



Federal and State Officials Vow Crackdown on Independent Contractor Misclassifications

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Employers may want to reexamine how they label their workers, as Federal and State officials have vowed to crack down on the misclassification of employees as independent contractors.

The use of independent contractors over employees can lead to substantial savings for employers. It can also lead to substantial deficits for State and Federal Governments in the event that employees are misclassified as independent contractors. In 2006, the Federal Government estimated that misclassification costs more than \$2.7 billion per year in Social Security, unemployment insurance and income taxes. Recently, the Department of Labor announced a five year strategic plan to collect Social Security and unemployment insurance premiums unpaid due to misclassification. This includes a \$25 million enforcement budget for 2011. The strategic plan targets industries such as construction, home health and child care, which have traditionally used independent contractors over employees.

In the wake of this vowed crackdown, employers should take a closer look at their workforce classification. While the increased use of independent contractors may lead to a savings in the short-term, misclassification can lead to substantial liability for back taxes, overtime pay and benefits.

There are several tests used to distinguish between an employee and an independent contractor, including a six-factor test used by the United States Supreme Court and a seven factor-test used by Kentucky courts. The most comprehensive is the test used by the IRS. The IRS considers the following twenty factors in determining whether a worker is an independent contractor or an employee:

- Level of instruction. If the company directs when, where, and how work is done, this control indicates a possible employment relationship.
- Amount of training. Requesting workers to undergo company-provided training suggests an employment relationship since the company is directing the methods by which work is accomplished.
- Degree of business integration. Workers whose services are integrated into business operations or significantly affect business success are likely to be considered employees.
- Extent of personal services. Companies that insist on a particular person performing the work assert a degree of control that suggests an employment relationship. In contrast, independent contractors typically are free to assign work to anyone.
- Control of assistants. If a company hires, supervises, and pays a worker's assistants, this control indicates a possible employment relationship. If the worker retains control over hiring, supervising, and paying assistants, this arrangement suggests an independent contractor relationship.

- Continuity of relationship. A continuous relationship between a company and a worker indicates a possible employment relationship. However an independent contractor arrangement can involve an ongoing relationship for multiple, sequential projects.
- Flexibility of schedule. People whose hours or days of work are dictated by a company are apt to qualify as its employees.
- Demands for full-time work. Full-time work gives a company control over most of a person's time, which supports a finding of an employment relationship.
- Need for on-site services. Requiring someone to work on company premises – particularly if the work can be performed elsewhere – indicates a possible employment relationship.
- Sequence of work. If a company requires work to be performed in specific order or sequence, this control suggests an employment relationship.
- Requirements for reports. If a worker must regularly provide written or oral reports on the status of a project, this arrangement indicates a possible employment relationship.
- Method of payment. Hourly, weekly, or monthly pay schedules are characteristic of employment relationships, unless the payments simply are a convenient way of distributing a lump-sum fee. Payment on commission or project completion is more characteristic of independent contractor relationships.
- Payment of business or travel expenses. Independent contractors typically bear the cost of travel or business expenses, and most contractors set their fees high enough to cover these costs. Direct reimbursement of travel and other business costs suggest an employment relationship.
- Provision of tools and materials. Workers who perform most of their work using company-provided equipment, tools and materials are more likely to be considered employees. Work largely done using independently obtained supplies or tools supports an independent contractor finding.
- Investment in facilities. Independent contractors typically invest in and maintain their own work facilities. In contrast, most employees rely on their employer to provide work facilities.
- Realization of profit or loss. Workers who receive predetermined earnings and have little chance to realize significant profit or loss through their work generally are employees.
- Work for multiple companies. People who simultaneously provide services for several unrelated companies are likely to qualify as independent contractors.
- Availability to public. If a worker regularly makes services available to the general public, this supports an independent contractor determination.
- Control over discharge. A company's unilateral right to discharge a worker suggests an employment relationship. In contrast, a company's ability to terminate independent contractor relationships generally depends on contract terms.
- Right to termination. Most employees can unilaterally terminate their relationship with a company without liability. Independent contractors cannot terminate services without liability.

The IRS twenty-factor test provides a useful guideline to employers when examining their workforce relationships. Application of this twenty-factor test will help your business determine if a relationship is truly independent.