

Experts: Carefully Consider Independent Contractor Classifications

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By Joanne Deschenaux

Given the present state of the economy, employers are looking for ways to reduce costs and overhead. One way a company may choose to save money is to classify current workers or new hires as independent contractors rather than employees, but misclassifying employees—even unintentionally—can prove to be extremely expensive for employers, opening them up to administrative fines and penalties as well as costly private lawsuits, according to Michael Schmidt, an attorney in Cozen O'Connor's New York office.

A lot of small businesses just don't understand the difference between an employee and a non-employee, said Frank Connolly, an attorney with the Washington, D.C., regional office of Jackson Lewis. "When it comes to a lot of start-ups or small businesses that don't have a lot of assets, a lot of it is naiveté and a lot of it is convenience. I don't have the money to pay a lot of people a lot of cash. I can avoid it by calling these people independent contractors. These employers probably don't realize that they are violating the law," he said.

In addition, the way the factors used to distinguish between employees and independent contractors have been historically applied by the agencies and courts have left employers without clear guidance to help them determine if they are classifying properly, noted Schmidt, who is also an adjunct professor of law at Touro Law School in Central Islip, N.Y.

He cited the following dangers of misclassification:

If an employer is not withholding taxes because it is treating employees as independent contractors, the Internal Revenue Service and state tax agencies may come calling.

If the employer is not making workers' compensation or unemployment insurance contributions for the misclassified individuals, state agencies "will have revenue concerns," and, in the case of an injury, an employer may not have necessary workers' compensation coverage.

If individuals are not treated as employees, they may be losing benefits and protections to which they are entitled under state law.

Recently enacted state laws impose penalties on certain employers for misclassifying workers.

And possibly the biggest ramification, if workers are incorrectly being treated as independent contractors, they are missing out on the protections of the federal Fair Labor Standards Act and state laws as to minimum wage and overtime, possibly leading to class litigation that could potentially cost the employer huge sums.

Recent State Actions

Under the Massachusetts independent contractor statute, enacted in 2005, but not really interpreted by the state courts until this year, a worker will be considered an employee unless the employer can show that all three prongs of the independent contractor test have been satisfied:

The individual is free from control and direction in connection with the performance of the service, both under his contract for the performance of service and in fact.

The service is performed outside the usual course of business of the employer.

The individual is customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service performed.

Applying this test, a state trial judge recently certified a class of exotic dancers whose employer improperly classified them as independent contractors (*Chaves v. King Arthur's Lounge* (No. 07-2505 (July 31, 2009))).

Maryland's recently enacted Workplace Fraud Act of 2009, goes into effect Oct. 1. Applying only to the landscaping and construction industries, the law "has onerous penalties" for misclassification, Connolly said (penalties of up to \$5,000 per misclassified employee as well as restitution paid to the employees themselves).

In addition to establishing standards for determining whether an employer-employee relationship exists, similar to those under the Massachusetts law, the law gives Maryland's Commissioner of Labor and Industry broad powers. If misclassification is found, the commissioner will notify the state comptroller, the Office of Unemployment Insurance, the Insurance Administration, and the Workers' Compensation Commission. "The Maryland act is particularly disconcerting," Connolly said. "It is not just one entity that comes after you. If one agency finds an impropriety, a number of agencies might come after you to see if you comply with their standards."

A new law in Colorado went into effect June 2, 2009. It subjects Colorado employers that misclassify employees as independent contractors to fines of up to \$5,000 for a first offense and \$25,000 for a second or subsequent offense per misclassified worker.

Avoiding Classification Errors

In order to avoid classification errors, the first step, Schmidt said, is for employers to try to get a better understanding of the criteria used to distinguish employees from independent contractors. All of the different tests basically come down to three major factors, he said:

The degree of behavioral control the employer has over the worker.

The degree of financial control the employer has.

The parties' own views and their treatment of the work relationship.

Connolly also offered some guidelines to help employers distinguish employees from independent contractors. First, he said, if the individual is working on his or her own (without a formal business entity in place), assume he or she is an employee. Second, give serious consideration to the question of whether what the contractor is doing is an integral part of your business.

Third, ask whether you are hiring this person for a discrete project. Is he or she more like a plumber, who shows up for an isolated problem, tells you when he or she will be there and has his or her own tools; or more like a nanny, who shows up when requested, keeps the hours you set and follows your instructions. The plumber is likely to be a contractor; the nanny an employee.

Finally, ask whether the individual is working substantially full-time for your company. If so, employee status is more likely, Connolly noted.

Schmidt further recommended that a company not rely on position statements, but investigate and look at the day-to-day functions being carried on by individuals to see if those individuals really are independent contractors or if they should be classified as employees. The company should document its conclusions, setting out the criteria relied on and the reasons why the individuals were classified as independent contractors rather than employees, he added. In some cases, the employer should consider using third-party help. "Use an outside leasing organization for workers, rather than hiring or reclassifying employees as independent contractors, to minimize your risk," he suggested.

Because the potential exposure and risk of misclassification is really significant for companies, Schmidt said, "They should take a strong look at how they are classifying and who they are classifying instead of waiting to get a knock on the door." Further, according to Connolly, "I think that it is really important for HR to get a handle on the independent contractors that their companies are engaging. At the end of the day, HR is probably in the best position to identify that there may be a problem," he concluded.

Joanne Deschenaux is SHRM's senior legal editor.

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