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C L A S S I F Y I N G

## independent contractors and employees:

# Easier said than done

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Many businesses choose to classify certain workers as independent contractors rather than employees. There are a number of potential benefits of this classification. However, as many employers are now experiencing firsthand, independent contractor arrangements are coming under increased scrutiny by state and federal government agencies. Moreover, an organization that misclassifies may be exposing itself to substantial liability under various state and federal laws.

In addition, some states, including Wisconsin, have altered the test for determining employee status under state law and have imposed new penalties for employee misclassification.

There is no one test for determining whether an individual is an employee or an independent contractor. While a

particular worker may be an independent contractor for purposes of income tax laws, he or she may be an employee for purposes of unemployment or workers' compensation.

An employer must perform a careful analysis under a variety of laws, such as federal and state income tax laws, unemployment compensation benefits and tax laws, workers' compensation laws, the Fair Labor Standards Act (FLSA), employment discrimination laws, immigration laws and the Employee Retirement Income Security Act (ERISA). Following is a brief summary of the tests used under some of those laws, as well as some other issues employers should consider when classifying a worker as an independent contractor.

### Internal revenue code

The Internal Revenue Code (IRC) requires businesses to withhold income

taxes and withhold and pay Social Security and Medicare taxes on behalf of employees. However, this is not the case with independent contractors. The Internal Revenue Service (IRS) currently utilizes three "common law" rules to determine whether an individual is correctly classified as an employee or an independent contractor:

- **Behavioral:** Does the company control or have the right to control what the worker does and how the worker does his or her job?
- **Financial:** Are the business aspects of the worker's job controlled by the payer? (e.g., how the worker is paid, whether there are reimbursements for expenses, and who provides tools and supplies, etc.)
- **Type of Relationship:** Are there written contracts or employee type



benefits (e.g., pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?

The IRS has advised that businesses must weigh all of these factors in determining whether an individual is an employee or an independent contractor. The IRS has also recently announced a Voluntary Classification Settlement Program (VCSP) that allows employers, under certain circumstances, to avoid liability for past employee misclassification.

## **Federal Fair Labor Standards Act**

The U.S. Department of Labor (DOL) recently intensified its efforts to investigate employers who improperly classify employees as independent contractors for purposes of the FLSA. This has been

a publicized point of emphasis under the Barack Obama Administration. In addition, the DOL has recently entered into a memorandum of understanding with the IRS to collaborate in the investigation and enforcement of independent contractor classification issues.

The DOL and the courts generally have applied a six-factor test, commonly referred to as the “economic reality” test, to determine whether a worker is an employee or an independent contractor for purposes of the FLSA.

## **Wisconsin: unemployment compensation**

The definition of “independent contractor” for purposes of unemployment compensation under Wisconsin law has recently changed. As of Jan. 1, 2011, there is a new, two-part test for determining

eligibility for unemployment compensation benefits (i.e., whether an individual is an employee or independent contractor). See Wis. Stat. § 108.02(12)(bm).

A worker is not covered for purposes of the statute if the services of the individual are performed free from control or direction by the employer and the individual satisfies six or more specific conditions. The test must be satisfied “by contract and in fact.”

Like the DOL, the Wisconsin Department of Workforce Development (the state agency responsible for enforcing Wisconsin’s employment-related laws) has committed additional resources and attention to investigating alleged violations of employee misclassification.

## **Employee benefits**

Some businesses classify workers as independent contractors to avoid provid-

ing those workers fringe benefits such as medical insurance coverage or retirement benefits. Before doing so, however, a business should carefully review the terms of its employee benefit plans to ensure that language in the plans actually excludes such workers.

The seminal case on this issue involved Microsoft Corporation. Microsoft had excluded numerous workers from coverage under various employee benefit programs on the basis that they were independent contractors. However, the Microsoft plans provided that each employee was eligible to participate and defined employee to include any common law employee.

The Ninth Circuit Court of Appeals held that individuals deemed by Microsoft to be independent contractors actually met the test for common law employees, and were therefore eligible for coverage.



For more information  
regarding worker  
classification visit  
<http://tinyurl.com/6gfbegx>.

Since the Microsoft case, a number of class action lawsuits have been filed relating to misclassification and employee benefit plans. Businesses should consider revising the terms of their employee benefit plans to exclude workers treated as independent contractors.

## Conclusion

Worker classification can be a complicated analysis involving the application of various laws and legal tests. State and federal authorities are increasing their efforts

to investigate and prosecute businesses they believe are incorrectly classifying employees as independent contractors. Moreover, plaintiffs' lawyers are now frequently challenging worker classifications by using class action lawsuits, which are especially costly for businesses to defend against in court. Accordingly, businesses would be wise to revisit their worker classification decisions to ensure compliance with the current law.

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