



DELAWARE

EMPLOYMENT LAW LETTER

Part of your Delaware Employment Law Service

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EMPLOYER LIABILITY

Will 'misclassification initiatives' reduce employers' use of independent contractors?

by Scott A. Holt

Employers' use of independent contractors instead of traditional employees has steadily increased over the past 20 years. Some employers feel they can save money by using independent contractors instead of full-time employees. The contractors themselves may value the autonomy and economic perks that independent contractor status provides. Also, the specific skills and knowledge that independent contractors can bring to a short-term project can be critical — and therefore worth a premium, albeit one that isn't sustainable in the long term. But the use of independent contractors isn't as perfect as these mutually beneficial points may make it seem.

Federal government means business

A report prepared by the Government Accountability Office (GAO) in the fall of 2009 concluded that employee misclassification is a "significant problem" with "adverse consequences" because it reduces tax revenues flowing to the government. In fact, the misclassification of employees as contractors is projected to cost the U.S. Treasury Department more than \$7 billion in lost payroll tax revenue over the next 10 years.

The theory goes that since independent contractors are by definition self-employed, they aren't considered "employees" and therefore aren't covered by the various tax withholding laws. Independent contractors also aren't subject to most employment laws, so in addition to avoiding taxes, some employers may reclassify employees as independent contractors to avoid

paying overtime and benefits and escape workers' compensation liability.

Thus, the crackdown on the misclassification of employees as independent contractors began. The U.S. Department of Labor (DOL) has made the proper classification of employees and independent contractors one of its "top priorities." The agency's 2011 budget includes an additional \$25 million for what it calls the "Misclassification Initiative," designed to target misclassification of independent contractors. Approximately 100 additional DOL enforcement personnel will be added to investigate employers.

The IRS is in the middle of a similar misclassification crackdown. In February 2010, the IRS began intensive audits of randomly selected employers. One of the focal points of the audits is whether employers are improperly misclassifying workers as independent contractors to save on taxes and employee benefits.

There's also new federal legislation on the horizon. Congress is expected to take up legislation that will penalize employers for employee misclassification. One proposed piece of legislation, known as the Independent Contractor Proper Classification Act, was sponsored by President Barack Obama when he was a member of the U.S. Senate.

States get in on the act

States are getting into the enforcement act as well. New York and Massachusetts have created task forces to locate misclassified employees. Other states, such as Maryland and Colorado, have enacted new laws that impose harsh penalties on employers that misclassify employees as independent contractors.

In Delaware, the General Assembly passed its own law last year imposing stiff penalties on construction industry employers that improperly classify employees as independent contractors to save on business costs and avoid paying taxes. In addition to penalties of \$1,000 to \$5,000 per misclassified employee, employers that fail to produce the requested records can be issued a stop-work order by the DDOL and fined up to \$500 for each day the requested records aren't produced.

Tread carefully

Compliance presents its own difficulties, though. The tests used to determine whether someone is an independent contractor or an employee are fact-intensive and differ among government agencies. In addition, each state may have its own unique test to determine a worker's proper status.

Still, the penalties for noncompliance make this a treacherous area for the unwary employer. In addition to federal and state government agencies seeking unpaid payroll taxes and associated penalties, employment lawsuits alleging misclassification are becoming increasingly common. Claims from misclassified workers range from those seeking unpaid wages

and overtime to multimillion-dollar class-action lawsuits. Misclassified employees have also successfully recovered retirement benefits, medical coverage for injuries they sustained on company property, and rights to employee stock options and bonuses.

Bottom line

Given the increased attention on misclassification, the time to act is now. An internal review and audit of worker classifications should be a crucial component if you currently employ independent contractors.

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