THE IRS versus THE INDEPENDENT CONTRACTOR

The stakes are high ... and companies better know the rules.

Many pharmaceutical companies are now using independent contractors in increasing numbers; in many cases, these contractors are former employees. What started off as a trickle a few years ago has become a torrent. Quite often, former employees — whether they left voluntarily or not — end up back at their old companies, sitting at their old desks, doing their old tasks. The difference is their old employer is their new client. And they're getting paid as a 1099 independent contractor, instead of as a W-2 employee.

"Contingent" workers such as these — independent contractors, returning retirees, consultants, freelancers, etc. — have become an ever-increasing segment of the workforce. And in many companies they're actually changing the face of the workforce.

The contingent workforce already numbers about one in every three American workers, and is the fastest-growing segment of the workforce. In some biotech and high-tech firms, the percentage of contingent workers will grow to 50% within the next year or two.

According to Andrew E. Schultz, president of PrO Unlimited, a Boca Raton, Fla.-based consulting and outsourcing company specializing in helping companies address compliance and management issues associated with the use of contingent workers, this trend isn't anywhere near peaking. According to recent Department of Labor statistics, by

In an exclusive to PharmaVOICE, Andrew E. Schultz,president of PrO Unlimited, discusses the impact of an emerging workforce — independent contractors.

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2005, the biggest employer in the United States may be "self."

"The implications for American business — especially for sectors such as biotech or pharmaceutical — are nothing short of profound," Mr. Schultz says. "An increasing number of companies are identifying a more flexible workforce as a way to operate more efficiently, to protect themselves against layoffs in an economic recession, and to respond more effectively to moves by the competition. In public companies, lower employee head count is generally seen in a more favorable light on Wall Street, so there's ever-increasing pressure on senior management to limit the number of full-time employees."

To stay with the known competition, and to anticipate and meet the threat from new emerging firms, companies want any advantage they can get. They realize that contingent workers are often among the most talented in their fields and are willing to pay top-dollar for this talent — often as much as $150 or more per hour. Furthermore, they realize they can avail themselves of this talent without having to pay employment taxes or provide benefits.

In turn, many of the pharmaceutical industry's most talented people are coming to a realization of their own — that they can earn more as independent contractors than as employees.

"It sounds like a great solution … a win-win situation for both the workers, particularly if they already have benefits from another source, and the company," Mr. Schultz says. "But recent events are proving that the reality can be somewhat different than the theory."

The reality, according to Mr. Schultz, is in fact often very painful. Pharmaceutical executives employing independent contractors should know what the consequences might be.

"If you have people who are being paid on a 1099 basis, look out," he says. "The IRS has its sights set on you…and them."

THE IRS PERSPECTIVE

According to Mr. Schultz, the IRS is not convinced that independent contractors are paying their fair share of taxes. As a result — and because of the rapid growth of this workforce — tax authorities now are taking a very aggressive stand in ensuring compliance with regulations.

"And with good reason," he says. "The General Accounting Office has estimated that unpaid taxes by the self-employed account for a $20 billion annual tax loss to the government. Both the federal government and state taxing agencies now are allocating significant resources in an attempt to recover this money."

According to Mr. Schultz, independent contractors raise a red flag with the government, because they may be functioning more as employees than as "independents." Recent studies indicate that close to half of the 9 million individuals currently working as independent contractors are misclassified; in the eyes of the law, they're actually employees.

Mr. Schultz says the criteria used by the IRS and many states has traditionally been a series of common law questions, known in tax circles as "The Famous Twenty Questions." These questions generally point to how much control a company has over a worker's performance. The more control, the more likely an independent contractor will be classified as an employee. If the company is the worker's primary source of income, for example, and/or the worker is a former employee of the firm, it will be extremely difficult to prove that a legitimate independent contractor relationship truly exists.

The IRS says to be considered an independent contractor, a person must be paid by the project rather than the hour. Additionally, that person should have articles of incorporation, business insurance, and other clients besides your company. The person should have a standard business risk of profit or loss. And, according to Mr. Schultz, that's just the beginning.

Unfortunately, each question can be — and often is — open to interpretation. Complicating matters further, the Department of Labor and the states each have separate guidelines of their own.

INSTALLING A COMPLIANCE SYSTEM

For companies currently classifying some professionals as 1099/independent contractors, it's important to come up with a plan — before the IRS does it for them. A good compliance system should include the following:

- A **METHOD OF ANALYZING** the proper classification of all potential independent contractors.
- A **FILE DOCUMENTATION SYSTEM** for all independent contractors who are determined to be truly "independent." It is imperative that the arrangements with these workers be set up properly, or the company is at risk. There must be very strong contracts with each worker, setting out clearly that they meet the IRS guidelines. Remember, too, that the company also must arrange for the protection of the company's intellectual property.
- A properly set-up **THIRD-PARTY PAYROLL ARRANGEMENT** for those independent contractors and/or returning retirees who probably would not pass the test of the tax authorities.

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Just for the record, a company would be best off avoiding getting into a legal arena with the IRS. In 90% of the companies the IRS investigates, the agency finds some misclassified contractors. In that case, the company could be feeling the consequences for a long time.

RECENT RULINGS HAVE RAISED THE STAKES

Fines, penalties, and interest charges from both the IRS and state tax authorities have been staggering, including a number of assessments of more than $10 million from a single firm.

In addition to the penalties, is the potential disqualification of retirement and benefit plans that can result from an unfavorable independent contractor audit. If the IRS concludes that a company's "consultants" were employees — and should have been counted in the qualified benefit plan calculations — the entire plan could be disqualified.

Mr. Schultz says most companies are not aware of how bad the consequences can be. To illustrate his point, he suggests examining a couple of recent cases where companies were caught off guard. Microsoft recently paid $97 million to settle a suit that began as the result of an IRS audit of its independent contractors. Or the Time Warner case, in which the company recently settled a suit with the Department of Labor. Or IBM. Or Roadway Services. Or any one of numerous other companies that — too late — realized the problems in managing a contingent workforce, and in remaining compliant with government regulations.

Now, a new area of concern is emerging, with individual states often acting more aggressively than the IRS.

CONTRACTS ARE NOT ALWAYS THE ANSWER

Some companies try to protect themselves with written contracts claiming the contractor's independence from the company. But, according to Mr. Schultz, companies shouldn't make the mistake of relying on this. Regardless of what is written in the contract, the IRS and state tax authorities will make a company prove that its 1099 wage earners are really independent. For legitimate independent contractors, a written contract is indeed essential. However, if the actual relationship is that of an employer and an employee, the contract is most likely not worth the paper it's written on.

If a company does decide to work with a consulting firm on these issues, it's important to engage a firm that is experienced at navigating the maze of federal and state regulations. Mr. Schultz says it's important to truly understand just who is and who is not an independent contractor. If it is necessary to use a third-party payroll, make sure it is set up properly, with contracts that protect intellectual property and with non-disclosure agreements. And always, always, insist on strong documentation from an independent contractor proving that he or she truly is an independent contractor.

THE BOTTOM LINE

In our increasingly downsizing world — and especially in areas like pharmaceuticals — contingent workers and independent contractors are here to stay. Used wisely, these workers can be an integral part of the business plan. But it can prove a nightmare to those companies that are not adequately prepared.

"Thankfully, however, there is one simple thing a company can do to ensure that it is among those that are prepared: install a compliance system that works, and stick with it," Mr. Schultz says. "If your company uses independent contractors, make sure they really are independent contractors…before the government does it for you." ❖

PharmaVoice welcomes comments about this article. E-mail us at feedback@pharmalinx.com.

Install a compliance system that works. And stick to it.