

A Question Worth 30% of Labor Costs: When Is a Contingent Worker an FTE?

by Oana Lupu

Over three decades, multinational companies have brought contingent workers closer to the core of operations. Four out of five HR professionals say their organization uses independent workers.¹ Many companies run an intricate web of subcontractors, temporary agencies, franchises and other third parties that supply contingent workers.² At Google, more than half of those providing labor are contractors. They write code, develop artificial intelligence, drive shuttles and serve food.³

David Weil, a business professor and former U.S. Department of Labor official, describes in his book, “The Fissured Workforce,” a quest to please investors through increasing use of contingent workers. Managers can quickly order up staff with specialized skills, adjust the head count and reduce costs by up to 30%.⁴

Now Weil sees the pendulum swinging back. “Unfortunately, far too many companies are allowed to have it both ways.” He says they directly control contingent workers while being able to “escape the responsibilities required by our basic workplace laws.”

In the U.S., the state of California agrees, having passed a law going into effect on 1 January 2020 that dramatically broadens who counts

as an employee. Companies must apply a strict test to classify workers as independent contractors.⁵ It’s all part of an emerging global trend. Japan passed an equal pay for equal work law that protects temporary dispatch workers.⁶ Uber drivers in Nigeria have started their own class-action lawsuit.⁷ Political candidates in the U.S., the U.K. and Australia all support similar changes.^{8,9}

Governments also want to increase their tax base, although the Trump administration’s deregulation agenda is a notable exception.¹⁰ “We’ve seen a downturn in federal investigations and enforcement on misclassification,” employment attorney Justine Phillips, a partner at Sheppard Mullin, told us in an interview. She said individual U.S. states are still pressing ahead.

Defining Independent Contractor Misclassification

Misclassification laws are designed both to protect employees and to prevent companies from avoiding taxes, benefits and protections for these workers.¹¹ The U.S. federal government loses \$16 billion each year from unpaid employer payroll taxes.¹⁰ Up to 20% of businesses misclassify at least one contractor.¹³ This can provide a cost advantage over competitors.¹³ Thousands of companies, including FedEx, Macy’s, Penthouse and Lowe’s have settled lawsuits brought by workers alleging misclassification.¹⁴

What These Trends Mean for Business

A patchwork of independent contractor laws has sprung up, and we can expect more in the future, which increases the complexity of workforce management for global operations.

Risk of Misclassification Lawsuits

Labor shortages have emboldened workers pursuing class-action lawsuits.¹⁵ “There’s no question that there has been an uptick,” labor attorney Jeffrey S. Horton Thomas explained. Companies may end up paying settlements, fines, and increased overtime, taxes and other benefits going back years.

Costs From Reclassification

Some companies will consider reclassifying workers from contractors to employees. Doing so will increase the cost of their labor by about 30% more because of payroll taxes, unemployment insurance contributions and other benefits.⁴

Increased Risk From Manager Actions

If managers treat contractors like employees, the company risks future legal action.

Assembly Bill 5

California Assembly Bill 5 (AB 5) introduces a new, stricter test for employees versus independent contractors in California, regardless of the size of the employer. Gov. Gavin Newsom signed the bill into law on 18 September 2019 and it will take effect as 2020 begins.

The law defines all workers as employees for Labor Code and Unemployment Insurance Code purposes unless the employer can prove all three of the following factors (the ABC Test). The worker:

- A** Is “free from control of the hiring entity” in the performance of his or her work
- B** Performs “work that is outside the usual course of the hiring entity’s business”
- C** Is engaged in an independently established trade, occupation or business

Some of the workers excluded from the test for independent contractor status include:

- Licensed insurance agents
- Physicians, dentists, podiatrists, psychologists and veterinarians
- Licensed attorneys, architects, engineers, private investigators and accountants
- Individuals performing services in marketing, human resources, travel sales, graphic design, grant writing, fine art, photography and freelance writing under certain circumstances

Under AB 5:

- Employers bear the burden of proving their workers satisfy the ABC Test.
- State and city government officials can sue employers in cases of alleged misclassification.

Source: Jeffrey S. Horton Thomas, Akerman LLP

How to Minimize the Risks Within a Contractor Workforce

Functional leaders can take seven steps to begin optimizing compliance and minimizing risks.

Take Collective Responsibility

Managing contractor risks and liabilities should be a shared responsibility throughout the organization. “I would expect line directors to be involved, I would expect the CFO to have a voice, I would expect risk and compliance to play a role,” Robert Ployhart, professor of business administration at the University of South Carolina, told us.

But this isn’t always the case. “If you’re in procurement or legal, you can have this fantasy of these arm’s-length contractors who are completely divorced from the core things the firm does and are managed pretty carefully,” said Matthew Bidwell, associate professor of management at The Wharton School of the University of Pennsylvania.

And human resources tends to abdicate responsibility because independent contractors are not employees. Justine Phillips says this “myopic mentality” results in “nobody really managing the independent contractor workforce.”

Teach Managers What’s Different About Working With Contractors

Offer regular courses to help managers communicate with contractors in a compliant way. For example, if a contractor is performing poorly, the manager should avoid directly telling him or her what to do. Employment attorney Richard Reibstein suggests saying, “You’re your own boss, you decide how to do this.” Managers can follow-up with, “If you want my suggestions, I could share them, but I know you’re not obligated to follow them.”

Boost Compliance If You Don’t Intend to Reclassify Workers

There may be ways to increase compliance without the need to reclassify independent contractors, according to Reibstein, who is a partner at Locke Lord and publisher of a legal blog about independent contractor compliance. Changing the structure, documentation or implementation of contractual relationships can help, he said.

Plan Carefully If You Need to Reclassify Workers

Reclassifying workers in a short amount of time “is delicate and can create a tremendous amount of risk,” Phillips warned. A surge in status changes may encourage workers to sue the organization to claim benefits they missed out on while they were contractors and may also trigger an audit from state authorities. Phillips recommends a gradual, planned transition. Phases could include tighter scrutiny of contractor hiring moving forward, an internal audit of current contractor roles and setting a date by which every employee is on staff, has a compliant contractor arrangement or has his or her relationship terminated.

Create Gatekeepers to Assess Contractor Risks

Companies need to appoint people responsible for deciding whether new talent entering the organization to fill specific roles can be classified as contractors. Phillips recommends using a checklist to verify legal compliance. In the U.S., IRS form SS-8 or a state-specific checklist, like California’s DE 231, are great examples.

Consider Using Employment Agencies

If your contractors are employees of a staffing firm, “you don’t have any problem at all, but it’s going to be more costly,” according to Reibstein. But, he said, if they are also operating as contractors for that staffing firm, you may still be liable in a lawsuit if the staffing firm hasn’t optimized its own compliance with contractor laws.

Determine the Optimal Level of Involvement With Franchisees, If Applicable

Franchisors are in a vulnerable position. They should seek legal advice to decide whether to increase control over franchisees to enhance compliance with contractor laws, or keep a distance to reduce their exposure.

Keep On Top of Contingent Worker Change

Given the uncertainty facing multinationals managing their contingent workers, it will be crucial to seek specific legal advice. It will be an ongoing challenge to monitor and manage these shifts in the legal framework for contingent workers worldwide.

¹ Society for Human Resource Management and SAP SuccessFactors

² “Labor Standards, the Fissured Workplace, and the On-Demand Economy,” The Fissured Workplace.

³ “Inside Google’s Shadow Workforce,” Bloomberg.

⁴ “The Gig Economy Won’t Last Because It’s Being Sued to Death,” Fast Company.

⁵ Jeffrey S. Horton Thomas, labor attorney.

⁶ “Japan to Implement Fair Pay Rule for Temporary Workers,” Nikkei Asian Review.

⁷ “Uber Drivers in Lagos Are Suing It for Employee Status,” Quartz Africa.

⁸ “U.S. Presidential Candidate Booker Says He Will Bolster Worker Rights, Hike Taxes on Rich,” Reuters.

⁹ “A Gig Deal — ‘Gig Economy’ Regulation Initiatives at the Federal Level,” Herbert Smith Freehills.

¹⁰ “Employment Taxes: Timely Use of National Research Program Results Would Help IRS Improve Compliance and Tax Gap Estimates,” United States Government Accountability Office.

¹¹ “Get the Facts on Misclassification Under the Fair Labor Standards Act,” United States Department of Labor.

¹² “(In)dependent Contractor Misclassification,” Economic Policy Institute.

¹³ “Lots of Employees Get Misclassified as Contractors. Here’s Why It Matters,” Harvard Business Review.

¹⁴ “Is Your Company on the Independent Contractor Hit List?” Forbes.

¹⁵ “Companies Often Mislabeled Employees as ‘Freelancers’ to Cut Costs. Workers Are Fighting Back,” Vox.