



# The Perils of Misclassification

Attorneys warn businesses to review payrolls and not run afoul of forceful government measures.

By Tracey Regan, Contributing Writer

*When the New Jersey Legislature approved the Construction Industry Independent Contractor Act in 2007*, the state signaled an aggressive new stance against companies that mislabel employees as independent workers to save money on taxes.

Three years later, state regulators have ratcheted up enforcement of independent contractor (IC) rules across industry sectors, employment lawyers here say, while the federal government has moved recently to tighten both tax and labor laws that regulate them.

The federal government is also investing in enforcement. President Barack Obama's 2010 budget includes \$25 million targeted specifically at employee misclassification, including funds to pay for additional Internal Revenue Service auditors and attorneys. In February, the IRS announced it would begin randomly auditing 6,000 companies that use independent contractors for employment tax compliance.

Amid gaping budget deficits, the administration contends that these and other federal initiatives, including proposed changes in the U.S. tax code and the Depression-era Fair Labor Standards Act, will bring in \$7 billion over 10 years.

Employment attorneys across the state say they are warning clients to review their payrolls closely to make sure they do not fall afoul of these forceful new measures. The financial risks for businesses in sectors ranging from construction to IT are substantial, while the consequences for small companies are potentially devastating.

"This new approach is to go out and find violations, looking to make up billions of tax dollars lost due to employees being misclassified," says Michael Shadiack, a law partner at the Roseland-based firm Connell Foley. The U.S. Department of Labor, he notes, contends that between 7 and 15 percent of workers are misclassified, and, as a result, the IRS estimates tax losses of \$3.5 billion a year.

“We hear from our clients that Department of Labor and IRS audits are a disturbing trend,” he says.

The difference between employees and independent contractors hinges on the degree of control the employer exerts over the worker and the performance of the job. The savings to employers - in federal and state taxes and benefits - is significant.

“The ultimate concern is that if the IRS determines the worker was mischaracterized as an independent contractor, the employer could be assessed for all of the unpaid taxes - both the employer and employee payroll taxes, together with interest and penalties,” says John Schmidt, a law partner with Lindabury, McCormick, Estabrook & Cooper, with headquarters in Westfield.

Workers who contest the terms of their employment may also seek to recoup missed benefits, such as healthcare insurance and retirement fund contributions.

“There can be a nightmare scenario with respect to overtime liability, since ICs do not receive overtime. Misclassified workers might even be entitled to vacation pay and other employee benefits,” says Douglas Diaz, a partner at Archer & Greiner, a law firm based in Haddonfield.

Diaz says that while New Jersey has tough laws on the books, regulators here have ramped up enforcement, including surprise audits.

“A wage violation can trigger an investigation in which the State Department of Labor looks at the entire company for legal compliance and, more often than not, may communicate with the IRS so it can follow up with any additional investigations of its own,” he says.

In New Jersey, the state’s Unemployment Compensation Law takes a three-pronged approach toward



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distinguishing between employees and independent contractors that is known as the “ABC test.” Under the law, companies must be able to prove: that (a) they do not control or direct the manner in which the contractor performs the job; that (b) the

service is outside the usual course of business or that it takes place outside of the company’s place of business; and that (c) the independent contractor has a clearly established trade or business.

“The ‘C’ prong is generally the one that gives companies the most trouble,” Diaz wrote in a recent article on the topic. Government auditors, he says, will often check to see if contractors operate under a trade or corporate name, have their own business cards, stationery and business phones, and are able to show that their income is not derived from just one company.

The 2007 law regulating employment contracts in the construction industry, known by its acronym CICA, provides for criminal penalties against companies that violate employment rules.

When he examines employee contracts, Schmidt says he first asks about the job itself and whether it has previously been done by employees and, if so, whether the employer will continue to have both independent contractors and employees perform the same tasks.

“I try to determine if the independent contractor is engaging in work that is a regular, integral part of the employer’s business or a single or isolated project or task,” he says, adding that he goes on to ask detailed questions about how the job will be managed in order to assess the company’s level of control.

“Will the employer direct and control the details of the independent contractor’s work or simply tell the IC about the end product wanted and then allow the IC to control the means of getting to that end product?” he asks, adding that control in this regard includes the working schedule, the total number of hours to be worked, whether the

tools or equipment are provided by the employer and whether the employer determines the place of work. He also asks whether the contractor is paid a fee or an hourly or weekly sum, whether the IC can work for third parties over that period and how the relationship can be terminated.

“We advise our clients to maintain strict record-keeping as to why a worker is classified as an independent contractor because they may have to one day prove that the worker is properly classified. All the investigators have to do is request the employer IRS Form 1099s for each worker and ask what each worker did. The employer then has the burden to prove that the worker was properly classified,” Shadiack says.

Employment attorneys say that some companies inadvertently violate rules, and so they urge them to proactively review their payrolls.

“We tell our longtime clients that once they’ve reached 40 to 50 employees, if they don’t have in-house expertise, it’s a good idea to take an employment law audit,” says Scott Ohnegian, a law partner at Riker Danzig, based in Morristown.

“Some employers are nervous about reclassifying employees and telling them, because they don’t know what their exposure will be going backwards. The going forward part is easy. So some businesses want to see it on a spread sheet, going backwards, and to know what their risk is if they don’t fix it,” he says, adding, “It’s easy to figure out taxes and wages, but the likelihood you’ll be the subject of an audit is something I can’t quantify.”

Companies continue to mislabel employees even in industries that have been targeted for enforcement, in part because employment terms can be genuinely ambiguous.



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“The construction industry is unique in that companies use workers who might be on a job for a day, one week or three weeks. The industry struggles with how to classify these workers,” Shadiack says.

“Our firm represents a large number of construction companies. We keep our clients abreast of proposed bills and new laws in the area of worker misclassification by way of legal alerts,” he adds.

Schmidt says industries with large sales forces are likely targets for investigation in this new environment, particularly in cases in which companies are outsourcing their salespeople.

“IT is ripe for investigation,” he adds. “People in IT departments are often working for just one company, but are designated as ICs and paid as 1099 workers.”

Ohnegian notes that employment terms for IT workers often vary according to company size.

“It’s often appropriate for a small business to retain outside IT and call them in once or twice a week to help, but some larger organizations have these people working 40 hours

a week, and they’re supervised,” he says. “Both the state and federal government will crack down harder on employers who have done it intentionally.”

Two new bills introduced in Congress this year would further tighten independent contractor laws and increase penalties.

The Employee Misclassification Prevention Act, which amends the Depression-era Fair Labor Standards Act, would make it a federal offense to misclassify employees. The bill also requires employers to keep careful records on work performed by independent contractors, and to notify them of their classification and their rights under the law. Civil penalties would range from up to \$1,100 per violation to up to \$5,000 for employers deemed repeat or willful offenders.

The Fair Playing Field Act of 2010 would amend the Tax Code to eliminate a safe haven that provides for reduced penalties when an employer fails to deduct and withhold income taxes and the employee’s share of FICA taxes. The bill also calls on the Treasury Department to issue clear guidelines on employment classifications for federal employment tax purposes, among other provisions.

Under current federal law, worker misclassifications are enforced by way of actions under the Employment Retirement Income Security Act (ERISA), the National Labor Relations Act, the Civil Rights Act, and/or the Fair Labor Standards Act, Shadiack says.

“We counsel our clients to proactively self-audit their workers’ classifications to determine if they are properly classified,” Shadiack says. “In light of pending federal legislation and New Jersey’s fervor to enforce CIICA, the only unacceptable action by an employer is inaction.”