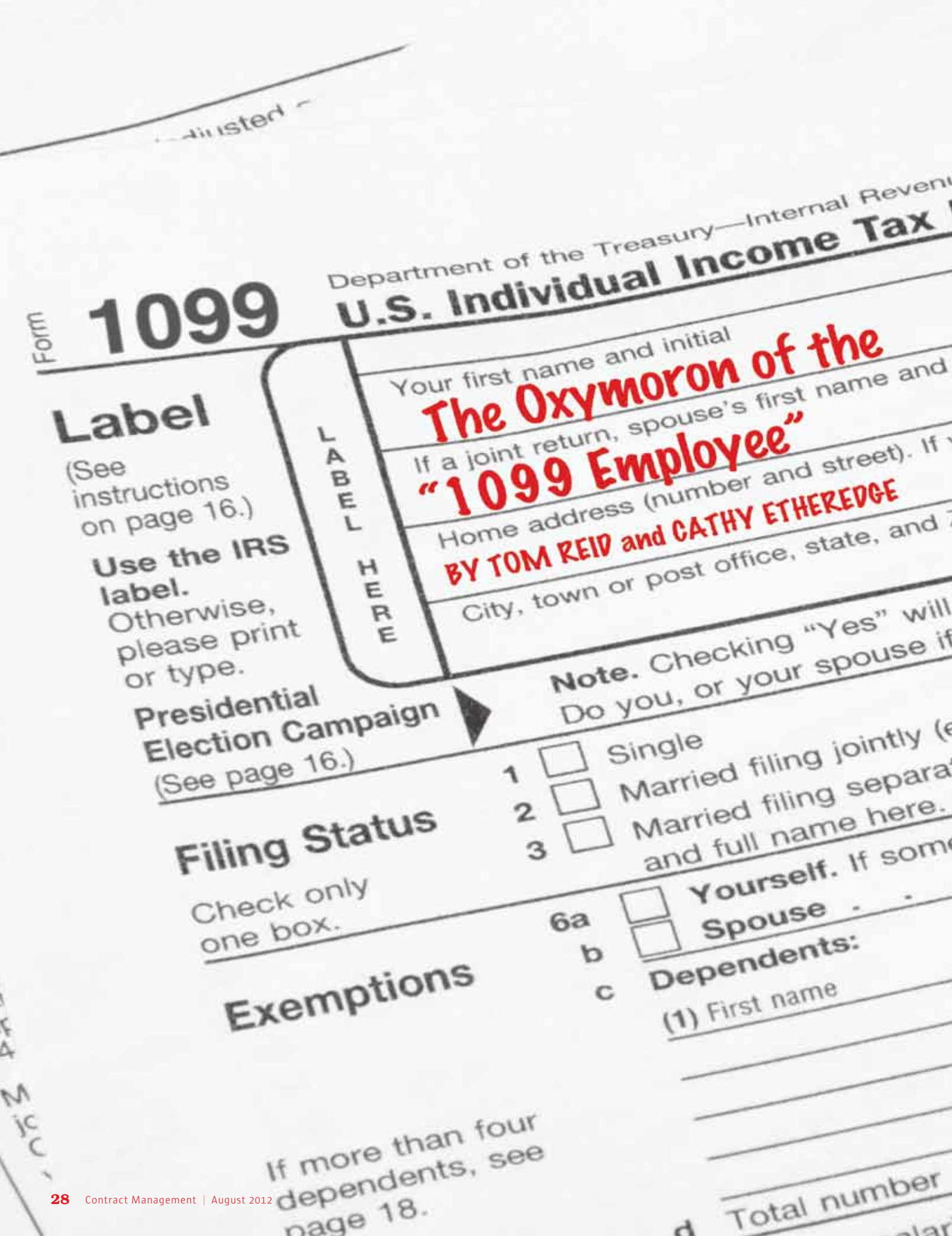
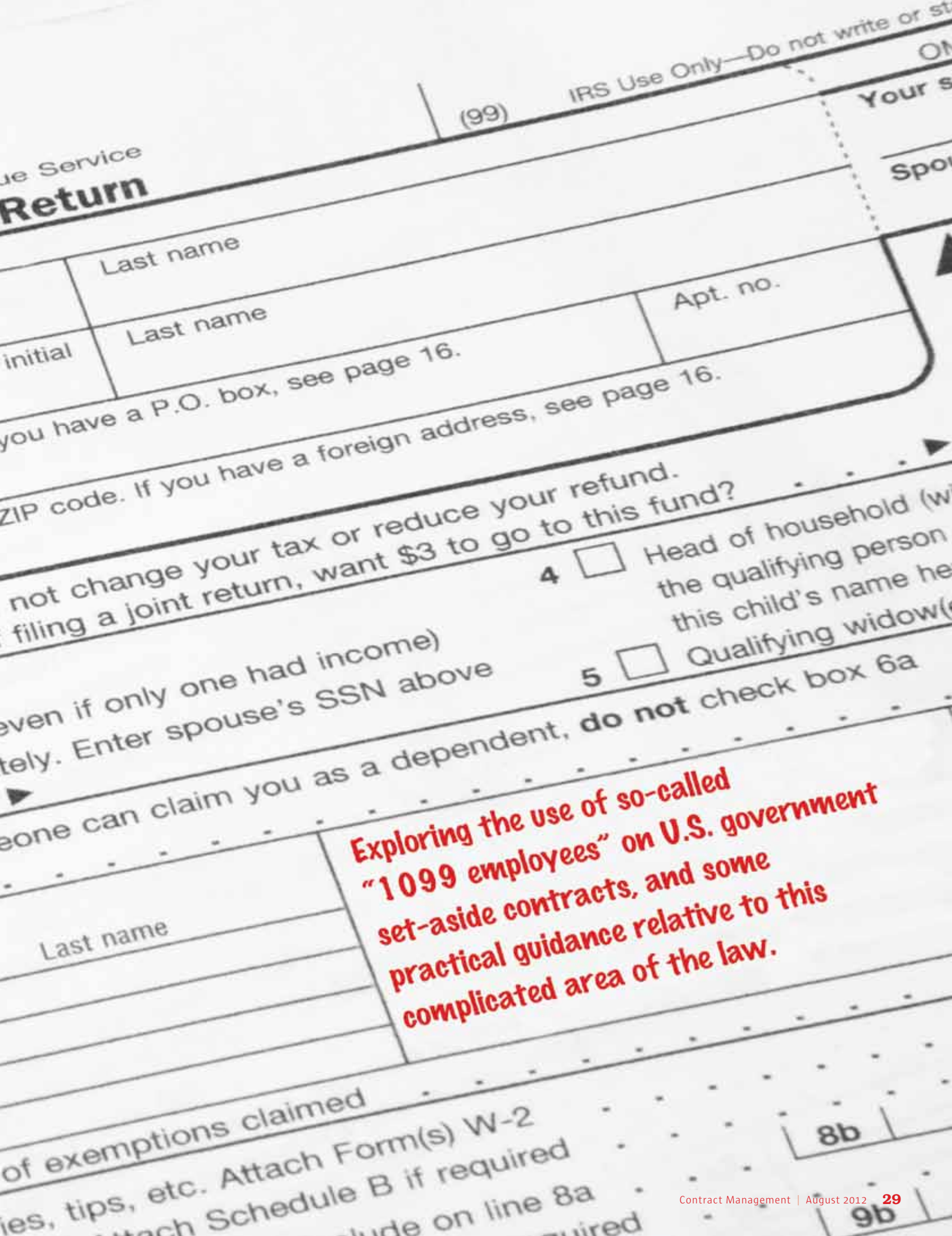
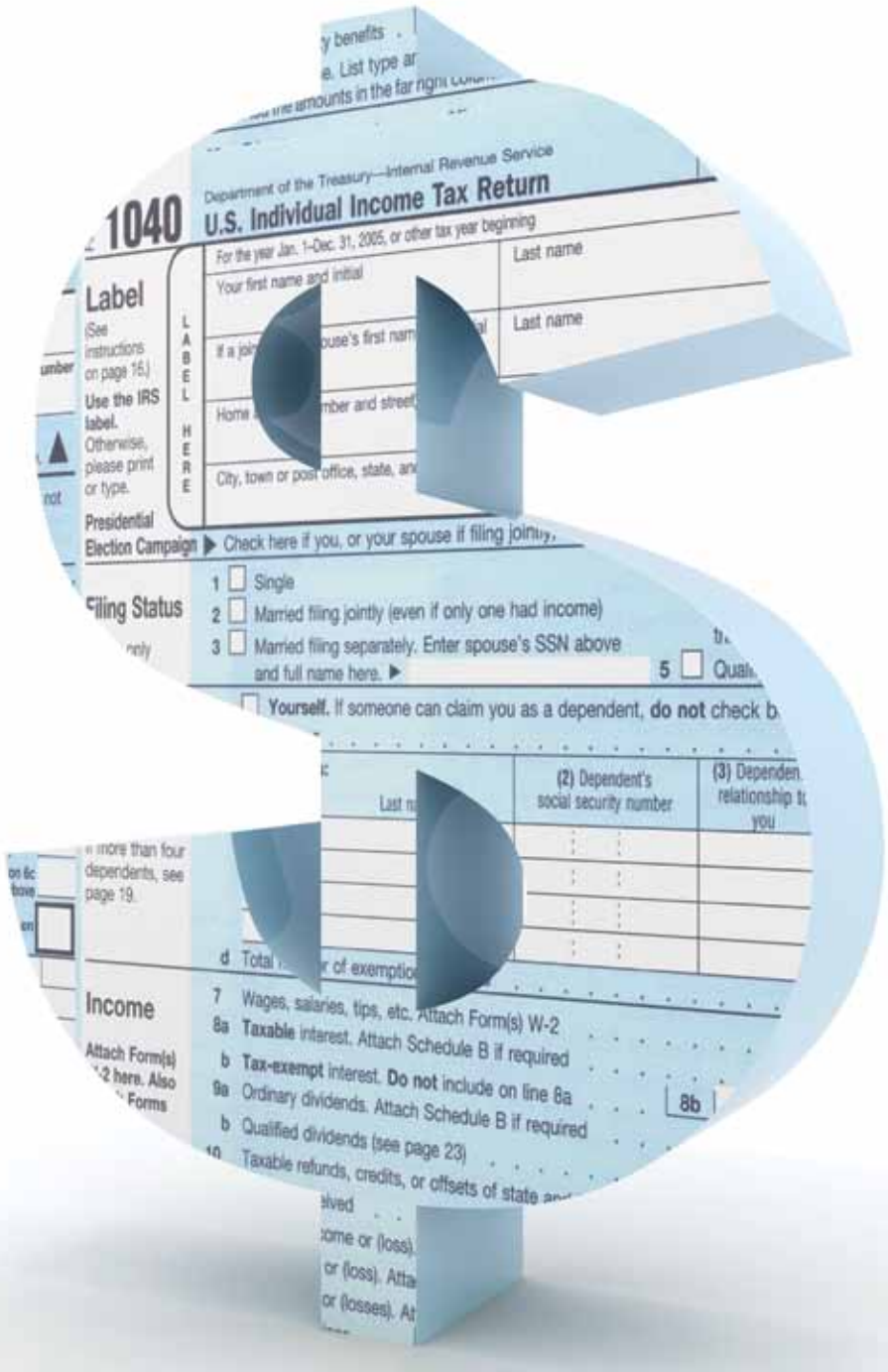

Form 1099
Department of the Treasury—Internal Revenu
U.S. Individual Income Tax
Label
(See instructions on page 16.)
Use the IRS label. Otherwise, please print or type.
LABEL HERE
Your first name and initial
The Oxymoron of the
If a joint return, spouse's first name and
"1099 Employee"
Home address (number and street). If
BY TOM REID and CATHY ETHEREDGE
City, town or post office, state, and
Presidential Election Campaign
(See page 16.)
Note. Checking "Yes" will
Do you, or your spouse if
Filing Status
Check only one box.
1 Single
2 Married filing jointly (e
3 Married filing separat
and full name here.
Exemptions
6a Yourself. If some
b Spouse
c Dependents:
(1) First name
If more than four dependents, see page 18.
d Total number


Exploring the use of so-called "1099 employees" on U.S. government set-aside contracts, and some practical guidance relative to this complicated area of the law.

Employees are costly.

The recruiting, hiring, orienting, training, and housing of employees are significant costs to any business. When high turnover is experienced, these costs escalate quickly. To maintain a "standing army" of talent until that sole-source set-aside contract is awarded is simply not a viable business model for many small businesses. This issue can become particularly pertinent as it relates to the "Limitations on Subcontracting" clause that requires the use of the preference holder's own employees for, generally, 51 percent of the cost of labor.



One option often used to minimize the costs of having regular full-time employees is to bring on a staff of temporary employees. This usually results in the use of a variety of independent contractors whose remuneration is reflected not in a W2 as is done with employees, but via Internal Revenue Service (IRS) Form 1099. For W2 employees, the employer is responsible for paying all the necessary taxes and benefits. A person receiving a 1099 is, by definition, not an employee and is therefore responsible for paying his or her own taxes and providing his or her own benefits. This article will explore the use of so-called "1099 employees" on government set-aside contracts, the legal implications

of doing so from both a tax payment and contract compliance perspective, and then offer some practical guidance relative to this complicated area of the law.

The primary reason for using a workforce comprised of independent contractors is cost. Non-employees (also called "independent contractors" or "consultants") are not entitled to benefit programs, often work at remote locations, are not directly supervised by an employee of the business, and are responsible for paying their own taxes. Further, they work when tasks are assigned and receive remuneration with the acceptance of the agreed-to deliverable, whether that is a final work product or simply time. Most start-ups and many other businesses of all sizes use independent contractors as a legitimate and lawful business model to minimize their costs. There is nothing wrong with doing so.

The problem arises when these so-called independent contractors are not afforded their independence and are treated nearly identically to employees. The problem is compounded when these independent contractors do not file and pay all the appropriate taxes. Thus, both the employer and the independent contractor end up believing that some of the "savings" from using a 1099 worker are real when in essence they are depriving the government of appropriate taxes. This is where the IRS and Department of Labor (DOL) get involved. The costs of defending allegations, or even participating in an audit, can be considerable. It is this aspect of the issue that concerns the taxing authorities.

A 2000 study commissioned by DOL found that 30 percent of firms misclassify employees as "independent contractors." A 2007 Government Accountability Office (GAO) report states that at least 150,000 workers did not receive the protections and benefits to which they were entitled due to misclassification. A government contractor receiving a preference award has the additional issue of verifying that they are still "small" by the appropriate North American Industry Classification System (NAICS) standard, sometimes based on the number of employees, and that they are not affiliated with other companies (be that a collection of independent contractors, a personnel leasing company, or a large business who serves technically as a subcontractor) such that their qualification for the preference becomes jeopardized. A self-certification that turns out to be false can result in the loss of the contract, prosecution for making false claims or false statements to the government, and suspension or debarment from engaging in federal work. These are very severe sanctions over and above the tax liabilities and possible penalties.

The recent memorandum of understanding between the IRS and DOL, signed September 19, 2011, in essence, is a pact between the two agencies "to share information with each other and coordinate law enforcement efforts."[1] Audits and reports have demonstrated that sufficient confusion and inconsistency in the use and classification of independent consultants is extensive. These

agencies, along with many states, have decided it is worthwhile to investigate and crack down on companies that are misclassifying employees as independent contractors.

At this writing, 13 states have signed on to cooperate with the IRS and DOL to share information and select the appropriate enforcement tool. There are legitimate and lawful reasons to use independent contractors rather than employees, and the renewed emphasis on the proper classification can present problems for government contractors whether they are using independent contractors or employees. There is no safe harbor in either selection.

The IRS issues guidance on the standards it uses to determine the proper classification, but that is the key—it is only guidance. There is no "safe harbor" short of requesting a revenue ruling on the specific facts of your case from the IRS. Further, states often have different standards regarding the classification of an individual as an "independent consultant" or "employee," and they do not consistently follow the IRS guidance or each other. This makes for a complicated landscape and presents significant difficulties for a government contractor attempting to navigate the terrain.

The term "1099 employee" is an oxymoron. By definition, a worker is *either* an employee *or* an independent contractor. Even if the worker is from a subcontractor, that worker is the employee of some entity and still not an independent contractor.

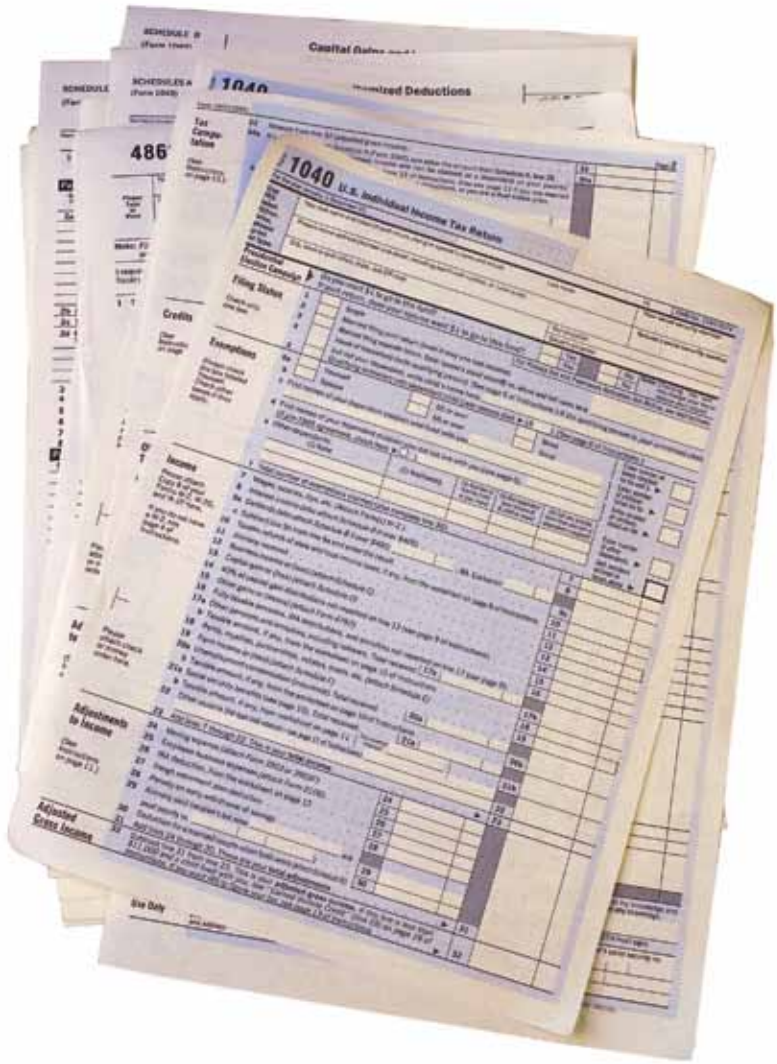
Determinations and Definitions

The Supreme Court has determined that the following factors are key to the determination of employee versus independent contractor:

- Skill required,
- Source of tools and instrumentalities,
- Location where work is performed,
- Duration of relationship of parties,
- Hiring party's right (or lack thereof) to assign additional projects,
- Hired party's discretion over when and how long to work,
- Method of payment,
- Hired party's role in hiring and paying assistants,
- Whether the work is part of the hiring party's regular business,
- Whether the hired party is in business,
- Whether "employee benefits" are provided, and
- The tax treatment of the hired party.[2]

The IRS traditionally used a 20-factor test. By its own statements, the IRS admitted that this was a non-exhaustive list, and that none of the elements in the list were determinative standing alone, although some of the items were considered as more significant. For example, the IRS looked not just to the right to control the end result, but also included the right to determine the "manner and means" of accomplishing the result as a key discriminator.[3] Some of the other 20 criteria include:

- **Services Rendered Personally**—If the worker can accomplish the job through assistants or delegates, he or she is



probably an independent contractor. If the worker personally is required to do the work, he or she is probably an employee.

- **Continuing Relationship**—If the worker was previously on the payroll and was converted to an "independent" status, or has been with the employer for an extended period essentially doing the same job, the worker is probably an employee. If he or she only comes when called and that is infrequently, he or she is probably an independent contractor.
- **Significant Investment**—What does the worker have at risk? Does he or she own the major equipment needed to accomplish the work? If so, he or she is probably an independent contractor.
- **Payment by Hour, Week, Month**—If the worker is paid based on time increments worked rather than jobs completed, he or she is probably an employee.[4]

The more control a company exercises over how, when, where, and by whom work is performed, the more likely the workers are employees, not independent contractors.

More recently, the IRS has used a three-category test that includes several factors, but with the same non-exhaustive, no-single-factor-determinative caveats:[5]

- Behavioral control:
  - Instruction including how, when, or where to do the work; what equipment or tools to use; whether to hire assistants; and where to obtain supplies and services.
  - Training.
- Financial control:
  - Significant investment.
  - Unreimbursed expenses.
  - Opportunity for profit or loss.
- Type of relationship:
  - Written contract.
  - Employee benefits.

In addition, you will find that some states have a statutory definition for an "independent consultant"; however, the definitions vary. For example, in Arizona, the statutory definition states:

> An independent contractor is a person engaged in work for a business, and who while so engaged is independent of that business in the execution of the work and not subject to the rule or control of the business for which the work is done, but is engaged only in the performance of a definite job or piece of work, and is subordinate to that business only in effecting a result in accordance with that business design.[6]

In both California and Nevada, the statutory definition is quite succinct:

> "Independent contractor" means any person who renders service for a specified recompense for a specified result, under the control of his principal as to the result of his work only and not as to the means by which such result is accomplished.[7]

Yet states such as Massachusetts, New Jersey, New York, and Pennsylvania are void of any statutory definition, but have state-based legal standards to determine the relationship.

Since all of this is only guidance, the courts have often relied on their own interpretation of the situation, adding and subtracting factors deemed significant to the trier of fact. In each case the intent seems to dig below the form of the relationship and get to the real substance. The courts also seem to consider whether the employer is taking unfair advantage of the employee and simply setting up a scheme to avoid the payment of taxes.

Certainly the collection of payroll tax and social security tax are important. The failure to pay taxes can result in interest, penalties, and sometimes even criminal prosecution. When a person works as an independent contractor, they are personally responsible for paying the full percentage of their wages in the social security context, and may also have to file quarterly tax payments. As previously noted, surveys from the IRS, GAO, and DOL have all suggested that these taxes are grossly undercollected for independent contractors.

The significance of the proper classification of workers as employees, subcontractors, or independent consultants extends beyond just tax considerations. For example, the Occupational Safety and Health Administration (OSHA) imposes certain requirements on employers and requires that employee injuries be reported and posted statistically in the work space. Non-employees are not reported in this system, but OSHA has a "Multi-Employer Citation Policy" sweeping all possible targets into its net and thereby recognizing that an employee can have more than one employer.

The Fair Labor Standards Act also explicitly applies to employees only. Courts will often use the "economic realities" test when interpreting this law, placing more emphasis on the benefit to the business from these workers and whether the business model would even be viable without these workers. The classification of workers as employees under this law requires the payment of overtime. This law also recognizes the concept of "joint employers" and the commensurate joint and several liability on each employer of the same employee.

The Employee Retirement and Income Security Act of 1974 (ERISA) controls employee health and welfare benefits. Although this act defines "employee," the definition is of no help since it states that an *employee* is "any employee of the employer." Nonetheless, employees are entitled to the benefits offered by the employer; independent contractors are not. Proper classification, or reclassification, can result in considerable cost to the employer. Microsoft learned this very expensive lesson in a series of landmark cases related to their use of "freelancers" that were treated identically to its employees even though they had signed agreements from this group of workers stating that they acknowledged that they were not "employees." They did not receive a regular paycheck, but were paid by accounts payable after submitting invoices. The courts ruled that substance controls over form, and those freelancers were ultimately given overtime and benefits reserved for employees.

Employers are also responsible for assuring that they employ only those who are a lawful resident in the country and eligible to work under the Immigration Reform Control Act of 1986. "Employment by Contract" rules under this law can create a liability to the employer, even for independent contractors.

The Civil Rights Act of 1964 also comes into play. Title VII discrimination, as well as actions affecting workers under the Age Discrimination in Employment Act of 1967, The Americans with Disabilities Act, and the Family and Medical Leave Act, all provide certain protections to employees while independent contractors are not covered. Misclassification can create very expensive litigation in each of these areas.

The National Labor Relations Act also covers only employees. The use of independent contractors may avoid certain union-organizing campaigns, but the courts have recognized "joint employer" situations under this law as well if it has been deemed that the contractors are not as independent as the employer intended. There is also a "Federal Worker's Compensation" program for certain classes of employees. Both the Jones Act and the Defense Base Act may apply, and misclassifying employees as contractors can lead to unexpected liability under these laws, including potential criminal liability.

Finally, the Healthcare Insurance Portability and Accountability Act, as well as the Patient Protection and Affordable Care Act, give certain rights and obligations to employees that do not cover independent contractors.

Thus, the proper classification of employees can have consequences well beyond the issue of paying taxes. Each of these laws can create liability for an employer who misclassifies its workers. Even so, there are times when a government contractor *wants* its workers to be employees since it can have a bearing on the employer's eligibility for certain programs.

Joint Employees

Historically, many courts have suggested that an employee can have only one employer. In more modern times, the focus has been less on the employee's responsibilities to multiple masters and more on the employee's rights to benefits and entitlements. Since taxing and enforcement authorities like to have more than one target to pursue, the concept of joint employment is fairly common today. Can a government contractor use this to its benefit? As previously noted, the use of independent contractors is a legitimate business arrangement, even though such workers are not technically employees. Simply placing a worker on a 1099 status, as Microsoft learned, does not automatically make him or her a non-employee. The use of a subcontractor likewise presumes that employees are employed by that subcontractor, not the prime contractor, and most subcontract agreements make this abundantly clear so as to avoid any con-

sideration of joint employment that would make the prime responsible for compliance with the various laws (previously discussed) as they relate to those workers.

How a government contractor classifies its workforce can have additional ramifications. For example, a business size can be misrepresented in self-certification if personnel are not properly categorized. This can lead to loss of the contract and even more serious consequences if the action is deemed a deliberate attempt to defraud the government. Further, when a company has received an award under one of the various government preference programs, the contract contains the Limitations on Subcontracting clause, usually requiring that the contract awardee perform 51 percent of the work with its own "employees." This has the two-fold intent of preventing a non-eligible company from using an eligible company as a "front" for the award while effectively forcing the small business to grow and graduate the preference program. Can the contractor count those that are paid as independent contractors—who will receive 1099 status as independent contractors—as part of their employee workforce? Apart from an investigation by the IRS, possibly in conjunction with state authorities, can you withstand the potential loss of your contract, termination costs, and possible suspension or debarment for not complying with a significant contract clause? This topic needs some very careful planning and consideration.

The expressed policy of the Small Business Administration (SBA) is to assist small businesses. This assistance spans the areas of financial aid, such as loan programs, business guidance (as provided by SCORE—a nonprofit association dedicated to helping small businesses grow through education and mentorship), and contractual assistance via various preference programs. When a government contract is involved and the contractor has been selected based on one of the various preference programs, there is a further requirement that at least 50 percent of the work will be performed by the contractor's employees. Does a "1099 employee" count? Unfortunately, the answer has to be the classic legal answer of, "It depends," for which the natural response should be, "On what does it depend?" The Limitations on Subcontracting clause addresses the requirements for services, supplies, construction, and specialty trades.[8]

Any set-aside based on size status, and that would include "Women-Owned Business," "Small Disadvantaged Business," "Veteran-Owned Business," or any other such classification that requires the business to be "small" within its applicable NAICS code, must use "employees of the concern" for the respective percentage of the work. Pertinent SBA regulations offer some further guidance. For example, 13 C.F.R. 126.103 (pertaining to Historically Underutilized Business Zone (HUBZone) set asides) states:

> *Employee* means all individuals employed on a full-time, part-time, or other basis, so long as that individual works a minimum of 40 hours per month. This includes employees obtained from a temporary employee agency, leasing concern, or through a union agreement or co-employed pursuant to a professional employer organization

> agreement. SBA will consider the totality of the circumstances, including criteria used by the IRS for federal income tax purposes and those set forth in SBA's Size Policy Statement No. 1, in determining whether individuals are employees of a concern. Volunteers (i.e., individuals who receive deferred compensation or no compensation, including no in-kind compensation, for work performed) are not considered employees. However, if an individual has an ownership interest in and works for the HUBZone [small business concern] a minimum of 40 hours per month, that owner is considered an employee regardless of whether or not the individual receives compensation.[9]

Similarly, 13 C.F.R. 121.106(a), relating to size standards, generally states:

> In determining a concern's number of employees, SBA counts all individuals employed on a full-time, part-time, or other basis. This includes employees obtained from a temporary employee agency, professional employee organization, or leasing concern. SBA will consider the totality of the circumstances, including criteria used by the IRS for federal income tax purposes, in determining whether individuals are employees of a concern. Volunteers (i.e., individuals who receive no compensation, including no in-kind compensation, for work performed) are not considered employees.

Thus, SBA clearly takes an expansive view of "employee" for its purposes, even recognizing that workers who are the legal employees of another entity, including temporary services and professional employee organizations, are counted as employees of the small business. This, by necessity, mandates that some type of joint employment of these workers exists.

Maintaining the "standing army" required to compete for and perform contracts puts small businesses at an economic disadvantage. To address this, a small business concern should first decide whether it is trying to increase employment to meet its contractual requirements, or decrease its employment to maintain preference eligibility. This may require the drafting of an agreement that clarifies the key aspects of the arrangement, whether with an individual or with an entity such as a subcontractor. Keep in mind that joint employment—whether intentional, accidental, or by operation of law—makes the prime contractor ultimately responsible for the costs, including taxes and other benefit costs, if the labor-providing organization ceases to exist or otherwise fails in its obligations. This agreement should outline the rights and responsibilities of each party as to the various employment issues, as well as the right to audit and the responsibilities for record retention.

Second, affected employees should have the full situation explained to them and they should acknowledge the nature of the relationship in writing. This avoids later confusion or claims that the relationship is other than as described in the agreement with the worker or its employer of record.

Third, any company using nontraditional employees should do so in accordance with a business plan that explains the pros and cons of doing so, and further has policies in place that explains the difference between regular employees, joint employees, and independent contractors. These will assist greatly in the event of an SBA audit of the applicable contract clauses. To aid in the determination of an employee or an independent contractor, a simplified checklist is shown in **FIGURE 1** below.[10]

Figure 1.

[Date]

[Company name] CONFIDENTIAL

Identifying Factors	Contractor	Employee
Control factors:		
Employer provides training to worker		x
Worker works on-site		x
Worker works off-site	x	
Company supervisors worker's job		x
Worker has regular work hours		x
Worker has irregular work hours	x	
Employer sets work hours		x
Financial factors:		
Worker is salaried		x
Employer sets hourly rate		x
Employer provides tools/equipment to worker		x
Worker invests in tools/equipment for use in job	x	
Worker receives benefits from employer		x
Worker has ability to have profit or loss from job	x	
Worker pays own expenses	x	
Relationship factors:		
Worker and employer have contract for services or products	x	
Worker can hire others to complete a task	x	
Worker and employer have long-term work relationship		x
Work relationship relates only to contract work	x	
Worker performs similar projects for other companies	x	
Worker works only for company		x

Conclusion

Government contractors are encouraged to review their treatment of independent contractors under both federal and state law. If deemed appropriate, the IRS can help make the distinction between *employee* and *independent consultant* by submitting Form SS-8, "Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding" to the IRS. The consequences and costs associated with misclassifying employees under all of the various laws and preference programs are too important to treat cavalierly. **CM**

ABOUT THE AUTHORS

TOM REID, CPCM, FELLOW, is director, Government Contractor Services, Navigant Consulting, Inc., and a member of the Denver Chapter of NCMA. He is a frequent lecturer and author on a great variety of government contracting topics. He has previously received both the Outstanding Fellow Award and the National Achievement Award from NCMA. He serves as a mentor to NCMA's Contract Management Leadership Development Program (CMLDP) participants and is admitted to practice law in the state of Texas, before the U.S. Court of Federal Claims, and the U.S. Supreme Court.

CATHY ETHEREDGE, CPCM, CFCM, FELLOW, is the vice president-director of contracts for UXB international, Inc., based in Blacksburg, Virginia, and is a member of the Research Triangle Park Chapter of NCMA, where she currently serves as chapter president.

Send comments about this article to cm@ncmahq.org.

ENDNOTES

1. Richard J. Reibstein, Lisa B. Petkun, and Andrew J. Rudolph; "U.S. Labor Department and IRS Sign Pacts to Coordinate Their Crack Downs on Independent Contractor Misclassification" (September 23, 2011); *available at* **www.lexology.com/library/detail.aspx?g=760771bc-e152-4f1a-bd0f-71040d022f54**.
2. *Derived from Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318 (1992).
3. *See* Rev. Rule 87-41, 1987-1 Cum Bull. 296, 2980299.
4. A full list can be found at **www.comptroller.ilstu.edu/downloads/20-factor-test-for-independent-contractors.pdf**.
5. IRS Publication 1779 (Rev. 8-2008) Catalog Number16134L.
6. *See* Kathleen Buchli, "Independent Contractor Definitions for Selected States" (Senate Labor, Commerce, Research and Development Committee, Washington State Legislature, September 2007).
7. *Ibid*.
8. FAR 52.219-14, in pertinent part, states:

   By submission of an offer and execution of a contract, the offeror/contractor agrees that in performance of the contract in the case of a contract for—

   Services (except construction). At least 50 percent of the cost of contract performance incurred for personnel shall be expended for employees of the concern.

   Supplies (other than procurement from a nonmanufacturer of such supplies). The concern shall perform work for at least 50 percent of the cost of manufacturing the supplies, not including the cost of materials.

   General construction. The concern will perform at least 15 percent of the cost of the contract, not including the cost of materials, with its own employees.

   Construction by special trade contractors. The concern will perform at least 25 percent of the cost of the contract, not including the cost of materials, with its own employees.
9. It is instructive that the 1999 version of this section stated:

   Employee means a person (or persons) employed by a HUBZone small business concern on a full-time (or full-time equivalent), permanent basis. Full-time equivalent includes employees who work 30 hours per week or more. Full-time equivalent also includes the aggregate of employees who work less than 30 hours a week, where the work hours of such employees add up to at least a 40 hour work week. The totality of the circumstances, including factors relevant for tax purposes, will determine whether persons are employees of a concern. Temporary employees, independent contractors or leased employees are not employees for these purposes.

   This was changed in 2007 to the language appearing in the body of this article.
10. Source: Microsoft Office template, **http://office.microsoft.com/en-us/templates/employee-or-independent-contractor-checklist-TC001230492.aspx**.