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The IRS Targets Independent Contractors

Small companies are likely to see the greatest scrutiny as government agencies crack down on permalancers

By [Anne Field](#)

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For decades the IRS has played a game of find-the-freelancer at businesses where independent contractors remain on the payroll for months or even years. Companies, especially small ones, increasingly rely on such workers because they offer greater flexibility—and because they're cheaper. Employers can save as much as 30% on wages by avoiding payroll taxes, unemployment insurance, worker's compensation coverage, and benefits they provide regular employees.

Now both the IRS and state agencies across the country are redoubling efforts to uncover long-term "temps." In February the IRS launched a three-year program that will examine 6,000 companies to find permanent workers misclassified as freelancers in violation of the Tax Code. President Obama's proposed 2011 budget includes funding for 100 additional federal staffers to pursue such cases, and it would repeal a 32-year-old rule allowing companies in industries ranging from construction to health care to legally classify long-term employees as independent contractors. What's more, a 2008 initiative linking the computer systems of various agencies makes it easier for the IRS and states to share data on how companies classify employees.

Most of the IRS action on independent-contractor violations will target small businesses and the self-employed, the General Accountability Office reports. Over the past decade the average size of small businesses has fallen, an indication that they're using more freelancers. In tough economic times, keeping independent contractors on the payroll makes sense because they're easier to shed if the business starts to falter. Furthermore, without the legions of lawyers and tax consultants available to big corporations, small companies are less likely to understand—and therefore to follow—the complex rules covering freelancers.

The moves come amid what some researchers say is closer overall scrutiny of small and midsize businesses by the IRS. Over the past five years the agency has increased by 30% the hours spent auditing companies with less than \$10 million in assets while decreasing by a third the time spent on large-company audits, according to the Transactional Records Access Clearinghouse, a research center at Syracuse University. While the IRS disputes that study's methodology and says it isn't targeting small business, some tax experts say such a strategy would make sense. The IRS believes smaller businesses are more likely to evade taxes, says Dean A. Zerbe, a managing director of alliantgroup, a Houston tax consultancy. "It's also easier and quicker to audit smaller businesses."

When small companies are scrutinized by the IRS or other agencies, they have a hard time mounting a challenge to any penalties they might face. Last June, Paula Routly, co-owner of Seven Days, an alternative weekly in Burlington, Vt., got a \$317 bill from the Vermont Labor Dept. The agency said she hadn't paid unemployment insurance for one of

the paper's 14 freelance delivery drivers. Though Routly insists she didn't break any rules and is appealing the assessment, her attorney told her "it might be cheaper to give in than to pay the legal fees it would cost to fight," she says.

The current push could lead federal agencies to standardize the employee classification system so it's clearer just where to draw the line between temps and full-time employees. "No one has ever been able to come up with a universal test," says GJ Stillson MacDonnell, an attorney at employment law firm Littler Mendelson in San Francisco. "So we end up being whipsawed between different state and federal definitions."

Representative Jim McDermott (D-Wash.) has introduced a bill that would help clarify the definition of a contractor and increase penalties for companies that misclassify employees. "Far too many workers aren't receiving the benefits and protections they deserve," McDermott says. "This will level the field for companies playing by the rules."

The bottom line: *The government is stepping up scrutiny of companies using contractors and is working to clarify the definition of a freelancer.*

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