



Risky Business: Classifying Workers In The New Economy

In this post-recession era, full-time employees are becoming a vanishing breed. And in greatly increasing numbers more companies, and more workers, are embracing non-traditional approaches to employment. This changing labor market will have far-reaching impacts — talent acquisition and career management strategies are obvious targets. However, as the nature of the employer/employee relationship evolves, federal and state revenue authorities must make adjustments to maintain the flow of employment-related tax dollars. Therefore, how you classify your current and future workers will take on increased significance — *and risk*.

The Work Force Is Evolving. Calling All Freelancers!

Largely due to current economic conditions, US-based companies are accelerating their use of freelance or contract talent. In a recent USA Today article, “A Quarter of Workforce Could Become Temps as Contract Work Grows,” Gary Mathiason of Littler Mendelson, a leading employment law firm, affirmed that as the economy rebounds, “half of the jobs created in the recovery will be filled by contractors, consultants, and other temps.”

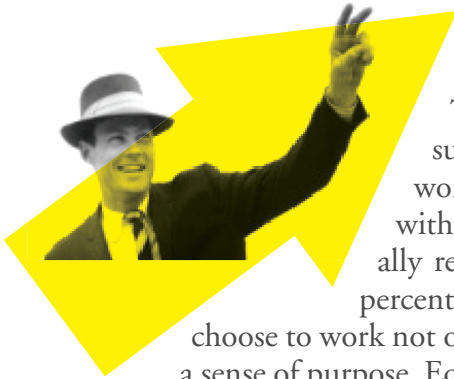
By definition, a freelance contractor is a person who pursues his profession without a long-term commitment to any one employer. They generally enjoy a great deal of freedom in choosing their area of work and the people with whom they want to work. Freelancers are mainly active in the service sectors such as graphic and website designing, content writing, advertising, consulting, and other creative and professional services. They are hired by every size of company as well as individuals for specific projects. This arrangement is usually a win-win situation for both parties. The employer is able to outsource his work without the necessity of creating a permanent position within the company, which benefits him economically (e.g. no added burden of payroll taxes and employee benefits). Even with reduced full-time staff, companies can still deliver goods and services on a business-as-usual basis.

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The Work Force Is Evolving. Calling All Freelancers! (CONTINUED)

Meanwhile, contractors have freedom in selecting their work, sometimes working from the comfort of their own home, and at any time that is convenient. Which is the reason so many “traditional” workers, those that work predictable hours and exhibit loyalty to a single employer, are opting for the freelance model. Contractors are not looking for employers to whom they can belong, but to networks in which they can thrive.

This Is Not Your Father’s Career Track.



The concepts of employee retention and career development may be supplanted by an emphasis on maintaining long-term connections to workers who manage their own advancement and change assignments with increased freedom. A recent AARP-sponsored study, using a nationally representative sample of 1,500 workers age 45 to 74, shows that 69 percent plan to work in some capacity during their retirement years. They choose to work not only for money but also for intangible benefits such as enjoyment and a sense of purpose. Equipped with sought-after knowledge and networks, these “emerging” workers are the catalysts of the new economy, moving quickly between jobs and assignments, transferring ideas, skills, and attitudes. The growing freelance market is rich in talent endowed with precisely the skills, capabilities and attitudes that are highly sought by employers.

Employer Tax Deficits Are Growing. And For Most States, It’s A Pain In The Budget.

By using independent contractors employers can save as much as 30% on payroll expense by avoiding payroll taxes, unemployment insurance, workers’ compensation coverage and other benefits they provide regular employees. However, inappropriately paying employees as independent contractors has helped (along with the Great Recession) to create huge state and federal tax deficits. One federal study concluded that employers illegally passed off 3.4 million regular workers as contractors. The Department of Labor estimates that up to 30% of U.S. companies misclassify employees. Ohio’s attorney general estimates that his state has 92,500 misclassified workers that cost the state up to \$35 million a year in unemployment insurance taxes, up to \$103 million in workers’ compensation premiums and up to \$223 million in income tax revenue.

30%

This revenue shortfall has led the federal government, along with several states, to enact legislation which increases government enforcement of and penalties for employee misclassification practices by employers. Companies found misclassifying employees can be assessed back taxes including social security, unemployment tax, workers’ compensation benefits, a hefty fine of \$1,100 per misclassification, and a civil penalty of up to \$5,000 for repeated violations.

Employer Tax Deficits Are Growing. And For Most States, It's A Pain In The Budget (CONTINUED)

To show they mean business, in February 2010 the IRS launched an initiative under their National Research Program (NRP) to audit 6,000 businesses, 2,000 per year over the next 3 years. These audits are focused on worker classification, fringe benefits, executive control, expense reimbursement and other payroll related issues. Employers are being randomly selected in every geographic region of the country targeting both large and small organizations. The New York Times recently reported that President Obama's 2010 budget assumes the federal crackdown will yield at least \$7 billion over 10 years.

Red Flags: We Have You On Radar!

Within the IRS and Department of Labor, red flags start flying from any number of triggers.

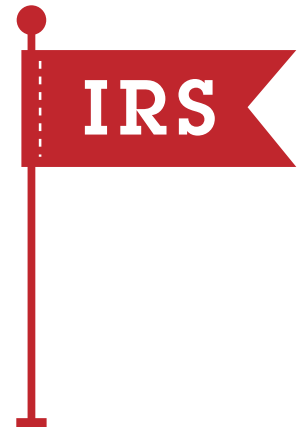
IRS Consider the example of a legal secretary who presented herself as an independent contractor to a prominent Colorado law firm. After her project with the firm ended she filed for unemployment benefits. An investigation into her claim revealed she had no clients other than the law firm, worked hours as dictated by the firm, performed all her work on the firm's premises using the firm's equipment, and was under the direction and control of the firm's attorneys. The Colorado Department of Labor and Employment, therefore, considered her to be an employee – not an independent contractor – and deemed her eligible for unemployment benefits. Additionally, the law firm was held liable for back payroll taxes and penalties.

Well-intentioned employers can easily end up on IRS and DOL radar screens when a Worker's Comp claim is filed by a contract worker. This happens with surprising frequency despite the logical assumption that an independent contractor should understand the implications of a business-to-business relationship. Likewise, an audit of Form 1099 records can lead authorities to an employer's doorstep.

It's not just government agencies that have stepped up surveillance. Civil lawsuits are growing in every state. An estimated 5,788 class action lawsuits for wage and hour violations were filed in 2009, a 40% increase over the prior year and representing over 80% of all class actions.

FedEx Ground and FedEx Home Delivery have been named in a class action suit brought by drivers for these divisions. The lawsuit asserts that the drivers are not independent contractors, as the company classifies them. The drivers are claiming damages for unpaid employee benefits, as well as unpaid overtime and unreimbursed employee expenses.

At the risk of stating the obvious, audits (*and the red flags that trigger them*) are things to be avoided. Audits can be long, invasive, and expensive ordeals. So even when you win, you lose!



Employee Or Independent Contractor? You Can't Afford To Guess.

Given all the scrutiny, why are so many workers misclassified? Besides the financial benefits of contracting labor, another answer is the complexity associated with worker classification. There is neither a single or simple test to determine whether a worker is an independent contractor or an employee. This isn't to say it can't be done, but knowledge of the various tests used by the IRS, Department of Labor, and state agencies is essential.

employee?

INDEPENDENT
CONTRACTOR?

Before you sign another 1099 contract it may be time for your organization to perform an independent contractor risk assessment to determine your exposure. Start by asking these preliminary questions:

- *Are your workers really operating their own businesses?*
- *Are you in any way directing their work activities?*
- *Do they have profit and loss potential?*
- *Who owns the equipment being used?*
- *Is the service being performed a core aspect of the business hiring the contractors?*



According to workplace experts, a growing number of companies are cutting costs by hiring independent contractors, though they are often given desks, phone lines and assignments just like regular employees.

The process for determining worker classification can be confusing. Factors that are relevant in one situation may not be relevant in another. The key is to look at the entire employment relationship. Determining worker classification is ultimately a case-by-case analysis based on factors that have been established at the federal and state levels.

In what is known as the Common Law Test, the IRS looks at three important areas:

- *Behavioral control (ex. Does employer provide instructions, training, or any direction of work activity?)*
- *Financial independence (ex. Does the worker have opportunity for profit and loss?)*
- *Relationship (ex. Is there a formal contract or agreement in place?)*



Also called Right of Control, the goal of this test is to determine whether the employer has the right to control the worker on the job. If so, the worker is classified as an employee rather than an independent contractor.

Each of these areas contains several common law factors that must be considered when making a determination. However, there is no predetermined formula that yields a definitive answer. In practice, the test must prove that the factors showing lack of control outweigh those that indicate control.

Employee Or Independent Contractor? You Can't Afford To Guess. (CONTINUED)

Many states use a stricter variant of the Common Law Test. Known as the ABC Test, it also contains three components:

- *Control or direction of work (ex. instructions or training provided)*
- *Outside service (ex. worker's service is outside employer's normal line of business)*
- *Independent business or trade (ex. worker's business activity exists independent of employer)*

It is possible for the Common Law Test to yield a different result than the ABC Test. The employer must then decide which classification to use. One possible, but ill-advised, approach would be to classify the worker as an employee for IRS purposes and as an IC for state purposes.

Confused? PayReel Can Help.



With an emerging non-traditional workforce, stepped up surveillance and enforcement of labor laws, and complex compliance guidelines, you need a deliberate approach to hiring and worker classification.

We strongly urge you to invest 10 minutes by taking our online Self Audit. It will help you identify possible risks associated with your current independent contractor classifications.

PayReel has extensive expertise and up-to-date documentation. We offer contingent workforce solutions that help companies gain and maintain compliance with IRS, Department of Labor, and state labor laws. We are a trusted advisor to our clients and would like the opportunity to help you.

You'll find our Self Audit at www.payreel.com, or call us at 303.526.4900.