



[Print this article](#) | [Return to Article](#) | [Return to CFO.com](#)

Cracking Down on Independent Contractors

Federal and state regulators increasingly want to know whether companies' independent contractors are truly independent.

[Sarah Johnson](#), CFO.com | US

March 3, 2010

Employers may want to reexamine how they label their workers this year, as federal and state officials vow to clamp down on the misclassification of employees as independent contractors.

The Internal Revenue Service plans to look at the issue in audits of 6,000 randomly chosen companies during the next three years, starting this month. Meanwhile, proposals on Capitol Hill would give the Department of Labor more resources to ensure that companies classify their workers correctly. They would also change a safe harbor in the tax code that has enabled some companies to continue their practice of misclassifying workers.

Moreover, various states, including California, Massachusetts, New York, and Ohio, have recently enforced their rules on independent contractors by demanding changes and restitution from companies they found to have misidentified their workers as contractors. Earlier this year, for example, Massachusetts's Attorney General settled with four local dining-delivery companies that agreed to reclassify all their drivers as employees rather than independent contractors. Other states, including Maryland, have passed or proposed related new laws.

In a high-profile case, FedEx Ground has been the target of lawsuits, IRS auditors, and several states that believe the company has misclassified workers as contractors. Other companies that could be affected by a widespread crackdown include those that employ nurses, couriers, and construction workers.

To be sure, the issue has become more pressing because of the increased use of contract workers by companies wanting to introduce more flexibility in their labor costs in the wake of the downturn. That trend is expected to continue: CFOs plan to increase their temporary hiring over the next year, and most of them don't expect their companies' full-time staffs to return to prerecession levels before 2012, according to the latest Duke University/*CFO Magazine* Global Business Outlook Survey.

It's not surprising why, considering that independent contractors can be much cheaper than full-time workers. With contractors, who receive a 1099 tax form instead of a W-2, companies don't have to pony up for unemployment insurance, workers' compensation, health benefits, or Social Security taxes. Plus, companies aren't required to withhold income taxes for contractors. They are estimated to save as much as 30% in their payroll costs by going this route.

The price could rise, though, if officials make good on their word to uncover the presumed incidences of companies that fail to follow the rules, which vary by state and among federal agencies. The most recent federal estimates, from 2005, say that 7.4% of the workforce is considered to be independent contractors, but there is no solid, up-to-date data on how many of those workers are mislabeled. The IRS plans to get a better handle on contractor data by 2013, after concluding its round of random audits.

"Given the state of the economy, more people are trying to push the limits of when they can get away with classifying someone as an independent contractor, and probably a lot of people are pushing them too far," says Matthew Bainer, senior associate at Scott Cole & Associates, which represents workers with wage disputes.

Advocates of a crackdown believe it will benefit federal and state governments by bolstering their tax revenues and replenishing unemployment-insurance funds. The consequences of misclassifications vary by agency and the number of workers involved; companies may have to pay back taxes, unpaid wages, and penalties. In 2008 the IRS expected to collect almost \$64 million in taxes and penalties from 844 companies that misclassified workers.

President Obama claims the government could collect \$7 billion over 10 years by changing the incentives companies have for misclassifying workers, and by better enforcing the current rules through the hiring of 100 new employees in the Department of Labor. However, many misclassifications may come to light through a more indirect way: workers themselves. Contractors — some of whom do benefit from their status by having

flexible schedules and the ability to work for various employers — may discover they should have been labeled differently when putting together their tax returns. These discoveries may have become more commonplace in recent years as workers have become more knowledgeable about their rights through the Internet, Bainer suggests.

Indeed, the renewed attention to the issue stems in part from the rise in complaints from workers who find themselves ineligible for unemployment insurance (independent contractors are also not offered the same protections as full-time employees subject to labor laws). As a workaround, some companies are putting aside unemployment insurance for workers they account for as independent contractors for federal tax purposes, says John Barrie, a partner at Bryan Cave.

That may be a mistake, however, if the IRS notices the discrepancy. Indeed, experts suggest that firms tread carefully when trying to save on labor costs and maintain consistency in their reporting. (The IRS provides a 20-factor test to help companies determine the status of their workers.) In general, the IRS believes the issue comes down to how much power a company exerts over a worker.

"If companies are controlling what the worker is doing and when it's getting done, they probably have an employee [instead of an independent contractor]," says Grafton "Cap" Willey, a managing director at CBIZ Tofias, which provides tax and consulting services. "Paying additional taxes is probably cheaper than getting in trouble."

© CFO Publishing Corporation 2009. All rights reserved.