

# LABOR AND EMPLOYMENT LAW UPDATE



## WORKER CLASSIFICATIONS: THE AUDITORS ARE COMING! THE AUDITORS ARE COMING!

Whether a worker is classified as an employee or independent contractor carries significant legal and financial ramifications for employers. Amongst the obligations which are incurred by an employer with respect to an employee, but not an independent contractor, are unemployment, social security and Medicare taxes, income tax withholding, worker's compensation insurance, employee benefits and minimum and overtime wage requirements.

The Obama Administration believes many employers misclassify workers as independent contractors thereby creating a tax gap for the federal government and a compensation gap for workers. To address this problem, the President has proposed to hire 100 new enforcement personnel at the Department of Labor and the Treasury Department as part of a joint initiative targeting worker misclassifications. The budget proposal for fiscal year 2011, released on February 1, 2010, includes \$25 million for this joint initiative.

The federal joint initiative is in addition to similar state initiatives already under way to replenish unemployment trust funds which have become depleted by employee layoffs. With these simultaneous initiatives, it is even possible that an employer's worker classifications may be subject to multiple audits by different government agencies.

**THE STAKES OF AN AUDIT:** The stakes of an agency audit for employers can include more than back taxes for the government and/or back pay for a worker. Substantial penalties may also apply. An unfavorable audit can also provide the catalyst for private litigation by workers improperly classified as independent contractors.

**MICROSOFT'S LESSON:** An IRS audit of Microsoft in 1988 and 1989 determined that a group of "freelance" workers had been misclassified as independent contractors rather than employees. Soon thereafter, the "freelance" workers filed a class action against the company alleging they were entitled to the same employment benefits as regular employees. Microsoft ultimately settled the class action in 2000 for nearly \$100 million.

**DIFFERENT AGENCIES/DIFFERENT TESTS:** Unfortunately, there is no one test common to all federal or government agencies for determining whether a worker is an employee or independent contractor. As to a particular employer, different tests may be used depending upon whether the audit is being conducted by the IRS, the Department of Labor or a state agency.

**IRS:** The IRS looks at 24 factors relative to three issues: (1) Does the employer control or have the right to control what the worker does and how the worker does his or her job? (2) Are the business aspects of the worker's job controlled by the payer? (3) How do the employer and worker perceive their relationship?

**DEPARTMENT OF LABOR:** The Department of Labor looks to several factors to determine the underlying economic reality of the relationship and whether the worker is economically dependent on the employer.

**TEXAS WORKFORCE COMMISSION:** The TWC uses an old 20-factor test previously used by the IRS to determine whether the employer has the right to direct or control the worker, both as to the final results and as to the details of when, where, and how the work is done.

**SMOKING GUN?** An auditor can regard a single factor as establishing that a worker is an employee. Barring a statutory definition, however, such as that applicable to real estate agents under the Internal Revenue Code, no single factor demonstrates that a worker is an independent contractor. Even if one factor indicates that a worker is an independent contractor, other factors can persuade an auditor that the worker is an employee.

**WRITTEN CONTRACT:** An independent contractor agreement does not necessarily show in and of itself that a worker is an independent contractor.

**1099 FORM:** A worker may be an employee even if he or she has received from the employer a 1099 form and filed an income tax return based upon the 1099 form rather than a W-2 form.

**MANNER OF COMPENSATION:** Workers paid exclusively on a commission, product or project basis can still be employees.

**EXPENSES:** That a worker pays his own expenses does not confirm he is an independent contractor if other considerations demonstrate he is an employee.

**WORK AWAY FROM OFFICE:** A worker may be an employee even if the employer permits the worker to perform substantial work at home or on the road rather than at the employer's place of business.

**WORK HOURS:** A worker who establishes his own work hours can still be an employee if other factors persuade the auditor to such a finding.

**INCORPORATION:** If a worker operates as a corporation this factor is persuasive, but not determinative, that the worker is an independent contractor.

**HELPERS:** That a worker uses helpers does not alone prove the worker is an independent contractor because the circumstances can still suggest that the helpers are employees of the employer, not the worker.

**RECOMMENDATIONS:** Employers with workers classified as independent contractors should not wait for an audit letter. Rather, the following steps should be taken in anticipation of an audit:

**SELF-AUDIT:** Consider a self-audit with the assistance of legal counsel (to preserve privilege protections) to assess the risks of current worker classifications.

**DAMAGE CONTROL:** For workers improperly classified as independent contractors, options should be evaluated for limiting the employer's legal and financial exposure in the event of a governmental audit.

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