Employers besieged on all sides for misclassifying workers

By: Sylvia Hsieh Staff writer Published: April 5, 2013

In an effort to fend off a real audit of their books, one of the major tobacco companies hired a law firm to look into whether it was classifying its 5,000 workers correctly.

"The audit was to find out what kind of exposure they had," said Kristin R. Erenburg of Walter Haverfield in Cleveland, Ohio, the lawyer hired by the company.

The company decided to investigate itself rather than wait for a knock on the door from the Internal Revenue Service, the Department of Labor, any number of state agencies or a class-action plaintiffs' lawyer.

Employers are facing pressure on all fronts over their practice, either chosen or inadvertent, of misclassifying workers as independent contractors instead of full-time, benefit-earning employees.

GJ Stillson MacDonnell, an employment tax attorney at Littler Mendelson in San Francisco, said that corporations are not the only targets of audits for misclassifying workers. Partnerships, LLCs, mom-and-pop operations, nonprofit organizations, religious organizations — and even government agencies — have been audited.

The IRS and DOL publicly brag on their websites about the money they've raked in from auditing employers' payroll records. Since 2011, 14 states have signed agreements with federal agencies to share information they have about employers suspected of misclassifying workers. In January, the DOL proposed to survey workers about their jobs and how they are classified. And class actions brought by workers who believe they were wrongly classified remain at the top of the list when it comes to hot litigation trends.

Cash-strapped states and federal agencies are looking to collect money at the same time as companies are trimming their payrolls.

"We are concerned that misclassification is beginning to occur in industries where we haven't typically seen it historically. As a law enforcement agency, we must be aware that this issue may come up in almost any investigation in any industry," according to a U.S. Department of Labor spokesperson.

In one example, the DOL collected back wages and liquidated damages for dozens of restaurant workers in Boston who were improperly categorized as independent contractors of a staffing agency rather than direct employees of the restaurants.

While there is no law that makes misclassification itself illegal, the denial of wages, overtime and other benefits, such as unemployment, often triggers an investigation into whether a worker was properly categorized.

By classifying workers as independent contractors, small employers can stay small for purposes of some federal laws that set 50 as the threshold number of employees making benefits mandatory, such as the Family and Medical Leave Act and new Obamacare provisions requiring companies to provide health care to employees.

"It costs more money. It's purely a matter of economics and ease. There are far fewer requirements" when individuals are not employees, said Kraig J. Marton, an attorney at Jaburg & Wilk in Phoenix, who has represented businesses in Labor Department investigations and employees who triggered them.

Others say that companies tend to classify workers based on how they've always done things and to stay in business.
"The big problem is that for many businesses, because all their competitors treat workers as independent contractors, it's very difficult as a business matter to convert them to employees," said Dennis N. Brager, a tax attorney at the Brager Tax Law Group in Los Angeles.

The majority of IRS audits come from a tipoff by state agencies when a worker applies for benefits.

"When someone files an unemployment claim who is not engaged as an employee, it opens the door to an audit — not just of that one person, but of the entire organization," said MacDonnell.

An audit under the Internal Revenue Code seeks payment of all taxes owed, plus penalties and interest, while other statutes, such as the Fair Labor Standards Act, impose treble damages in addition to back wages and overtime.

Even though rules that distinguish an employee from an independent contractor are not black-and-white, and depend on how the individual is treated on a daily basis by an employer, MacDonnell recommends that employers "take a step back and consider the consequences" when deciding how to classify an individual.

"If you want to engage someone as an independent contractor, you should not rely on 'I've engaged them that way before' or 'I know the Jones Company has engaged independent contractors,'" she said.

Brager agreed.

"The law is complicated and it's confusing, and employers look around and see what competitors are doing. They ask their friends and they don't take the time to sit down with professional advisors," he said.

Preempting an audit

The IRS has launched a voluntary compliance program that allows employers to self-report, reclassify their employees and pay a fraction of what they owe in back taxes.

"The IRS is making a genuine effort to use a carrot to convert people and cut a really good deal," said Brager, noting that employers who voluntarily reclassify pay no more than 10 percent of federal payroll taxes owed.

The IRS announced in February that it was expanding a "low cost" voluntary compliance option to more employers by loosening eligibility requirements until June 20, 2013.

However, despite the incentives, not many companies are taking the bait.

"I'm not seeing a stampede of companies voluntarily coming forward," Brager said.

However, some employers, mostly larger ones, are asking lawyers to perform independent audits to soften the blow if it does strike.

Ultimately, the tobacco company Erenburg represented discovered it had misclassified some independent contractors and reclassified them as employees.

The company then made sure those employees signed waivers of their right to sue for wage and hour violations in exchange for their new classifications.

"If we were ever in litigation over it, at least we had mitigated the potential for those employees to sue," Erenburg said.

Even though an internal audit would not prevent government agencies from looking into an employer's books as far back as seven to 10 years, she said, it could strengthen a company's position in a real audit.

"If they can right the ship in time, it looks good that [they] had reclassified some employees … if an agency does come knocking on the door," she said.

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