



Misclassifications Matter

Insights

7.01.10

(Labor Letter, July 2010)

As businesses look for ways to save money without lowering productivity, the benefits of hiring an independent contractor can be appealing for several reasons. Businesses who hire the services of properly classified independent contractors avoid many of the monetary responsibilities that attach to hiring employees: worker's compensation insurance, employment tax, and wage withholding responsibilities, amongst others.

Additionally, businesses may circumvent many workforce-protection laws such as the Fair Labor Standards Act and Age Discrimination in Employment Act, by hiring the services of independent contractors. For a true independent contractor, benefits include being able to deduct business expenses.

But hiring an independent contractor is much more than simply re-labeling a job description and having an employee sign an agreement. The specific tests used to determine independent contractor status are complex and vary by the state or agency enforcing the misclassification. Generally, the classification will center around the amount of control the business has over the worker.

As appealing as any cost savings is now, misclassification can, and likely will, come back to haunt the business later – in the form of audits, fines, assessments, and civil litigation.

Why Big Brother Is Watching

The Bureau of Labor Statistics estimated that there were 10.3 million independent contractors in the United States as of 2005, but did not estimate how many were misclassified. In its last misclassification study that took place in 1984, the Internal Revenue Service (IRS) estimated that 15% of employers misclassified approximately 3.4 million employees as independent contractors resulting in a tax revenue loss of \$1.6 billion (in 1984 dollars). Recently the Government Accountability Office prepared an extensive Congressional Report on the issue of employee misclassification and stated that misclassification could be "a significant problem."

As a result, government agencies are cracking down on independent contractor misclassification. Beginning this past February, the IRS began auditing businesses as part of a National Research Program to find businesses who misclassify employees as independent contractors. Specifically, the IRS. plans to audit 6,000 businesses regarding employee misclassifications over the next three

years. The Department of Labor's proposed 2011 budget includes \$25 million for a joint initiative with the Treasury Department to combat the misclassification of independent contractors.

Pending legislation includes the "Taxpayer Responsibility, Accountability and Consistency Act" that amends the Internal Revenue Code to limit what is a "reasonable basis" for classifying a person as an independent contractor and not an employee. The bill also increases penalties for misclassification.

Be Careful!

While no single factor is determinative, here are the generally accepted areas to watch:

Behavioral Control

Does the company control or have the right to control what the worker does and how the job is done? Factors indicative of an employment relationship include whether the means and manner of the work is controlled. More detailed instructions indicate that the worker is an employee. Less detailed instructions reflect less control, indicating that the worker is more likely an independent contractor.

An evaluation system that measures the details of how the work is performed is indicative of an employee relationship. An evaluation system that measures the end result may be indicative of an independent contractor relationship. Training programs may also be indicative of an employee relationship, but again, no single factor is determinative.

Financial Control

Who controls the business aspects of the worker's job? Independent contractors often have a significant investment in the equipment they use, and are more likely to have unreimbursed expenses than are employees. An independent contractor is generally free to seek out other business opportunities. The opportunity to make a profit or loss is another factor indicative of an independent contractor relationship. In comparison, an employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time, even if the wage may be supplemented by a commission.

Relationship Factors

Is the worker treated like an employee? A written contract may be indicative of an independent contractor relationship. Other factors indicative of an independent contractor relationship is that the worker does not receive employee-type benefits (i.e. pension plan, insurance, vacation pay, etc.). Factors indicative of an employment relationship include whether the work is for an indefinite period of time and whether the work performed is a key aspect of the business.

In determining whether to classify a worker as an employee or independent contractor, look at the entire relationship and consider the degree or extent of the right to direct and control. If workers

look like employees, act like employees, and are treated like employees, it is very likely that they are employees and should be classified accordingly.

And if you decide to classify certain workers as independent contractors, be sure and document each of the factors used in coming up with the determination. This will be very helpful if faced with an audit or litigation later.