companies is going to have to be responsible for collecting and paying payroll taxes, complying with the various federal employment laws, and providing a certain level of income and benefits. Both options are expensive.

The other area that has affected our industry in recent years is the shift in regulations that set standards for substantiating per diem payments. Some individuals are ineligible to receive a per diem even though they may be away from home and are duplicating their living expenses. The procedure for paying per diems used to be quite simple. Almost everyone on the project was paid a per diem, and the individual would substantiate his or her expenses to the IRS. Any amount received in excess of these expenses was subject to social security, federal income tax, and other applicable taxes. Those who were considered itinerant, or were not away from home, would be responsible for paying the tax burden on amounts received. The company's only responsibility was to properly report the amounts paid.

The first significant change came when companies were no longer allowed to issue Form 1099s for unsubstantiated business (travel) expense. In essence, the IRS said to the employer, "If an individual is eligible to receive reimbursement for travel expenses, pay that amount, and you will not be required to report the amount paid." This process appeared quite simple; however, in practice it proved to be fairly complicated. It became the company's responsibility to determine which employees should not (under IRS guidelines) ►

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