

IRS AND DEPARTMENT OF LABOR PLAN CRACKDOWN ON INDEPENDENT CONTRACTOR MISCLASSIFICATION: ACT NOW TO MINIMIZE YOUR RISK

The Internal Revenue Service (IRS) and U.S. Department of Labor (DOL) may have your company in their sights. These agencies have increased their interest in potential misclassification of employees as independent contractors. But even if the IRS and DOL do not come knocking at your door, the departments of labor in South Carolina and North Carolina are likely to begin addressing the misclassification issue more aggressively as well.

Reasons Behind Crackdown

According to the IRS, misclassification of employees as independent contractors costs the federal government billions annually. A 2006 Government Accountability Office report estimated that misclassification costs the U.S. government more than \$2.7 billion per year in Social Security taxes, unemployment insurance taxes, and income taxes. This number has surely grown with the downturn in the economy, as employers look to cut costs to stay competitive and thus use more independent contractors. Analysts estimate that companies utilizing independent contractors save as much as 30 percent of payroll by avoiding payment of payroll taxes, unemployment insurance taxes, and workers' compensation insurance premiums.

In February of this year, the IRS began what it refers to as its "National Research Project." However, the title is misleading. Under this "project," the IRS plans to aggressively conduct 2,000 random audits per year over the next three years. One of the primary focuses of the audits will be to identify companies that have misclassified employees as independent contractors. Those that have done so face the prospect of paying back payroll taxes as well as fines. These tax bills and fines can grow exponentially over time.

The DOL has similar plans. The White House's 2011 fiscal year budget proposal includes a \$25 million increase for the DOL. The DOL plans to use \$12 million of the increase to hire 90 new investigators who will conduct up to 4,700 audits. Calling the audit plan its "Misclassification Initiative," the DOL says it will focus on the following industries: construction, child care, home health care, grocery stores, and poultry and meat processing – all areas of the workforce that the DOL and plaintiffs' lawyers have traditionally targeted for wage payment claims and lawsuits. But unlike the IRS' pursuit of back taxes, the DOL's audits will focus on misclassification and whether

misclassification has resulted in an employer failing to pay overtime wages or at least the minimum wage.

The DOL will use \$11.3 million of the proposed budget increase to fund similar state initiatives, and the remaining \$1.6 million will go to the DOL's solicitor of labor to pursue enforcement actions against companies. Although South Carolina and North Carolina have not announced misclassification initiatives, increased funding from the DOL and decreases in state revenues – especially unemployment taxes – may prompt each state to conduct more audits. Importantly, the results of misclassification can be disastrous for employers. A California maid and cleaning service business recently paid \$3.5 million in back wages and over \$1 million in liquidated damages to resolve misclassification claims.

Conducting A Self-Audit

With the possibility of the IRS, the DOL, or other federal or state agency audits looming, companies should evaluate their use of any independent contractors. With the assistance of legal counsel, companies should conduct a self-audit to determine if employees have been misclassified as independent contractors. A key benefit to engaging legal counsel to assist with the self-audit is that the results are protected by attorney-client privilege in the event a company's classifications are challenged.

A self-audit is not as easy as it may sound. Each agency applies different standards to determine if a worker is an independent contractor or an employee. Unfortunately, there are no magic factors to help a company make a determination. In fact, in the event that a company has difficulty making one, the company may request a determination from the IRS. IRS Form SS-8 (Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding) asks a requesting company to first explain why an individual is an employee or an independent contractor and then requires the company to answer 32 questions (45 for service providers or salespersons) regarding the company's "behavioral control," "financial control," and the "relationship of the worker and firm."

In spite of the IRS' tedious forms and general lack of guidance, the common theme among each agency, including the IRS, is whether the company exercises control over the worker. For example, the IRS website states that "an individual is an independent contractor if you, the person for whom the services are performed, have the right to control or direct only the result of the work and not the means and methods of accomplishing the result." Thus, the critical inquiry is the extent to which the company exercises control over the worker. The more control exerted, the more likely the worker is an employee.

The use of independent contractors can be enticing. With some exceptions, most federal and state employment laws, such as Title VII of the Civil Rights Act of

1964, do not apply to independent contractors. Moreover, independent contractors often afford companies greater flexibility with their workforce as well as cost savings. On the other hand, misclassification can be costly. In light of recent activities and future plans of the IRS and DOL, if your company utilizes independent contractors, you should act now to minimize the risk of misclassification.

This Employment Law Update is published as a service to our clients and friends. It is intended to be informational and does not constitute legal advice regarding any specific situation.

N|P Employment and Labor Law Group

CHARLESTON

843.577.9440

Cherie Blackburn
Molly Hughes Cherry
Josh Ellis

CHARLOTTE

704.339.0304

Sean Phelan
Grainger Pierce

COLUMBIA

803.771.8900

Mike Brittingham
Jennie Cluverius
Kristian Cross
David Dubberly
Vickie Eslinger
William Floyd
Joan Hartley
Angus Macaulay
Susi McWilliams
Nikole Mergo
Sue Odom
Sam Painter

GREENSBORO

336.373.1600

Trudy Ennis
Peter Pappas
Bill Wilcox

GREENVILLE

864.370.2211

Grant Burns
Jamie Hedgepath
Leon Harmon
Rusty Infinger
Michael Pitts
Tom Stephenson

HILTON HEAD

843.689.6277

Melissa Azallion

MYRTLE BEACH

843.213.5400

Cherie Blackburn
Molly Hughes Cherry

RALEIGH

919.755.1800

Joe Diab
David Garrett
Ernie Pearson

NEXSEN | PRUET

