Alternative Solutions for Worker Misclassification Risk

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WorkforceLogic – Your Trusted Advisor

WorkforceLogic
Optimizing Your Workforce

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Introduction

Today, most companies are aware of worker misclassification and the risks and penalties associated with this practice. In part, this awareness is due to headlines about the staggering fines and penalties following lawsuits at FedEx, Microsoft, State Farm, Wal-Mart and others. The outcome of these cases suggests that employers have only two alternatives to the traditional W-2 employee model when hiring outside labor or independent contractors: 1) take a chance and run the risk of misclassification fines and penalties, or 2) use a third party, typically a traditional staffing company, to payroll a worker not qualified to be paid on a 1099.

The first alternative has the obvious drawback of multiple associated risks. These are substantial and include liability for the following unpaid costs: federal, state and local income tax withholdings; Social Security; Medicare; unemployment insurance premiums; Workers' Compensation premiums; overtime compensation; and work-related expenses. Another risk is claims by "common law employees" for pension, profit-sharing, medical coverage and stock options.

The second alternative may work for administrative-level contractors, but professional-level and niche independent contractors tend to look disdainfully on the payroll model offered by a traditional staffing company. Unfortunately, employers who choose this route are likely to come out on the losing end. High-level contractors often turn to another hiring company when unable to agree on the terms of engagement, including payment for services. The in-demand niche worker can easily find a client company, typically a competitor willing to meet their demands.

Most employers are unaware that there are alternatives to the two extremes mentioned above. They don't realize that a variety of tailored, flexible and legal solutions can be designed. The successful development of such solutions requires expertise in compliance legislation and familiarity with comparative cases. It requires a vendor with a solid track record and the confidence to stand up to those who would challenge its compliance recommendations. This whitepaper offers tangible examples of how WorkforceLogic is that vendor.

Federal, State and IRS Laws

Because the laws are constantly changing, proper worker classification can seem like a game without clear-cut rules. To shed some light on the many legal grey areas, WorkforceLogic has assembled a series of real-world examples to illustrate how companies unwittingly get into legal trouble. In each case, WorkforceLogic was able to provide helpful solutions.

Misclassification Lawsuits Affect all Businesses

Many companies believe that worker misclassification lawsuits hit only large businesses trying to sidestep the law or those with shoddy contractor documentation. This is not the case. Consider these true audit stories:

1) **A philanthropic organization** was audited by the EDD and found guilty of worker misclassification, as well as non-payment of employer payroll taxes. The organization had funded a grant to a group of independent contractors. These contractors were stationed in isolated areas around the world performing research on global warming and its impact on spotted salamanders. A California tax auditing agency performing random audits identified these researchers as employees of the institution. The group of workers and the philanthropic organization maintained that their working relationship was independent contractor and client, but the auditing agency stood its ground. The organization called upon WorkforceLogic for assistance. WorkforceLogic analyzed the situation and brought in outside legal counsel that specialized in employment law. The legal counsel recommended that the organization establish the field researchers as "professional experts" providing a niche skill set and real expertise. Moreover, the philanthropic organization was positioned not as an employer, but as an entity providing finances to support the advancement of mankind.

   This is just one example of how WorkforceLogic thinks outside the box–beyond the traditional payroll solution—to create legal, practical and successful alternative compensation models.

   Please note that this solution, although perfectly legal, was not designed as a workaround for employers looking to skirt their employer obligations, and it is not necessarily the perfect response for other employers in similar situations. This unique model is for situations that include individuals who do not purport a business offering (e.g. the field researchers) but are not traditional employees either. It shows how WorkforceLogic uses their command of compliance regulations to solve complex problems and mitigate compliance risk.

2) **A software company in Silicon Valley** reviewed all of its independent contractor relationships for proper documentation and found one contractor who could not legally claim independent contractor status. When the company identified the worker as a candidate for payroll or as a W-2 employee, the worker pushed back. He contacted the IRS for a worker classification ruling and asked them to reevaluate the relationship using a simple IRS Form SS8, without supporting documentation. To encourage a favorable IRS ruling of independent contractor status, the worker misrepresented both the business structure and the work to be performed. The IRS did not verify the claim of independence and rendered its determination that the

worker qualified as an independent contractor. The contractor then shared his "success story" with other workers who did not qualify as independent contractors and coached them on how to fill out the Form SS8. This created the threat of an audit being triggered by a glut of SS8 form hitting the IRS, should enough workers band together. WorkforceLogic was brought in to solve the issue. They were able to obtain a copy of the errant determination and initiate an appeal process on behalf of the client company. They submitted the original statements and supporting documentation provided by the worker (used to support the W-2 payment recommendation) to the IRS. After WorkforceLogic clarified the situation with the IRS, the auditor agreed with WorkforceLogic's decisions and commended them on the proper classification. The worker who falsified claims of independence to the IRS received a written copy of the reversal of its initial ruling.

As demonstrated above, the burden of proof is upon the employer company to substantiate independent contractor status. Due to the complex rules and regulations surrounding proper classification of workers, many companies—fearing costly legal bills or retribution from the IRS—simply pay the misclassification penalties without arguing the accusations. WorkforceLogic has helped many companies fight improper misclassification rulings and reduce or eliminate fines and penalties. WorkforceLogic has the experience and the confidence to stand up to government agencies when they have interpreted the facts incorrectly, in other words, when they have made a mistake. Since its inception, WorkforceLogic has *never* had an IRS or State worker classification overturned.

Below are two examples of how WorkforceLogic has saved hundreds of thousands of dollars for companies:

1) **A large gaming company** received an unemployment claim for a worker they paid on a 1099. The company denied the claim, noting that the worker was an independent contractor and therefore not eligible for unemployment benefits. This denial of benefits triggered an audit by the Employment Development Department (EDD). The audit letter, which arrived while the Human Resources Manager was out of the office traveling, demanded a list of all workers paid on 1099s covering a look back period of three years. The accounts payable department simply complied with the request and began pulling the data together. It gave the EDD not only the requested names, but additional documentation should the auditor have questions. Had the company established a protocol or policy for handling such requests, it may have been able to hold the auditor off until it was better prepared for the audit. The "look back period" demanded by the EDD covered a time frame when the company did not have a central repository for contracts and contractor documentation. Because of this, the Human Resource Manager was frantic, knowing the organization did not have *any* evidence to support or justify 1099 payments for the majority of its workers. The company was facing a penalty of more than $600,000! Once WorkforceLogic was brought in, they were able to legally recreate the relationship

between the client company and the contractors. They made hundreds of phone calls to former employees, conducted dozens of interviews and collected numerous affidavits. WorkforceLogic then began the tedious reconstruction of hundreds of worker files containing copies of the required supporting documentation to justify the 1099 payments. When all was said and done, WorkforceLogic succeeded in getting the fines and penalties reduced to less than $80,000. Their next feat was to implement an audit-proof 1099 contractor compliance program that would stand up to any future auditor scrutiny.

2) **A data storage technology company** was audited after it denied unemployment benefits to a worker who, according to its records, was paid on a 1099 for numerous projects. In fact, the independent contractor had slowly "become" an employee over the course of several projects and several years by allowing the company to become his sole source of income as he became too busy for other clients. This change in the relationship left the company liable, even though the company was not aware that the contractor was no longer working with other clients. When the contractor's current project ended, the contractor filed an unemployment claim naming the storage company as his employer, prompting an audit. The auditors found several other workers that they reclassified as employees, and they assessed tens of thousands of dollars in fines and penalties. Following the audit, the company paid the large fines, and then engaged WorkforceLogic to provide compliance and payroll services to prevent future worker misclassifications. The company was audited three years later, but this time things were very different. The company was not concerned about the outcome because it had compliance files to support all of its 1099 classifications. No fines, no penalties and no evidence of wrongdoing were found during the audit. The company has maintained its relationship with WorkforceLogic for nine years, and the client routinely expresses its appreciation for the peace of mind WorkforceLogic has provided.

Again, the burden of proof is upon the employer company to substantiate independent contractor status. In the majority of cases, companies are unable to do so because they lack the necessary resources—in-house compliance expertise, supporting paperwork for every contractor classification and a full understanding of the circumstances surrounding each classification decision. Therefore, most companies panic when confronted by an auditing agency. WorkforceLogic can actually reconstruct the projects or relationships and build the case files to dispute fines and penalties. They know where to look for the necessary data and how to construct a case to substantiate a company's legal right to hire independent subcontractors when appropriate.

Keeping Up-to-Date on Legislation

In addition to defending companies based on existing compliance laws, WorkforceLogic helps companies stay up-to-date on new employer regulations as they emerge. The laws for each agency are different, vary from state to state and are complex and ever-changing.

For example, three federal bills aimed at independent contractor abuses were introduced this session, one in the Senate and two in the House:

1. **Independent Contractor Proper Classification Act of 2007 (ICPC)**, S. 2044, is designed to tighten existing employer safe harbor in the tax code. This bill includes significant changes and numerous provisions for worker protection: compels the IRS to require employers to reclassify workers previously misclassified as independent contractors; eliminates the ban on the IRS issuing regulations or revenue rulings on employee/independent contractor status; prevents employers from claiming reliance on industry standards as the reason for misclassification of employees. If enacted, S. 2044 will: create an administrative process whereby workers can request and receive a written recommendation of proper classification; require safeguards against employer retaliation; require employer to pay all legal fees to misclassified employees. The IRS will then inform the Department of Labor of employer misclassification practices and require both to issue annual reports on misclassification and efforts to curtail same.

2. **The Employee Misclassification Prevention Act of 2008 (HR 6111)** would amend the Fair Labor Standards Act to clarify that employee records must reflect the worker's accurate status. It would require state unemployment insurance agencies to conduct audits and to identify employers who are intentionally misclassifying employees. It would allow the Department of Labor (DOL) and the Internal Revenue Service (IRS) to form a task force and refer cases of misclassification to one another. Lastly it would require the DOL to develop a system to track and monitor states' efforts to identify and penalize employers who misclassify workers.

3. **The Taxpayer Responsibility, Accountability, and Consistency Act (HR 5804)** would revise and amend relevant sections of the Internal Revenue Code and the Revenue Act of 1978, eliminating accidental worker misclassification. These changes would reduce the number of worker misclassifications while casting a bright light on employer tax evasion. Culpable businesses would face increased IRS fines and penalties.

Additionally, the State of California has a plan for combating its overwhelming worker misclassification issue. California SB1490 is a bill that calls for recordkeeping and employer notification of independent contractor status, with

posting requirements. If passed, employers would be required to provide independent contractors with a written notice of their status including tax liability, ineligibility for labor and employment protections, and their legal right to obtain written confirmation of their status from the Employment Development Department.

WorkforceLogic is a leading expert in the world of compliance regulations. They know the political motivation that drives new legislation. WorkforceLogic tracks regulations in progress and puts a risk mitigation process in place to keep companies in compliance and out of costly legal battles.

Alternative Solutions for Misclassification Risk

The examples provided above clearly show that worker classification is not a simple black-and-white issue. Being pursued by the Federal or State Government, or the IRS, for worker misclassification does not need to be an automatic guilty verdict, nor does being in compliance today ensure that an employer will be in compliance tomorrow. Even if a company on-boards all its independent contractors, there is no guarantee that it will then be operating without risk. This circles back to the fact that companies have more than two alternatives for hiring independent contractors (i.e. bear the misclassification risk or payroll the workers).

WorkforceLogic acts as a trusted advisor, helping employers determine the best way for their unique company and their unique independent contractors to work together. WorkforceLogic offers a consultative approach to engaging highly specialized individuals who want to be paid as independent contractors but don't fully meet the legal requirements. These individuals can start work as payrolled employees while WorkforceLogic consults with them behind the scenes to make sure they build a business that will pass any agency's scrutiny.

Today's niche and transient workers are increasingly demanding the freedom to work as independent contractors, regardless of tightening compliance laws. Employers face a challenge as they try to both accommodate skilled workers and mitigate the risks associated with this particular talent pool. WorkforceLogic has been there, many times. They have performed more than 20,000 contractor evaluations, and they have a perfect audit record. WorkforceLogic has *never* had an IRS or State classification decision overturned. Their clients know they have compliance programs that they can depend on, with predictable audit results. WorkforceLogic helps each client build a risk mitigation program that fits its culture and provides peace of mind, with a guaranteed layer of protection against worker misclassification fines and penalties.