



The Remedy: 5 Potential Strategies to Mitigate Independent Contractor Misclassification

Independent Contractor
Compliance Strategies

Compliance **HR**
Simplifying the Complexity of Employment Law

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The Remedy: 5 Potential Strategies to Mitigate Independent Contractor Misclassification



Determining whether a worker is properly classified as an “employee” or an “independent contractor” is a complex – and increasingly difficult – challenge for Human Resources leaders and the Legal teams who support them.

The rapid growth of the gig economy, increased economic uncertainty, and the seismic shift to remote work have increased regulatory agency attention on this issue – and as a result, has dramatically increased the risk of worker misclassification for employers.

The Challenges of Independent Contractor Compliance

Proper worker classification is difficult because there are often overlapping but different tests depending upon the employment law topic (e.g., income tax, payroll tax, unemployment insurance, wage & hour, etc.) and which government agency is conducting the audit (e.g., tax, labor, federal, state, local, etc.) Depending on the jurisdiction and the focal point of the inquiry, it is not uncommon to see different determinations for the same worker.

As a general construct, all worker classification rules are looking at two sides of the same coin:

1. the degree of the worker’s independence from the client (who is paying the worker for their services) and,
2. the degree of the client’s control over the worker.

The fundamental employment law principle is that employees work for, and under the supervision of, their employers, who control what will be done and how it will be done. While independent contractors are self-employed and have independence from the client company, who can control only the result of the work, not how it will be performed.

This distinction between employer and client organization is significant. Employers have a substantial legal obligation to their employees, including adherence to wage and hour laws, state and federal income tax wage withholding, payment of unemployment and Social Security taxes, and workers' compensation and disability insurance, among many other labor law protections. Alternatively, independent contractors are not entitled to most of these benefits; all client companies need to do is pay the contracted rate and issue a Form 1099.

Consequently, classifying a worker as an employee or as a contractor can have a large effect on the costs of hiring that individual. For this reason, many government agency auditors view misclassification as an illegal means deployed by businesses to improperly reduce their labor costs and deprive the worker of their legal protections as an employee. Sometimes this may be the case, but with the workforce increasingly splintering and the rise of the gig economy and remote work, it is often a necessary strategy used by organizations to attract and engage the workers they need to get vital work done.

5 Potential Strategies to Mitigate Independent Contractor Misclassification

Despite the complexity of the laws and regulations surrounding worker classification, there are a variety of strategies that organizations can implement to help mitigate their exposure to risk.

These strategies make it possible to work safely with contractors in this complex and highly regulated environment, if the right choices are made before engaging an IC. In this whitepaper, we will address five strategies offering varying degrees of risk mitigation, convenience, and investment cost.

1. Do nothing
2. In-house HR or Legal team
3. Outside counsel
4. Outsource to an agency
5. Expert-based risk assessment solution

Let's explore each of them in greater detail.

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OPTION #1: Do nothing

This option is by far the most common approach. It amounts to just continuing to roll the dice, playing the odds that nothing will go wrong.

For obvious reasons, this strategy is not a recommended solution to mitigate risk—it will most likely create long term problems for your company.

Federal and state agencies report they lose billions of dollars per year in non-withheld income taxes and unpaid employment taxes due to the misclassification of independent contractors. Their stated goal is to close this “tax gap.” As a result, numerous federal and state agencies have made it a priority to collect this money by launching aggressive audit campaigns directed at companies, big and small, who use independent contractors. It is just a matter of time before a state or federal agency will knock on your door. If you haven't taken the proper steps to insure you're doing it correctly you could be facing a large unplanned liability.

OPTION #2: In-house HR or Legal team

The second option is to hire and/or train an in-house expert whose primary responsibility is to stay on top of, and be able to apply, the federal and state laws and rulings for Independent Contractor compliance. This is a full-time, highly technical position that requires seasoned expertise. The risk and complexity grows exponentially if you have a multi-state business footprint.

The biggest challenge with this approach is often the lack of experience and out-of-date, or inadequate, expert knowledge base to research and correctly interpret the regulations. Left to their own devices, internal teams often rely on whatever guidance they can find using their favorite internet search engine.

One of the options within this category is to use a former IRS or state auditor who specializes in this area of law, but good ones who know their business and make the transition to the private sector are hard to find. Some companies designate an in-house paralegal or legal staff for this work, but many attorneys do not specialize in this area of employment law and don't find it interesting, so they don't keep up on the recent rulings and trends.

Having a full-time in-house expert is only cost effective if you need to make these decisions on a frequent basis, and are willing to invest in staying current with the constantly changing regulations.

Determining proper worker classification can be a challenging and complex inquiry for employers. Since there are significant financial and reputational penalties for getting it wrong, employers are advised to seek out specialized help to mitigate the risk.

OPTION #3: Outside Counsel

The third option is to engage an outside law firm, specializing in labor law, on retainer to help you make the decisions as they come up. A larger firm, like Littler Mendelson, ensures your organizational employment law compliance needs can be met and supported by experts on each topic (ex. minimum wage, employee handbooks, etc.) and that you have support in local jurisdictions if you need it.

Using a legal expert to help you make the right determination can be a great option if you have no internal HR or legal support, and you do not often engage independent contractors.

However, most of the time you have to make this decision quickly in order to bring in the talent and get the project off the ground. Law firms are generally not set up to handle quick turnarounds and may slow down your HR or procurement decision cycle. In addition, engaging an attorney each time you want to evaluate an IC will be expensive and is usually not an ideal long-term solution for a growth company.

OPTION #4: Outsource to an Agency

A fourth option is to utilize a Temporary Staffing or specialized contractor payroll firm to evaluate and engage your independent contractors. While this can be a good option, particularly if you need the recruiting help, there are a number of challenges with this model.

Firms providing contingent workers for temporary projects are a viable option so long as the firm protects you from the inherent risks in this model. These firms typically recruit, conduct background screening, hire, place and pay the consultant in your company. Many of these firms train the workers, set the wage rates, withhold taxes, and provide account management and cost tracking to help you stay on budget. These firms also provide liability insurance and workers' compensation coverage, which will protect you from down-stream claims and significantly mitigate your employment risks. Usually these firms' primary expertise is temporary staffing, so IC qualification is not always a core capability.

You still control the employee's work during the assignment, but for all other purposes, including discrimination and harassment claims, the staffing firm is responsible for the consultant. The down-side to this arrangement is that many highly skilled consultants (the ones you really need for your project) are qualified IC's and will neither work as an employee nor want to be associated with a staffing firm. In addition, the pay and benefits packages offered by most staffing firms may not be robust enough to attract or retain top-level talent. Although this option provides the safety you desire, it may not provide the IC expertise you need.

Most importantly, you cannot completely outsource the risk. Even with a contract that offers indemnification against worker misclassification, it is important to remember that contract law does not supersede employment law. If the worker is determined to be misclassified, your company could still be liable—regardless of what the contract says. In this instance, your company would most likely be named as the employer since it was the organization that received the benefit of the contractor's work product.

OPTION #5: Expert-based risk assessment solution

The fifth and final option is to utilize an expert-based solution to evaluate your potential independent contractors and provide your management team with a risk assessment. This is a specialized legal services tool, delivered in the form of a software as a service (SaaS), developed and maintained by independent contractor classification experts.

With a subscription to a tool like this, your internal compliance team can conduct a risk assessment on each new, potential independent contractor project quickly and easily, and walk away with the confidence that they are avoiding the myriad of risks previously discussed.

It is very important that the risk assessment solution you select be built with the national experience, knowhow, and regulatory agency expertise of a major employment law firm. This provides you with the reassurance that all applicable federal and state regulations are considered, and the determination is informed by actual case law. To help mitigate your risk, the best of these services evaluate your IC use case against the most stringent agency standard in your location, and provide feedback and guidance on how to reduce your exposure further.

Conclusion

Determining proper worker classification can be a challenging and complex inquiry for employers. Since there are significant financial and reputational penalties for getting it wrong, employers are advised to seek out specialized help to mitigate the risk.

Fortunately, as this whitepaper highlighted, there are a few viable strategies that employers can take to substantially mitigate the risks of incorrectly classifying workers as independent contractors.

Disclaimer

This whitepaper is intended to serve as a starting point for educating Human Resources and Legal professionals on certain aspects of employment law and is not a comprehensive resource of requirements. It offers practical information concerning the subject matter and is provided with the understanding that ComplianceHR is not rendering legal or tax advice, or other professional services.

ComplianceHR – Simplifying the complexity of employment law

ComplianceHR offers the only on-demand, intelligent suite of HR compliance solutions focused on helping companies of all sizes address the ever-changing federal and state employment law requirements on employee handbooks, leave, onboarding, minimum wage, overtime, independent contracting, and more. All our solutions are powered by the subject matter expertise of Littler, the world's largest employment law firm and built on Neota's AI-powered platform. ComplianceHR solutions empower HR professionals, compliance teams, and attorneys to treat their workforce fairly while minimizing associated costs and risks. A great example of this is Navigator IC.

ComplianceHR's IC Compliance Solution

Independent contractor misclassification is perhaps the most difficult employment law compliance issue that companies face today. With Congress, state legislators, federal and state agencies, unions, plaintiff's attorneys and other groups all focused on regulating independent contracting, the legal updates and risks are seemingly endless.

If your organization engages independent contractors to get work done, you are most likely exposing your organization to significant compliance risk.

Different federal and state laws apply different tests for IC status – three, four or even six different tests may apply to a single contractor under wage-hour, unemployment, workers' compensation, employment tax, safety and equal opportunity laws. With this complexity, how is an employer supposed to know if a worker is an independent contractor or an employee?

Navigator IC

Navigator IC helps you take the guesswork out of this complex decision in a matter of minutes. And because we update all of our tools in real-time, you can be confident that the results and guidance you receive are accurate and up-to-date. This easy-to-use solution provides you with:

- An easy-to-use questionnaire for inputting individual fact patterns
- Risk assessments driven by expert analysis of applicable federal and state regulations and the outcomes of over 1,700 court cases
- Instant, actionable guidance and a customized report on how to lower the risk of misclassification
- A summary of applicable laws
- A complete questionnaire transcript

See a Demo

To learn more about ComplianceHR and Navigator IC, [register for a no obligation consultation](#) with a compliance expert. After you've met with our compliance consultant, you will receive a free, 14-day trial to use all of the Navigator Suite applications.