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**IS IT TIME FOR AN INDEPENDENT CONTRACTOR AUDIT?**

The economic benefits of hiring workers as independent contractors are obvious: employers do not pay the employer's share of Social Security and Medicare nor unemployment and worker's comp premiums, there are no benefits such as health insurance and retirement plans, and independent contractors are not protected by the wage and hour nor discrimination laws. A study by Michigan State University calculated that hiring independent contractors, instead of employees, can save employers 20% to 40% on labor costs. However, are these independent contractors really independent contractors and not employees in disguise? This question is becoming increasingly important because federal and state governments are stepping up their enforcement activities concerning the misclassification of employees as independent contractors and the penalties for misclassification can be severe.

The U.S. Bureau of Labor Statistics estimates more than 10.3 million workers in the United States are treated as independent contractors (7.3% of the workforce) and a United States Department of Labor study in 2000 found that more than 30% of businesses have misclassified these employees as independent contractors. The Governmental Accounting Office recently estimated that misclassification of employees as independent contractors resulted in the underpayment of social security, unemployment, and income taxes of $2.72 billion in 2006. In Michigan, unemployment insurance audits recovered over $800,000 of premiums for the years 2006 – 2008 due to misclassification of independent contractors.

In response to these findings, the Department of Labor has instituted the "We Can Help" program and hired ninety full-time investigators to investigate misclassification of employees. The Internal Revenue Service has instituted a program which will conduct 6,000 random audits of businesses over three years aimed solely at the misclassification issue. Michigan has formed an Interagency Task Force to investigate misclassification and hired an outside contractor to perform audits for unemployment insurance. In short, governmental enforcement at all levels is increasing.

The costs to an employer are significant if it is determined an employer has misclassified an employee as an independent contractor. The employer's liability will include the amounts owed on unpaid taxes and insurance premiums along with penalties and interest and, possibly, the amounts it should have withheld from the employee's pay for income taxes and the employee's share of Social Security. Additionally, misclassification may also give rise to additional liability under the wage and hour laws, specifically overtime pay, and possibly benefits owed to the employees.

Given the foregoing state of affairs, an audit of independent contractor relationships is prudent. However, any audit is complicated by the fact that different governmental agencies apply different tests in determining whether a worker is an independent contractor or an employee. The Internal Revenue Service used to apply a test

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with twenty factors, but now has a "simplified" test. Michigan applies the "economic realities test" (except in worker's comp matters which has a different test). One constant with all these tests is that there is no "bright line" demarcation between employees and independent contractors. Usually, some factors indicate an independent contractor and other factors suggest an employee. However, the basic question as to whether a worker is an employee or an independent contractor primarily turns on the type and amount of "control" exercised by the employer. Generally, the employer's "control" of an independent control is largely limited to controlling the **result** of the work. If the employer retains control over the **means** and **methods** of the work, then the worker will most likely be considered an employee and not an independent contractor. Stated another way, the employer can tell an independent contractor what is to be accomplished, but not how to do it. If an employer tells a worker when and where to do the work, what tools or equipment to use, what workers to hire or assist with the work, where to purchase supplies or services, what work must be performed by a specified individual, or what order or sequence to follow, then there is a high likelihood the worker will be deemed an employee. Conversely, if the worker uses his own tools and equipment in the work, makes his services available to other employers, or can realize a profit or loss on the work, then it is very likely the worker will be deemed an independent contractor. It must be stressed that these are only some of the factors which are considered in determining whether a worker is an independent contractor or an employee.

The fact that the employer and the worker have a contract specifying that the worker is an independent contractor is of little importance. The fact that the worker is highly skilled or only going to be employed for a short period of time is largely irrelevant. Rather, the focus is an amount and type of control the employer has over the performance of the work.

I recommend that any audit of an independent contractor relationship start with applying the IRS test to the specific facts of the independent contractor position. An honest and objective evaluation of the facts and the law is essential. If the audit discloses potential legal problems, the employer can possibly adjust the relationship in order to have a better chance of meeting the requirements for an independent contractor relationship or, if necessary, reclassify the worker as an employee. It can be anticipated, especially given the federal and state governments' financial conditions, that enforcement activity will increase and a finding that an employee has been misclassified as an independent contractor will be very expensive for the employer.

This article was written by attorney C. Phillip Baither. Please contact Mr. Baither for further information regarding this article or any other labor and employment issues.

C. Phillip Baither
Attorney at Law

Robison, Curphey & O'Connell

105 Brown Street, Suite 100 · Tecumseh, MI 49286 · (517) 423-5404 · www.rcolaw.com

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