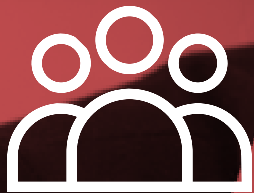

The Risks of Independent Contractor Misclassification

Improperly engaging a worker as an independent contractor instead of an employee can be a costly mistake. Here's what employers need to know...

ComplianceHR
Simplifying the Complexity of Employment Law

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The Risks of Independent Contractor Misclassification

The laws and regulations surrounding worker classification are complex, and getting it wrong can introduce significant risk to an organization, regardless of its size or industry. Unfortunately, for employers in the US, lawmakers and regulators have made it even more difficult with different and often contradictory guidance between the many federal and state agencies who enforce proper worker classification.

The purpose of this whitepaper is to provide a broad overview of independent contractor misclassification, highlighting the challenges for employers, and potential strategies to mitigate the risk.

The Challenge with Independent Contractors

As you often hear in the news, there is a growing number of workers in the US who prefer the lifestyle, flexibility, and income potential of working as independent contractors.

Like most supply and demand equations, there are two sides to this story. The increase in independent contractors workers has been enabled by a growing number of organizations in the United States that use contingent workers as a part of their day-to-day operations. Many of these companies view independent contractors as a vital component of their human capital strategy and a necessity in order to attract talent and remain competitive in the 21st Century.

Laws and regulations governing worker classification are complex and challenging to follow. Due to this complexity, expert knowledge of independent contractor compliance is generally not core to most Human Resources groups. Many organizations choose to ignore the issue, or they make a quick decision based on a quick Google search of applicable rules or maybe historical precedent. A much smaller percentage rely on in-house legal or HR staff to make a determination, but this is seldom their core expertise or desired activity.

Due to the lack of expertise, complexity of the law, and the growing focus on creating policies and laws around independent contractors,

the associated risks for employers are high. Moreover, this growth of contingent workforce utilization has led to a dramatic increase in worker misclassification investigations by various federal and state agencies.

Driven by the current employee-centric regulatory climate—where agencies are actively seeking to recapture "tax gap" revenue from employers while ensuring that all worker protections and benefits are provided to employees—these investigations can often result in costly settlements, hefty legal bills, and a host of other undesirable outcomes for the employer.

Independent Contractor is a Valid Worker Category (So Long as You Get It Right)

Contrary to what many politicians and labor organizations would have you believe, it is not illegal to engage independent contractors to get work done. Organizations get in trouble when they fail to properly classify a worker, and then subsequently engage that worker as an independent contractor when the worker really should have been an employee.

Most US employment law is based on the Common Law construct of the employee/employer relationship. No matter which regulatory agency we consider, the standards and tests used to determine worker classification generally have **a bias that every worker is a non-exempt employee of the organization–not an independent contractor**. This will also be the default position of the agency in an audit. The burden of proof, and the risk of getting it wrong, is completely on the employer. In the auditors view, the party that is benefiting from the work product (the employer) must prove that the worker is an independent contractor based on the agency's standards.

Key Terms and Concepts

Worker misclassification is a complex employment law topic. So, a good place to begin is with some basic definitions.

Employee and Employment

The FLSA defines employee as "any individual employed by an employer" and employment is defined as including "to suffer or permit to work." The concept of employment in the FLSA is very broad and is tested by "economic reality." Under common-law rules, anyone who performs services for you is your employee if you can control what will be done and how it will be done. This is the case even when you give the employee freedom of action.

In general, when you are an Employee...

- Your employer must withhold income tax and your portion of social security and Medicare taxes.
- Also, your employer is responsible for paying social security, Medicare, and unemployment (FUTA) taxes on your wages.
- Your employer must give you a Form W-2, Wage and Tax Statement, showing the amount of taxes withheld from your pay. This is why employees are sometimes referred to as "W-2 workers."

Short-term and Temporary Workers

Federal and state laws define the terms "employment" or "employ" very broadly and, as a result, short-term, temporary, casual, and seasonal workers are generally also considered to be "employees" of the organizations that utilize these categories of workers as part of their operations. Employers that fail to (a) properly classify their workers as employees (as opposed to independent contractors) and/or (b) accurately and timely report the number of employees in their employ, subject themselves to lawsuits and audits/investigations brought by employees and government regulators.

Independent Contractor

There is no universal test to determine who is an independent contractor.

Unfortunately, for employers there is no universal test to determine who is an independent contractor. Instead, different agencies have adopted a variety of tests, e.g., "right to control," "economic reality," "hybrid," and "entrepreneurial," all of which tend to be subjectively applied. Under common law, an employee is someone who the employer has the control over as the manner and means as well as the results. Conversely, an independent contractor is someone who is engaged only to produce results.

In general, when you are an Independent Contractor...

- The business you provide services to may be required to give you Form 1099-MISC, Miscellaneous Income, to report what it has paid to you. This is why these workers are often referred to as "1099 workers."
- You are responsible for paying your own income tax and self-employment tax (Self-Employment Contributions Act – SECA). The business does not withhold taxes from your pay.
- You may need to make estimated tax payments during the year to cover your tax liabilities.
- You may deduct business expenses on Schedule C of your income tax return.

Misclassification

Alternatively referred to as worker misclassification, IC misclassification, or employee misclassification, all of these terms are used interchangeably in the field to describe the same scenario: An employer mistakenly (or sometimes purposefully) engaging and paying a worker as an independent contractor when they should have been engaged as employee of the company. As noted in the introduction, agencies care about proper worker classification for two primary reasons: (1) The collection of the appropriate employer taxes and (2) Ensuring the worker receives the appropriate benefits and labor standards protections—for example: minimum wage and overtime protections under the Fair Labor Standards ACT (FLSA).

The Growth of Independent Contracting

The independent workforce enables companies, government agencies, and not-for-profit organizations of all sizes to expand their workforces during periods of peak demand—such as holiday seasons for retailers—and then revert to a leaner core team when workloads return to normal. The ability to call in specialized help on an as-needed project basis has great value for companies of all sizes—from small businesses and start-ups, all the way up to global enterprises.

As the labor market tightens, and the “war for talent” heats up, innovative companies are realizing the contingent workforce can be a vital component of an overall workforce strategy.

- There are 64.6 million independent workers in 2022, **up 26% over 2021**. The number of Full-Time Independents, those regularly working more than 15 hours per week, soared 27% to 21.6 million- up from 15.3 million in 2019. [Source: MBO Partners, 2023 State of Independence]
- In 2022, 36 percent of employed survey respondents said they labor as independent workers, up from the estimated 27 percent in 2016. [Source: McKinsey, American Opportunity Survey]
- Eight in ten companies (80%) think cost savings and increased flexibility are important aspects of using a contingent workforce. Other important factors include ability to quickly adjust the size of the workforce (77%), higher quality workers (76%), access to a larger candidate pool (73%), and expert training (67%). [Source: Spherion and Harris Interactive]

The increased percentage of the working population identifying themselves as independents is due to several factors. Digital platforms, such as Upwork and LinkedIn, have empowered a larger pool of workers to promote themselves and find work. To weather the volatility created by the COVID-19 pandemic, many companies shifted to remote-first business models and created a more agile workforce, made up of more workers that are independent. Finally, layoffs during the pandemic and cost-of-living issues pushed a larger number of workers to seek additional revenue opportunities by way of independent contractor positions.

With all of this evidence, it is clear to see why contingent labor is a vital, and growing, component of the total U.S. workforce.

The IC Use Case

Here is a common scenario that plays out every day in today's workplace: Let's say you have a critical project that needs to get done ASAP, but nobody in your organization has the time, or perhaps the experience, to complete it. Now imagine that you just found a highly skilled, experienced, and motivated worker to complete the project. The worker comes highly recommended and insists the only way they will do the work is as an Independent Contractor (IC). Since there isn't anyone in your company with the skills to do the job, and you know the IC would cost much less than a full time, pay-rolled employee, you engage them.

The ability to call in specialized help on an as-needed project basis has great value for companies of all sizes—from small businesses and start-ups, all the way up to global enterprises.

As an employer, you know that employees come with Social Security, unemployment insurance, worker's compensation insurance, health insurance, dental, matching 401(k), life insurance, overtime pay, protection against discrimination, and an endless list of other fringe benefits, protections, and operational costs that are commonplace in the United States. The IC model allows you to secure the exact skill set you need while avoiding these costs and obligations, and the issue of what to do with the worker after the project is completed. The IC will make more income, can claim business expenses denied to employees, and has the freedom to accept other, lucrative jobs while still serving your company.

In this scenario it looks like you made a smart business decision that will get a vital project completed while saving the company money. This appears to be the perfect win-win outcome. Right?

As we saw in the prior section, the Independent Contractor model can be good for the company and good for the IC. The model reflects

the individual, entrepreneurial spirit that has made America great, and appears to have no downside.

That is, until something goes wrong...

What Can Go Wrong When Engaging Independent Contractors

There are a number of significant risks when using independent contractors that most companies never consider until it is too late. The possible triggers are endless, but here are a few of the most common examples:

- The IC suffers an injury on the job, and then files a worker's compensation claim...
- The IC causes an auto accident with injuries while commuting to/from your worksite, and in addition to an insurance claim, the other party also sues your company (hoping for deep pockets)...
- The IC decides they are missing out on the benefits offered to your employees, and should not have been classified as an IC. So, they fill out an IRS SS-8 form to determine their status...
- The IC believes they have been treated unfairly, or was harassed by company employees while on the project and files a complaint with a supportive agency...
- The IC doesn't perform to expectations and is terminated. They disagree with your decision and spitefully engage an employment law attorney...
- The IC completes the job successfully and leaves, then files for unemployment insurance benefits when they can't find their next gig...
- A government regulatory agency knocks on your door and questions the consultant's classification, asking you to produce documentation that you classified the worker correctly...

Each of these events, along with a host of others, can trigger a 20-20 hindsight evaluation of your decision to classify the worker as an IC instead of an employee by a regulatory agency (or a judge). If you did not do it right in the beginning, or if you guessed, gambling that nothing would go wrong, your company could be facing a very large unplanned liability now that the honeymoon between you and your IC is over.

These investigations often include an investigative survey by the agency to find other potentially misclassified workers within your organization. Further compounding the problem for employers: the audits can go back three years.

To make matters worse, these investigations often include an investigative survey by the agency to find other potentially misclassified workers within your organization. Further compounding the problem for employers: the audits can go back three years. At that point, there is often little to no project documentation, project sponsors have left the organization, and that worker who "forced" the decision to be classified as an IC is now represented by a plaintiff's attorney and has developed selective amnesia about their project and is changing the narrative.

When you made the decision whether the contractor was an employee or an IC, your criteria might have been based upon the expressed wishes of the parties and what was financially sound and practical for a successful project. However, the courts, the IRS, and the state enforcement agencies use a different set of criteria to decide who is an Employee and who is an Independent Contractor.

Today's regulatory and tax enforcement environment is riddled with complexities and hazards for organizations using IC's. For example, in California there are at least three government agencies that are interested in the proper classification of workers: the Internal Revenue Service (IRS), the Employment Development Department (EDD) and the Department of Industrial relations (DIR). Each of these three agencies has the responsibility for ensuring accurate worker classification. They are diligent in their work and when they find errors in classifying workers, **they will charge your company with back taxes, penalties, interest, and fines.**

Given this level of interest and cooperation between agencies, it should come as no surprise that the National Employment Law Project (NELP) found that, in 2017 to 2018, 9 out of 10 California businesses inspected were found to be out of compliance by at least one agency. Furthermore, they found that two out of five resulted in findings of violations by every California agency involved in that state's task force.

These agencies often have Memorandums of Understanding with one another – agreements to share information about companies found to be "Out of Compliance." Once this information is shared, the results of a state tax audit can also become the basis for an IRS tax assessment, greatly multiplying your unplanned liabilities. It is not unusual for the combined tax assessments to be **several millions of dollars**.

A particularly egregious category of potential outcomes are civil class action lawsuits filed by disgruntled workers. In a typical case, workers who signed on willingly as IC's later decide the grass is greener on the other side of the fence, which opens the door for a class action lawsuit. If the court decides your company didn't do

it right, the unplanned liability resulting from these actions can be very costly. Even if the company eventually wins through a series of appeals, the time, energy and cost of fighting these lawsuits drains time and resources, distracts top management from core business activities, and results in significant employer brand damage.

No company is exempt from this phenomenon. In recent years, many companies have been subject to class action lawsuits related to the misclassification of their workers. Most of these cases never become public, as the majority of companies involved elect to settle with the auditing agency to avoid the negative PR, management distraction, and legal expenses. To find more examples, simply use your favorite search engine to look up "Independent Contractor Class Action Lawsuits." You will find hundreds. You will also find specialized law firms that encourage workers to instigate lawsuits. These law firms often prominently advertise their successes to attract new cases.

Overview of the Risks and Potential Penalties for Misclassification of Employee as Independent Contractors

There are numerous government agencies interested in the issues surrounding employee misclassification. This section highlights the most common risks and potential penalties for misclassification of employees as independent contractors.

In addition to federal statutes, there are a number of state-specific tests to determine independent contractors. As a result, employers face many potential penalties for misclassifying their workers.

The list below includes penalties under federal law, as well as some general types of penalties under state law. Some state misclassification laws are more onerous, including those states enacting legislation that create rebuttable presumptions that all workers in certain industries are employees. Other states have greater penalties for misclassifying workers, including, for example, triple damages for unpaid wages. Therefore, employers must carefully consider the potential state-specific penalties in addition to the federal penalties when determining how to classify their workers.

- **Fair Labor Standards Act (FLSA)** – The U.S. Department of Labor (DOL) enforces several labor laws to protect contingent workers, including the FLSA, which provides minimum wage, overtime pay, and child labor protections. Employers that

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misclassify their workers may be liable for unpaid wages, 100% liquidated damages, civil penalties up to $2,050 per violation (as of January 16, 2020), reasonable attorneys' fees and costs. Criminal penalties may include up to a $10,000 fine and imprisonment for up to six months, upon conviction for a second violation. Under the FLSA, there is a two-year statute of limitations for back pay or three years, if an employer is found to have willfully violated any provision of this Act.

- **Employee Retirement Income Security Act (ERISA)** – Employers may be liable for unpaid ERISA and non-ERISA benefits that the worker would have received if workers had been properly classified.
- **Federal and State Tax Liabilities** – Employers that misclassify their workers may face Internal Revenue Service penalties including: (a) 100% of the combined worker-employer contribution under the Federal Insurance Contributions Act, comprised of both Social Security and Medicare taxes; (b) federal income tax not withheld; and (c) unemployment insurance (FUTA), as well as penalties and interest. Under state tax laws, employers may, at minimum, be required to pay for taxes that were not deducted or withheld from misclassified employees, as well as any additional penalties and interest.
- **State Labor Laws** – Employers that misclassify their workers may be liable for unpaid wages, liquidated damages (double or triple), civil penalties, reasonable attorneys' fees, prejudgment interest and costs. In some states, employers face criminal penalties for violating labor laws, which may include fines and imprisonment. Additionally, the statute of limitations to commence an action for unpaid wages or compensation may be longer in some states. For example, the statute of limitations under the New York Labor Law is six (6) years, which significantly increases the potential penalties for employers that are found to have misclassified their workers.
- **State Workers' Compensation Laws** – Employers that misclassify their workers may be subject to both workers' compensation claims and civil tort actions by injured employees, and can also face significant fines and/or be convicted of misdemeanors or felonies, depending on the scope of the violation. In New York, an employee-friendly state, workers' compensation penalties for misclassification may also include a fine of $2,000 per every 10-day period of noncompliance or a sum not in excess of two times the cost of compensation for its payroll during the period of non-compliance.

Is has been estimated that the total costs of federal and state agency assessments could result in taxes, penalties, interest, and fines that range between 27% and 53% of the gross remuneration originally paid to all the consultants/contractors determined to be misclassified. **For example, every $100 paid to the consultant/contractor could cost an additional $27 to $53 in additional taxes, penalties and interest.**

- **State Unemployment Insurance Laws** – Employers that fail to pay contributions for independent contractors found to be employees may be assessed certain unpaid contributions for the period of time the employer is in default. Employers may also be subject to criminal prosecution by a fine or imprisonment, or both.
- **State Wage Notices and Statements and Recording** – Keeping Penalties – In some states, employers that fail to provide employees with wage notices and pay statements (pay stubs) may face fines and penalties.
- **Personal Liability** – Corporations and individuals who are found to be employers by courts and administrative agencies are subject to the penalties described above under the FLSA, ERISA, as well as various state labor, workers' compensation, and unemployment insurance laws.
- **Two-Prong Attack from Employees and Government Regulators** – Employers that misclassify employees are subject to potential claims from employees and government regulators who may file private court actions, including collective-and-class actions. Employers are also subject to regular and aggressive audits and investigations conducted by federal, state, and local governmental agencies, which have increasingly started to share information to coordinate their enforcement efforts.

The following table provides a quick overview of the various federal and state agencies that care about employee misclassification.

Key Federal and State Agencies that Can be Affected by Employee Misclassification [Source: GAO]

Government Entity	Law	Areas potentially affected by employee misclassification
U.S. Department of Labor	Fair Labor Standards Act	Minimum wage, overtime, and child labor provisions
	Family and Medical Leave Act	Job-protected and unpaid leave
	Occupational Safety and Health Act	Safety and health protections
U.S. Department of Treasury–Internal Revenue Service	Federal tax law, including: Federal Insurance Contributions Act Federal Unemployment Tax Act Self-Employment Contributions Act	Federal income and employment taxes
U.S. Department of Health and Human Services	Title XVIII of the Social Security Act (Medicare)	Medicare benefit payments
DOL/IRS/Pension Benefit Guaranty Corporation	Employee Retirement Income Security Act	Pension, health, and other employee benefit plans
Equal Employment Opportunity Commission	Title VII of the Civil Rights Act	Prohibitions of employment discrimination based on race, color, religion, gender, and national origin
	Americans with Disabilities Act	Prohibitions of discrimination against individuals with disabilities
	Age Discrimination in Employment Act	Prohibitions of employment discrimination against any individual 40 years of age or older
National Labor Relations Board	National Labor Relations Act	The right to organize and bargain collectively
Social Security Administration	Social Security Act	Retirement and disability payments
DOL/state agencies	Unemployment insurance law	Unemployment insurance benefit payments
State agencies	State tax law	State income and employment taxes
	State workers' compensation law	Workers' compensation benefit payments

The Many Standards for Determining IC Classification

Each of the various state and federal agencies have their own legal standards, rules, and case histories for determining who is an employee or an independent contractor. These different tests can make it very challenging for organizations to determine who is an employee or an independent contractor.

Making it even more difficult for employers to interpret, let alone apply, each of the factors can take on a different weight depending on the profession being considered. In addition, both federal and state laws have statutes that make exceptions to the common law rules.

The numerous rules are also often weighted differently depending on the reason the worker's status is being questioned. The threshold or "bar" defining an employee is set either higher or lower for different programs. For example, if a worker has been injured on the job they are more likely to be considered a "covered employee" than the same worker reviewed during an audit by the IRS for the purpose of income tax withholding. The Employee/IC threshold for unemployment insurance coverage is different from either the IRS or a worker's injury case. So, **it is actually possible for the same worker to be an IC for one agency and an employee for another**. Once one agency has held a worker to be an employee the others are more likely to agree; however, if an agency holds a worker to be an IC the others will still rigidly and independently apply their own set of rules.

A 2020 analysis, focusing on state-level reports on misclassification, estimated that as many as 30% of employers may misclassify their workers.

[Source: National Employment Law Project]

If the status question has arisen because of a civil class action law suit, where disgruntled workers sue their employer for such grievances as overtime, business expense reimbursement, co-employment benefits and rights, sexual harassment or discrimination–the judge may even elect to ignore the government administrative rulings and use their own criteria.

Whew! That's a lot of uncertainty and risk... So, what options do employers have to be compliant?

Conclusion

Few issues are likely to provoke more divergent views from regulators and employment lawyers than the role and classification of independent contractors in the U.S. workplace. Driven by a number of demographic and economic reasons, a growing number of companies are engaging independent contractors to get vital work done. In doing so, they face an increased risk profile due to independent contractor misclassification. Rapidly evolving federal and state legal standards for when and under what circumstances businesses can properly classify workers as independent contractors are forcing organizations to navigate this increasingly complex risk.

The consequences of misclassifying a worker as an independent contractor—which potentially range from unpaid wages and tax contributions to civil penalties and liquidated damages—can be significant, particularly for businesses that utilize a substantial number of contractors.

Fortunately, 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.

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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 contracts 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

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