

THE DANGERS OF MISCLASSIFYING LANDMEN: IS THE GOVERNMENT'S NEW SETTLEMENT PROGRAM TOO GOOD TO PASS UP?

By Michael Kelsheimer, Looper Reed & McGraw



The days of the lone landman driving around the back roads taking leases and visiting courthouses have become a thing of the past. Though there are still a few independent landmen that fit this mold, clients have demanded change and consolidation. Now there are brokerage firms and even more consolidation. It is not a bad thing. It is just different. But the problem arises when landmen are still being treated and paid as independent contractors when they actually are employees (at least in the government's eyes).

> WHY SHOULD YOU CARE?



Because the government cares (and as I will discuss later, there is a settlement program available right now that could save you tens of thousands of dollars).

It might come as a shock, but independent contractors often do not report all of their income on their tax returns. This deprives the government of not only income tax revenue, but FICA and FUTA taxes as well. Unable to raise taxes or reduce the national debt, the IRS and Department of Labor (DOL) are looking to squeeze tax dollars from anyplace they can find money. The "misclassification" of independent contractors is one place they are truly focused.

Three hundred new investigators have been hired. Fines in this area are up 500%. The IRS has started using sophisticated new software programs that monitor businesses that fit a profile for misclassification. Among other things, the software analyzes businesses that have large numbers of 1099 type payments to individuals over threshold amounts and 1099 payments to the same individuals year after year. And, to make matters worse, government agencies have started cooperating and sharing data on potential violators making them easier to catch.

> HOW BAD COULD IT BE?

I've got your attention, but you're still not convinced, right? In

an IRS audit, you may be assessed the employer half of back payroll taxes, penalties, interest; the "contractor's" half of back payroll taxes; and the amount that "contractor" should have withheld for income tax purposes. In some cases, this number approaches 40% of the amount paid to each "contractor" over the last three years. If you are a brokerage firm with 10 landmen treated as contractors and you pay them \$75,000.00 per year, this could mean \$900,000.00 in back taxes.

Of course, it probably will not end with the IRS. Because the agencies are sharing information, the IRS may now hand you off to the DOL. The DOL will then come in and ask for the time sheets for those "contractors" who are now employees over the last two or three years. Because you treated them as contractors, you will not have any time sheets so DOL will interview the landmen and ask how many hours of overtime they worked in the last 3 years. With a free pass to answer and no time records to dispute them, the landmen can tell the DOL just about anything and it will then assess you for that overtime. Assuming those same 10 landmen say they worked 2 hours a week of overtime over the last three years, DOL might assess you with as much as \$182,799.60 in back overtime before penalties.

But it does not end there, Texas Workforce Commission (TWC) may then audit you for unemployment benefits for terminated "contractors" that should have been treated as employees. And, once bitten by the IRS and DOL





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themselves, your competitors may decide that the best way to stay competitive is to turn in all of the other companies using the same approach. For this, they will receive up to 15% of the government's recovery in addition to leveling the playing field. While there may be honor among oilmen in the patch, the opportunity to level the playing field and make some money may prove too tempting to pass up.

> WHAT IS THE TEST TO DETERMINE WHETHER SOMEONE SHOULD BE TREATED AS AN EMPLOYEE?

As is often the case when lawyers are involved, the answer is complicated. The IRS, DOL, and TWC each have their own test. Thankfully, however, the general ideas are similar. The following questions assess the fundamental issues of the tests and should give you an idea of whether this may be a problem for your business:

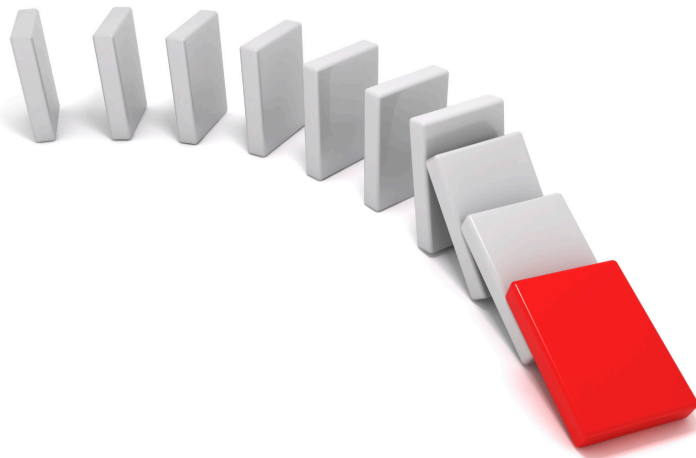
1. Do you provide training, either initially, or along the way for your landmen?
2. Do you have set hours you expect your landmen to be working?
3. Do you instruct the landmen on the sequence in which they should perform tasks or do you leave it to them to figure out completely how to bring you a finished product?
4. Do your landmen work in your offices?
5. Have you taken away per diem payments because they just don't make sense anymore?
6. Do you provide office supplies and/or computers to the landmen to perform their work?
7. Do you provide access to title information through a company system?
8. Do you pay landmen based on the hours worked or a set rate per day?
9. You do not charge back your landmen for bad work if your client rejects their work or requires it to be redone?
10. Do your landmen get paid for all their time on a project rather than having the responsibility to complete a project in a certain time for a certain price?
11. You do not have a written contract with your landmen setting out their relationship?
12. You do not require landmen to work for you through an entity that they create and own?
13. Do your landmen work for you over a long period of time, or for years?
14. Your landmen do not work for any other companies or handle landmen services for other clients?
15. Do you expect the landman you assigned the work to complete it himself rather than hand it off to an assistant he might hire?
16. Do you provide health insurance or other benefits to one or more of your landmen?

If you answered "yes" or "correct" to any of the questions above, you could be a candidate for investigation. There is not a minimum number of positive answers to be at risk, but the more affirmative answers you gave, the more risk you have of being audited and your landmen being reclassified as employees.

> WHAT SHOULD YOU DO?

For those of you who answered yes enough to become concerned, there are basically two options:

1. take steps to reduce or eliminate the "yes" answers above;
2. take advantage of the very favorable settlement program now offered by the government to reduce your liability by as much as 95% and re-characterize the contractors as employees moving forward.





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How you approach minimizing the factors above will be different for every business, but you should start with these thoughts:

1. Put the landmen on a written contract that maximizes support for independent contractor status.
2. Require landmen to form entities that then contract with your business.
3. Provide no training or hire someone outside to train the landmen before they come to work for you.
4. Switch landmen to a project based pay schedule which they invoice you for and move away from daily, weekly, or hourly rates.
5. Create risk of loss for the landmen in each project. If they don't do good work, reduce the amount they are paid.
6. Make the landmen responsible for their own place to work and their own supplies.
7. Work to reduce other factors above from "yes" to "no" in the context of your business style and systems.

It makes sense to work with your employment law counsel to help with this process to ensure the least possible risk moving forward. Though you may hate the thought of paying a lawyer, the money you save could be very significant.

> WHAT IS THE SETTLEMENT PROGRAM AND WHY IS IT SUCH A GOOD DEAL?

Even with its new investigators, the government cannot catch all the violators. With that in mind, the government has offered a settlement that is primarily aimed to bring violators into the fold



so that the government gets that tax revenue on a go-forward basis. To entice businesses to do so, a settlement program has been offered where employers can reduce their exposure for the past to a small fraction of what it might be if your business was audited. Taking the example above where the employer could be exposed to as much as \$900,000.00 in back taxes, their new liability could be less than \$10,000.00.

To qualify, an employer must: (1) agree to treat contractors as employees going forward; (2) have timely filed all 1099s for contractors in years past; (3) be in compliance with all past audits; and (4) not be under audit presently. We do not know how long this program will be offered. It could be withdrawn next month, so there is significant risk associated with waiting to enter the program. Check with a lawyer specializing in employment law for more information.



Michael Kelsheimer is a Shareholder in the employment law section at Looper Reed & McGraw where he is joined by a number of employment law attorneys with experience in all areas of employment and labor law. Michael recognizes that the cost and expense of litigation makes resolving employment disputes challenging. To help avoid these concerns, he utilizes his experience in and out of the courtroom to prevent or quickly resolve employment disputes through proactive employer planning and timely advice. When a dispute cannot be avoided, Michael relies upon his prior experience as a briefing attorney for the United States District Court and his extensive experience in employment and commercial lawsuits to secure favorable resolutions for his clients. For more information on Texas employment law, visit Michael's blog at www.TexasEmployerHandbook.com.

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