

I'm From the Government and I'm Here to Get Paid

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The Internal Revenue Service and the attorneys general of several states, including Ohio, have sounded the alarm: if you are misclassifying workers as contractors instead of employees, you may face an audit and significant financial exposure. While many businesses legitimately use independent contractors for select work, some use them to cut down on workers' compensation, unemployment coverage, group health insurance benefits, pension matches, stock purchase programs, and the need to pay overtime. By some estimates, there are over five million misclassified workers, or up to a third of all audited companies' workers, and the government intends to get its share of that payroll to fund public services and programs.

Over the years, the IRS has developed various tests, including the so-called 20-factor test, to determine whether an individual is an employee or an independent contractor. The factors consider the level of control a company has over an individual, and are reviewed on a sliding scale; thus, no single factor will be dispositive of a finding of "employee" or "contractor."

Generally, independent contractors are brought on for shorter durations, are expected to provide their own materials, and utilize their own methods to provide a work product by a defined deadline. Their payments are documented with a 1099 form, used to report income. Employees, on the other hand, are hired for a longer duration, typically have an established work schedule, and rely on materials or tools provided by the employer to complete the work in the manner specified by the employer. Employees' income is reported on W-2 forms, which delineates withholdings for taxes and entitlements.

Employers are responsible for contributing one-half of an employee's Social Security and Medicare. While independent contractors are required to pay their entire shares, this often does not occur. Similarly, the unemployment and workers' compensation coverages ordinarily paid by employers for employees is often not paid by contractors, despite statutory requirements.

In Ohio, approximately 2.3% of companies are audited annually by the Ohio Department of Jobs & Family Services, which administers the unemployment program. Extrapolating the findings of misclassification made in just these audited companies, the state estimates it loses \$20 million in unpaid unemployment insurance contributions. The U.S. Department of Labor's research estimates suggest that if only 1% of misclassified workers were misclassified, the national unemployment insurance trust fund is losing \$198 million annually.

A comparable analysis for the Ohio Bureau of Workers Compensation suggests that it loses \$103 million a year in unpaid premiums. And the state Department of Taxation suggests that misclassification results in \$36 million of uncollected state taxes.

Because companies have deeper pockets when misclassification is claimed, the employer will be the first one asked to write checks. These preliminary steps can help you avoid worker misclassification:

- Define the scope of the work that is being contracted out and be sure it is not easily confused with regular work done by your business.
- Be comfortable with the level of control that you need to cede to a contractor. Remember, the more control you exercise over the way a worker performs the work, the more likely you will be deemed to be an employer.
- Use a written agreement, preferably one crafted by your legal counsel, to define the relationship and specify which party is responsible or not responsible for various financial or insurance obligations.

For more information about independent contractor issues, please contact Joëlle Khouzam, Brigid Heid, Megan Boiarsky or your CPM attorney.