



August 4, 2009

Independent Contractor Issue Heats Up

Desperate for revenue, state and federal officials are increasingly looking at the potential misclassification of employees as independent contractors. At the same time, employers may be revisiting the area as well in an effort to reduce costs. Such classifications are complex and should be reviewed carefully, experts warn.

Andrew R. McIlvaine

Cash-starved governments are looking everywhere for revenue amid the economic crunch and that may be leading them to focus on a potentially lucrative source of funds: Companies that improperly classify their employees as independent contractors.

At least six states -- Colorado, New Jersey, New York, Washington, Pennsylvania and Maryland -- have recently enacted or are considering new legislation designed to halt independent-contractor misclassifications. In Maryland, the Workplace Fraud Act of 2009, recently signed into law by Gov. Martin O'Malley, imposes fines up to \$5,000 per employee on companies that "knowingly misclassify" workers as independent contractors.

At the federal level, the "Employee Misclassification Prevention Act," introduced last year by Rep. Rob Andrews, D-N.J., would make misclassification a prohibited act under the Fair Labor Standards Act.

In addition to imposing employer penalties, the bill would require firms to keep records of employee or independent-contractor classifications as well as notify workers of their classification and their right to challenge that classification.

Michael Schmidt, a New York-based partner at Cozen O'Connor who closely follows the independent contractor issue, says Congress is unlikely to tackle the legislation again this year due to its current focus on healthcare reform, but he's "fairly confident" it will be reintroduced next year and will be passed "in some form."

In the meantime, he says, more states will continue to enact legislation designed to crack down on companies that misclassify their workers.

And then there are the state attorneys general, eight of whom notified Memphis-based FedEx in June of their concern that drivers for the FedEx Ground division are classified as independent contractors instead of as employees.

The company, which is facing multiple lawsuits brought by drivers who claim they were incorrectly classified, has defended those classifications, arguing that, because its drivers are free to hire their own employees and buy and sell routes, they are indeed independent contractors.

Janine Yancey, president of Sacramento, Calif.-based compliance-training firm emTRAIN, says the reasons for the flurry of attention surrounding the issue may have more to do with shortfalls in tax receipts rather than a concern for ethics.

"It's a reflection of the dire financial straits our federal and state governments are in," she says.

Because companies are not required to pay "employment taxes," such as for unemployment insurance and FICA, for independent contractors, state and federal governments may be losing "billions of dollars" in revenue when workers are not classified as employees, says Yancey, who worked as an employment attorney prior to founding emTRAIN in 2000.

This lost revenue is only aggravating the states' pain. A report released in July by the Albany, N.Y.-based Rockefeller Institute of Government revealed that during the first quarter of this year, states suffered their steepest drop in tax collections in the 46 years that quarterly data has been available.

The report found that, after adjusting for inflation and other anomalies, tax revenues had declined in 47 of the 50 states during the first quarter of 2009.

"Many of my clients are getting a lot of heat this year from state and federal agencies wanting to conduct audits of their workforces to check for misclassification," says Yancey.

Schmidt agrees.

"States are looking at [these crackdowns] as a revenue generator," he says.

Employers, meanwhile, may be tempted to reclassify their existing employees as independent contractors as they seek to cut costs amid the recession.

Unlike employees, independent contractors aren't entitled to protection under laws such as the Family and Medical Leave Act, nor are they eligible for company-sponsored health insurance, workers' compensation coverage or other benefits.

"I think misclassification is occurring with greater frequency these days as companies look for more effective ways to run their businesses in this economy," says Jay Zweig, a partner at Bryan Cave in Phoenix.

In some cases, he says, HR leaders are examining the work employees do to determine whether it would be more cost-effective to reclassify them as independent contractors. Companies must tread very carefully in this area, he warns.

"Before you change someone's classification, you need to do a careful analysis of both local and federal tests that determine whether someone is considered to be an employee or an independent contractor," says Zweig.

One especially tricky area is outside sales, where salespeople work from their own offices and may -- to a large extent -- control their own schedules, he says.

"You have to carefully analyze whether the salespeople truly are independent: Do they have to report in every day, for example, or, can they represent as many different products as they want?" asks Zweig. "It's not always clear-cut."

Using former employees as consultants is another slippery area.

HR must carefully review any reductions-in-force that include consulting agreements with laid-off employees, he says.

"If the 'consultants' are simply wrapping up their previous jobs or doing essentially the same things they were doing when they were employees, then they may not be independent contractors," says Zweig.

Schmidt says what's needed is a uniform national test for determining employee or independent-contractor status versus the hodgepodge of federal, state and local tests that exist today. However, he's not optimistic that such a standard will be implemented anytime soon.

"The more states that jump into the fray on this, the harder it will be to get a national standard," he says.