

# Worker Classification – Employee or Independent Contractor?

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# Agenda

- Introduction
- Factors Used to Classify Workers
- How Misclassification of Workers Happens
- Best Practices for Proper Classification
- Risks and Penalties of Misclassification
- How to Deal with a Government Audit
- Questions

# Introduction

- Preliminary Remarks
- Questions – hold all questions until the end of the presentation; Will Try to Respond to Emails
- Alternatives to Independent Contractors Discussed, i.e., Subcontractors, Employees

# Definitions

- Independent Contractor – not on payroll of established company, e.g., sole proprietorship or one-person company.
- Employee – on company payroll.
- Subcontractor – on payroll of another, established company.

# Advantages of Employees

- No Concerns About Misclassification
- Employer Policies and Work Rules Automatically Apply
- Common Law Duties of Loyalty Apply
- Key Competencies Retained

# Disadvantages of Employees

- Expectation of Continued Employment
- Costs of Training
- Costs of Tax and Withholding Obligations
- Cost of Hire, e.g., Recruiting, Interviewing and Doing Background Checks
- Costs of Benefits, Severance

# Advantages of Independent Contractors

- Already Trained
- No Expectation of Continued Employment
- Workers Often Prefer Independent Status
- Provide Own Insurance, Tools and Work Space
- Not On Payroll; No Withholding Obligations

# Advantages Cont'd

- No Costs of Hire, e.g., Recruiting, Interviewing and Doing Background Checks
- Unsatisfactory Contractor Can be Summarily Terminated
- No Liability for Employee Benefits. (Benefit Plans Can Exclude Contractors)
- No Severance Costs or Overtime Compensation
- Contract Governs the Work, Not Employment Laws



# Disadvantages of Independent Contractors

- **Risk of Misclassification – Tax Penalties and Worker Eligibility for Employer Benefits**
- No Duties of Loyalty
- Loss of Expertise When Contract Ends
- Work Rules and Confidentiality Requirements Do Not Automatically Apply
- Lack of Knowledge of Employer's Specific Needs

# IRS Factors for Classification of Workers as Employees or Contractors

- Generally, IRS Looks to the “Economic Realities” of Work Relationship, i.e., Direction and Control of Work By Employer
- Specifically, IRS Considers the Factors Set Forth in Form SS-8, “Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding”

# Factors for Classification – Cont'd

- Was Worker Solicited by Bid or Application
- Was Worker Previously On Employer Payroll
- Is There a Written Contract With the Worker
- Is the work performed on Employer's Premises or Elsewhere

# Factors for Classification – Cont'd

- What, if any, Training Provided by Employer
- Does the Worker Control Work Schedule
- Does the Worker Control How Work Is Performed
- What, if any, Reports are Required From Worker

# Factors for Classification – Cont'd

- What, if any, Meetings is Worker Required to Attend
- How Does Worker Receive Work Assignments
- Can Worker Hire Others To Do the Work
- How is Worker Compensated, e.g., Hourly, Lump-Sum, Piece Work

# Factors for Classification – Cont'd

- What Supplies, Equipment, Materials, Tools Does the Worker Provide
- What Expenses Are Incurred by Worker in Performing Services
- What Expenses Are Reimbursed by Employer
- Does Worker Provide Liability and Worker's Compensation Insurance

# Factors for Classification – Cont'd

- Does the Worker Perform Similar Services for Other Entities
- What Evidence is There of the Worker Having Own Business, e.g., Business Cards, Website, Directory Listing, Corporate Status, etc.
- Can the Work Relationship Be Terminated By Either Party Without Penalty
- What Does Worker Do, e.g., Production Work

# Factors for Classification – Sales

- Does Worker Solicit New Customers
- Does Employer Provide Worker With Leads
- Are Orders Subject to Approval By Employer
- Who Determines the Worker's Territory



# State Law

- State Law Typically Focuses on Right of Employer to Control Work
- Also Focuses on Whether Worker Performs Services for Entities Other Than Employer
- Can Be Criminal Penalties For False Statements to Avoid Taxes [CRS 8-81-102(2)]

# Issues with Interns

- IRS Looks Primarily To Which Party Benefits Most – Employer or Intern
- If Employer Would Pay Someone Else to Do the Work, the Intern is an Employee
- In addition to taxes owed, Misclassified Intern is Also Owed Minimum Wage and Overtime

# How Misclassification Happens

- Worker Insists on Independent Status
- Headcount Drives Classification
- Work Relationship Evolves to Full-Time
- Work Done By Contractor Is Also Done by Employees

# Best Practices for Proper Classification

- Centralized Decision-Making
- Decision Tree at Time of Engagement
- Compare Worker Situation to IRS Factors
- Written Agreement
- Monitor Independent Contractor Relationships

# Decision Tree

- HR Issues With Worker On or Off the Payroll
  - Costs of Hire
  - Availability of Candidates
  - Work Includes Skills Employer Needs to Retain
  - Need for Supervision, e.g., for Quality Control
  - Headcount
  - Short- or Long-Term Position

# Decision Tree; HR Issues, Cont'd

- Effective Use of Independent Contractors is also Based on Effective Analysis of Company Needs, e.g.,
  - Is Overtime Pay More Cost Effective
  - Does Contractor Productivity Compare Favorably With Employees
  - Can Sick Time Be Reduced and/or Vacations Managed Without Use of Contractors

# Decision Tree – Cont'd

- Legal Issues With Worker Off the Payroll
  - Does Worker Have Other Customers
  - Compare Worker Duties With IRS Factors
  - If Worker Not Independent Under IRS Rules, Consider Employee Leasing Agency
  - If Worker Independent, Have Written Agreement

# Terms of Written Agreement for Independent Contractors

- Contractor Responsible for Taxes
- Contract Provides For No Payment if Contractor Performance Unsatisfactory
- Contractor Responsible for Worker's Compensation and Liability Insurance
- Payment on Lump-Sum Basis, Not Hourly



# Terms of Written Agreement, Cont'd

- Contractor to Provide All Tools, Equipment, Labor and Supplies
- Project Completion Date
- No Reimbursement of Expenses
- Confirmation of Independent Status
- Work Done Off of Employer's Premises

# Monitor Independent Contractors

- Require Proof of Worker's Compensation and Liability Insurance On Ongoing Basis
- Provide ID, e.g., Badge, Indicating Non-Employee Status
- Make On-Line Bid Process Different and Separate From Job Application Process
- Prohibit Attendance at Employer Functions and Meetings (Unless Essential To Project)

# Monitoring, Cont'd

- Employer Should Not:
  - Engage Contractor Full-Time for Extended Period
  - Provide Business Cards, Uniforms, Etc.
  - Provide Credit Cards, Cell Phones, Etc.
  - Require Specific Hours of Work
  - Provide Dedicated Work Space
  - Supervise Day-to-Day Work

# IRS Penalties for Misclassification

- Interest on Unpaid Taxes
- Civil Penalties for:
  - Late Filing
  - Disregard of Tax Rules
  - Understatement of Tax Liability and,
  - Aiding the Understatement of Tax Liability

# Penalties – Cont'd

- If Contractor Paid by Job but Deemed an Employee, Company Could Owe Overtime Compensation and/or Minimum Wage
- If the Case, Company Owes:
  - Increase Wages
  - 100% Penalty on Amounts Owed and,
  - Attorney Fees

# Penalties – Cont'd

- Per IRS, Company Officers are Liable to Pay a Penalty for a “Willful” Failure to Withhold
- “Willful” Means the Officer Ignored an Obvious Risk of Misclassification  
*Feist v. US*, 607 F.2d 954 (Ct. Cl. 1979)

# How to Deal With a Government Audit

- Cooperate
- Let Workers Know of Audit
- Provide Documents and Information Selectively

# Audit, Cont'd

- Provide Documents Off-Site
- Obtain Legal Counsel
- Consider Voluntary Settlement With IRS



# Voluntary Classification Settlement Program (VCSP)

- Use IRS Form 8952
- For Employers Treating Workers as Non-Employees
  - Who Have Complied Requirements of Form 1099
  - Who Have No Current Dispute With IRS Regarding the Workers
  - Are in Compliance with Prior IRS Audits

# VCSP, Cont'd

- Employer Agrees
  - To Treat Workers as Employees Going Forward
  - To Extend S/L From 3 to 6 years
- Advantages to Employer
  - IRS Agrees Not to Audit Worker Classification for Prior Years
  - Tax Savings, and No Interest or Penalties

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