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How to Deal with and Avoid an Employee Misclassification Audit

A Guide for Mitigating the Risks Associated with Independent Contractor Audits

You've Been Served. Now what?

You receive a notice that your company is being audited for independent contractor misclassification. How did this happen, what should you do, and how do you prevent this from happening in the future?

As use of independent contractor talent has increased in recent years so has heightened security from government agencies regarding the issue of misclassification. An uncertain regulatory environment and an increase in enforcement efforts, related to employee misclassification, present significant risks of financial liability for companies of all sizes.

What is misclassification?

Misclassification can be tricky as federal, state, and local government agencies each apply different tests to determine the proper classification of an employee.

Tests include:

- The **Department of Labor (DOL)** uses an economic realities test to determine the meaning of "employment relationship" in applying the Fair Labor Standards Act (FLSA). This test focuses on economics rather than technical concepts and looks at whether or not the individual is economically dependent on the business it serves.
- The **IRS** examines three broad categories—financial control, behavioral control, and type of relationship—with a focus on determining tax liability.
- **State laws** assess whether an individual is an independent contractor or employee according to state workplace laws.

Lack of uniformity among these tests means that an individual may be properly classified under one test and improperly under others.

Other Important Factors:

- **The worker's business:** Does the worker in question consider themselves to be a business and offer their services to the market?
- **The relationship of parties:** How do the worker and the employer perceive their relationship and how does it appear to the public?

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- **Economic factors:** How is the worker paid, how are expenses handled, and does the worker receive any benefits?

No one factor or set of factors is conclusive; the entire relationship and all factors must be examined in order to make an informed decision.

Understanding the Potential Triggers for an Audit

We generally only hear about the high-profile cases and class-action lawsuits, but it's important to understand that any company, regardless of size or industry, can be audited for misclassification. Here are the main red flags that can trigger an audit.

An independent contractor files a workers' compensation or disability claim.

Workers' compensation requirements can vary by state, and state requirements may treat an independent contractor as an employee under workers' compensation law.

An independent contractor files for unemployment compensation benefits.

When an independent contractor files for benefits, the claim is evaluated, and this evaluation can trigger an audit.

A whistleblower reports misclassification.

An independent contractor can notify the IRS if they believe themselves to be wrongly classified.

Dual classification in the same tax year.

A worker that receives a W-2 and a 1099 from an employer in one year can trigger an audit.

High risk industry

The IRS, DOL, or a state unemployment agency selects companies in high risk industries for audits.

- Janitorial Services
- Construction
- Nursing
- Staffing
- Internet Services
- Transportation and Trucking
- Cable Companies
- Security
- Catering Services
- Oil and Gas
- Landscaping
- Ride Share/Limousines
- Food Services
- Motions Picture and Sound Recordings
- Adult Entertainment

The Audit

No company wants to be audited, but a strong understanding what happens in an audit and how to prepare can be your best defense.

The audit letter will typically contain the following:

- Period covered by audit
- Scope of records to be reviewed
- Specific entity being audited

The agency will also request specific records such as:

- 1099s
- Checks, cash payment records, and bank statements
- Tax reports and income tax returns
- Payroll records
- Financial statements
- List of the corporation's officers and related corporate entities

Preparing for the Audit

To prepare for the audit, review and work through the following steps:

1. Appoint an internal audit team with representatives from legal, HR, payroll, tax, and outside counsel.
2. Schedule a conference call with the auditor. You may also want to schedule subsequent conference calls in an attempt to narrow the scope of the investigation. The auditor will typically ask for all 1099s for a three-year period, but the audit can also include the review of all 1099s.
3. Determine the audit period so that you can focus your information gathering and resources accordingly.
4. Find out what triggered the audit. This not only helps in preparing for the audit, but in preventing future problems.
5. Consider setting aside reserves and issuing a litigation hold.

Conducting the Audit

The auditor may want to schedule an onsite visit, but you can suggest that meetings be held in a neutral location such as the offices of your outside legal counsel. If possible, send documents to the auditor after the request has been made. Submit your most defensible cases to the auditor first. You can schedule a meeting with the auditor to review any borderline or difficult cases. It is critical to provide an honest assessment where misclassification is

Resolving the Audit

If applicable, negotiate your settlement amount. You can also negotiate penalties and fines. When you submit your settlement check to the agency, be certain to reserve all rights and indicate that you are not admitting liability for misclassifications.

Next, make voluntary changes to your process for engaging and managing independent contractors. This may include working with third party vendors or reworking your internal documented process.

Consequences of an Audit

Misclassification can be disruptive and expensive. The potential consequences include:

- Responsibility for back pay and liquidated damages
- Having to pay back taxes, interest, and penalties
- Paying Social Security and FICA
- Disqualification of company benefit plans
- Liability for overtime, meal periods, PTO, leaves, and rest brakes
- Contractors may claim 401(k), severance, health or welfare coverage, or employee stock purchase plans
- Criminal and civil penalties and sanctions
- Additional contributions to unemployment compensation and workers' compensation funds

Avoiding an Audit

If you are audited, use the experience to improve your process for engaging independent contractors while minimizing the risks of misclassification. Follow these 10 steps to put a better process in place for engaging and managing independent contractors.

1. Develop, or update existing, guidelines for hiring and managing independent contractors.
2. Conduct your own internal audit and investigate current classification practices.
3. Ensure that the contractors you engage qualify as independent and have a detailed description of the services performed by contractors for your records.
4. Have a written contract when engaging independent contractors.
5. Avoid having contractors use your office or company equipment.
6. Refrain from engaging independent contractors to perform the same type of service as an employee or former employee of the company.
7. Don't re-engage a former employee as an independent contractor to perform the same services.
8. Be mindful of co-employment.
9. Form an internal team to deal with these issues before they arise.
10. Partner with a company that specializes in independent contractor engagement and compliance.