Independent Contractors and Worker Misclassification

—Overview—

For several years, identifying and penalizing employers who misclassify workers as “independent contractors” has been an initiative of both state and federal agencies. From an employer’s perspective, misclassifying employees as “independent contractors” can result in severe criminal, legal and financial liability. This Fast Facts explains the tests used to determine proper classification, what liability is triggered and how to stay out of harm’s way.

—Background—

The prospect of hiring an independent contractor instead of bringing on a new employee often seems attractive, especially in a difficult economy. Generally speaking, employers do not have to provide benefits to independent contractors, and independent contractors do not receive the same rights and protections as employees. As a result, employers do not have to pay unemployment, disability or social security taxes or pay workers’ compensation premiums for independent contractors.

When hiring an independent contractor, however, employers must ensure that the person hired actually functions as a contractor and not an employee. Worker misclassification occurs when an employer hires a worker and incorrectly (whether intentionally or unintentionally) treats that person as an independent contractor rather than an employee as required by law.

—Why should employers be concerned about worker misclassification?—

Many employers think they can manage their risk by having their workers explicitly agree to be treated as independent contractors. However, this clearly is not the case. Both the federal and state governments take worker misclassification seriously. New Jersey routinely conducts random audits citing an estimated $535 million in taxes that go unreported due to misclassification. The NJ Department of Labor and Workforce Development randomly audits roughly 2 percent of the state’s 230,000 employers to ensure that unemployment and disability insurance payments are properly remitted for workers. In addition, the Internal Revenue Service conducts random audits of businesses specifically examining the use of independent contractors. If federal or state authorities find that an employer has misclassified one or more employees, the criminal, legal and financial penalties can be severe.
—How is worker misclassification determined?—

There is no easy answer to this question as, there is no one-size-fits-all approach used by all authorities. The statutory “ABC” test (discussed below) guides New Jersey state agencies in their analysis, while different tests guide federal authorities depending upon the agency involved. In any event, all facts and circumstances are examined on a case-by-case basis. Even more confusing is the fact that a worker may be considered an employee under one test but an independent contractor under another.

—What tests does New Jersey apply to determine whether worker misclassification has occurred?—

The NJ Department of Labor and Workforce Development relies on the strict statutory “ABC” test for determining independent contractor status. Under this test an employer must establish that each worker: (a) is free from direction and control; (b) provides a service outside the employer’s usual course of business or places of business; and (c) is engaged in an independently established trade, occupation or business.

In a valid independent contractor relationship, the company is only concerned with the ultimate result to be achieved, not with how the result gets achieved. Therefore the “A” prong of the test, freedom from direction and control, essentially is a codification of common law. The “A” prong focuses on whether the company controls the means and methods the individual uses to achieve the result the company desires. Controls such as dictating starting and quitting times; filling out company reports and evaluations; mandatory attendance at meetings; and, subjecting the individual to warnings or other forms of discipline severely weaken the case for independence.

Other common factors analyzed in New Jersey may include: the training necessary for the job; the job length; the means of compensation; the degree of supervision; the fringe benefits offered; the manner of termination; and the understanding of both parties to the relationship.

While the “A” prong can be controlled through the installation of appropriate processes, the “C” prong is problematical as it is largely outside a company’s control. The 1991 Supreme Court case, Carpet Remnant Warehouse v. New Jersey Department of Labor, provides guidance in applying the “ABC” test and, in particular, the “C” prong. The Court determined that the C-prong provides the best indication of a worker’s dependency on a particular employer. Factors considered under the C-prong include:

- The duration and strength of the business or enterprise of the worker in question;
- The number of customers the worker in question has and the volume of business generated by each;
- The number of employees retained by the worker in question;
- The tools, equipment, vehicles, etc. owned by the worker in question; and
- The amount of compensation received by the worker in question from a particular employer versus that received from other customers.

The New Jersey Department of Labor and Workforce Development has posted excerpts from relevant court cases to assist employers in interpreting the “ABC test.” It also published the Worker Classification Questionnaire used by its auditors and investigators to evaluate if the relationship of an individual with an employer is that of independent contractor or an employee. This information is available at:
http://lwd.state.nj.us/labor/ea/empinfo/EmployeeIndependentContractor.html.
—What are the penalties for worker misclassification in New Jersey?—

New Jersey is one of the more aggressive states in punishing worker misclassification in that employers may face criminal, civil, and administrative penalties under several different laws. For instance, if an employer does not provide workers’ compensation insurance because a worker has incorrectly been deemed an independent contractor, the employer could be charged with a fourth degree crime (akin to criminal sexual contact, shoplifting, joy riding, etc.). The employer may also face fines of up to $5,000 for the first ten days of non-compliance in addition to up to $5,000 for every ten day period thereafter.

Similarly, an employer who fails to provide unemployment insurance because of misclassification is responsible for the back taxes for both the employee and the employer contributions in addition to interest. These penalties could result in an added 15 percent interest charge or $4,440 for worker who earns at least $29,600 per year.

In the case of misclassifications in the construction industry (which state officials have, in the past, found to harbor the most abuse), an employer may be fined up to $1,000 or imprisoned for up to 90 days, or both. In addition, each week in which a worker is misclassified even for one day constitutes a separate offense. Also, the potential penalties are much more severe if the misclassification is done "knowingly" and, depending on the amount of the contract, can include a maximum fine of $150,000 and up to 10 years’ imprisonment (for contracts of $75,000 or more). Last, the employer may be issued a stop-work order on all job sites where the misclassification has occurred.

In addition, an employer may have to pay back payroll taxes, face worker-initiated lawsuits under the wage payment or employment discrimination laws and be subject to unfair labor practices under state and federal law.

—What federal tests exist to determine whether worker misclassification has occurred?—

The U.S. Department of Labor and the Internal Revenue Service (IRS) have their own distinct tests for determining worker misclassification. Although the IRS once published a 20-point test to determine the relationship of a worker and employer, it now groups those points into three broad categories:

• Behavioral: Does the company control or have the right to control what the worker does and how the worker does the job?
• Financial: Are the business aspects of the worker’s job controlled by the payer? (How the worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)
• Type of Relationship: Are there written contracts or employee type benefits? Will the relationship continue and is the work performed a key aspect of the business?

Employers can request an IRS determination by visiting [http://www.irs.gov/pub/irs-pdf/fss8.pdf](http://www.irs.gov/pub/irs-pdf/fss8.pdf). However, some experts caution that the IRS typically classifies workers as employees whenever their status is not immediately apparent. Furthermore, employers that receive an IRS determination may lose certain protections against liability for misclassification.

The U.S. Department of Labor often applies the “Economic Realities Test” under the Fair Labor Standards Act (FLSA) which includes the following six factors to determine if a worker is an employee or an independent contractor:
• The degree to which the functions of the worker in question are essential to the business operation;
• The ongoing nature of the relationship between the worker in question and the employer;
• The extent to which the worker in question has invested in his own materials and supplies;
• The control the employer has over the worker in question;
• The degree to which the employer affects the profit and loss opportunities of the worker in question; and
• The level of skill, judgment and initiative required for the functions performed by the worker in question.

Although the IRS’ “three point” test and the federal “Economic Realities Test” are commonly used, they are not the only tests to determine worker status. That status can also be evaluated under a host of other federal laws including, but not limited to, the Civil Rights Act, the National Labor Relations Act, the Americans with Disabilities Act, and the Age Discrimination in Employment Act (all of which borrow concepts from the various tests described above). Additionally, the court decisions analyzing the same facts as the regulatory agencies are very unpredictable.

— What are the penalties for worker misclassification at the federal level? —

Federal penalties for worker misclassification can be severe. In most instances of misclassification, the IRS requires an employer to pay a percentage of back taxes (federal income taxes, federal unemployment taxes, Social Security, etc.) for each misclassified worker retroactively for the past three years. A higher percentage of these taxes may be owed in instances where the IRS considers the misclassification to be intentional.

In some cases, an employer can resolve a misclassification issue with the federal government without being forced to pay the back taxes due. Section 530 of the Revenue Act of 1978 provides relief from the payment of back taxes if the employer in question:

• Submitted timely and proper federal tax documents (1099s) indicating the amount paid to the worker;
• Did not treat workers performing similar job functions as employees; and,
• Had a reasonable basis for classifying the worker as an independent contractor.

(Various proposals are pending at the national level to eliminate this “safe harbor” but none have been enacted to date.)

Unfortunately, there is no similar safe harbor in dealing with the U.S. Department of Labor, which can require employers to pay back wages, overtime, benefits, and impose other statutory penalties. Under the Fair Labor Standards Act (FLSA) each worker who has been misclassified may be awarded wages, overtime, and additional compensation for three years with a possibility of doubling the amount as “liquidated damages”.

Even after an employer is charged at the federal level, the matter may still be referred to New Jersey authorities who have the ability to impose their own penalties. Additionally, employers could also face individual lawsuits from workers claiming they were denied benefits because of an improper classification.
— How can employers stay out of harm’s way? —

First and foremost, an employer should think carefully about entering into independent contractor relationships that last indefinitely or over the long term. Employers should periodically conduct audits of all positions and review the requirements for an employee versus an independent contractor. In some cases, the relationship between a contractor and employer may change over time. For example, an employer may hire a contractor to complete a specified project with a set deadline, but may find the project has become more of a long-term activity. As a result, it may be more appropriate for the contractor to be reclassified as an employee. Another best practice an employer may want to consider is executing a separate contract with an independent contractor for each project he is completing so as to emphasize the independent nature of the relationship. Above all, outside counsel should always be sought if there is any doubt as to the status of a worker.

— What should an employer do if an employee has been misclassified? —

Employers should immediately consult with outside counsel to correct the mistake, evaluate their liabilities, and determine next steps.

— Additional Resources —

Independent Contractor (Self Employed) or Employee?

Construction Industry Independent Contractor Act
http://lwd.dol.state.nj.us/labor/wagehour/lawregs/indep_contractor_act.html

Wage and Hour Compliance – NJ Department of Labor & Workforce Development
http://lwd.dol.state.nj.us/labor/wagehour/content/wage_and_hour_compliance_faqs.html

Employee or Independent Contractor - NJ Department of Labor & Workforce Development
http://lwd.state.nj.us/labor/ea/empinfo/EmployeeIndependentContractor.html

— For more information —

If you need additional information, please contact NJBIA’s Member Action Center at 1-800-499-4419, ext. 3 or member411@njbia.org.

Updated: July 28, 2016

This information should not be construed as constituting specific legal advice. It is intended to provide general information about this subject and general compliance strategies. For specific legal advice, NJBIA strongly recommends members consult with their attorney.