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## **THE DANGERS OF MISCLASSIFYING EMPLOYEES**

**By Marc R. Engel, Esq.**

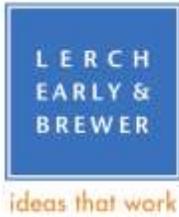
### **I. Context**

The characterization (or mischaracterization) of a worker as an independent contractor, as opposed to an employee, is no small matter. This characterization affects eligibility for employees for Social Security, Medicare benefits, and also tax responsibilities. As a general proposition, contractors are not covered by minimum wage, overtime, and the anti-discrimination laws, and employers do not have to pay unemployment insurance, workers' compensation, or Social Security taxes for them.

Nearly two years ago, as part of its initiative to attempt to qualify for the first time since 1984, how many employers mischaracterized employees, the Internal Revenue Service (IRS) announced that it would audit 6,000 random employers beginning in February, 2010. In 1984, the IRS estimated that employers had mischaracterized 3.4 million workers, the results of which deprived the government of \$1.6 billion in tax revenues that year. Those figures seem virtually certain to rise.

The "reasons" offered by employers for treating certain individuals as independent contractors are generally well known and include the following:

1. "We have always done it this way."
2. "Independent contractors have always wanted to be treated in this manner and, besides they do not want to pay taxes."
3. "Everyone else does it this way."
4. "We will be at a (competitive) disadvantage if we do not do it this way."



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## II. The IRS Test

Over the years, the IRS has applied various tests, including the 20 factor test known to many employers, and later a 5 factor test to determine whether a worker was properly regarded as an employee or independent contractor.

### The 20 Factor Test

1. **INSTRUCTIONS.** A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the individual or entity for whom the services are performed have the right to require compliance with instructions.

2. **TRAINING.** Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the persons for whom the services are performed want the services performed in a particular method or manner.

3. **INTEGRATION.** Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control.

4. **SERVICES RENDERED PERSONALLY.** If the services must be rendered personally, persons for whom the services are performed are generally interested in the methods used to accomplish the work as well as in the results.

5. **HIRING, SUPERVISING, AND PAYING ASSISTANTS.** If the persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job. However, if a worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor relationship.

6. **CONTINUING RELATIONSHIP.** A continuing relationship between the worker and the persons for whom the services are performed indicates an employer-employee relationship.

7. **SET HOURS OF WORK.** The establishment of set hours of work by the persons for whom the services are performed indicates control.



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8. **FULL TIME REQUIRED.** If the worker must devote substantially full time to the business of the persons for whom the services are performed, such persons have control over the amount of time the worker spends working and effectively restrict the worker from doing other gainful work. An independent contractor, on the other hand, is free to work when and for whom he or she chooses.

9. **DOING WORK ON EMPLOYER'S PREMISES.** If the work is performed on the premises of the persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere. Work done off the premises of the persons receiving the services, such as at the office of the worker, indicates some freedom from control. Control over the place of work is indicated when the persons for whom the services are performed have the right to compel the worker to travel a designated route, to cover a territory within a certain time, or to work at specific places as required.

10. **ORDER OR SEQUENCE SET.** If a worker must perform services in the order or sequence set by the persons for whom the services are performed, that factor shows control.

11. **ORAL OR WRITTEN REPORTS.** A requirement that the worker submit regular and/or written reports indicates a degree of control.

12. **PAYMENT BY HOUR, WEEK, MONTH.** Payment by the hour, week, or month generally is indicative of an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. On the other hand, payment made by the job or on straight commission generally indicates that the worker is an independent contractor.

13. **PAYMENT OF BUSINESS AND/OR TRAVELING EXPENSES.** If the persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee.

14. **FURNISHING OF TOOLS AND MATERIALS.** The fact that the persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employment relationship.

15. **SIGNIFICANT INVESTMENT.** If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office), that factor tends to indicate that the worker is an independent contractor.



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16. **REALIZATION OF PROFIT OR LOSS.** A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor.

17. **WORKING FOR MORE THAN ONE FIRM AT A TIME.** If a worker performs more than a small amount of services for many unrelated persons or companies at the same time, that factor generally indicates that the worker is an independent contractor. However, a worker who performs services for more than one person may be an employee of each of the persons.

18. **MAKING SERVICE AVAILABLE TO GENERAL PUBLIC.** The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship.

19. **RIGHT TO DISCHARGE.** The right to discharge a worker is a factor indicating that the worker is an employee. An independent contractor, on the other hand, generally cannot be fired so long as the independent contractor produces a result that meets the contract specifications.

20. **RIGHT TO TERMINATE.** If the worker has the right to end his or her relationship with the persons for whom the services are performed at any time without incurring liability, that factor indicates an employer-employee relationship.

\* \* \*

The IRS has attempted to fine tune the 20 factor test even further. According to the IRS, the relevant facts fall into three main categories: behavioral control; financial control; and the relationship of the parties.

**A. Behavioral Control (Original Factor Nos. 1, 2, 4, 5, 7, 8, 9, 10 and 14)**

Behavioral control focuses on facts and circumstances that show whether there is a right by the employer to direct *how* the employee does the work. Accordingly, an employer does not have to control or direct the *way* the work is done so long as it has the *right* to control or direct the work. For example, extensive instruction tends to suggest that an individual is an employee. These instructions can include, among other things, how, when or where to do the work; what tools or equipment to use; what assistants to hire to help with the work; and where to purchase supplies and services. On the other hand, less extensive instructions about what should be done tend to suggest that an individual is an



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independent contractor. Training is another key aspect of behavioral control. If the business provides the individual with training about required procedures and methods, this indicates that the business wants the work done in a certain way and is suggestive of an employment relationship. Further, the nature of the evaluation system informs the characterization. If the evaluation measures the details of how the work is performed, this tends to point to an employment relationship.

**B. Financial Control (Original Factor Nos. 12, 13, 15, 16, 17 and 18)**

The second broad category recognized by the IRS characterization is financial control. If an individual has a significant financial investment in his or her work, this tends to suggest an independent contractor relationship. Although no precise dollar amount is required, the investment must have substance. Whether an individual is reimbursed for some or all of his or her business expenses also sheds light on the nature and extent of financial control. Instances where individuals are not reimbursed for expenses, particularly if those expenses are high, may suggest an independent contractor relationship. A third component of the financial control category focuses on the opportunity for profit or loss. If an individual can realize a profit or loss by virtue of his or her work, this tends to suggest that the individual is in business for himself or herself and, therefore, an independent contractor relationship exists.

**C. Relationship of the Parties (Original Factor Nos. 3, 6, 19 and 20)**

The third broad category recognized by the IRS in the independent contractor/employee characterization is the relationship of the parties. This category focuses on how the individual and the business perceive their relationship. The receipt of employee benefits such as insurance, pension, or paid leave is highly suggestive of an employment relationship. However, the lack of benefits may suggest either an employment or independent contractor relationship. A written contract may also reflect how the parties regard their relationship. That said, it is important to keep in mind that how the parties characterize their relationship is *not* dispositive. In other words, the IRS will analyze the *substance* of a worker's relationship with a business, as opposed merely the *form* of that relationship.



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Employers who improperly classify workers subject themselves to significant litigation risk and other penalties. In addition, states throughout the country are increasingly expressing their frustration with mischaracterization by enacting statutes that impose additional penalties on employers which improperly treat employees as independent contractors.

**III. Other Recognized Tests**

**A. The Common Law Test.** This test is used when a statute does not define “employee.”

1. whether the organization can hire or fire the individual or establish the rules and regulations of the individual's work;
2. whether and, if so, to what extent, the organization supervises the individual's work;
3. whether the individual reports to someone higher in the organization;
4. whether and, if so, to what extent, the individual is able to influence the organization;
5. whether the parties intended that the individual be an employee, as stated in written contracts or agreements; and
6. whether the individual shares in the losses, profits and liabilities of the entity.

**B. The Hybrid Test.** This is often used by courts analyzing discrimination claims under Title VII and the ADEA.

1. The employer's right to control the means and manner by which the work is accomplished;
2. Whether the work is generally done under the direction of a supervisor or is done by a specialist without supervision;
3. The skill required in the particular occupation;
4. The length of time during which the individual has worked;
5. Whether the employer or the individual provides the equipment used and the place of work;
6. The method of payment, whether by hour, project, or by the job;
7. The manner in which the work relationship is terminated, i.e., by one or both parties, with or without notice and explanation;



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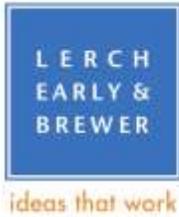
8. Whether paid leave is provided;
9. Whether the work is an integral part of the business of the "employer;"
10. Whether the "employer" pays social security taxes;
11. Whether the worker accumulates retirement benefits; and
12. The intent of the parties.

**C. The Economic Realities Test.** This test is often applied to cases under the Fair Labor Standards Act (FLSA). This test essentially asks whether the individual is economically dependent on the entity, or is effectively in business for himself.

1. The extent to which the services in question are part of the company's business;
2. The amount of the individual's investment in the company's equipment and facilities;
3. The nature and degree of control retained by management;
4. The permanency of the relationship.
5. The amount of initiative, skill or judgment required; and
6. Individual opportunity for loss or profit.

**D. Remedial Legislation Test.** This test is applied by courts when a statute is designed to address a specific issue (i.e., unemployment, workers compensation, etc.).

1. For example, under Maryland law, it is very difficult for an individual to be considered an independent contractor for *unemployment insurance* purposes in light of the rigorous test set forth by the legislature. In 2009, the Maryland legislature enacted the Workplace Fraud Act to address what it perceived to be widespread mischaracterization of workers, particularly in the construction and landscaping industries.



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**IV. Risks and Damages**

A. State and federal tax liability

The Department of Labor Wage and Hour Division recovered in excess of \$185 million in unpaid wages in fiscal year 2008. Although it is unclear from these statistics what portion of the recovered wages come from the mischaracterization of workers as independent contractors, it is safe to assume that the percentage is significant.

**B. Employers may owe minimum wages and overtime (as well as the dollar value of benefits not provided) to “contractors.”**

C. Employers may be liable to employees for benefits (insurance, vacation, retirement, etc).

D. Workers compensation issues.

**V. Other Issues**

a. The single or integrated employer – asks whether the operations of 2 entities are so interrelated that they should be treated as a single employer.

b. Joint employer – courts will analyze whether more than one employer retains control over the employee.

1. This has particularly significant ramifications for temporary agencies and their clients.

c. Successor employer.

d. Parent corporations being responsible for the actions of subcontractors.



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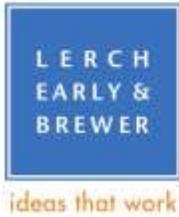
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e. The importance of proper independent contractor agreements. Terms found in independent contractor agreements include, among other things, the following:

- i. Affirmation of independent contractor relationship;
  - ii. Method and manner of payment;
  - iii. Statement that employee controls means; entity controls outcome;
  - iv. When and how termination occurs and consequences of termination;
  - v. Who pays for tools and equipment;
  - vi. Who pays for out of pocket expenses;
  - vii. Statement regarding absence of benefits (other than statutorily required benefits);
  - viii. Tax responsibility.
- f. Indemnity rights.
- g. Audits
- h. Privileges Issues
- i. Attorney-Client Agreement
  - ii. Attorney Work Product
- i. Dangers of “do-it-yourself fixes”

**The Stakes Have Never Been Higher – Proactive Steps for Employers to Take**

Employers, with the assistance of counsel, should conduct thorough audits of their workers to determine whether they are properly classified as employees. Second, if employers have improperly classified employees as independent contractors, then they should work closely with counsel to determine how best to remedy the mischaracterization. Third, employers should also train supervisors and managers on the key differences between independent contractors and employees so that they can recognize, for example, whether two individuals working side by side on a project and doing essentially the same work have been characterized differently. Fourth, employers should carefully review independent



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contractor agreements to determine if the terms are consistent with and actually support an independent contractor relationship. Fifth, employers need to balance the risks against the benefits of treating individuals as independent contractors as opposed to employees, and appreciate that an individual may be deemed an employee under one statutory framework and an independent contractor under another.

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Marc R. Engel, Esq. is a shareholder at Lerch, Early & Brewer, Chartered where he co-chairs the firm's Employment and Labor Group and is a member of the firm's Litigation Group. Mr. Engel advises clients on employment issues, litigates employment and business disputes, and counsels companies and organizations on litigation avoidance strategies. He also mediates employment and civil litigation matters. In 2011, Mr. Engel was listed in Washingtonian Magazine's Top Lawyers for Employment Law. Mr. Engel can be contacted at (301) 657-0184 or by e-mail at [mengel@lerchearly.com](mailto:mengel@lerchearly.com). For more information about the firm, please visit our website at [www.lerchearly.com](http://www.lerchearly.com). **This article is not intended to provide legal advice as to any specific matter. Employers should consult with counsel to discuss and evaluate issues pertaining to the characterization of workers.**