

INDEPENDENT CONTRACTOR CRACKDOWN: BE PREPARED!

By Richard L. Steer and Arthur Zagorsky



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The Internal Revenue Service, the U.S. Department of Labor and many state governments are cracking down on how companies classify their workers. The Obama administration has announced a plan for the Departments of Labor and the Treasury to hire 100 additional workers to conduct special audits focused on worker classification. The administration has indicated that the government can collect \$7 billion over the next ten years from firms that misclassify their employees as independent contractors.

The IRS has launched a three-year program that will randomly examine 6,000 companies to identify permanent workers misclassified as freelancers in violation of the Tax Code. Most of the IRS action will target small businesses

and the self-employed, according to the General Accountability Office. The IRS asserts that smaller businesses are more likely to evade taxes and furthermore, it is easier and quicker to audit smaller businesses.

The pool of independent workers is enormous. According to a 2005 study by the Bureau of Labor Statistics, the most recent year for which figures are available, approximately 10.3 million workers or 7.4% of the employed workforce were classified as independent contractors. The survey did not indicate how many of those workers were misclassified.

U.S. Department of Labor estimates indicate that up to 30% of companies allegedly misclassify at least some of their employees. Some estimates indicate that companies can hold down labor costs by as much as 30% if they use independent contractors, because they do not have to pay Social Security and Medicare taxes, provide vacation or sick leave, pay for workers' compensation and unemployment insurance, or worry about minimum wage or overtime provisions.

While the law on employee classifications has not markedly

changed over the years, the emphasis on how to apply well-known legal principles has changed significantly. The New York State Department of Labor has been interpreting the factors for determining independent contractor status extremely strictly. In a recent case, demonstrated proof that a contractor had other clients and was a member of the Freelancers Union was not sufficient to prevent a finding of employee status.

New York State agencies have utilized a wide variety of factors in determining employee status. Many of the same factors are also utilized by the Internal Revenue Service.

Historically, the IRS utilized a 20-factor test in considering the determination of a worker's independent contractor status. In 2006, however, the IRS streamlined the 20 factors and organized the factors into the three main categories used today:

Behavioral Control – Facts that show whether the business has a right to direct and control how the worker does the task for which the worker was hired include the type and degree of instructions, evaluation and training the business provides the worker.

Instructions – An employee is generally told:

- When, where and how to work
- What tools or equipment to use and who owns them
- What workers to hire to assist with the work and who pays them
- Where to purchase supplies and services
- What work must be performed by a specified individual
- What order or sequence to follow when performing the work

Training – An employee may be trained to perform services in a particular manner.

Financial Control – Facts that show whether the business has a right to control the economic aspects of the worker's job include:

- The extent to which the worker has unreimbursed business expenses

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- The extent of the worker's investment in the equipment or facilities used in performing services
- The extent to which the worker makes his or her services available to the relevant market
- How the business pays the worker
- The extent to which the worker can realize a profit or incur a loss
- Whether the worker is paid on a tax form 1099

Type of Relationship – Facts that show the type of relationship include:

- Written contracts describing the relationship the parties intended to create
- The extent to which the worker is available to perform services for other, similar businesses
- Whether the business provides the worker with employee-type benefits, such as workers' compensation benefits, insurance, a pension plan, vacation pay or sick pay
- The permanency of the relationship
- The extent to which services performed by the worker are a key aspect of the regular business of the company

The factors listed above are not an exhaustive list and other factors surface based on particular cases and industries. Many of the same factors are used under the New York State law in classifying employees. The key is to look at the entire relationship, consider the degree or

extent of the right to direct and control, and finally, to document each of the factors used in coming up with the determination.

Employers who believe that simply having a written independent contractor agreement will protect them are in for a rude awakening. Many employers' agreements and documentation simply do not go far enough in light of the new reality. Therefore, businesses that consider hiring independent contractors should consult an attorney to ensure that they comply with federal, state and local worker classification requirements. A thorough review of independent contractor agreements, even those that the company has used for years, is crucial.

About Richard L. Steer, Partner

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