



## Worker (Mis)classification Can Lead To Trouble

Insights

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*(Labor Letter, February 2010)*

Over the past year, federal and state governmental agencies have signaled their intent to more seriously investigate the misclassification of employees as independent contractors. For various reasons, employers often find it desirable to classify certain workers as independent contractors, but state and federal agencies often look at classification decisions very closely.

One reason is because independent contractors are not covered by most employment laws since they are not "employees." Additionally, classification of individuals as independent contractors deprives federal and state governments of tax revenue for such individuals, as they are not subject to payroll taxes. For instance, the federal government lost an estimated \$34.7 billion in tax revenue between 1996 and 2004 due to such classification of workers.

While there are instances where individuals are legitimately classified as independent contractors, such individuals are often in fact misclassified employees – and penalties can be severe.

### **"Hey You!" What You Call Them Doesn't Count**

Clearly, just calling someone an independent contractor does not make them one – and that's so even if the employee has agreed in writing to accept that status. While state laws vary somewhat, generally, workers are considered employees if they are subject to another's right to control the manner and means of performing the work. In contrast, independent contractors are individuals who obtain customers on their own to provide services. They may have other employees working for them, and they are not subject to close control over the manner by which they perform their services.

The independent contractor relationship can offer advantages to both businesses and workers. Businesses may choose to hire independent contractors because it enables them to easily expand or contract their workforces to accommodate workload fluctuations or fill temporary absences. Workers may choose to become independent contractors to have greater control over their work schedules or when they pay taxes, rather than have employers withhold taxes from their paychecks.

But there are incentives to *misclassify* employees as independent contractors. While employers are generally responsible for matching the Social Security and Medicare tax payments their employees make and paying all federal unemployment taxes and a portion of or all state unemployment taxes

make and paying all federal unemployment taxes and a portion of or all state unemployment taxes, independent contractors are generally responsible for paying their own Social Security and Medicare tax liabilities and do not pay unemployment taxes because they are not eligible to receive unemployment insurance benefits. In addition, businesses generally are not required to withhold the income, Social Security, or Medicare taxes from payments made to independent contractors that they are required to withhold for their employees. Independent contractors may also be responsible for making their own workers' compensation payments, depending on their state program.

### **Proposed Federal Legislation . . .**

Last year, the Taxpayer Responsibility, Accountability and Consistency Act of 2009 was introduced in Congress. The proposed legislation would allow individuals classified as independent contractors to petition the IRS to determine their proper classification, would limit the ability of employers to classify individuals as independent contractors, and would increase penalties for misclassification. Both bills are in committee. If passed, the legislation would expose employers with independent contractors to increased likelihood of investigation and more severe monetary penalties than under current law.

### **. . . And Heightened Enforcement Of Existing Laws**

Under existing employment laws, federal and state agencies are beginning to scrutinize employers for potential misclassification. On the federal level, the Government Accountability Office (GAO) recently issued a detailed report entitled "Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention." You can view the report online at the [GAO website](#).

The GAO report notes that policing misclassification had been historically difficult because the two agencies directly affected by misclassification issues, the U.S. Labor Department (DOL) and the IRS, do not share information. The GAO report also determined that the DOL did not investigate misclassification as such, but rather addressed it in the context of other wage complaints, which compromised its ability to police misclassification. The report concluded that the DOL was neglecting to review key documents or tax filings in the course of conducting investigations, and as a result was not proactively addressing the problem of employee misclassification.

The report also criticized the DOL for not educating employers and employees about misclassification and for failing to assess appropriate penalties to employers who were intentionally misclassifying their employees. Finally, the report also noted that the DOL does not generally share information with its state counterparts. According to the GAO the IRS has a better track record with respect to misclassification enforcement and had much more effective investigatory and enforcement programs in place than did the DOL, but the effectiveness of such programs was limited by the lack of communication between the DOL and the IRS.

There are 19 specific recommendations in the report, which are addressed to the heads of the DOL and IRS, aimed at helping prevent and correct employee misclassification. These include: clarifying the definition of independent contractor under federal law; providing employees with greater rights to complain about misclassification; defining misclassification as a wage law violation; revising the

to complain about misclassification; defining misclassification as a wage law violation; revising the Internal Revenue Code to make misclassification more difficult; increasing education and outreach; requiring withholding of taxes for independent contractors; enhancing compliance with IRS regulations by employers; and increasing coordination and information sharing between federal agencies.

Although the recommendations were advisory, the GAO Report stated that "both DOL and IRS generally agreed with our recommendations, and either agreed to implement or to take steps consistent with our recommendations, such as exploring their implementation." Consistent with the report, the IRS has signed information sharing agreements with labor agencies in 29 states, through which the IRS and the state agencies will share the results of misclassification audits. Additionally, in February 2010, the IRS will begin an audit of 6,000 different employers over three years in an effort to uncover occurrences of misclassification and to recover lost revenue. It's likely that the DOL will increase its enforcement activity in light of the GAO report as well.

At the state level, many states, (including Colorado, Illinois, Maryland, Massachusetts, New Jersey, and New Mexico) have passed laws aimed at misclassification in the construction industry, an industry with a history of misclassification issues. By way of example, the Illinois Employee Classification Act, which became effective in January 2008, was enacted with the stated purpose of recapturing lost tax revenue. The Act restricts the ability of construction contractors to classify individuals as independent contractors. It also provides the Illinois Department of Labor with broad investigatory and enforcement powers, and establishes penalties of up to \$1,500 per day for a violation of the Act, as well as liquidated damages.

It also creates a private cause of action, with the right to backpay, lost benefits, and liquidated damages. Such damages can be significant. Indeed, in December 2009, the Illinois Department of Labor imposed a \$328,500 penalty on a construction contractor based on the misclassification of 18 employees as independent contractors. This is the largest penalty to date under the Illinois Employee Classification Act.

Other states, such as Iowa, Michigan, New York, and Wisconsin, have created taskforces designed to uncover instances of misclassification. These taskforces have been active and effective. In 2009, New York's taskforce reported that it uncovered 12,300 instances of misclassification, which resulted in \$6 million in employment taxes and penalties.

### **What This Could Mean To Your Business**

The revenue shortfalls at the state and federal level during the past several years appear likely to continue for the foreseeable future. Governments, which are loathe to raise taxes or cut services, are searching for ways to make up this shortfall. It is therefore likely that governments will continue the trend of increased and more serious worker misclassification investigations, as occurrences of misclassification often result in significant penalties.

In addition to more aggressive investigations, state and federal laws may soon be amended to make the classification of individuals as independent contractors more difficult and riskier. The

the classification of individuals as independent contractors more difficult and riskier. The heightened governmental attention to these issues will also lead to more private civil lawsuits, as the damages available in such cases make them attractive to plaintiffs' attorneys.

In light of these developments, you should assess carefully how you classify your employees and ensure that any individuals classified as independent contractors are, in fact, properly classified. It is far better to internally uncover and proactively address any potential misclassification issues, rather than to learn of such issues for the first time when confronted by a governmental audit. And because of the technical nature of assessing whether employees are properly classified, it's a good idea to seek the advice of knowledgeable employment counsel.

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