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THE PERILS OF MISCLASSIFIED INDEPENDENT CONTRACTORS

THE RISK INCREASES UNDER OBAMACARE

There are substantial enticements for a company to improperly classify an employee as an "independent contractor." These include the avoidance of payroll taxes, withholding taxes, employee benefits, wage and hour law compliance, unemployment compensation and employment law compliance in general. However, the risk in doing so, in the form of government audits, taxes and penalties and worker claims, has always been manifest and substantial. Moreover, the "Employer Mandate" under the Affordable Care Act adds to that risk in several ways.

We have, for many years, counseled our clients that:

- Misclassification of workers is almost always a bad idea and should be avoided when possible.

- In the "border line" case, i.e. when it is not totally clear that the worker is sufficiently independent to justify independent contractor status, the existence of a well-drawn contract can carry the day by emphasizing all of those terms that are consistent with the worker being "independent" rather than an employee.

- Finally, there is every reason to believe that the federal and state agencies will continue to aggressively seek out and challenge misclassifications. Therefore, even an obvious independent contractor classification should be evidenced by a well-drawn contract which enunciates all of the terms of the relationship, thereby confirming that the worker is indeed "independent."

The "Employer Mandate" increases the value of this advice for the reasons discussed below. If you wish to learn more about this risk and the ways to manage the risk, please read on.

"Employer Mandate" Under Obamacare

A new temptation to undertake the misclassification risk has arisen by virtue of "Obamacare."[1] This law includes the well-publicized "Employer Mandate" which, effective January 1, 2015[2], requires "large employers" (those with at least 50 full-time employees or full-time equivalent employees) to provide "Affordable Care" to their employees or face substantial financial penalties. This means that the "large employer" must offer minimum essential coverage to substantially all of its full-time employees and their children up to age 26.

We have heard that some companies are re-classifying existing employees as independent contractors…just to avoid the Employer Mandate by going below the 50 employee threshold. This could be suicidal since, in the event of a government examination, that employer will have the very difficult burden of explaining why and how the parties' relationship changed drastically just in time to avoid application of this requirement!

"Failure to Offer" Penalties

If an employer fails to offer required coverage, and just one full-time employee enrolls through an insurance exchange and receives an exchange subsidy, the employer will be obligated to pay, for each month this situation exists, a nondeductible $166.67 penalty ($2,000 annually) for ***each*** full-time employee in excess of 30.

The Misclassification Risk Under Obamacare

In light of the Department of Labor's ongoing "Misclassification Initiative" there is every reason to believe that the US DOL (and the state DOLs) will continue to aggressively pursue companies that misclassify workers as independent contractors. To the extent that the Employer Mandate leads companies to misclassify workers to fall below the 50 employee threshold, that will first of all expose the misclassifying company to back taxes and contributions, interest and penalties under the labor laws and tax laws…it will also expose those companies to steep "Failure to Offer" penalties under ACA described above.

A More Subtle Misclassification Risk

A less obvious risk arises for companies that have misclassified workers innocently and/or for reasons unrelated to ACA. For example, a company may have 45 employees and ten independent contractors on January 15, 2015. In that case, the company would not be subject to the Employer Mandate. However, if an agency subsequently (e.g. effective December 31, 2017) finds that five of the ten independent contractors were misclassified, the company will not only be liable for traditional monetary assessments (back taxes and contributions, interest and

[1] More formally known as the Patient Protection and Affordable Care Act of 2010 a/k/a "ACA"
[2] This was originally scheduled to become effective on January 1, 2014.

penalties for the misclassified workers)…it may also be subject to the $2,000 per year per worker "Failure to Offer" penalties for the two year duration of the misclassification…i.e. $140,000 just for the Obamacare penalties!

A Note About Determining who is an Independent Contractor

Traditionally, the IRS applied the "common law" test to determine whether workers qualify as independent contractors. This test focuses on whether the employer has the right to control the worker, through application of numerous factors, none of which is determinative on its own. In certain cases, an adverse finding can be avoided by reliance on the so-called Section 530 Safe Harbor [3]which generally allows a company to treat a worker as an independent contractor for employment tax purposes (regardless of the worker's status under the common law test) if the company has a reasonable basis for this treatment and applies it consistently. Unfortunately, there is as yet no indication that the IRS will allow safe harbor type relief in the face of ACA penalties.

Conclusion

In summary:

- Misclassification of workers is almost always a bad idea and should be avoided.

- In the "border line" case, i.e. when it is not totally clear that the worker is sufficiently independent to justify independent contractor status, the existence of a well-drawn contract between company and worker can carry the day by emphasizing all of those terms that are consistent with the worker being "independent" rather than an employee.

- Finally, there is every reason to believe that the federal and state agencies will continue to aggressively seek out and challenge misclassifications. Therefore, even an obvious independent contractor classification should be evidenced by a well-drawn contract between company and worker which enunciates all of the terms of the relationship, thereby confirming that the worker is indeed "independent."

There are additional techniques that may be applied to confirm and memorialize the existence of an independent contractor relationship. If you wish to explore these techniques or if you have any questions about the independent contractor issues, or about any other facet of employment law, please contact Richard Waxman at:

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In case you have trouble accessing the Newsletter, a PDF copy is attached in the banner at the top of this e-mail.

[3] More formally known as Section 530 of the Revenue Act of 1978.