

THE DANGERS OF MISCLASSIFICATION

Referring to right of way professionals as independent contractors



Lawsuits and regulatory actions attacking the alleged misclassification of workers as independent contractors have posed scary and expensive legal problems for some right of way service firms. It's an issue that both the managers of firms and the individual contractors should be aware of so that it can be handled prudently.

Justifying the Position

To show how aggressive some labor and tax agencies can be on the issue, let's consider a recent situation in New Jersey. The case concerned pyrotechnicians who handled fireworks shows for a pyrotechnic manufacturer named Garden State Fireworks Inc. For the most part, fireworks shows



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are special events, occurring most frequently on holidays. In fact, 80 percent of the company's business occurred on the Fourth of July. Therefore, many pyrotechnicians only provide their services a few days each year and hold other "real" jobs from which they earn their true living.

Given the unique character of the work, Garden State treated its 100+ pyrotechnicians as independent contractors. The company didn't direct the details of how these pyrotechnicians set up their shows, and the contractors never did any work for the company at its manufacturing plant. Their services were limited to handling shows out in the field.

Garden State had been audited in the past by the IRS, who had reviewed its practice of compensating pyrotechnicians as contractors, specifically confirming in writing that the classification was acceptable for federal tax purposes. Yet, several years later in 2013, the New Jersey Department of Labor challenged the company's practice for purposes of state unemployment and disability contributions, demanding more than \$30,000 for the unpaid contributions and penalties. The Department of Labor justified its position on the basis that New Jersey's classification test is different and more stringent than the test for federal tax purposes. The state Labor Commissioner ruled in favor of the Department of Labor and the penalties were imposed.

This result should have been improbable. How could a pyrotechnician—who only works in that capacity a few days a year and who holds a full-time regular job—plausibly seek the benefits of unemployment insurance after working on a Fourth of July fireworks show? Well, the New Jersey Department of Labor is renown for its extreme positions, and that's exactly the position it took. After four years of struggling through expensive hearings and proceedings, the company finally appealed that result to the Superior Court of New Jersey, Appellate Division. In September 2017, common sense prevailed, and the appellate court determined that the state was wrong. The appellate court reasoned: "It is difficult to conceive that an individual who does work for a company one to three days a year, while

working full-time in another profession, could be reasonably considered an employee of that company."

If a state labor department takes the position that pyrotechnicians who work a few days a year cannot be classified as independent contractors, how do you think such government agencies may view the classification of professionals providing daily right of way-related services within right of way firms? When such firms are challenged on the practice, they often do not fare as well as the fireworks company—unless they are well prepared to support their classification.

Incentives for Treating Workers as Contractors

Most companies that treat any of their workers as independent contractors recognize the strong economic and operational justifications for the decision. Common reasons supporting the practice include:

- Independent contractors don't have to be paid overtime for working more than eight hours in a day or 40 hours in a week.
- Contractors can be hired and fired more easily.
- Bookkeeping is simpler with contractors, as companies need only report payments to them on an annual 1099 tax form and don't withhold taxes or make Social Security and Medicare contributions for them.
- Firms do not typically offer contractors regular employee benefits like 401k contributions, paid sick or vacation time, or maternity leave.
- Firms usually don't pay unemployment or disability premiums for contractors.
- Classifying a service provider as an independent contractor may insulate the firm from liability for the service provider's errors or omissions.

It's important to note that using the independent contractor classification is quite often not a one-sided preference. Many right of way professionals themselves prefer to be treated as contractors rather than employees. A key reason for that preference is that the arrangement enables the individual to deduct business-related expenses to a much greater level than an employee. A person working as an independent contractor and reporting their income on IRS Schedule C may write off expenses such as business vehicle use, home office costs, business meals, insurance and supplies. This may lower their taxable income. Many individuals also simply prefer "being their own boss."

Evaluating Whether Workers are Properly Treated as Contractors

While the economic incentives are strong, the risks stemming from misclassifying workers as contractors are real and significant. When audited or sued by state and federal agencies, some right of way firms have been found liable for significant sums for unpaid employment taxes, social security contributions and workers compensation premiums, along with substantial penalties and interest.

Right of way firms have also found themselves as defendants to lawsuits filed by workers contending they were misclassified as contractors and therefore did not receive benefits to which they may have been entitled to had they been given employee status. Aggrieved workers may sue for unpaid overtime, unpaid employee expenses, penalties and interest.

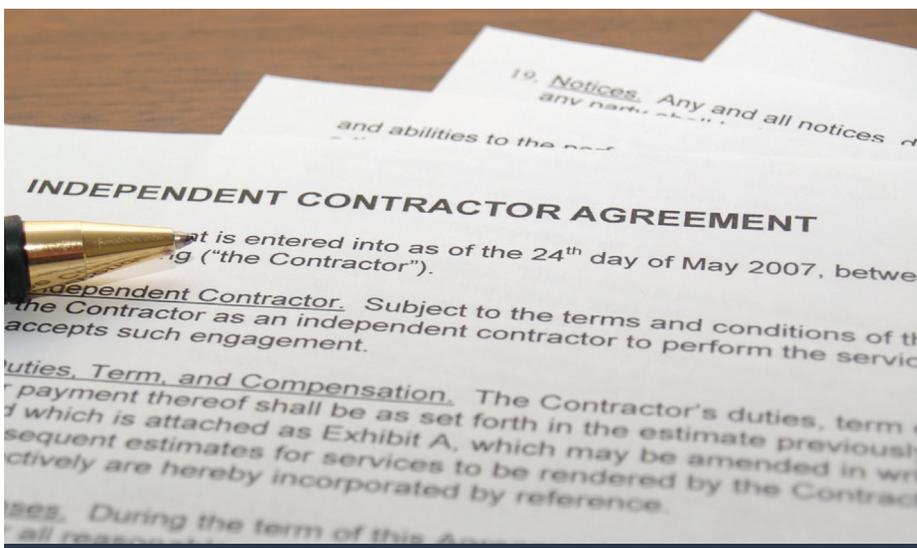
All companies treating right of way professionals as contractors are advised to seek knowledgeable legal counsel about how to handle the legal arrangements properly under the specific laws of the states in which they operate. Whether or not classification of a service provider as a contractor is legally correct is a difficult question to answer. The legal tests differ for federal tax purposes versus for overtime, unemployment insurance, workers compensation or liability. And the tests also vary by state. There is simply no single standard for determining whether a worker is properly treated as an independent contractor.

Although the specific tests and their factors vary significantly, there is a general theme that runs through most. The key question under what is referred to as the "common law" test is the firm's control over the worker.

The IRS has summarized the common law test in its wage withholding regulations and states that a worker generally will be considered an employee when: "the person for whom services are performed [the right of way firm] has the right to control and direct the individual who performs the services [the contractor], not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished." Treas. Reg. §31.3401(c)-1(b).

Below are some key factors relating to control that need to be considered. If any of the questions have strong "yes" answers or more than a few are "yes," the company should think twice before classifying the worker as contractor.

- Does the company train the worker on how to perform their right of way services?
- Is the worker required to be present on the company's premises or office?
- Is the worker required to work certain hours or days?
- Is the worker required to devote substantially full time to the firm?
- Does the company pay for the worker's tools such as computers, software and data?
- Is the worker paid by the hour or week (as opposed to by project)?
- Is the worker permitted to accept and be paid for work independent of the company?
- Are other workers performing the same service with the company treated as employees?
- Can the worker realize a profit or suffer a loss as a result of their services for the firm?



A Proper Independent Contractor Relationship

Many firms providing right of way services properly structure their independent contractor arrangements to minimize potential problems. To decrease the risk of misclassification becoming a legal problem, any company treating workers (who provide services to the company on a regular basis) as independent contractors should avoid some basic red flag practices. In particular, a company should not:

- Refer to its independent contractor service providers as “staff members” in brochures, websites or in any media—at least not without stating specifically that they are independent contractors to the company.
- Classify some workers as employees but others as contractors, even though they perform the same services.
- Require a contractor to sign a non-compete agreement or other agreement to work exclusively for the company.

A company should also utilize a written independent contractor agreement. The agreement will not be a controlling factor in any classification test, but can provide good evidence of the firm’s and the worker’s view of the relationship. Here are some key points the agreement should cover that need to be true:

- The independent contractor should have the right and freedom to work the hours that they deem necessary to perform accepted projects, and the manner of performance should be under the exclusive control of the worker.
- The agreement should permit the contractor to perform services for other firms, and permit the contractor to market their services to others.



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- The contractor should be responsible for their own training and “tools,” including computers, software, data and other work-related supplies.

Lastly, a simple and key component of many audits has been to look at the contractor’s business card. If the business card refers to the contractor as a staff member of the firm, that won’t be helpful to the firm’s classification position. The business card should identify the independent contractor as the operator of their own business enterprise.

In Summary

The decision to hire someone as an employee or a contractor can have a significant impact on both parties. By carefully weighing the pros and cons of both classifications, both the firm and the independent contractor can make the best strategic decision. ☺



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