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WORKER MISCLASSIFICATION POSES SERIOUS RISKS FOR BUSINESSES

Colorado, along with many other states and the federal government, is cracking down on businesses that misclassify workers as independent contractors. An independent contractor, or consultant, is a non-employee. They are not subject to payroll tax withholdings, nor are they eligible for other benefits typically afforded to employees. For example, they are not eligible for and do not receive: workers' compensation and unemployment insurance (unless provided by another entity); health, medical, or retirement benefits; vacation, sick leave, or family/medical leave; overtime; or protections against discrimination and retaliation under Title VII and other federal anti-discrimination statutes. They also are not eligible to join a union. Thus, contractors often provide a cheaper alternative to hiring individuals as employees. But not everyone qualifies for contractor status, and misclassification impacts government revenue.

The General Accounting Office estimates independent contractor misclassification costs federal revenues \$2.72 billion annually. With significant shortfalls facing federal and state governments, it is no wonder they are making misclassification a priority. The 2011 federal budget authorizes \$25 million to the United States Department of Labor (DOL) to target employee misclassification, the DOL will hire 90 new wage and hour investigators and 10 additional lawyers to just target worker misclassification, and the Internal Revenue Service will randomly audit 6,000 businesses over the next three years. Because so many individuals are misclassified, the increased enforcement will likely have a significant impact on a variety of industries.

The penalties for misclassifying someone as a contractor can be severe. Under a new

Colorado law, businesses may be fined up to \$5,000 per misclassified employee for a willful violation. If another willful violation occurs, the penalty jumps to \$25,000. In addition to these potential penalties, businesses that have misclassified individuals as contractors may be liable for failing to withhold and pay the employer's share of taxes, failing to pay unemployment or workers' compensation insurance, overtime violations, and benefit plan disqualification, to name only a few.

Companies may also face penalties for failing to collect immigration-related documents to ensure that contractors are legally authorized to work in the United States. And if individuals who were once classified as contractors are reclassified as employees, businesses might find that they inadvertently violated laws they did not even know applied to them. For example, the Family and Medical Leave Act (FMLA) applies to businesses with 50 or more employees. An employer may deny a request for FMLA leave on the basis that it has fewer than 50 employees. But if contractors are misclassified, and their inclusion on the employee roster would place the total number of employees over 50, the employer may have violated the FMLA by denying the request for leave. By then, it's often too late to easily remedy the problem.

Given these risks, why do businesses continue to misclassify individuals as contractors? Although some businesses may intentionally classify individuals as contractors to skirt the tax and other obligations associated with employees, many others do not know that they are violating the law. The law is unclear as to who actually qualifies as a contractor. Different agencies have different tests, all of which apply various factors instead of bright-line rules, leading to substantial confusion. And individuals often ask to be retained as contractors because they want more take-home pay. But regardless of whether someone asks or even demands to be characterized as a contractor, the business will be held accountable if the person does not qualify for such status.

Because the penalties for misclassification can be so severe, and given the heightened enforcement and attention by the government, businesses that hire contractors should consider the steps

below to ensure their workers are properly classified.

1. Know the law.

Before retaining an independent contractor, review the various legal tests for contractor status. A good place to start is the IRS's website (www.irs.gov). The IRS looks at three main elements to determine who qualifies for contractor status: behavioral control, financial control and the relationship of the parties. Within each element, there are a number of factors the IRS will use to determine whether the element favors employee or contractor status. Colorado's Department of Labor and Employment has helpful information as well. Like the IRS, Colorado looks at two main elements: whether the person is subject to the company's direction and control, and whether the person is regularly and customarily engaged in an independent trade or occupation. Although the tests vary, the factors used to determine whether a person is truly a contractor often overlap. For example, if the individual has to be at work at specific times, is subject to detailed directions on how to complete tasks, must submit regular reports, is trained, is provided with tools or equipment, and if the person does not provide the same or similar services to others, the person is likely an employee, not a contractor. Someone who is financially dependent on one organization is often viewed as an employee, not a contractor. Auditors will ask if the individuals at issue have their own business card, whether they have formed an entity, and whether the individuals regularly advertise their services to the general public. If the answer to each of these questions is no, the auditor will likely conclude that the individuals are employees, not contractors. Auditors will also look at whether the person is performing skilled or unskilled labor. A highly skilled person is not automatically an independent contractor, but state and federal agencies often seek to protect the unskilled workers from companies that seek to obtain a competitive advantage by avoiding overtime and workers' compensation insurance. Also, if contractors are performing

the exact same services as employees, there is a good chance the contractors are misclassified.

2. Temporary employees are not contractors.

Many businesses mistakenly believe that because someone is needed for only a few days, weeks, or months, that person can be retained as a contractor. Not so. The length of the relationship can be important, but it is only one factor. Many times, someone hired for a day – such as a receptionist or a person providing clerical support – is an employee. Moreover, individuals initially retained on a “temporary” basis sometimes stay longer than expected. Be careful to ensure that so-called “temporary” workers fit the test for contractor status. If an individual stays on for a significant period of time, consider changing their classification to that of an employee. And if you find that employees are throwing a retirement party for an independent contractor, that is a good sign that the person was likely misclassified.

3. Use written contracts with independent contractors.

The contracts should contain the information required by Colorado law, including a prominent disclosure that the contractor is not entitled to unemployment insurance (unless provided by another entity) and the contractor is responsible for paying all taxes. Keep in mind, however, that a written contract will not always save the day. If the person does not otherwise qualify as an independent contractor, a court will not treat her as such, regardless of what the contract says.

4. Internal control.

Organizations typically have a centralized process for hiring employees. But for contractors, such controls are often lacking, leading to haphazard retention of individuals as contractors. Put some rules in place for those who might retain contractors to ensure appropriate procedures are being followed. Be careful before retaining a former employee as a contractor, even for a short period of time. Former employees who become contractors are a “red flag” for auditors, as they are often performing the same

work as when they were an employee and they do not meet the tests for contractor status. Allowing a retiree to transition to contractor status can be dangerous for the same reason: They are performing the same or similar work as when they were an employee. Courts and auditors look beyond titles to what the person is doing for the organization, and so should you. If you retain contractors through a third party, review the agreement with that entity to see who bears the risk of misclassification.

5. Audit yourself. Involve inside or outside counsel and review who you have retained as a contractor. You may find that there are no written contracts memorializing the relationship, that the person has been with your organization for years (indicating employment status), or that contractors are being treated like employees. For example, they are given standard business cards, uniforms, they participate in regular employee meetings or are subject to evaluations like employees.

Misclassification of individuals as contractors is widespread. Regardless of whether it is intentional or inadvertent, the consequences remain severe. To avoid those consequences, be proactive and be aware of the differences between contractors and employees.

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