Worker Classification: What’s the Real Cost?

When you need help to run your business, you have to decide whether to hire an employee or outsource the work to an independent contractor. For the most part, independent contractors are on their own when it comes to taxes, insurance, and retirement savings. In contrast, the costs of these employees are largely your responsibility. You’re free to opt for the arrangement that works better for your business. But you can’t simply attach a label to a worker and make it stick; it all depends on the degree of control that you exercise. Here’s what’s at stake for your decisions and actions.

1. Employment taxes

As a rule of thumb, it costs about 10% of a worker’s pay to cover employment taxes, which include the employer’s share of FICA (Social Security and Medicare taxes) and federal and state unemployment taxes. What’s more, in most cases you have to carry workers’ compensation insurance. So it costs more to have an employee than an independent contractor.

The IRS uses various factors to determine worker classification. These factors are grouped into behavioral control (whether you have the right to tell the worker when, where, and how the work gets done), financial (whether you or the worker controls such matters as when payment is made, if there is reimbursement for expenses, and who pays for the tools of the job), and the type of relationship created by you and the worker (what both envision, whether there is a written agreement, and the permanency of the arrangement).

If the IRS challenges your treating a worker as an independent contractor and you lose (you should have classified the worker as an employee), you face back taxes and serious penalties. However, you can voluntarily reclassify workers as employees using the Voluntary Classification Settlement Program (VCSP).

The VCSP is a program that provides an opportunity for taxpayers to reclassify their workers as employees for employment tax purposes for future tax periods with partial relief from federal employment taxes. To participate in this voluntary program, the taxpayer must meet certain eligibility requirements and apply to participate in the VCSP by filing Form 8952, Application for Voluntary Classification Settlement Program, and enter into a closing agreement with the IRS.

If eligible for the program, the cost is only 10% of the tax for the most recent year, with no interest or penalty. Or you may be able to rely on a safe harbor (called Section 530 relief).

2. Employee benefits

If you have employee benefit programs, such as a qualified retirement plan, you must include employees. Independent contractors are on their own for retirement savings. The cost of employee benefit programs can add another 10% or more of compensation to your payroll costs.

At present, you don’t have to offer health coverage to employees, but that may change. Whether you will be subject to the employer mandate depends on the number of your full-time and full-time-equivalent employees. Starting in 2016, if you have 50 to 99 such employees, you must provide health coverage to your full-time staff or pay a penalty (companies with 100 or more employees face the employer mandate in 2015). The IRS explains how to figure full-time employees, which essentially means working 30 hours per week.

How does an employer identify its full-time employees for purposes of the Employer Shared Responsibility provisions?

An employer’s number of full-time employees matters both for purposes of whether the Employer Shared Responsibility provisions apply to an employer and whether an Employer Shared Responsibility payment is owed by an employer (and the amount of that payment).

CONTINUED ON NEXT PAGE
**Frontline continued from page 10**

An employer identifies its full-time employees based on each employee’s hours of service. For purposes of the Employer Shared Responsibility provisions, an employee is a full-time employee for a calendar month if he or she averages at least 30 hours of service per week. Under the final regulations, for purposes of determining full-time employee status, 130 hours of service in a calendar month is treated as the monthly equivalent of at least 30 hours of service per week.

The final regulations provide two measurement methods for determining whether an employee has sufficient hours of service to be a full-time employee. One method is the monthly measurement method under which an employer determines each employee’s status as a full-time employee by counting the employee’s hours of service for each month. The other method is the look-back measurement method under which an employer may determine the status of an employee as a full-time employee during a future period (referred to as the stability period), based upon the hours of service of the employee in a prior period (referred to as the measurement period). The look-back measurement method for identifying full-time employees is available only for purposes of determining and computing liability for an Employer Shared Responsibility payment, and not for purposes of determining if the employer is an applicable large employer. The final regulations describe approaches that can be used for various circumstances, such as for employees who work variable hour schedules, seasonal employees, and employees of educational organizations. These methods prescribe minimum standards for the identification of full-time employee status. Employers always may make additional employees eligible for coverage, or otherwise offer coverage more expansively than required.

### 3. Government mandates

Employees are protected by a number of federal workplace laws (some only apply if the company has a certain number of employees as indicated in parentheses), including:

- Age Discrimination in Employment Act bars workplace discrimination of those age 40 and older (20 or more employees)
- Americans with Disabilities Act barring discrimination on the basis of a physical, mental, or emotional disability and requiring reasonable accommodations for the disability on the job (15 or more employees)
- Civil Rights Acts bars discrimination in the workplace on the basis of a variety of factors (e.g., race, gender) (15 or more employees).
- Equal Pay Act mandates equal pay for men and women performing substantially the same work (2 or more employees)
- Fair Labor Standards Act for minimum wage and overtime rules (2 or more employees)
- Family and Medical Leave Act for unpaid time off (50 or more employees)

Companies that violate these laws can be subject to government penalties and lawsuits by workers. Employment laws do not apply to independent contractors.

### Conclusion

In figuring the real cost of employment, add 15% and 50% of compensation to your budget for taxes, insurance, and benefits for employees (e.g., a $40,000 employee costs you at least $46,000 and, depending upon the benefits package, as much as $60,000). Think about the cost before you add workers to your payroll. And make sure that if you decide to outsource, you do it right. Work with TPM so that the arrangements you make conform to law requirements.