Snell & Wilmer

# WORKPLACE WORD


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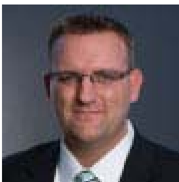

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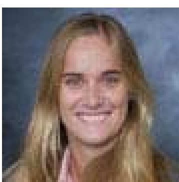

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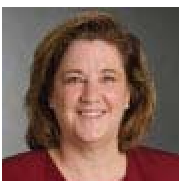

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## We Agreed They Are Independent Contractors, Isn't That Enough?

Absolutely not! The fact that workers have an express written agreement to be independent contractors or have explicitly requested to be independent contractors is not enough to make them independent contractors. Now, more than ever, employers need to evaluate their independent contractors and ensure that they are properly classified pursuant to the legal requirements. Federal and state governmental agencies have a renewed focus on independent contractor misclassification.

### Continued Focus on Misclassification

Millions of individuals in the workforce in this country are classified as independent contractors, many of whom may be misclassified as such. Federal and state governmental agencies recently signaled their intent to continue their crackdown on independent contractor misclassifications. This has become a focus in large part because of tax revenues. State and federal tax shortfalls are estimated in the billions of dollars owing to improper classification of workers. Misclassification leads to massive uncollected employment-related taxes as the Internal Revenue Code requires an employer to deduct and withhold

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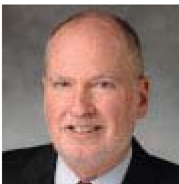

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income and social security taxes from the wages paid to employees. As a result, in 2010, the Internal Revenue Service (IRS) announced it will conduct comprehensive employment tax audits of 6,000 employers from 2010 through 2012. Similarly, in the Department of Labor's (DOL) FY2012 Budget Proposal, the DOL included a new multi-agency "Misclassification Initiative" to strengthen and coordinate federal and state efforts to enforce labor violations resulting from misclassification of employees as "independent contractors" and to deter violations in the future. The DOL requested more than $15 million to support field investigator training activities and an additional 3,250 investigations. The DOL set forth that these investigations will be directed to specific industries with higher rates of violations, including construction, child care, home health care, grocery stores, janitorial, business services, poultry and meat processing and landscaping.

**The Consequences of Misclassifications**

Misclassifications can have serious negative legal implications including potential liability under the federal Fair Labor Standards Act, state employment laws, and federal and state tax laws. Misclassification of employees as independent contractors can result in substantial liability and penalties for, among other things, back taxes, overtime pay, workers compensation, employee health benefits, retirement benefits and, in some states, failure to provide meal and rest breaks. These legal implications become even more severe when an employer is faced with misclassification of an entire set of individuals.

For example, in the recent case of *The Department of Labor v. International Detective & Protective Service, Ltd.*, a federal court in Illinois ruled in favor of a group of 57 private security guards on a claim that they were misclassified as independent contractors and awarded them more than $200,000. In addition, in 2009, a California court approved a settlement of $12.8 million to a class of 660 delivery drivers who claimed that they were misclassified as independent

contractors while treated as employees and thereby deprived of overtime compensation and other benefits of employment.

Moreover, if an employer fails to withhold and pay employee income taxes and employee Federal Insurance Contributions Act taxes during a calendar year, based on incorrectly classifying an individual as an independent contractor instead of an employee, the employer is subject to civil penalties and, if such failure to collect or pay over taxes is willful, potential criminal penalties.

**Common Misconceptions**

One of the problems employers face when classifying workers as independent contractors is their reliance on common misconceptions. Some common misconceptions companies have regarding classification of independent contractors is that any of the following is enough for a worker to be an independent contractor: the worker wanted to be treated as an independent contractor; the parties signed a written independent contractor agreement; the worker performs assignments only sporadically, inconsistently or is on call; the worker is paid commissions only; the worker has no supervision; or the worker performs assignments for more than one company. None of these factors alone is enough to classify a worker as an independent contractor.

**So What is the Standard?**

Unfortunately, there is no one test that determines whether an individual is an independent contractor. Rather, there are multiple different tests that apply depending on the legal issue and the agency enforcing the applicable law. For example, there are tests created by the IRS regulations, the DOL guidelines, state agencies and federal and state case law. Each test relies on different factors and different tests place priority on different elements of a worker’s relationship with the company. While there is some overlap amongst the various tests, application of different times sometimes gives rise to

different results such that an individual may be classified as an independent contractor under one test while not under another. However, one of the key factors in each of these tests is whether the company has control over the manner and means of accomplishing the desired result. If a company has the right to control the manner and means of accomplishing the desired result, the worker is most likely an employee.

The IRS has a 20-factor test that focuses on three areas: behavioral control, financial control and type of relationship. The IRS looks at, among other things, whether the worker typically must follow instructions regarding when, where and how to perform a job; whether there is required training; whether the worker's services are integrated into the business operations; whether there is an ongoing relationship between the worker and the company; whether there are set hours of work and whether it is full-time work; whether work is performed on premises and whose tools and materials are used to perform such work; how the worker is paid and who pays for the worker's business or travel expenses; what the company's rights are to discharge the worker and vice versa; and whether the worker can realize a profit or suffer a loss as a result of providing services.

**Conclusion**

Now is the time to identify and acknowledge legal risks associated with using "independent contractors" and ensure that all individuals who have been classified as independent contractors meet the applicable legal requirements.

**State Updates:**

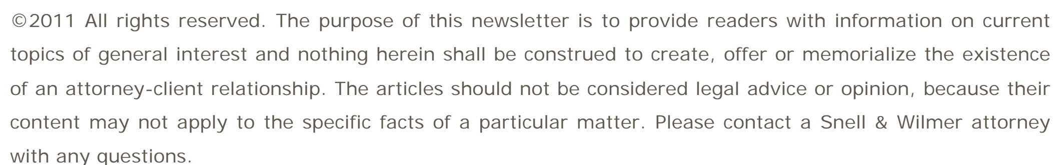
**California:**

Just last month, the California Legislature passed a bill prohibiting the willful misclassification of individuals as independent contractors and creating civil penalties of between $5,000 and $25,000 per

violation. If the Governor signs this bill, it will become law in the State of California.

It should also be noted that the IRS recently announced the Voluntary Classification Settlement Program. For more information on this topic, see the article in the October 4 Legal Alert entitled Worker Classification.

If you have any questions about the content of this newsletter, you may contact a Snell & Wilmer attorney by email or by calling 602.382.6000.



Past Issues
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