Independent contractor alert: Feds on the lookout for misclassification

Companies that use freelancers, consultants, per diems, long-term temps and other contingent workers are under assault. The federal government is poised to take a leading role in cracking down on employers it suspects of misclassifying employees as independent contractors.

The feds aren't alone. Labor unions are seeking to organize employees they claim have been misclassified as independent contractors.

Class-action plaintiffs' lawyers are seeking out workers who might have been misclassified and thus been deprived of overtime pay and pension and medical benefits.

State regulators are seeking back taxes and premiums for unemployment and workers' compensation funds.

Lax government enforcement

For years, lax enforcement by federal and state agencies created a comfort zone in which employers could increase their use of independent contractors. But beginning in 2007, several states began taking steps to curb what they regarded as mounting evidence that employers have been misclassifying some workers as independent contractors.

Those state initiatives took the form of legislation that substantially increased the penalties for employers that misclassify employees. Now employers face stronger legal requirements for determining who is an independent contractor.

By mid-2007, it appeared that the federal government was ready to take firm legislative and enforcement steps to rein in employee misclassification. However, IRS initiatives announced in 2007 receded in the face of the financial crisis in late 2008. So did House and Senate legislation introduced in 2007 and 2008, as Congress turned its attention to health care reform in 2009.

GAO report on misclassification

All that appears about to change following the issuance of a comprehensive report to Congress by the Government Accountability Office (GAO). Released late in 2009, the report—titled "Employer Misclassification: Improved Coordination, Outreach and Taxation Could Better Ensure Detection and Prevention"—has prompted both the Obama administration and Congress to refocus attention on independent contractor misclassification.

The GAO report (read it at **www.gao.gov/new.items/d09717.pdf**) identified 19 potential legislative and regulatory actions aimed at addressing misclassification. Among the recommendations:

- Enact laws that would make misclassification itself a violation of the nation's wage-and-hour laws.
- Narrow the so-called "safe harbor" provisions in the federal tax laws.
- Enhance IRS compliance programs.
- Improve coordination and information sharing between federal and state agencies.

Taking action

One of the measures included in President Obama's FY 2011 federal budget proposal would authorize $25 million to target misclassification. That would fund an additional 100 Department of Labor and Treasury Department enforcement agents. Their job: Track down and penalize employers that misclassify workers.

The IRS in February began an Employment Tax National Research Project involving line-by-line audits of 6,000 businesses focusing on, among other things, employee misclassification.

This year, Congress is expected to consider bills that would amend the Fair Labor Standards Act to make misclassifying an employee a violation of federal law and limit the "safe harbor" provisions of the tax laws that many businesses have relied upon to classify groups of workers as independent contractors.

What should businesses do?

For employers that continue to pay their contingent workers on a 1099 basis, it's imperative to review whether those workers are properly classified as independent contractors under the current federal and state legal standards. Do this in concert with your attorney, so it is covered by attorney-client privilege.

This is a highly fact-specific analysis that involves examining numerous criteria that generally focus on an employer's control over the manner and means of performing the services being rendered.

Depending on the results of the legal analysis, employers can choose from a number of different options:

- Restructuring the relationship to enhance compliance with federal and state tests for independent contractor status.
- Reclassifying workers by converting them to employees.
- Using employee-leasing firms to employ the workers directly.

The parties' written agreement is a critical component in determining independent contractor status. Merely stating that a worker is an independent contractor is essentially meaningless if the rest of the agreement spells out work and working conditions that do not reflect a client-contractor relationship.

Even worse, some poorly crafted agreements can actually undermine an independent contractor finding.

In contrast, carefully restructuring the relationship and having your attorney draft solid contractor agreements can be the difference between a court or administrative agency upholding a worker's independent contractor status or finding that the company is liable for an array of misclassification liabilities.