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**Our Employee Benefits and Executive Compensation attorneys have a diversified national practice. We assist clients of all shapes and sizes - businesses in virtually every industry sector, 501(c)(3)s and other tax-exempt organizations, and governmental entities under 414(d) - on compensation and benefit-related issues.**

**Venable's Labor and Employment attorneys counsel mid-sized and large employers - unionized and non-union, public and private. We deal with every type of workplace issue, including personnel policies, EEO claims and class actions, merger and acquisition labor cost reductions, wrongful discharge suits, OSHA, wage and overtime disputes, and trade secrets/non-compete litigation.**

## Focus on Misclassification – Are Your Workers “Employees” or “Independent Contractors?”

Many employers use independent contractors to supplement their regular employee workforces, but not all of them properly distinguish between “employees” and “independent contractors.” Out of concern for the rights of misclassified workers, and in the interest of boosting their own tax revenues, federal and state governments are increasing their efforts to identify and correct independent contractor misclassifications. Congress and the agencies are considering new laws, issuing new mandates, and allocating funds to increase government enforcement efforts against employers who have misclassified workers as independent contractors. The consequences for violators can be significant.

### Scope of Misclassification Errors

Companies who misclassify workers as independent contractors may be subject to significant federal, state and local tax liabilities (plus interest and penalties). Companies may face additional reporting and withholding obligations and potential liability for back wages, overtime pay, and unpaid unemployment benefits. Reclassification can also raise administratively complex issues when an individual's reclassification results in eligibility for retirement and/or health benefits. Every company and organization using independent contractors should perform an audit of its workforce classification process to ensure compliance with applicable federal and state laws and regulations. Performing this check-up now will minimize liability for any retroactive or additional penalties that may be assessed as part of the government enforcement initiatives that are now underway.

### IRS Employment Tax Initiative

In 2010, the IRS began a three-year audit initiative targeting 6,000 randomly selected employers. The audits focus on small businesses, tax-exempt organizations and the self-employed community but do not exclude large businesses. The IRS announced that 2,000 notice-of-audit letters were sent in 2010 and that the letters will continue to go out to other employers.

As part of these employment tax audits, IRS examiners are focusing on the classification of workers as independent contractors. Employers should work closely with counsel to review independent contractor arrangements and determine whether it is appropriate to prospectively reclassify some or all workers as employees.

IRS officials have publicly stated that these employment tax audits will be more invasive than prior employment tax initiatives. In addition to worker classification issues, the IRS will focus on fringe benefits, reimbursed expenses, executive compensation, and backup withholding. Employment tax is obviously a complicated area, and experienced counsel can help employers prepare for the challenges of an employment tax audit.

### Department of Labor Misclassification Initiative

The U.S. Department of Labor is also increasing its focus on worker misclassification, dedicating millions of dollars and scores of investigators to enforcement efforts. The President's 2012 Budget proposal calls for stepped-up enforcement activity across the board from the DOL, dedicating \$46 million to help combat worker misclassification. Of that \$46 million, \$25 million is for the DOL to administer State grants to “identify misclassification and recover unpaid taxes.” The Wage & Hour Division is also budgeted to receive \$15 million to fund investigations of employers who are suspected of worker misclassification (up from \$12 million in the President's 2011 Budget proposal).

### State Misclassification and Legislative Initiatives

State governments are also working to combat misclassification. Legislatures in several states (including Maryland, Connecticut, New York, and Pennsylvania) have enacted or are considering laws cracking down on worker misclassification. Penalties under these laws can be as high as \$300 per day per misclassified employee.

In support of these efforts, the DOL, IRS and 37 states have agreed to share information related to worker misclassification. State employment tax auditors will bundle evidence and make referrals to the IRS, and the IRS will similarly make referrals to state agencies.

In addition, for the past few years Congress has been considering some form of worker misclassification reform. Various pieces of legislation have been introduced, but never passed, in multiple Congressional

sessions. In particular, some of the bills proposed to change the landscape of worker misclassification and eliminate Section 530 relief for employers. Section 530 relief currently allows a company that reclassifies an independent contractor as an employee to reduce its employment tax liability drastically when the company can demonstrate that it had a "reasonable basis" for the original classification. Elimination of Section 530 relief would have a significant impact on employers that have a history of independent contractors in certain positions or based upon industry practice. We will continue to closely watch legislative initiatives related to worker classification.

The best time to evaluate your own independent contractor/employee classification distinctions is before the government knocks on your door. Our employment tax professionals are ideally suited to assist employers with employment related questions, audits, and examinations. Please contact one of the authors listed or a member of our [Employee Benefits and Executive Compensation](#) or [Labor and Employment](#) groups if you have any questions.

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