

Proceed With Caution When Using Independent Contractor Status

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Classifying workers as independent contractors continues to be a risky proposition for employers. Many employers utilize this classification to avoid paying minimum wage/overtime, or to avoid providing benefits. Improper classification may result in tax and wage law violations for the employer and its officers and directors.

Misclassifying workers for federal withholding tax purposes can result in severe penalties imposed by the IRS. The employer is responsible for properly classifying workers and for collecting income and other payroll taxes. The Government Accounting Office estimates that 38% of the employers the IRS examines have misclassified workers as independent contractors. Misclassification risks for the employer include liability for back payroll taxes, plus penalties and interest, criminal sanctions, including imprisonment and fines, and personal liability for corporate officers of up to 100% of the amount the employer should have withheld from the employee's compensation in payroll taxes.

Misclassified workers may also have claims against the employer for minimum wage/overtime payments under the Fair

Labor Standards Act ("FLSA"), and under state wage & hour laws. The United States Department of Labor ("DOL") continues to aggressively enforce the FLSA. In 2005, the DOL collected nearly \$119.4 million in overtime violations and more than \$14.8 million in minimum wage violations on behalf of employees. Private lawsuits under the federal and state wage & hour laws also continue to spiral upward. In 2004, there were 3,617 cases filed under the FLSA, an 87% increase since 2000.

Whether an independent contractor relationship exists is a very fact-sensitive determination. Federal and state agencies utilize different tests for evaluating and determining independent contractor status. Labeling someone as an independent contractor has no bearing on whether an independent contractor relationship is deemed to exist. Rather, the day-to-day interaction between the individual and the employer must clearly establish that the individual's business conduct and financial success are not solely linked to the employer in order for independent contractor status to apply.

The IRS employs a three-factor test to determine whether a worker is an independent contractor or an employee. The test examines the relationship between the employee and the business. "Behavior control" is the most important of the three factors utilized by the IRS and focuses on whether the employer has a right to direct or control how the work is done through instructions, training, or other means. Control must apply to both the manner in which the work is performed and the result. And, the employer does not have to exercise the control, but must only have the

right to do so.

The other factors used by the IRS include "financial control" and "type of relationship." "Financial control" focuses on whether the employer has a right to direct or control the financial and business aspects of the worker's job, which includes whether the worker has un-reimbursed business expenses, the extent of the worker's investment in the facilities used in performing services, the extent to which the worker makes his or her services available to the relevant market, how the employer pays the worker, and the extent to which the worker can realize a profit or incur a loss.

"Type of relationship" focuses on how the worker and employer perceive their relationship and includes factors such as whether there is a written contract describing the relationship, the extent to which the worker is available to perform services for other similar businesses, whether the employer provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay, the permanency of the relationship, and the extent to which services performed by the worker is a key aspect of the regular business of the company.

DOL utilizes the "economic reality test" for determining worker status under the FLSA. This test considers numerous factors that include the degree of control exercised by the employer over the manner in which the work is performed, the relative investments by the employer and the worker in materials and equipment, the degree to which the employee's opportunity for profit and loss is determined by the

employer versus the worker's own managerial skill, the skill and initiative required in performing the job, the permanency of the relationship, and whether the service is an integral part of the employer's business.

State agencies, like the New Jersey Division of Taxation and the New Jersey Department of Labor, utilize tests similar to those used by the IRS and DOL to determine independent contractor status. Regardless of the test used, state agencies generally examine the same factors evaluated by the federal government in an effort to determine whether the individual at issue enjoys the relative operational and fiscal freedom from the employer that is needed to support independent contractor status.

Misclassifying workers as independent contractors can have serious consequences for the employer as well as its officers and directors. Federal and state agencies empowered with enforcing the tax and wage & hour laws will vigorously evaluate the facts and circumstances underlying the relationship between an employer and its purported independent contractors in an effort to determine whether the independent contractor classification has been properly applied. When workers are misclassified, the employer risks fines and penalties imposed by the IRS or state taxing agencies, and risks violating the minimum wage and overtime requirements of the FLSA and state wage & hour laws. Consequently, independent contractor status should only be used after the employer completes a careful review and evaluation of the facts and circumstances underlying the relationship.

Please email the author at jmaddaloni@pbnlaw.com with questions about this article.

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