Landmen as Independent Contractors:

Is the government's voluntary settlement program too good to pass up?

By Michael Kelsheimer and Charles Sartain

The days of the lone landman driving around the back roads taking leases and visiting courthouses are becoming a thing of the past. Though there are still a few independent landmen who fit this mold, clients have demanded change and consolidation. Now there are brokerage firms and other combinations of landmen. It is not a bad thing. It is just different.

The fly in the ointment is that the government views landmen who work for these companies as employees and not independent contractors.

Why Should You Care?

Because the government cares. 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 Internal Revenue Service and Department of Labor are looking to squeeze tax dollars from any place they can find money. The "misclassification" of independent contractors is one place they are truly focused.

Hundreds of new investigators have been hired. Fines in this area are up 500 percent. 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 IRS Form 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.

This means the IRS is looking for brokerage firms that are treating landmen as contractors when they should be employees. This means landmen who should be treated as employees by their brokerage firms may have a claim against the brokerage.

Now we have your attention, but you're still not convinced. After all...

How Bad Could it Be?

In an IRS audit, the employer could be assessed half of back payroll taxes, penalties, interest and possibly 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 percent 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 $75,000 per year, this could mean $900,000 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, which will then come in and ask for two to three years of timesheets for those "contractors" who are now employees. Because you treated them as contractors, you will not have any timesheets, so the DOL will interview the landmen and ask how many hours of overtime they worked in the last three years. With a free pass to answer and no time records to dispute, the landmen can tell the DOL just about anything, and the DOL, in turn, will assess you for that overtime. Assuming those same 10 landmen say they worked two hours a week of overtime over the last three years, the DOL might assess you with as much as $182,799.60 in back overtime before penalties.

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

Now that we firmly have your attention, you might ask:

What is the Test to Determine Whether Someone Should be Treated as an Employee?

As is often the case in the law, 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. Do you 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. Do you not have a written contract with your landmen setting out their relationship?
12. Do you 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. Do your landmen 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 and hold onto the Section 530 Safe Harbor defense; and (2) take advantage of the very favorable settlement program now offered by the government to reduce your liability by as much as 95 percent and re-characterize the contractors as employees moving forward.

How you approach minimizing these risk factors 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 that 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 risk factors from "yes" to "no" in the context of your business style and systems.

Though you may hate the thought of paying an attorney, the money you could ultimately save by engaging an attorney could be significant. For that reason, it makes sense to work with employment law counsel to help with this process to ensure the least possible risk moving forward.

What is the Section 530 Safe Harbor Defense?

Some landmen and brokerage firms are holding onto the idea that they can defeat the IRS misclassification argument using the Section 530 Safe Harbor defense, which relates to Section 530 of the Revenue Act of 1978. The idea behind the defense is that if everyone is doing the same thing, the IRS cannot declare a misclassification. While this may be true, it only has the potential to be successful against the IRS. Claiming Section 530 before the DOL or the TWC will fall on deaf ears because they are not subject to it.

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 IRS 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. In the example presented earlier where the employer could be exposed to as much as $900,000 in back taxes, their new liability could be less than $10,000.

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.

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