

LEGAL Q&A | THE MANY PITFALLS OF USING CONTRACTORS

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This Legal Q&A two pager gives an overview of the potential problems of using contractors and freelancers in Germany, in particular the risk of misclassification. Incorrectly classifying an employee as a contractor can have considerable effects on the company – from retroactive liability for taxes and social security contributions to reputation damage and even criminal liability of the company's managing directors in certain cases. It is therefore crucial to know the main criteria for determining them correctly.

1. What is the difference between a contractor and an employee?

A contractor or freelancer is defined as an individual performing services on an independent basis, assuming the sole entrepreneurial risk for his services or business. The performance of services is usually regulated in a service contract (*Dienstvertrag*), or, where they relate to a definable project to be completed, in a contract for works (*Werkvertrag*). An employment relationship, on the other hand, will be governed by an employment contract, requiring the employee to perform services in accordance with the direct instructions and supervision of his employer while being integrated into the employer's organization.

2. Why is this distinction relevant?

This distinction between contractors and employees is decisive as regards the applicability of labor and employment law, and the payment of social security contributions and wage tax. In general, an employment relationship involves greater protection for the employee and stronger duties and responsibilities for both parties compared to independent contractors. However, trying to avoid this by simply concluding a service contract instead and calling the individual a contractor will not work if his status actually is that of an employee.

3. What are the consequences of misclassification in terms of employment and labor law?

If an actual employment relationship was incorrectly declared a service relationship, the individual will be considered an employee by law retroactively from the beginning of the contractual relationship. Thus, employee rights (e.g., vacation entitlement, continued payment of remuneration in case of illness) will apply retroactively from the beginning of the contractual relationship provided they are not time-barred. Furthermore, employee protection laws are applicable, in particular the Dismissal Protection

Act (*Kündigungsschutzgesetz – KSchG*). In fact, besides discovery in a regular social security audit, misclassification issues often come up when separating from a (supposed) contractor who is filing a claim for unfair dismissal claiming to be in fact an employee.

4. What about social security and tax law consequences?

Misclassification cases carry further financial risks: Social security contributions for pension, health, unemployment and nursing care insurance must be paid for up to four years retroactively, in case of intent even for up to 30 years. The company is liable for both its share of social security contributions and the employee's share. Late payment surcharges and interests can also be incurred.

Furthermore, tax authorities can make the company pay wage taxes that have not been paid – the possibility of recourse against the employee in practice often comes to nothing. The company must also reimburse the tax authorities for the input tax deduction from the contractor's VAT.

5. Are there further consequences to be considered?

In addition to these legal and financial risks, there are risks to the company's reputation that could hamper further growth. Furthermore, in case of a potential exit, misclassifications often become apparent when negotiations with investors are underway. Professional investors will always examine legal risks as part of their due diligence. A large number of contractors who likely turn out to actually be employees after the due diligence can quickly dampen the initial desire for an investment and may significantly influence the conditions of the transaction due to the associated financial risks (notably subsequent payment of social security contributions).

6. What if we contract with a service provider instead of the contractor directly?

If, instead of hiring a contractor directly, the company chooses a service provider who provides services based on a contract for works or for services, this will often lead to similar problems. In many cases, the provider will be acting like a de facto temporary employment agency and the individual, who is technically employed by the provider, will be employed like the company's own employees, be subject to work instructions and integrated into the company's organization. That is considered illegal personnel leasing, which will lead to very similar liability risks for the company as misclassifying contractors. The company should therefore also look closely at these arrangements.

7. How can we identify a supposed contractor as an actual employee?

The most important criteria speaking for an employee status are the obligation to follow instructions at work and integration into the company's organization. Other factors indicating employee status are when team members receive small-step work instructions from the company, cannot freely organize their working time, have company business cards and e-mail addresses without being specifically identified as externals, have badges and unrestricted access to all rooms and internal networks, participate in company events and receive employee-like benefits. Contractors on the other hand can refuse orders, may use own employees and own material, perform services for several companies, and do not carry out any activities that are also carried out by a comparable employee.

8. If the supposed contractor is working via his own company, he cannot be our employee, right?

It is a common misunderstanding that founding a company (usually a one-man GmbH) and contracting only via that company is a safe way of avoiding misclassification issues. Particularly in cases where the individual can actually be equated with his one-man company, this will not make a big difference when assessing his status. The entrepreneurial risk and presence on the market will only be considered as one factor within the overall assessment.

9. What can we do to prevent misclassifications?

To prevent misclassifications, companies need to ensure that as few criteria as possible speak for employee status and as many as possible justify contractor status. To do this, the company needs to have in place well-drafted contracts, but above all it needs to organize the actual working processes so that they match a true contractor relationship. It is not the wording of the contract that is decisive, but the everyday practice. Therefore, awareness of the issues involved should be present at all levels – this can, e.g., be achieved by conducting regular trainings. A very easy way to implement some control at the contractual level with contractors is a regular contractor self-certification, i.e., a confirmation by the contractor that he fulfils certain requirements, like having other customers.

10. Is there a safe way to identify and minimize the risk?

The company as well as contractors themselves may request a status clearance decision via the status clearance procedure at the clearing office of the German statutory pension insurance (*Deutsche Rentenversicherung Bund*). The decision will be based on an overall assessment of all circumstances.

The form package, with directions for completing it, is available via www.deutsche-rentenversicherung.de (in German only). Applications can be sent electronically to the clearing office (Bundesweite-Clearingstelle@drv-bund.de-mail.de). After an initial examination, the clearing office will request further information and, if necessary, documents within a set time period. If the clearing office assumes a responsibility to pay social security contributions, a hearing is held before a decision is made.



Status clearance may be applied only as long as the authorities have not initiated another administrative procedure. The statutory pension insurance already considers an announced audit as the initiation of an administrative procedure.

11. Which aspects of agile project methods need to be considered regarding contractors?

In agile project teams – for example using Scrum – employees and contractors often cooperate closely and interact frequently. Despite all agility, contractors should not be integrated into the company's work organization. The risk of misclassification can be reduced by using solely external development teams instead of mixed teams. These can be managed by a specific internal contact person who is also part of the agile structure, e.g., the product owner.

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