



GLOBALIZATION  
PARTNERS

[globalization-partners.com](http://globalization-partners.com)

# FREE YOURSELF FROM THE CONTRACTOR TRAP



# WHAT WE DO

Globalization Partners enables companies to quickly and easily expand into 187 countries without the hassle of setting up local branch offices or subsidiaries. You identify the talent, and we employ your team member via our in-country payroll. This enables you to quickly and easily hire around the globe, and lifts the burden of figuring out HR, tax and legal matters from your shoulders to ours.

## **Globalization Partners**

Succeed Faster



Contact us today to see how we can help you expand your team around the world.



## Falling Into the Trap

The story almost always begins the same way. A first sales hire in Brazil. An amazing programmer in Poland. A QC overseer of the third party manufacturer in China. Your company has decided that this year's business strategy will involve at least one venture overseas. This means you and your US based HR team will be responsible for facilitating the perfect hire once the decision has been made.

The pressure is on. An exceptional candidate has been identified and is anticipating an offer. Everyone is excited. You begin to research what you'll need to make payroll. After perusing countless websites with conflicting information, you begin to panic. You wonder how you're going to make this hire when you don't have an entity registered in--country to act as the employer of record. The panic deepens. Losing this hire would mean delaying access to a much needed market opportunity or worse yet, losing the candidate to another company, maybe even a competitor.

With the pressure mounting, you, like many HR professionals in companies small and large, default to hiring the candidate as a contractor or consultant. "Let's just get the person on board and see." If the individual is open to it, then this appears to solve several immediate problems. Your company can make an immediate offer to secure good talent instead of waiting several months to register an entity; you can pay the employee regularly through a simple wire transfer, and your company is able to "fly under the radar" in that particular country for a market test. You also avoid maintaining a string of dormant entities that were set up to hire just one person who subsequently left. It seems like a simple solution where everyone wins. Problem solved.

But is it?

Without a local subsidiary or branch office, your company cannot legally employ a person in-country, make payroll tax payments, or provide statutory local benefits.



## Limiting the Talent Pool

Before you start down the road to hiring a contractor, it's worth reviewing what the potential risks might be. And the first one occurs before the individual is hired. Is this definitely the best candidate for the role or was the best candidate not prepared to be paid as a contractor?

Most overseas candidates are well versed in their employment and benefit rights and the truly exceptional may be reluctant to take a position as a contractor or freelance consultant. Often, the net result is that taking the contractor route reduces the talent pool. By far the biggest deterrent to candidates accepting a contractor role is that in many countries, an individual receives significant employee benefits through basic payroll taxes, even without any supplementary insurance. For instance, Japan provides such excellent public healthcare that any additional health insurance is neither expected nor offered. Australian social security includes a 9.5% contribution to "superannuation," which is a strong government pension plan. In addition, local labor laws in most countries will provide the individual with a range of statutory rights, including minimum vacation, public holidays and statutory notice periods.

Typically, the best candidates are leaving a role as an employee and don't want to surrender the security and benefits they currently enjoy. Even if you are certain the candidate you've found is the right fit and he or she is willing to work as a contractor until other arrangements are made, there are "gotchas" that can spring up to create a complex set of problems that become difficult to solve.

## Contractor or Employee

### - What's the Difference?

As a rough guideline, contractors are defined as individuals who are:

- **Hired on a short term basis (project-based), for less than 6 months, or**
- **Hired, but also have a portfolio of their own clients, and your company is just one of those clients.**

Unfortunately, most contractors don't fit neatly into either of these categories, and your company takes on significant risks and liabilities by incorrectly categorizing what the tax authorities would likely deem global employees and wiring them gross pay once per month.

When is a contractor considered an employee? International tax and HR advisors generally use the following parameters:

**Does the individual...**

- Work full time for one company?
- Take management direction from that company?
- Have no other clients?
- Receive some employee benefits? (i.e. vacation days, stock options, car allowances, private health insurance, etc.)

If you answered yes to one or more of these questions about the hire you are hoping to make, there could be complications down the road. This is particularly true if the relationship with the contractor doesn't end on a positive note.

“At will” employment is a singularly US term. In just about every other jurisdiction, some form of notice period exists in labor law. If the contractor claims employee status, they could also claim unfair dismissal.

## The Consequences

You may be tempted to dismiss the small risk of discovery and reclassification by the authorities. But the chance of discovery by the local authority is not necessarily the greatest risk. After all, how many authorities have time to investigate more than a small percentage of contractors? However, it's worth bearing in mind that some countries have the means to be more vigilant than others. For instance, in Brazil, incoming payments made from a corporation to an individual are automatically flagged for investigation by the tax authorities. That's not to say that every payment will be investigated but some of them are, and the means to track them is in place. More granularly, outgoing payments from the Brazilian client to its overseas supplier are also tracked, and if a match is discovered, the Brazilian client can be fined for working with a company that is hiring someone illegally. In the age of austerity measures and limited funds, local authorities are getting more sophisticated than ever about identifying tax opportunities.

Setting aside the risk of discovery direct by the tax authorities, the greater risk is what could happen should you part ways with a disgruntled contractor.

If you decide to terminate your engagement with a contractor, and the negotiation does not go well, the bigger threat can be that the contractor turns, or threatens to turn, whistle-blower to the authorities. Often the threat of action is sufficient to elicit a significant payout to the contractor - which can run into the hundreds of thousands of dollars. The contractor is often well versed in how misclassification works, and the easy access to labor courts in countries such as France and most of South America make this more than an idle threat. The total amount of income tax, payroll tax, interest and penalties that your company would pay if the case goes to court will be the ballpark amount that the contractor will use to negotiate an exit payout. If such a case does go to the authorities, and they deem that the individual has the attributes of an employee, here are some of the common consequences you can expect:



Independent contractor fee	\$100,000
Withholding tax @35%	\$53,846
Gross salary	\$153,846
Payroll taxes @ 46%	\$70,769
Over 3 years	\$373,846
<b>Plus penalties of ???</b>	
<b>Plus interest on amounts owed of ???</b>	

- In an employment relationship, it is the employer's responsibility to withhold and report income taxes, not the employee's. In addition, the employer is required to pay employer payroll taxes. If a tax assessment is made, and your contractor is reclassified as an employee, the fees paid to the employee are therefore typically treated as net income. Employee income tax and payroll tax is assessed on top of that. The assessments can go back several years, including interest and penalties. Considering income tax rates of around 30%, and payroll taxes going from around 10%–20% in Asia and up to 40% in some European countries, plus interest and penalties, the total assessment can be a substantial amount, with figures north of USD250,000 not uncommon.

Even if you attempt to mitigate this risk by putting a clause in the contractor agreement which clearly states that the contractor is responsible for his or her own tax and has not entered into an employment relationship with your company, if you treated the contractor like an employee in day to day practice, then that will determine employee status. What you have written in the agreement won't matter. In just about every other jurisdiction, some form of notice period exists in labor law. So if the contractor claims employee status, they could also claim unfair dismissal. As an example, in the UK, an unfair dismissal award could go to 12 months' pay, with a cap of GBP78,335 with some forms of claim uncapped. There could also be claims for non-payment of holiday/sick pay and possibly other discrimination claims. After all, if the contractor/employee is going to court, he or she will want to maximize the possible compensation.

- By hiring contractors, companies avoid registering in-country and following the corporate laws required of all companies doing business there. When discovered, this can trigger potential corporate tax issues. Once the tax authorities realize the company has hired illegally in-country, they may then assess that the company's activities have triggered Permanent Establishment, or nexus, and that they should have been following corporate law and paying local corporate taxes all along. The legislation covering this is well documented by local tax authorities in many jurisdictions. Reclassification is the proverbial blood in the water.

The issue around contractors is one of managing risk. How risk-tolerant is your company as plans are being made to hire contractors? Is it an early stage startup, where the business case for having boots on the ground in a particular country is strong, and the decision is made to kick the can of contractor management down the road? Or do you work for a public company that has a policy of not hiring 1099 contractors at all? Does the reward outweigh the risk, or is it the other way around? These are the questions you'll need to answer as you consider your overseas hiring strategy.



## Controlling Your Contractor Risk

As companies mature, there often comes a point where they decide that they must bring their contractor risk under control and hire these individuals as employees. As their operations grow in other countries, companies may also want to address a growing feeling of inequality, in that their contract states don't enjoy the same level of employee benefits as colleagues in a neighboring country where the company has its own entity. Contractors are often happy with the decision to switch to employee status because they receive some increase in benefits, even if that increase is through the payment of employer social security and other mandated benefits.

The bigger and more complex problem comes in setting an appropriate employee salary compared to the contractor fee. Contractors in transition tend to negotiate heavily for increased salaries because they may not have withheld taxes while they were contractors. For those who did, self-employed taxes could result in a lower income tax bill. In any event, their net pay typically ends up lower as an employee than as a contractor – a situation that you'll need to address with a fair amount of finesse. Striking a balance between too much and not enough is a delicate dance.

The best way to deal with the contractor to employee transition is having a detailed negotiation which includes:

- Some small estimate of self-employed taxes
- Additional benefits received as an employee
- A general net to gross estimate to arrive at a new salary

There is typically a tendency to overcompensate because you don't want to lose the valuable skills of an individual who has proven his or her worth. Therefore, you will be tempted to agree to a final salary that is significantly more than the amount paid to a typical employee. If your company is considering growing its operations in a particular country, this inflated salary can create challenging precedents for future hires. Plus, the extra employee salary and payroll tax cost may outweigh the apparent savings of those early days of hiring this individual as a contractor.

Showcasing the value of the benefits you'll be contributing on the new employee's behalf will help smooth the negotiations and keep over-inflated compensation in check.



## How to Hire Globally and Remain Compliant

If you have determined that the person you are planning to hire or have already hired meets the qualification of an international employee versus a contractor, all hope is not lost.

One solution is to hire through a global professional employer organization. Global PEOs help companies get to market faster by offering a legal alternative to hiring directly. Your company can bypass the entity set up, registration, payroll tax deductions and payments without having to “fly under the radar” or risk being at the mercy of a disgruntled contractor who is well versed in the home country’s labor law.

The PEO hires the individual on your behalf as an employee in-country through its legally registered entity. The PEO takes care of payroll and meeting mandatory labor requirements, while your company manages and directs the individual on a day-to-day basis. The employee receives local statutory benefits, is covered by all mandatory labor laws and your company reduces its exposure to employment risk. If the employee doesn’t work out, the termination process is simple, usually consisting of the agreed notice period in the employment contract and any remaining severance or other pay. Above all, it brings the exposure to contractor risk under control and allows you to make a legal hire quickly.

Whether you’re about to make your first overseas hire or have already hired overseas and need help climbing out of the contractor trap, Globalization Partners can help. We’ll work with you to make that first hire quickly, legally and smoothly or help you transition an existing contractor to employee status in more than **187 countries worldwide**.

**Reach out today and free yourself from the contractor trap.**





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