

INDEPENDENT CONTRACTOR OR EMPLOYEE? GETTING IT WRONG MAY COST YOU

Employee or independent contractor? - An incorrect classification can have costly consequences for employers. Misclassifying a worker as an independent contractor opens up the door to liability for unpaid federal, state, and local income tax withholdings, and unpaid Social Security and Medicare contributions, as well as claims for unpaid pensions, profit sharing benefits, medical benefits and stock options. The laws defining classification are often vague and complex; and they are enforced by different state and federal agencies, including the Internal Revenue Service ("IRS"), state unemployment and workers' compensation agencies, insurance companies, and the courts.

Many employers try to keep employee costs down by engaging independent contractors. That way the employer avoids the cost of payroll taxes, workers' compensation insurance, employee benefits, and social security and Medicare taxes. But are these workers truly independent contractors or are they actually employees?

Worker classification is a very fact-specific analysis that does not end simply because the contract between the company and worker identifies the worker as an independent contractor. Rather, the primary inquiry with most classification methodologies is how much control the employer has over the worker and how much independence the worker retains. Particularly important are the levels of control employers have about how, when, and where the worker performs, what tools or equipment the worker uses, and where the worker purchases supplies. Also important are the levels to which the worker is integrated into the company's operation.

While the legal landscape defining an independent contractor relationship remains complex, recent developments in New York, New Jersey and across the nation reflect a swing of the pendulum toward re-classifying many independent contractors as employees in a wide variety of circumstances and the launching of aggressive enforcement initiatives to make sure that workers are properly classified.


New York

In 2007, former New York Governor Spitzer established a joint task force, which is still in effect, to address worker misclassifications in New York. The Joint Enforcement Task Force allows state agencies charged with classification enforcement, including the Workers' Compensation Board, the Workers' Compensation Inspector General, the Department of Taxation and Finance, the Attorney General's Office and the New York City Comptroller's Office, to coordinate their investigations and share information.

New Jersey

In recent years, New Jersey has cracked down on employers who misclassify employees as independent contractors. Under New Jersey's enforcement provisions, the results of audits by the Department of Labor that





indicate that an employer has misclassified employees as independent contractors will be referred to the state's Taxation Division. Thus, employers who misclassify workers may be penalized by both the Labor Department and the Taxation Division. Recent reports indicate that Governor Corzine has directed the Department of Labor to step up audits on worker classifications.

Federal

In November 2007, the IRS, which previously devised a 20-factor guideline to assist in the determination of whether a worker is an employee (IRS Rev. Rul. 87-41), announced a new state and federal information-sharing plan for employment tax audits. These new agreements between the IRS and state workforce agencies are designed to provide a centralized method for the IRS and state employment officials to exchange information.

Employee misclassification has also attracted the attention of many elected officials, including President Obama during his tenure as U.S. Senator. As a Senator, he introduced the Independent Contractor Proper Classification Act of 2007 in the U.S. Senate. The bill, which did not come up for debate and did not pass during the Session of Congress in which it was introduced, would have revised procedures for worker classification by focusing on Section 530 of the Revenue Act of 1978. Section 530 relieves an employer of employment tax liabilities which arise from a failure to treat an individual as an employee if the employer meets three requirements: reasonable basis, substantive consistency, and reporting consistency.

Similar legislation was also introduced last year in the U.S. House of Representatives. The Employee Misclassification Prevention Act, introduced on May 21, 2008 by New Jersey Representative Rob Andrews, would amend the Fair Labor Standards Act to require employers to keep records of non-employees who perform labor or services for remuneration and to provide a penalty for employers who misclassify employees as independent contractors. On April 15, 2008, Representative Jim McDermott introduced the Taxpayer Responsibility, Accountability, and Consistency Act of 2008 which is intended to make it more difficult for employers to classify workers as independent contractors. The bill would remove a loophole in the U.S. Tax Code which allows employers to avoid paying social security taxes and withholding taxes for employees improperly classified as independent contractors. Neither of these bills became law, but their introduction highlights the growing efforts by lawmakers to enact legislation to identify and stop employee misclassification.

In light of the legislative landscape, a review of your employee and independent contractor classifications would be warranted. Please do not hesitate to contact us regarding any questions you may have in this regard.

This *Executive Compensation & Employee Benefits Law Alert* was written by **David T. Harmon** and **Rachel A. Wingerter**. If you have any questions regarding the information in this Alert, including the classification of your workers, or any other matters, please do not hesitate to contact the authors, dtharmon@nmmlaw.com and rawingerter@nmmlaw.com, respectively.

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