



FLEXIBLE WORKFORCE: The Risks and Rewards of Co-Employment

Co-employment, Defined

Co-employment – a situation in which a worker has an employee-employer relationship with two different companies – can be a rewarding and beneficial arrangement for the employee as well as the company for whom the employee is productive. An employee hired by a staffing company to work on assignment for the client organization is a prime example of a co-employment arrangement. Employees in these arrangements are contingent (or temporary) workers.

More companies are seeking flexibility and cost savings through the use of contingent labor, while more workers choose the flexibility of temporary work in order to meet the complex requirements of the work-life balance. Yet with all the advantages offered by a co-employment arrangement, it can also increase a company's risk for legal and tax issues, as illustrated by the *Vizcaino v. Microsoft*

case¹, in which the courts found that independent contractors and temporary workers on assignment at Microsoft were entitled to benefits.

Here, we explore the advantages and risks of co-employment, put to rest the myths circulating around what truly helps companies mitigate co-employment risks, and detail the elements of a solid co-employment policy.

Advantages of a Flexible Workforce

The flexible workforce consists of the growing number of workers who are choosing employment on a contingent basis. They may be individuals seeking self-employment, retirees looking to earn additional income, or individuals with specialized skills. A flexible worker may be classified as a true 1099 worker (sole proprietor); an independent worker that set up a company of

¹ *Vizcaino v. Microsoft Corp.*, 173 F.3d 713 (9th Cir. 1999) (Microsoft III).

one (LLC or S-corporation); a contractor that works as an employee of an agency (even if the worker finds his or her own engagement); and associates of a Portable Employer of Record (PER). Flexible workers enjoy greater control over their schedules, the freedom to select more challenging or interesting projects, and in some cases, better compensation. As the workforce recognizes the benefits of untraditional work arrangements, it is likely that more individuals will turn to independent contractor status.

Companies are also embracing the flexible workforce because of the increased dependence on knowledge workers, the aging labor force, more single parents in the work environment and their need for flexibility, and workers looking for challenge and increased skills through job differentiation. Companies also recognize that with the ebb and flow of production come the varied needs for headcount. Relying on a flexible workforce to meet these changes in demand allows companies to save money on state and federal employment taxes, unemployment benefits, and workers' compensation. Their payroll departments aren't unduly burdened by calculating and distributing wages for an ever-changing population of employees, and their Human Resources departments aren't further encumbered with on-boarding and off-boarding employees, background and I-9 verifications and unemployment hearings.

Co-employment Risk

With the rewards of a co-employment arrangement come the possibility of risks with legal and tax consequences. If a company fails to adequately define its flexible workforce as such, and confusion exists over whether a flexible employee is truly independent, working directly for the staffing firm placing her on assignment, or a common-law employee of the company, the risk increases. All indications are that the flexible workforce will expand, and with more flexible workers comes an even greater risk. Consider:

- Contingent worker use is expected to grow significantly.^{2, 3}

² “73% of buyers project growing their contingent workforce over the next two years; a third project growth of 50%+.” Source: SIA - Staffing buyer survey: contingent workforce growth, usage rates and reasons for using contingent labor (10/13/2008).

³ “CW [contingent worker] usage trending up. Among surveyed CW buyers, average CW usage was up from 12% of the workforce

- In an enhanced effort to enforce its policies, the IRS is implementing harsher taxation penalties for companies that incorrectly classify a worker as contingent. In a worst-case scenario, this could cost a company 40 percent of a worker's pay. If the company is found to have misclassified an employee, the penalty could involve paying income taxes that were not withheld, FICA, FUTA, interest, and penalties.⁴

Mitigation myths: Common techniques that may not help

It is commonly believed that simply treating 1099 workers differently than traditional employees would mitigate a company's risk and insulate them from IRS fines and lawsuits. While it is a good policy to implement some of these practices, they won't provide complete protection, as evidenced by the *Vizcaino v. Microsoft* case and subsequent cases:

- **Implementing a corporate tenure policy and forced breaks between contracts** (tenure limits and forced breaks have not held up in any cases for co-employment). The Employee Retirement Income Security Act (ERISA), the principle law regulating employee benefits, is what often fosters the misconception that a 1,000 hour or one-year tenure will help mitigate co-employment risk. In reality, the rule does not apply to non-employees or those excluded from the benefits plan.
- **Separate badges** for employees versus contractors
- **Limited building access** for contractors
- **Different e-mail addresses** for contingent labor than employees, including a disclaimer indicating that this e-mail is not from a company employee

in 2007 to 13.1% in 2008, with usage projected to go to 14.3% by 2010. What's driving the increase is not higher median use (which is relatively static) but a steady rise in the proportion of heavy buyers; for nearly one in five buyers, CW usage is now 21% or more.” Source: SIA - 2008 Staffing Buyers Survey: Insights into Staffing Clients' Actions, Plans and Key Decision Drivers.

⁴ Source: *Assessing and Managing Risk in Contract Workforce Management* paper written by HCI (Jan. 2007).

- **Excluding contractors from corporate parties**, meetings or other work functions that do not directly relate to the worker's assignment
- **Not issuing company business cards** to contractors
- **Not performing personal assessments** or reviews on contract or contingent workers
- **Not giving awards** or bonuses to contingent workers

Mitigating the Risk: Elements of a solid co-employment policy

If excluding flexible workers from the holiday party and giving them separate badges isn't enough to reduce co-employment risk, what do companies need to do to ensure the co-employment arrangement is more heavily weighted away from risk and toward rewards? Employers need to arm themselves with appropriate internal and external resources to ensure a successful and dynamic workforce with minimal risk. Recommendations:

- **Use a third-party resource.** Require all contingent labor to be funneled through a department or program with expertise in outside labor use, ensuring that your staff follows all corporate policies and legal rules you deem appropriate for your program.
- **Use the three-question IRS test.** The IRS formerly referred to a set of 20 questions to help a company determine employment status, but has reduced it to three key questions. If you can answer 'yes' to any of them, you should consider making changes to your program:
 1. Do you have the right to control the worker's behavior?
 2. Do you have financial control over the business activities of the worker (method and frequency of compensation)?
 3. Is there a typical employer-employee relationship?
- **Implement a program for Section 530 reviews.** Section 530 of the Revenue Act of 1978 allows companies to qualify for tax relief

in a co-employment case if they meet specific criteria. It was upheld when Peno Trucking had misclassified their truck drivers as independent contractors. Despite the misclassification, the court upheld their right to 530 tax relief based on their reliance on a reasonable understanding of the law in terms of defining independent contractors. Peno Trucking was ruled not to be liable for employment taxes even though their workers were misclassified.⁵ Section 530 of the Revenue Act of 1978 provides relief from employment taxes (this does not apply to non-IRS issues from state agency audits or class actions) if:

- The individual is not treated as an employee
- Federal tax returns reflect treatment of the worker as a non-employee
- A reasonable basis for not treating the individual as an employee is present
- No worker in a substantially similar position is treated as an employee

- **Audit Independent Contractor (IC) status.** Ensure that all ICs are incorporated or are provided through a third party. Periodically audit your ICs' status and audit IC payroll tax payments by asking for Form 4669.
- **Establish IC billing as fixed fee or milestone-based rather than hourly.** This serves to further insulate companies from the financial piece of IRS scrutiny.
- **Develop and require legal language in all contracts with ICs to establish them as "non-employees."** Typically called the "Microsoft Inoculation" language, it explicitly states ICs' eligibility or ineligibility for any corporate benefits.
- **Ensure that the company benefits plan clearly excludes contingent workers.** Require that contingent workers sign a document acknowledging that they are not eligible for company benefits. Case after case has shown this to be a major step in mitigating risk – tenure limits alone aren't as powerful.

⁵ *Peno Trucking, Inc. v. Commissioner* (6th Cir. Oct. 3, 2008).

- **Let your staffing firm take employment responsibility.** Make sure staffing firms are responsible for screening, testing, training, discussing monetary increases, discipline issues, and the actual hiring and firing of contract workers.
- **The sure-fire test: establish if a 1099 worker is truly in business for him or herself.** Ask anyone working on a 1099 basis:
 - Do you have recurring capital expenses, e.g. office space, business phone line, office assistant?
 - Do you have multiple customers? If you are their only business income, that worker looks less independent. Someone who is in business for himself will have control over his work, direct his own work, provide the means and skill to complete the work he is contracted for, and will have an incentive to operate a profitable business.

One of the strongest decisions a company can make to mitigate co-employment risk is to implement a Managed Service Provider (MSP) program. MSP programs centrally manage contingent labor use across the company's entire enterprise with well-defined policies and procedures. The result saves companies millions of dollars through a well-executed contingent labor strategy that gains worker efficiency, improves the employment cost-to-productivity ratio and significantly reduces co-employment risks to insulate companies from exposure to lawsuits and tax penalties. Regular program assessments and reviews are an integral part of MSP programs to ensure compliance with changing government regulations, changes in workforce size, skill level, and new variations in how the flexible workforce defines technologies and logistics.

If your company's policy addresses little more than enforced tenure or limits on participation in company events, it's time to strengthen your contingent labor program to incorporate what the courts are now offering as protection against risks associated with co-employment.

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