Independent flight crews draw more IRS scrutiny

by David A. Lombardo

Some flight departments employ independent contractors as a way to keep their costs in check. However, with the IRS taking a new interest in the "independent contractor classification," companies might want to take a closer look at this plan and its tax and liability implications.

"Hiring independent contractors as pilots and flight attendants is a big issue in our industry today," Margaret Vernet, president of Corporate Aviators of Newtown, Conn., told **AIN**. She added that while it is common practice in some flight departments to hire "independent contractors," according to the IRS, pilots and flight attendants don't qualify for that designation. "Thousands of flight departments are putting their companies at significant financial and legal risk by misclassifying them."

Vernet said IRS rules define an employee as anyone who performs services for a company if the company has the right to control what will be done and how it will be done. "The legal test is whether or not the flight department has the right to direct and control the activities or work of the person," she explained.

"That means they instruct crewmembers on when and where to do the work. What day the trip is, what time it's leaving, when to show up, what airplane to fly, where to go, when to return, the itinerary from the time of departure to the return, what hotel to stay at, what catering service and so on."

Handling the Logistics

Just because a pilot or flight attendant is classified as an independent contractor in a written agreement, it doesn't change the official IRS position. "If you have an employer-employee relationship it makes no difference what you call it, or whether the individual is employed full or part time; you are liable for Social Security and Medicare taxes, unemployment insurance and income tax withholding," she said.

Vernet launched Corporate Aviators' employer of record service to provide a way for flight departments to be tax-compliant in compensating temporary flight crews without adding head count. Under the arrangement, crews become employees of Corporate Aviators for employment tax purposes and Vernet handles all of the requirements for taxes, insurance and the related red tape that flight departments don't want to worry about. "We also take care of their unemployment, Social Security, workman's comp, health plans and aviation liability insurance, not commercial liability," she added.

Commercial liability covers slip- and-fall, theft, flood, fire and so on; it's a common, general-purpose but low-liability coverage. Aviation liability insurance covers aviation exposure, which goes well beyond the limits of commercial liability to include such things as medical emergency response (particularly flight attendants giving CPR, first aid and other types of aid) and host liquor liability because alcohol is often served on board.

Vernet said that when her company sends someone out it makes sure the individual has a valid medical, certification and training. Though the business started in 1987 as an aviation staffing company specializing in temporary aviation-specific assignments, it has transitioned to an employer of record service in the past few years.

According to IRS Publication 15, employees are defined either under common law or under statutes for certain situations. Employee status under common law explains that a worker who performs services is an employee if the employer has the right to control what will be done and how it will be done, regardless of whether the employee has freedom of action.

"This is a major issue for all companies, and it is extremely important for our industry," Vernet said. "The IRS is cracking down on offenders with severe penalties, and major corporations are paying many millions of dollars in settlements. We cannot afford to take this issue lightly–and it's not going away."

If a company is unlucky enough to get audited and its independent contractors reclassified as employees by either the IRS or Department of Labor, the company faces employment taxes on wages paid to misclassified workers, Social Security and Medicare contributions, unemployment taxes, fines, penalties and interest.

It also opens itself up to lawsuits for health and retirement plans, stock options and other benefits to which employees are entitled. All of these result in huge expenditures of time and money, mountains of paperwork, negative publicity and potential incarceration. The IRS can impose personal liability upon the "responsible party" at the employer if it has failed to withhold taxes properly and has not paid FICA and unemployment insurance.

According to Vernet, over a six-year period the IRS reclassified independent contractors as employees in 90 percent of the 11,380 cases it audited, translating to $751 million owed by the offending businesses in back taxes and penalties.

"It's not just small companies that fall into the trap," she said. "Major corporations run afoul of the IRS code all the time. Starbucks had to pay out $18 million in a settlement, while Microsoft is looking at almost $97 million to compensate for denied benefits and employment tax penalties."

In addition to having the authority to demand back taxes, the IRS can impose penalties that range from 12 percent to 35 percent of the total bill.

The consequences for misclassifying an independent contractor extend beyond tax ramifications. There's also the issue of liability. If temporary crewmembers a company hires as independent contractors become injured while on assignment anywhere, or on company aircraft or premises, the company's Worker's Compensation policy is not likely to cover them, according to Vernet.

"Typically, such policies protect your employees only and exclude coverage for independent contractors providing services," she said. "And rarely do freelance crewmembers carry their own Worker's Compensation, making you vulnerable to lawsuits, legal defense fees, medical-compensation expenses, and lost wages when crewmembers can't work. Are you willing to take those risks?"

"Passengers can sue if they are injured as a result of medical care administered during a flight or for a lack of it being administered," Vernet said. "Passengers can also sue if they are injured as a result of improper evacuation. If the flight attendant involved in such incidents is not an employee of your company, who provides liability protection? Most insurance policies exclude this type of coverage for non-employees."

Thomas Coughlin, president of Ormond Beach, Fla.-based aviation insurance agent and broker AirSur, pointed out that labor laws regarding the use of independent contractors are complex and vary by state. The reason is that federal law governs unless a state or municipality addresses an issue with a higher standard, in which case the higher standard governs.

The Costs of Non-Compliance

Coughlin agreed with Vernet and said the IRS usually rules that independent contractors are full-fledged employees and penalizes operators for not paying employment-related taxes. "The reason is quite simple; the IRS figured out it was losing as much as $1.5 billion annually in uncollected employment tax revenues."

Coughlin said that under IRS Section 530 Safe Harbor the IRS looks for consistency of treatment and reporting. "Businesses are required to demonstrate that workers designated as independent contractors are consistently treated as such and that workers who perform similar functions are also treated as independent contractors and not employees," he said.

"That's where the flight department gets into trouble. Independent contractor pilots and maintenance technicians are going to perform similar functions as full-time employees."

"I think when a flight department manager hires an independent contractor he's putting on blinders and making assumptions he shouldn't be making," Coughlin said. "Independent contractors just want to get work and don't think out all the issues; it's important that you do. There's never a problem until the IRS audits you, someone's injured or you're sued. Then it's too late."

With regard to insurance, Coughlin points to an additional area of concern for the flight department. When a pilot's, or a maintenance technician's, negligence causes injuries or property damage that results in a lawsuit, the independent contractor might be named in the suit. But the business is the one with the deep pockets and the insurance, and the company could, and probably would, end up footing the bill for the independent contractor's mistake. ❑

Reprinted with the permission of **Aviation International News** © 2006.
From March 2006 Issue.