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CONSTRUCTION ACCOUNTING ARTICLE - Construction Employee Misclassification Receiving More Scrutiny

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According to the Government Accountability Office, independent contractors account for more than 7% of the U.S. workforce. They certainly have their place in the construction industry — be it as a specialized tradesperson, such as a carpenter, or as an IT or business consultant.

If your construction company has engaged an independent contractor recently, watch out. Government agencies have long been watchful for “employee misclassification” — that is, treating an independent contractor like a bona fide employee to, inadvertently or otherwise, avoid tax and benefits obligations. And, right now, the scrutiny has never been greater.

Advantages and Risks

We live in an increasingly specialized society. As such, there’s a growing subset of the workforce with very distinctive skill sets that can perform high-quality services. Through independent contractor relationships, companies are able to access these services without the long-term entanglements of traditional employment. Meanwhile, the workers themselves enjoy professional independence and flexibility.

And yet, risk remains. Classifying a worker as an independent contractor allows employers to deny them overtime pay, unemployment compensation, and health care and retirement benefits. In addition, independent status takes an individual off the company payroll, where taxes are automatically withheld. For these reasons, the federal government has a vested interest in ensuring workers aren’t, in its view, misclassified.

6 Key Factors

The IRS has long been a primary enforcer of employee misclassification. But it’s the Department of Labor (DOL) that developed tests to determine whether a worker is legitimately classified as an independent contractor or should be considered an employee and, therefore, covered under the Fair Labor Standards Act. These tests are subject to interpretation, but the following six factors are generally considered when making the determination:

1. The extent to which the work performed is an integral part of the employer’s business.

If the work performed by a worker is integral to the employer’s business, it’s more likely that the worker is economically dependent on the employer and less likely that the worker is in business for himself or herself.

2. The worker’s opportunity for profit and loss.

A truly independent party assumes notable financial risk for a business engagement. An employee gets paid either way.

3. The relative investments in facilities and equipment by the worker and the employer.

The worker must make some investment compared to the employer's investment (and bear some risk for a loss) in order for there to be an indication that he or she is an independent contractor.

4. The worker's skill and initiative.

Both employees and independent contractors may be skilled workers. To indicate possible independent contractor status, the worker's skills should demonstrate that he or she exercises independent business judgment. Further, the fact that a worker is in open market competition with others would suggest independent contractor status.

5. The permanency of the worker's relationship with the employer.

A permanent or indefinite relationship between employer and worker suggests that he or she is an employee as opposed to an independent contractor.

6. The nature and degree of control by the employer.

Analysis of this factor includes who sets pay amounts and work hours, and who determines how work is performed, as well as whether the worker is free to work for others and hire helpers. An independent contractor generally works free from control by the employer (or anyone else, including the employer's clients).

Joint Efforts

Since the 2008 recession, the DOL has seen an increase in the number of workers classified as independent contractors. In 2011, the IRS estimated a net tax gap (what should have been paid vs. what was paid voluntarily or through enforcement) of more than \$290 billion. The agency attributes a significant portion of that to employee misclassification.

The two agencies have now undertaken a joint initiative to reduce misclassification and improve compliance with applicable tax and labor laws. The agencies are sharing information and resources and cooperating on investigation and outreach efforts. These efforts are beginning to bear fruit. (See "DOL investigations gain workers back wages.")

Clear Message

For construction business owners, the message is clear: Don't ignore the potential benefits of an independent contractor arrangement, but review the DOL's six factors before and during the engagement. It's not unusual for a company to engage an independent contractor with short-term intentions only to gradually integrate the person into its staff, creating a risk of employee misclassification.

DOL Investigations Gain Workers Back Wages

The Department of Labor's (DOL's) Wage and Hour Division and the IRS have entered partnerships with 26 states to combat employee misclassification. In some cases, other agencies have gotten involved, including the:

- Employee Benefits Security Administration,
- Occupational Safety and Health Administration,
- Office of Federal Contract Compliance Programs, and
- Office of the Solicitor.

According to the DOL's website, these investigations resulted in more than \$79 million in back wages for more than 109,000 workers in industries such as the janitorial, temporary help, food service, day care, hospitality and garment industries during the 2014 fiscal year.

In April 2015, federal courts in Utah and Arizona approved consent judgments against 16 defendants operating construction businesses that misclassified employees as "member/owners." These judgments awarded \$600,000 in back pay and liquidated damages to affected construction workers, plus \$100,000 in civil penalties.

The defendants were ordered to stop using limited liability companies to avoid Fair Labor Standards Act compliance. They were also directed to comply with the act's minimum wage, overtime, recordkeeping, and antiretaliation provisions and pay all applicable federal, state and local taxes.

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