

Independent Contractors and the PEO

Brian M. Nugent, Esq.

A cornerstone of the PEO relationship is that both the PEO and its clients co-employ worksite employees. The PEO client service agreement (CSA) allocates employer responsibilities between the PEO and its client. Not all prospects, however, fit the traditional employer-employee model. What happens when a prospect or a client has independent contractors on which it regularly depends and asks the PEO to include such contractors in the PEO agreement? What if one of your sales associates has an opportunity, but the prospect is a sole proprietor? This article will discuss the issues for a PEO raised by independent contractors and other “non-employee” arrangements.

Independent contractors and sole proprietors are considered under the federal tax laws to be “self-employed.” A self-employed person is generally not subject to certain rules applicable only to employees, the most significant of which relates to the withholding of payroll taxes. The law does not require a purchaser of services from a self-employed individual to withhold payroll taxes.¹ Self-employed persons can also deduct business expenses without having first to meet minimum thresholds.² Oftentimes, the self-employed person will not want to give up this benefit. On the other hand, being self-employed has limitations. For example,

it is much more difficult to secure health insurance because the majority of affordable health insurance benefits are provided through group plans available only to employees of the group.³ Self-insured persons are also not eligible to participate in Section 125 and flexible spending plans.⁴

Independent contractors and sole proprietors can present numerous issues for a PEO. First and most basic,

by definition, neither are employees. The terms “employee” and “self-employed” are for the most part mutually exclusive.⁵

An employer is not required to withhold payroll or income taxes from an independent contractor. Wage and hour laws do not apply to independent contractors. Employer workers’ compensation insurance policies generally exclude independent contractors.⁶

1 Self-employed persons are required to pay SECA taxes quarterly and must pay the employer and employee portions.

2 These thresholds are contained in the federal tax code and are imposed on individual taxpayers.

3 Oftentimes the reason a self-employed person will want to employ a PEO is to access benefits. Generally, however, a group health insurance policy issued to a PEO will not cover independent contractors. Some carriers, however, will include some independent contractors if there is a close enough affiliation or “affinity” with the employer plan sponsor. As a general rule, whether a policy includes other than just employees (such as directors) is up to the insurance carrier.

4 There are circumstances, however, when a self-employed person can deduct health premiums on a pre-tax basis, but such a discussion is beyond the scope of this article.

5 The federal tax code contains certain exceptions where self-employed persons such as certain insurance sales persons (referred to as statutory employees) can avail themselves of certain employee benefits, but again such a discussion is beyond the scope of this article.

6 There are some exceptions to this rule, primarily in the construction industry. Policies issued to general contractors can cover subcontractors and by statute, some states mandate that all workers on a job site be covered under a general contractor’s policy.

in a nutshell

- Independent contractors and sole proprietors can present numerous issues for a PEO. First and most basic, by definition, neither are employees. The terms “employee” and “self-employed” are for the most part mutually exclusive.
- Contrary to what many small employers believe, two parties may not by agreement “deem” someone to be an independent contractor. Whether an individual is an independent contractor or an employee is determined by applying a series of factors required by the IRS.
- The PEO must also be vigilant about self-employed persons who provide services to the PEO’s clients. Although state law requires employers to provide workers’ compensation coverage, contractors have been known to work without the required insurance or allow coverage to lapse.

Because different rules apply, it is extremely important to know whether an individual characterized by a client as an independent contractor is indeed one or whether the person is actually an employee. A PEO cannot “mix and match” benefits and obligations to a self-employed individual merely because the prospect requests to be treated in a particular manner. Federal and state laws control how the PEO treats such a person.

Contrary to what many small employers (and perhaps PEOs) believe, two parties may not by agreement “deem” someone to be an independent contractor. Whether an individual is an independent contractor or an employee, and thereby subject to payroll taxes, is determined by applying a series of factors required by the IRS. These factors have traditionally been referred to as the 20-Factor Common Law Test, but after pressure from employer groups and labor, the IRS has “re-organized” the factors into three categories.⁷ Although “packaged” now into three categories, the same basic principles used by the IRS for years in its 20-Factor Test remain essentially the same in this new format. Thus, no PEO should accept an arrangement deemed by a client to be an independent contractor, particularly if the contractor provides regular services to the client.

Early in the life of the PEO contract, the PEO should conduct an audit of the client’s workforce. Such an audit should review the status of all employees and others providing services to the client. In addition to verifying whether employees are exempt or non-exempt under wage and hour laws, the PEO should apply the IRS test to any arrangements described by the client as that of independent contractors. It

would not be unusual to discover that an arrangement described as “independent contractor” was actually an employment relationship.⁸

The most important factor applied is “direction and control.” If the indi-

An employer is not required to withhold payroll or income taxes from an independent contractor. Wage and hour laws do not apply to independent contractors.

vidual is subject to direction and control from the party paying for the services, it is likely the relationship will be deemed employment. Also important is whether the individual works freely for other companies and sets her own schedule. If the individual provides services only to one company, she is likely an employee.

Therefore, if an individual qualifies under the IRS test as an independent contractor, the PEO should not include amounts paid to the contractor as payroll and is also under no obligation to withhold or remit taxes on such amounts.⁹ Certainly, the PEO can

choose—if it is set up to do so—to process payroll for the independent contractor under the contractor’s FEIN. However, such an arrangement would have to be administered on an ASO¹⁰ basis, and the person must be

excluded from certain benefits and insurance coverages.¹¹

Another significant risk presented to a PEO by a self-employed person relates to workers’ compensation insurance. Unless added specifically by addendum with the consent of the carrier, or otherwise clearly included within the policy, a self-employed person will not be covered under a workers’ compensation policy issued to the PEO.¹² The danger to a PEO is that if the self-employed person allows her workers’ compensation coverage to lapse and thereafter is injured while providing services to the PEO, state

7 A person need not qualify under all the factors. The IRS applies a “totality of circumstances” analysis in applying the factors. The three categories are: Behavioral Control; Financial Control; and Type of Relationship. In essence, the 20 factors are now divided into these three categories and organized in a more reliable way. For more information, please go to www.irs.gov/businesses/small/article/0,,id=99921,00.html.

8 Once the PEO agreement becomes effective, the PEO is responsible for withholding taxes and remitting payroll taxes. If a client has a person or persons misclassified as an independent contractor, the PEO is at risk for payroll taxes not deducted and paid during the term of the PEO agreement.

9 There are other requirements such as the issuing of W-9 forms to persons providing contracted services with which the PEO

must comply.

10 “ASO” stands for administrative services organization. The provider delivers essentially the same services as in a PEO contract but does not become an employer to do so. In essence, the service provider administers the payroll and insurance of its clients on the client’s behalf and provides HR and other services on a consulting basis.

Providing services in this manner is certainly less efficient and more difficult, but if the PEO has the right systems to facilitate the administration of services on behalf of the client, it can provide an acceptable profit.

11 See discussion below for more details.

12 Man from coverage employees at companies with fewer than a stated number of employees. The PEO must be familiar with such laws and be able to make a judgment whether it is willing to provide services to such providers nonetheless.

law could require the PEO's policy to respond to such an injury.¹³

The PEO must also be vigilant about self-employed persons who provide services to the PEO's clients. Although state law requires employers to provide workers' compensation coverage,¹⁴ contractors have been known

provided. Client agrees to require such certificates PRIOR TO the contractor beginning to provide services on a client work location. Failure to do so is a material breach of this Agreement. Client further agrees to notify the Company in writing of any independent con-

independent contractor or other self-insured person on the PEO's policy.

In conclusion, despite what may appear to be an opportunity for PEO revenue, if the prospect is an independent contractor or a sole proprietor, such a prospect may very well create more problems and potential risk than the net fees justify, particularly in light of having to administer such a prospect on an ASO basis. Benefits and workers' compensation insurance can be tricky at best and very costly at worst. Moreover, the PEO must be vigilant of clients employing independent contractors on their respective job sites. The only way to manage such a risk is to audit a client's payroll early in the relationship, repeat it at least semi-annually, visit worksites periodically, educate clients about the risks, and provide protections in the client service agreement.

Because it is difficult for a PEO to have sufficient control over its clients' worksites from day to day, the PEO CSA should address independent contractors and workers' compensation insurance.

to work without the required insurance or allow coverage to lapse. Thus, even though an independent contractor may be excluded from the PEO workers' compensation policy because she is not employed by the insured (the PEO), state law could, and has, compelled a carrier to provide coverage to an employee of an uninsured contractor injured on an employer work location.¹⁵ Therefore, it is imperative that a PEO require proof of workers' compensation insurance from all independent contractors providing services to a PEO client before any such contractor begins work.

Because it is difficult for a PEO to have sufficient control over its clients' worksites from day to day, the PEO CSA should address independent contractors and workers' compensation insurance. Below is suggested language:

Client agrees to secure from all independent contractors valid and current Certificates of Insurance that establish that the independent contractor has secured workers' compensation insurance pursuant to state law and that the insurance is for a term to include the anticipated length of time services will be

tractor that Client expects will provide services for a period of _____ () consecutive days for Client (including current independent contractors). In no event will any independent contractor, or its employees, or self-employed person be covered by the Company workers' compensation policy.

The client service agreement should make clear as well that any violation of independent contractor/workers' compensation insurance provisions is covered by the contractual indemnity clause¹⁶ to the PEO from the client. The indemnity should include any losses or expenses incurred in response to a claim filed by an employee of an

Brian M. Nugent, Esq., is principal of The Nugent Law Firm, P.C., Fort Collins, Colorado.

This article is designed to give general and timely information on the subject covered. It is not intended as legal advice or assistance with individual problems. Readers should consult competent counsel of their own choosing about how the matters relate to their own affairs.

13 The PEO and its carrier would contest any such conclusion. However, state law clearly favors coverage for injured workers and could compel coverage nonetheless because the injury occurred on a work location of the PEO or its client. If the injury is severe enough, you can bet that the worker and her attorney will argue for coverage.

14 The exception is Texas, where not only may an employer opt out of the workers' compensation system and take its chances in court, so too may an individual employee.

15 State law is generally interpreted to provide insurance coverage to an injured worker. If

the independent contractor providing services on a client's location is injured and it turns out that there was not in fact coverage, state regulators have been known to force the employer's carrier to provide coverage. Again, state laws usually favor coverage for injured workers. State case law has also held that a policy covers all workers at an insured's worksite.

16 The author assumes that every PEO client service agreement contains an indemnity from the client for its negligence and breach of contract.