

# Where tax and labor laws are concerned, handle your independent contractors with care

## Practice Matters

By Alan Joch

Few professions are as vulnerable to the economy's peaks and valleys as architecture. The accompanying changes in work load present a constant challenge to anyone who is responsible for staffing a firm. Overfill your full-time workforce during boom times, and when work slows you may find yourself burdened with salaries, benefits, and eventually severance expenses, which gobble up profits. If you run too lean, you risk burning out your talent with too much overtime and deadline pressure when the good times return.

For a growing number of architectural firms, the balm for economic uncertainty is a hiring strategy that mixes a manageable core of full-time employees with an easily regulated stream of freelancers, more formally known as independent contractors (ICs). Their hired-gun status means they hang around only as long as you need them, which makes it easier for firms to achieve optimal staffing levels. "The architectural industry lends itself to this strategy, because it's either feast or famine," says David C. McFadden, C.E.O. of Consulting for Architects, a placement service for independent architects headquartered in New York City. "For the architects, working as an independent is attractive because it gives them exposure to a variety of projects."

Unfortunately, relying on ICs comes with its own bundle of risks. The IRS presents a labyrinth of rules, some open to interpretation,

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that define the legal difference between an IC and a full-time employee. Add to that the tax and workers' compensation laws of individual states, and knowing who to pay what can seem overwhelming for employers. Even architectural firms that believe they are diligently following the guidelines can find themselves defending against employee-misclassification claims. "At my previous firm, a disgruntled [contractor] reported to the Department of Labor and the IRS that he felt he was an employee," says one architect. The IRS agreed with the freelancer and "we paid huge fines." Companies found guilty of misclassifying full-time employees not only face paying back taxes and interest but are liable for penalties as high as 35 percent.

Still, there are those firms that find the temptation to hide behind the legal complexities too difficult to resist. "Most firms have an aware-

ness of the IRS rules," says an industry veteran familiar with the hiring practices of some East Coast architects. "But many firms acknowledge tacitly that some people working in the office are not meeting the letter of the law." Managers in these companies may believe that the benefits of bending the rules outweigh the risks.

### ICs save budgets

Given the risks, why bother with ICs? Because, when used properly, they can keep companies humming at less cost than a staff composed solely of full-timers. Along with the negotiated salary and benefits, such as vacation pay, health insurance, and other perks, architectural firms pay a number of expenses that full-time workers may not be even be aware of, including income, Social Security, and Medicare taxes. These ancillary employment expenses can add an additional 30 percent to a straight salary. Hire an IC, and a company pays only the agreed-upon rate for the professional services. The rest is the contractor's responsibility. Once the project is completed, the firm may choose to contract for additional services or not, without the emotion or expense of a formal firing.

For this reason, ICs have for years been a popular resource across all professions. The Bureau of Labor Statistics reports that there were 8.6 million people, or 6.4 percent of the total workforce, employed as ICs at the beginning of 2001, the

last year for which there is data. This was roughly the same number as during the height of the last economic up cycle. Matthew Bidwell, a spokesman for the Institute for Work and Employment Research at MIT's Sloan School of Management, Cambridge, Massachusetts, notes that ICs represented a slightly lower percentage of the workforce in 2001 than in 1995, but says that in today's volatile economy, ICs may become more attractive to employers. Firms "would just as soon not make a permanent commitment" today, adds Ralph Steinglass, FAIA, principal of Teambuilders, a New York City organizational-development firm that focuses on architectural and engineering companies. "This works particularly well for smaller firms that are not sure about their work backlog."

### The IRS crackdown

Some observers have another explanation besides the economy for why the use of ICs declined in the last decade: fear of the IRS. "The IRS was cracking down on companies that used independent contractors throughout the 1990s," says Lawrence Lorber, partner and labor employment lawyer in the Washington, D.C., office of Proskauer Rose. "Because with independent contractors there is no withholding of taxes, and that has serious tax implications for the IRS." McFadden, of Consulting for Architects, has an even more blunt view: "The IRS gave state, city, and federal agencies marching orders to go out and claim a lot of money."

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The crackdown culminated when software giant Microsoft battled the government and a group of former ICs over its hiring practices. Microsoft relied on a cadre of freelance programmers and marketing professionals who received wages for their work but were left out of the company's benefits pool.

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Freelancers paid their own quarterly income taxes, and Microsoft paid no Social Security taxes for these workers. Freelancers even signed contracts that spelled out their independent status.

But in practice, these "freelancers" looked and acted like full-time Microsoft employees, with assigned offices and equipment on the Microsoft campus, and schedules that had them working side by side with the regulars. In 1989 the IRS went after Microsoft, which eventually paid taxes to the government and back pay for overtime work to some of the "misclassified" employees. The company then made some of these workers permanent employees. Others could continue only if they joined an employment agency that placed temps and would pay the required taxes.

Later, part of the original band of freelancers sued the company for retroactive benefits, including participation in its retirement and stock plans. Microsoft was eventually forced to compensate the workers. If the government's goal in going after Microsoft was to strike fear in the HR departments of smaller companies who considered bending the rules, it worked. Lorber says the Vizcaino ruling hovers over companies across all industries that hire ICs.

The Miller Hull Partnership, Seattle, is one design firm that finds freelancers useful to supplement its

permanent staff of 46 people. "We now have one guy who's helping build a model who has been here a couple of months," says Stacy Rowland, accounts manager. "We also have a former employee who left to start a firm, and we hired that firm as a consultant." She says the use of ICs is constantly in flux

at Miller Hull. "We can go for a year without having one, then if a big project on a fast schedule comes in, we may hire several."

But in good times or bad, Rowland's company doesn't hire ICs cavalierly. The laws surrounding independent contractors "can be pretty tight," she says. "The best arrangement is to contract with a guy who owns his own firm and works from that address. He submits invoices and gets a 1099 [a year-end tax statement for independents], doesn't fill out a time sheet, and works fewer than 30 hours a week."

That's an attractive profile because it addresses the key criteria the IRS uses to differentiate ICs from full-timers. Two basic types of nonpermanent employees pertain to the architecture industry. First, there are *independent contractors*, professionals who provide a service based on information the client presents as to what work will be performed. The service provider determines how the work gets done (the method) and provides the means (the tools and resources) for completing the task. These workers are responsible for paying their own quarterly estimated income taxes and typically receive 1099-MISC income summaries, rather than W-2 wage forms, at the end of the year, to file with their annual tax returns. *Common-law employees* are workers who may or may not be labeled

as full-time employees, but the methods and means for performing their services are governed by the client. This includes directives on when and where to do the work, the tools and equipment the worker will use, who will provide supplies and ancillary services, and in what sequence work leading up to the final product must flow. The government also considers whether the workers perform their service on site and in concert with regular employees, as in the Microsoft case. Employers of these types of workers are responsible for withholding and paying income, Social Security, and Medicare taxes.

McFadden believes employers sometimes get into tax trouble because some of these rules are open-ended. "The standards may be interpreted in different ways at the state, city, and federal level," he says.

To clarify employment relationships, Rowland routinely requires ICs to sign a contract that spells out their independent status, including the fact that her company won't withhold or pay income taxes. Some companies require ICs to provide a trove of additional paperwork. This documentation includes business cards, invoice forms, copies of professional licenses, and 1099-MISC forms from previous years, all of which can bolster an employer's case if it is charged with misclassifying employees. However, no amount of contracts and paperwork is enough in itself to protect a company if its freelancers don't meet the methods and means criteria. "With independent contractors, the rule of thumb is whether how they produce [the final work] is up to them, as long as the result is consistent with the employer's standards," he says. "If part of the deal is that they have to work between 9 and 5 and the employer is providing the computers to do the work, then I'd say the independent status may simply be a sham."

He adds that employers can lawfully create a category of temporary full-time employees who are hired for a particular length of

time but for whom the employer withholds taxes. The advantage: Since there's no expectation of long-term employment, these workers may be painlessly let go if business declines, but their tax status remains clear while they're on the job. "We have had a policy for years here where even temps working freelance are put through the payroll system," says Carl J. Nolan, comptroller for Fox & Fowle Architects, New York City. "They may not have insurance and benefits, but we pay payroll taxes."

Lorber says another increasingly popular option is to hire professionals through a temp agency rather than entering into direct agreements with the employee. The employer chooses services from the agency's stable of providers, who in turn are direct employees of the agency. In return for a service fee the employer pays the agency, the latter takes responsibility for withholding and paying federal and local taxes and may offer additional employment benefits, such as health insurance.

As work slacks off in some markets, firms are becoming more cost-conscious. Project managers who are fortunate enough to need help in a hurry need to involve HR, accounting, and legal advisers when making hires so that ICs are evaluated for more than just their design talents. Karen M. Johnston, AIA, principal of J.M. Califf AIA & Partners, a 4-person design firm in Irvine, California, gives this sage advice: "We don't contract with consultants unless they actually have their own businesses, can provide proof of a current city business license, provide contract services for other clients, and they do not physically work in our office. Anything less is too risky." ■