

## 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 they are actually being treated like an employee.

The largest and most well-publicized case was against Microsoft who settled its case in December 2000 for \$96.9 million. Presumably if it was willing to settle for this amount its potential liability was much, much more. And it settled after spending at least \$1 million in litigation costs only to lose the issue of whether the individuals were or were not employees.

Clearly co-employment risk is can be 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 coverageNone of these amounts may be collected from the worker.
  
3. If the worker sues (typically as a class-action lawsuit), they would sue for
  - a) Any overtime owed (and since you have not maintained 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 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) Attorney's fees related to all the above.

In theory, the corporation and/or the particular managers could also be held criminally liable for misclassifying the individual. Most of the wage hour laws also make various violations a misdemeanor but it is very rare for anyone to be criminally charged.

### **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 they are a legitimate business. Often independent consultants are screened using a 20-point checklist that the IRS has established as a guideline in determining whether or not a contractor can legally be paid on a 1099 instead of a W-2. This checklist helps determine who has the "right of control." Does the employer have control or the "right of control" over the individual's performance of the job and how the individual accomplishes the job? 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 act itself) determines the status as an independent contractor or employee. The 20-point checklist is only a guideline; it 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.

Following are the 20-points that have been established:

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, time-consuming administrative process, many corporations have hired third-party companies to handle the compliance process for them. These third parties do the screening of the prospective contractor 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 also 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, yellow page, 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)

In addition, many corporations are now asking that every independent consultant has the following 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 they become 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 doesn't need to deal with it
- b) The independent consultant can keep their sole proprietor/1099 status
- c) The independent consultant doesn't have to renegotiate their rates, and
- d) The corporation doesn't have to pay an 18-25% mark-up to the third party provider.

