Employment Edge 105th Edition—New Federal Report Highlights Increasing Risk to Employers from Improperly Classifying Employees as Independent Contractors

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In August 2009, the U.S. Government Accountability Office (GAO) released a detailed report to congressional leaders that culminated in a set of recommendations to address the persistent, widespread problem of employer misclassification of employees as independent contractors. (A copy of the report is found at http://www.gao.gov/new.items/d09717.pdf.) Specifically, the report recommends that the Department of Labor (DOL) and the Internal Revenue Service (IRS) step up enforcement efforts against employers. Therefore, this is a particularly opportune time for employers who have classified any workers as independent contractors to carefully review those decisions and, if appropriate, make changes.

Background

Workers may be classified as employees or independent contractors. While most workers are treated as employees and paid accordingly, in 2005 approximately 10.3 million U.S. workers (7.4 percent of the workforce) were classified as independent contractors.

While misclassification of employees as independent contractors itself is not a violation of any federal labor law, it can result in violations of various laws. For example, employers who misclassify employees as independent contractors are often cited by the DOL for violating the record keeping, minimum wage and overtime pay requirements in the Fair Labor Standards Act (FLSA).

In addition, employers are generally required to withhold income taxes from paychecks to employees, to withhold and pay Social Security and Medicare taxes for employees, and to pay unemployment taxes on wages to employees. Employers generally are not subject to these obligations with respect to payments to independent contractors. When employers wrongly classify employees as independent contractors, they expose themselves to liability not only for the unpaid employer portion of Social Security and Medicare tax for each employee, but also for a portion of (i) the income tax withholding that should have been taken from each employee's paycheck and (ii) the employee share of the Social Security (FICA) tax. When multiple employees in similar positions are wrongly classified, the potential liability to a single employer can quickly

become very large.

Standards Used to Make the "Independent Contractor or Employee" Determination

It is important for employers to remember that simply calling a worker an independent contractor is not determinative under the law. The DOL, IRS, and the courts will look beyond any agreement between an employer and worker to the real relationship in place.

The report recognizes that one of various "complex" tests are typically used to decide the worker classification question. The applicable test may vary from one jurisdiction to another and depending upon the particular statute involved.

Generally speaking, "a person is considered an employee if he or she is 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 (and who may have other employees working for them) and who are not subject to control over the manner by which they perform their services."

Most of the tests prescribe the analysis of multiple factors. The test applied most often under Minnesota law cites five factors:

1. The right to control the means and manner of performance
2. The mode of payment
3. The furnishing of material or tools
4. The control of the premises where the work is to be done
5. The right of the employer to discharge

(Guhlke v. Roberts Truck Lines, 128 N.W.2d 324 (Minn. 1964).)

In guidance meant for employers, the IRS states that "all information that provides evidence of the degree of control and independence must be considered" when making the classification decision, and advises, "The keys are to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally, to document each of the factors used in coming up with a determination."

Report Recommendations

The report concludes with a set of recommendations for future action by federal agencies—focusing primarily on increased efforts to enforce existing law—and include the following:

- The Secretary of Labor direct the DOL's Wage and Hour Division to increase its focus on the misclassification issue during targeted investigations.
- The Wage and Hour Division and the Occupational Safety and Health Administration (OSHA) share information on cases involving misclassification of employees and work together to refer cases outside

their jurisdiction to states and other relevant agencies.

- Further study of whether it would be advisable to amend the Tax Code to allow for sharing of relevant tax information by the IRS with enforcement agencies such as the DOL.
- Development of a standardized document on classification of workers that DOL would require employers to provide to new workers.
- The IRS extend an existing program under which employers can avoid certain penalties if they volunteer to prospectively reclassify their misclassified employees.

Employer Review and Follow Up is Advisable

The report notes that the DOL and IRS have already expressed general agreement with its recommendations and are already implementing them or taking steps consistent with them. Employers thus should expect a stepped-up focus on this issue by enforcement agencies. To lessen the potential risk, employers who have classified some or all of their workers as independent contractors are well advised to seek legal advice to make sure they have properly classified those workers and, if they have not, to make appropriate changes.

If you have any questions about independent contractor classifications or other employment law issues, please contact a member of Gray Plant Mooty's Employment & Labor practice group.