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Employee, Consultant Or Independent Contractor? Now Is The Time To Reconsider Classifications

By Angela K. Dorn, Esq.

Employee misclassification, most commonly occurring through the classification of employees as consultants or independent contractors (referred to collectively as independent contractors in this article), has become a significant problem in many industries. The U.S. Department of Labor has reported that upwards of 30% of companies misclassify at least some of their employees. The problem appears to be particularly widespread in the highly competitive construction industry, where so many individuals work as independent contractors and profit margins per job are slim. Perhaps more surprisingly, some studies show high rates of misclassification in industries such as education, health services, professional or business services, transportation services, and utilities.

The cost of employee misclassification can be high in several ways. The IRS contends that it, and the nation, loses billions in lost tax revenue annually because of employee misclassification, a concern that is increasing in the bad economy. It is expected that the IRS will work more extensively to investigate employment classifications in the workplace in an effort to capture these lost revenues. The consequences to employees

who the IRS determines have misclassified may be severe. Taxing authorities seek lost FICA, state and local tax revenue, along with significant penalties for each mistake in classification. Taxing authorities have little sympathy for employers who misclassify employees even for simple reasons like "mistake", as it is their contention that employers who engage in misclassification gain an unfair competitive advantage, an advantage which can be particularly strong in labor intensive industries.

Other risks to employers engaging in this practice are being found guilty of a violation of the Fair Labor Standards Act and owing back-pay for overtime and worker's compensation. Thus, penalties for extensive misclassification, however unintended, can financially ruin small, medium-sized and even large employers. The reputations of employers who have been convicted of misclassification have also suffered.

In recent years, several states have taken increased steps to combat employee misclassification. New Jersey has been particularly proactive in this matter. In 2007, the Department of Treasury and the Department of Labor and Workforce Development joined to eliminate employee misclassification so that employers found to have misclassified employees would face penalties from both the Department of Labor and Workforce Development and the New Jersey Department of Taxation. Other states (including New York and Illinois) have also made strides against employee misclassification through tougher legislation, stricter enforcement of penalties, and joint task forces or increased sharing of information between state agencies. These states have been able to impose millions in penalties against employers as a result of their new tactics.

Increased nationwide pressure against employee misclassification seems likely. Currently, 34 states share information with the IRS concerning misclassification related audits. States have reported this sharing of information as useful to them in collecting revenue and identifying employers who engage in misclassification, but often not as effective as their own intra-state agency communication.

Improved nationwide communication on the issue appears to be one option that may help lessen misclassification nationally. There have also been several recent efforts to strengthen federal legislation concerning this issue. The Employee Misclassification Prevention Act (introduced in the House of Representatives in May of 2008) is one bill in particular which may have a major impact. The proposed bill would amend the Fair Labor Standards Act to increase financial penalties for misclassification of employees, including a special penalty of up to \$10,000 per violation, against employers who repeatedly or willfully violate the act. The bill would also require employers to keep records of non-employees who perform labor or services for payment. The bill was referred to the Subcommittee on Income Security and Family Support and has not come up for debate, but members often reintroduce bills. The more likely scenario is that the bill will purportedly be re-written and re-introduced. A misclassification bill would likely have support from the Obama

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Administration. The Administration has supported or sponsored several pro-employee, workplace-related bills, and when he was a Senator, President Obama was one of two senators to introduce similar legislation in the Senate with the Independent Contractor Proper Classification Act of 2007 and co-sponsored a version of The Employee Misclassification Prevention Act introduced in the Senate in September of 2008 by the late Sen. Kennedy. The Obama Administration also supported Maryland's Workplace Fraud Act of 2009, which took effect on October 1st.

In the meantime, employers concerned about potential federal or state penalties for misclassification may be able to help minimize their risk by clearly documenting all records concerning labor or services provided by independent contractors, creating a standard independent contractor agreement, and by performing an employee classification assessment for any independent contractors providing services, using the IRS' well known tests for employee versus contractor classification.^[1]

These types of efforts should help an employer accurately assess whether the person working for them is indeed an employee or an independent contractor. But employers should note that none of these actions guarantees protection against penalties from violations of the Fair Labor Standards Act due to employee misclassification if an employee's classification is wrong; thus, they must remain mindful of how all individuals who provide labor or services are classified.

[1] <http://www.irs.gov/businesses/small/article/0,,id=99921,00.html>

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