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What's in a Name? Misclassifying Employees as Independent Contractors Can Be Costly

Are tax and other advantages tempting your staffing firm to classify workers as independent contractors instead of employees? The U.S. Internal Revenue Service and other federal agencies have long recognized this temptation, and many states are scrutinizing independent contractor arrangements too. A majority have enacted worker misclassification legislation, and many have created taskforces to crack down on businesses that violate the law. Coupled with federal enforcement efforts and class action lawsuits filed with increasing frequency, it all means that misclassifying workers can have serious consequences for your staffing firm—and your clients.

Employer Obligations

If a worker is an employee, the employer must pay its share of Social Security (FICA) and federal and state unemployment taxes, as well as withhold the employee's share of federal income and FICA taxes. The employer also will incur costs related to pensions, health insurance, vacation pay, sick pay, and workers' compensation insurance. In addition, employers face federal and state regulations regarding working conditions and overtime.

Given such employer obligations, over the years ASA has received calls from members complaining about staffing firm competitors that improperly classify their workers as independent contractors. These firms can gain a significant and unfair pricing advantage because they do not pay for workers' compensation, unemployment insurance, or Social Security, and do not withhold taxes from the people they send on assignment.

The rules governing worker classification are complex and, at times, have led to confusion about how temporary workers should be classified. In the great majority of cases, the individuals assigned by these firms really are employees because of the nature of the work they perform and their relationship with the staffing firm or client.

Common Law Multifactor Test

There are various tests—under various laws—to determine whether a worker is an independent contractor or an employee. IRS and federal courts examine multiple factors for federal employment tax purposes, many of which also are used to determine employer status under other laws affecting workers, at both the federal and state level.¹ The more factors that are present in a staffing firm's relationship with its worker, the

¹ For a comprehensive examination of common law employer issues in the staffing industry, see Bianchi and Lenz, *The Final Code §4980H Regulations; Common Law Employees; and Offers of Coverage by Unrelated Employers*, BloombergBNA Tax Management Memorandum (Sept. 8, 2014).

more likely a worker will be an employee and not an independent contractor. These factors include

- Whether the staffing firm or client has the right to instruct or direct how work is performed
- Whether the worker undergoes training
- Whether the work is integrated into the client's business
- Whether the client hires and supervises assistants to help the worker
- Whether the services must be rendered personally
- Whether there is a continuing relationship with the worker
- Whether the worker works set hours
- Whether the worker must devote his or her full time to the assignment or task
- Whether the worker works on the client's or staffing firm's premises
- Whether the worker must perform tasks in a particular order
- Whether the worker must submit written or oral reports
- Whether the worker is paid hourly, weekly, or monthly
- Whether the staffing firm or client pays the worker's business and travel expenses
- Whether the staffing firm or client provides tools and materials for work
- Whether the worker does not have a substantial investment in facilities used to work
- Whether the worker can realize a profit or suffer a loss in connection with the services
- Whether the worker works only for the staffing firm or client
- Whether the worker does not make his or her services available to the general public
- Whether the staffing firm or client can discharge the worker
- Whether the worker can terminate his or her relationship with the staffing firm or client without incurring liability

Potential Liability for Staffing Firm and Client

Most workers assigned through a staffing arrangement perform their work under the supervision and control of either the staffing firm or the client, and the work performed generally is of a nature that does not require the worker to exercise a substantial degree of independent judgment. While exceptions do exist—especially in the information technology field—most assigned workers can properly be classified only as employees under applicable law.

If a staffing firm misclassifies an employee as an independent contractor, the firm can face significant fines and penalties for, among other things, failure to withhold and remit taxes, pay Social Security, provide insurance coverage, and pay overtime. Moreover, if the staffing firm fails to pay, the firm's *client* may be held liable for those costs as a joint employer. Misclassification thus poses significant risks to both the staffing firm and its clients.

To protect your clients and mitigate the competitive harm due to worker misclassification, consider sending clients a letter alerting them to their potential liability if they use the services of independent contractors who are really employees. The letter should highlight some of the criteria used to determine whether workers are really employees. Sample language is provided below.

The letter is designed to cause clients to examine how the workers assigned to them are being classified, and to challenge staffing firms they believe may be improperly classifying workers. This in turn may prompt staffing firms that may be misclassifying to pay closer attention to their practices and ensure compliance with the law, thus leveling the competitive playing field.

For additional information on proper classification of workers, refer to the 13th edition of *Employment Law for Staffing Professionals*, published by ASA.

Alert Clients to Potential Liability

Consider sending your clients a cautionary letter to alert them to their potential liability if they use the services of "independent contractors" who are really employees, and to highlight some of the criteria used to determine whether workers are really employees. Sample language follows.

One of the many advantages of using a staffing firm is that you don't have to worry about workers' compensation, unemployment insurance, liability coverage, and payroll taxes and withholdings for the temporary workers assigned to you. That's because staffing firms generally are the employers of such individuals and handle those obligations.

However, some staffing firms don't carry out these employer obligations. They send out people classified as "independent contractors" and don't withhold taxes, don't pay Social Security taxes, and don't provide insurance. The danger is, if the workers are not independent contractors but are really employees under Internal Revenue Code or other applicable rules, *you* may be held liable as the employer.

ASA thinks it makes good business sense to ask your staffing firms if they employ the people they assign to you. If they say yes, there are questions you can ask to verify whether they are meeting their obligations. For example:

- Do they provide workers' compensation insurance?
- Do they pay unemployment taxes?
- Do they make proper income tax and other required withholdings and pay the employer's share of Social Security taxes?
- Are the workers' services covered by insurance?

If a staffing firm says it doesn't assume these obligations because its workers are independent contractors, you should ask

- Does the staffing firm have the power to hire and fire the workers?
- Does it establish the workers' pay rates?
- Does it pay the workers directly?
- Is the staffing firm the workers' only client?

If the answer to these questions is yes, you should be suspicious of any claim that the workers are independent contractors. IRS and court rulings indicate that "yes" answers mean the workers probably are employees and *not* independent contractors. That could mean problems for you.

ASA wants you to use staffing services with confidence and hopes this information will help you choose your service provider wisely.