Legal Alert: Reassess Independent Contractor Classifications Now in Light of President Obama's Proposed Budget

2/10/2010

Thanks to President Obama's budget proposal for the 2011 fiscal year, released on February 1, 2010, the Department of Labor may be one of the few employers to soon experience rapid growth. The President's proposal would add 100 new enforcement personnel and increase the agency's overall budget by $25 million. The increase is part of a larger plan for the Treasury and Labor Departments to join efforts in addressing the misclassification of workers as independent contractors – something the President views to be a cause of the $350 billion tax gap, which is the sum of noncompliance with tax law. He argues that cracking down on misclassifications over the next ten years will increase federal coffers by $7 billion over the same period.

The increased attention on independent contractor classifications is not entirely new, as numerous federal and state agencies have recently touted their intent to punish and curb employer abuse of the classification. According to some reports, the IRS has already added 200 new employment tax auditors and will conduct 6,000 audits focused on employment tax issues over the next three years. The audits will not be limited to large companies. A number of states have commissioned studies on worker misclassification and enacted new legislation to narrow the definition of "independent contractors." Some have even criminalized misclassification. In August, the Government Accountability Office issued a voluminous report to Congress urging better cooperation and coordination among state and federal agencies in addressing employee misclassification.

To make matters worse, courts seem to be increasingly eager to scrutinize independent contractor classifications. For example, before joining the United States Supreme Court, Sonia Sotomayor joined a Second U.S. Circuit Court of Appeals decision that found a doctor to be potentially misclassified. The decision opened up the hospital to potential liability for sexual discrimination allegedly perpetrated against the doctor.

Rolling the Dice is Attractive, but Dangerous

While the increased attention on the issue is not new, a significant increase in federal funding will be, and companies would be wise to reevaluate their use of the independent contractor classification now. Understandably, the temptation for employers to ignore the writing on the wall is great, as the classification provides a significant reprieve from increasingly burdensome federal and state regulations. For example, employers do not have to pay social security and Medicare taxes, pay into funds for workers' compensation

and unemployment compensation, withhold income taxes, provide statutorily-required leave or pay minimum wage or overtime for independent contractors. Also, potential liability for personal injury and other claims is significantly decreased. Title VII of the Civil Rights Act of 1964, the primary law prohibiting discrimination in the workplace, does not apply to independent contractors. (Although some courts have found employers liable for harassment by independent contractors directed toward employees, independent contractors generally cannot sue for discrimination under Title VII.) And the list goes on and on. In all, employers probably save somewhere around 30 percent on worker costs when they use independent contractors rather than employees.

However, the consequences for companies that are found guilty of misclassification are far from insignificant – they must generally pay the taxes and other payments originally avoided in addition to penalties. In 2000, a class action against Microsoft Corporation, filed on the heels of an IRS audit, cost the company almost $100 million to settle.

Reassessing Classifications is Challenging

Determining whether to use the independent contractor classification is notoriously difficult. Historically, the IRS used a 20 factor test. While the agency recently significantly simplified its analysis, the inquiry is still complex and fact-intensive. And incredibly, different agencies apply different tests. The U.S. Department of Labor (DOL) considers seven factors:

(1) the nature and degree of the alleged employer's control in terms of how the work is performed;

(2) the worker's opportunity for profit or loss based on his or her managerial skills;

(3) the worker's investment in equipment or materials;

(4) the degree of independent business organization and operation;

(5) the degree of permanency and duration of the working relationship;

(6) the extent to which the service rendered is an integral part of the alleged employer's business; and

(7) the amount of initiative, judgment, or foresight in open-market competition with others required for the success of the worker.

If there is a guiding factor, a lynchpin uniting the various tests, it would certainly be the alleged employer's control over the work performed. The more control exercised by the alleged employer, the more likely an employment relationship exists.

Used correctly, independent contractor classifications can save your company a great deal of expense. However, the classification should not be taken lightly, especially given the likely increase in the DOL's enforcement efforts. Consider taking the opportunity to self-audit now, before the IRS, the DOL, or an employee forces the issue. Any such audit should be conducted with the advice and assistance of experienced employment law counsel to help ensure that the results of the audit will be considered privileged should your

compensation practices be challenged.

If you have any questions regarding this Alert or other labor or employment related issues, please contact the Ford & Harrison attorney with whom you usually work, or the author of this Alert, Josh Drexler, an associate in our Atlanta office at jdrexler@fordharrison.com.