

Poles Apart

A Few Pointers On Avoiding the Misclassification Trap

By: Wes Nutten

To hire or not to hire? While many small business owners are tempted to classify their workers as independent contractors rather than employees to avoid taxes, paying benefits and other liabilities, doing so without the proper due diligence can lead directly into an expensive tax trap. In fact, the consequences of misclassification can result in more than just a dispute with the IRS; it can also take business owners on an unwanted journey through the class action legal system.

The misclassification trap was the issue in a recent series of five class action lawsuits in the Los Angeles County Superior Court between 2,200 class members who worked as exotic dancers at several gentlemen's clubs in Southern California. The dancers claimed that the clubs incorrectly classified them as independent contractors rather than employees, thereby denying them minimum wages, overtime compensation, proper breaks and reimbursement for uniform costs.

Although no single standard to distinguish between employees and independent contractors has been established, the IRS has devised a series of characteristics which could have helped the club owners and other businesses determine the nature of the relationship with their workers. These criteria are based on a three-part analysis: behavioral control, financial control and the relationship type.

Behavioral control covers *how* an employee performs the work and whether the business provides strict instructions about where and when the work must be done. Among the areas for consideration are whether the employer provides specific directions on what equipment to use, where to purchase needed supplies, and whether to hire additional workers to assist with the work. Further, if the business provides training, this can be strong evidence that the worker is an employee because independent contractors generally rely on their own methods of completing the work.

Financial control addresses the *amount of economic control* the business has in the worker's efforts to complete the job, such as the level of investment in equipment and unreimbursed expenses. The opportunity for the worker to realize profit or loss on the job also plays a role in determining classification. Typically, employees do not run the risk of loss while independent contractors often do. Lastly, unlike employees, independent contractors generally are free to work for multiple employers, can advertise their services and are often paid by flat fee.

The type of relationship describes *the structure that the business and the worker have established* to enable the work to be done, and can be characterized by whether a written contract exists, the permanency of the relationship and whether benefits have been provided. The IRS also states that if the services provided are a key aspect of the business, then it is more likely that the worker is an employee rather than an independent contractor.

In the class action lawsuits against the gentlemen's clubs in Southern California, the dancers argued that they were not provided with mandated 10-minute rest breaks during each shift as required by the Labor Code, as well as adequate rest areas separate from toilet areas or adequate seating while they were working. The plaintiffs and the gentlemen's clubs eventually reached an agreement on behalf of the settlement class.

Clearly, employers who make the mistake of improperly labeling employees independent contractors face serious legal and financial consequences. The issue is not limited to small business owners; the IRS is considering imposing a \$319 million tax liability on FedEx for misclassifying its operatives as independent contractors because they own their own vehicles. Although FedEx denies any irregularities, the firm still faces legal action from operatives claiming benefits that they would have accrued had they been classified as employees.

In June 2010, a Federal court judge issued a ruling that FedEx Ground and Home Delivery drivers in Illinois are employees of the company rather than independent contractors. The judge found that drivers are employees because their delivery work is an essential and necessary part of FedEx's business, and that the company controls all aspects of their work. The Court noted, for example, that drivers are required to wear FedEx uniforms and drive trucks identified with the FedEx brand.

So, what makes distinguishes an employee from an independent contractor? The following are the ten most important ways businesses can protect themselves from falling into the misclassification trap.

(1) Worker Instructions -- If a worker is required to comply with another person's instructions about when, where and how to work, he is typically considered an employee. To avoid this aspect of control, make sure that all instructions to independent contractors are extremely general and minimal.

(2) Training -- When a business owner trains a worker by requiring an experienced employee to meet with and educate the worker, this transcends the role of an independent contractor. Don't provide independent contractors with either periodic or scheduled training, and avoid correspondence and mandatory attendance at meetings.

(3) Hiring, Supervising and Paying Assistants -- Require independent contractors to hire, supervise and pay their own assistants under a contract that provides the worker to supply materials and labor. Disavow that the worker is representing the employer when hiring assistants.

(4) Setting the Working Hours -- Allow independent contractors to be the masters of their own time to the greatest extent possible with no specific hours.

(5) Requiring Full-Time Work -- If a worker is required to be on the job full time, the business is in far more control than is typical with independent contractors who are free

to work whenever they choose. Avoid having independent contractors set requirements for work hours or work volume.

(6) Working on Employer Premises -- The importance of this factor depends on the nature of the services involved, and the extent to which an employer would generally require employees to perform similar services on the employer's premises. If practicable, ask independent contractors to perform the work at their own workplace rather than allowing use of the employer's desk space, telephone, and computers.

(7) Setting the Order or Sequence of Work -- Employees are not free to follow their own pattern of work but must follow established routines and schedules of the business. Give independent contractors the freedom to map out their own agenda, rather than requiring them to perform tasks at certain times.

(8) Supplying Tools and Equipment -- When a business provides a worker with the tools needed to complete the job, it is indicative of an employee relationship. Businesses should require independent contractors to furnish their own tools and materials needed to perform services. As a last resort, the business can sell or lease the tools to the independent contractor.

(9) Working for Multiple Clients -- If a worker performs more than minimal services for a number of unrelated businesses at the same time, this factor generally indicates that the worker is an independent contractor. The key is whether the businesses are associated with each other and if they are part of the same service arrangement. The best protection is to allow independent contractors to work for others during the term of the contract.

(10) Significant Investment by the Worker -- If a worker invests in facilities to complete the work that are not maintained by the employer, it can be inferred that the worker is an independent contractor. Home offices often require special scrutiny because they are often the worker's residence and require a minimal investment in space and equipment.

Make sure that independent contractors rely appreciably on their own facilities to perform services; if a vehicle is involved, the business should not use it as one of its own vehicles.

Most firms eventually must face the choice of adding to their human resources capabilities, either by hiring independent contractors or employees. Knowing the potential ramifications of each option can help protect businesses from stumbling into a costly legal and tax trap.

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