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MISCLASSIFICATION OF WORKERS

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THE 1099 WORKER: PROPERLY CLASSIFIED? ... OR NOT.

You call your worker a “consultant” or even an “independent contractor.” You issue a 1099 every year. The worker has no objection to the arrangement. You’re in the clear, right? Not so fast. Through an arsenal that includes upcoming audits, harsh penalties, and dedicated enforcement personnel, the IRS and President Obama are taking aim at employers who misclassify workers as independent contractors. Is your company vulnerable to IRS audits and penalties for misclassifying its workers? Consult with counsel now, before it’s too late.

Just last month, the Internal Revenue Service instituted a three year National Research Program to evaluate compliance with employment tax laws by conducting audits of 6,000 randomly selected employers. As part of the IRS audits, employers can expect a close examination of whether workers are properly classified as an employee or independent contractor. Such misclassifications account for 82 percent of uncollected taxes, according

to recent estimates. In this time of budget deficits for Federal and State Governments, the incentive to identify and penalize misclassification is higher than ever.

Even if your company is not randomly selected for an IRS National Research Program audit, there’s still good reason to pay very close attention to worker classification issues. President Obama’s fiscal year 2011 federal budget proposal is aggressively targeting employers who misclassify their workers as independent contractors. Under the budget proposal, the Administration estimates that this new effort will increase Treasury revenues by **\$7 billion** over ten years by eliminating incentives for employers to misclassify employees and by penalizing those employers who do so. To enforce this measure, the budget also includes a **\$25 million** appropriation to hire **100** new enforcement personnel to uncover misclassifications and to provide grants to states as an incentive to address this issue. Many states — including New Jersey, New York, Connecticut, Illinois, Maryland, Massachusetts and Colorado — have passed legislation or established taskforces specifically aimed at preventing and penalizing worker misclassification. Make no mistake, the Federal and State Governments have

identified worker misclassification enforcement as a means of generating much needed revenue. Before your company finds itself funding that revenue, prompt compliance is essential.

Of course, the independent contractor classification — *when proper* — allows an employer to take advantage of many benefits and savings. There are many additional responsibilities, expenses, and statutory rights associated with employees, which are not applicable to independent contractors. For instance, an employer is required to withhold various federal and state taxes from an employee’s paycheck and submit it to the appropriate governmental entity, with potential liability imposed for a failure to do so. Although a company has an obligation to provide a form 1099 to independent contractors, which details payment from it during the prior year, the company has no obligation to withhold taxes for independent contractors. Companies also can save money if a worker is an independent contractor because they do not have to

make employer contributions to FICA (i.e. Medicare and Social Security taxes) and FUTA (i.e. unemployment insurance) for independent contractors.

Employees also have additional protections under Federal and New Jersey law, which independent contractors do not have. Independent contractors, unlike employees, are excluded from wage and overtime requirements and are not covered by Federal anti-discrimination statutes. Generally, companies are not liable to third-parties for the negligence or misconduct of independent contractors.

The determination of whether a worker is properly classified as an independent contract is a critical one. Too often, companies conclude that such a determination turns merely on whether a 1099 or W-2 is issued. Not so. Worker classification is a highly complex analysis that, more often than not, requires the advice of counsel. The consequences to employers of misclassifying an employee as an independent contractor are significant and expensive — but also avoidable.

Those who do not heed the warning of the Federal Government risk finding themselves a target of worker misclassification enforcement. Certainly, employers may be exposed to liability for back wages, overtime pay, and the taxes that should have been paid. In addition, the IRS imposes its own severe

penalties. Employers may have to pay a percentage of the misclassified employee's wages and taxes, even if the misclassification was unintentional. For example, penalties for unintentional misclassifications range from 20 percent to 40 percent of FICA that the *employee* should have paid and 1.5 percent or 3.0 percent of wages that were paid to employees misclassified as independent contractors. Penalties for intentional misclassification are even harsher, making the employer liable for 100 percent of the FICA that the *employee* should have paid and 20 percent of the wages paid to the employee.

Although a safe-harbor provision exists for some employers who improperly classify workers as independent contractors, legislation is currently pending in Congress — the Taxpayer Responsibility, Accountability, and Consistency Act of 2009 — that would erode those protections. In 2007, then-Senator Obama introduced a similar piece of legislation.

So are workers you treat as “independent contractors” truly independent contractors or should they be classified as employees? Simply calling a worker an independent contractor, of course, does not automatically make it so in the eyes of the IRS, where the presumption of innocence is so often turned upside-

down. While there are numerous tests to classify workers depending on the context, the IRS has adopted its own 20 factor test to identify independent contractors who are actually employees. The IRS test can be broken down into three main categories: (1) behavioral control; (2) financial control; and (3) the relationship of the parties. As those factors make clear, the classification is largely dependent on the factual circumstances of the relationship between the company and the worker.

If you have any questions about how to best deal with worker misclassification, please call David M. Wissert, Vincent A. Antonello, or Eric Jesse, members of the Firm's Employment & Labor Practice Group, at (973) 597-2500. We also would be pleased to provide you with assistance with respect to other employment practice and workplace compliance issues.

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