

Caution in hiring labor on contract

State stepping up audits of misclassified workers

Monday, August 2, 2010 12:00 AM

By Beth Fitzgerald



An employer can save 10 percent or more on labor expenses by using a contract worker instead of adding an employee to the payroll — but could face thousands of dollars in back payroll taxes and penalties if a state Department of Labor audit determines the contractor should have been considered a regular employee.

And penalties from those audits may be just the cure for a state unemployment fund that's critically underfunded. Last year, the DOL collected \$20.9 million from employer audits, up from \$18.3 million in 2008; the figures include misclassified workers as well as a range of other issues, including under-reporting of wages.

New Jersey is known for vigorously enforcing the laws on contractors, “and this is about to explode into a very big issue,” said **Terry Friedman**, a partner in the Edison accounting and consulting firm **Weiser Mazars**.

The surge in layoffs during the recession is triggering audits, but most are random: **Ron Marino**, assistant Labor commissioner, said the agency's goal is to randomly audit at least 2 percent of the state's nearly 233,000 employers each year.

Last year, 6,424 audits turned up 17,947 misclassified contract workers, Marino said. Even though the agency completed 200 fewer audits in 2009 than in 2008, the number of misclassified contractors rose by nearly 1,000.



Bruce Freeman, who runs his own public relations firm, ProLine Communications, out of his Livingston home, works as an outside contractor for his clients and hires contractors for his own company. He says he loves the freedom of being his own boss. [Christina Mazza]

“This is going to be big, and New Jersey is one of the states in the forefront,” said **Don Mallo**, vice president of human resources at **Extensis**, a professional employer organization in Woodbridge. He said the issue affects competition within an industry, as employers using contract workers can gain a cost advantage over competitors that don't.

When a contract worker is laid off, he or she is unable to collect unemployment, since their former employer only pays into the state Unemployment Insurance Trust Fund for employees. A contract worker filing such a claim is a red flag for Labor, which may proceed with an audit; should the agency determine the worker was misclassified, the employer may be on the hook for three years of back payroll taxes — including disability, family leave, Social Security and Medicare.

Marino said employers who violate contractor rules must repay the unemployment insurance, which this year is 2.8 percent of the first \$29,700 of wages, or \$831.60. But a far bigger headache for the employer is the 15 percent per year interest charge penalty — \$4,455 for a misclassified employee who earns at least \$29,700 this year.

Audits generate revenue for the state's unemployment insurance fund, which is severely underfunded — in

years past, it was common practice for officials to raid the fund to balance the state budget. Now, one of the biggest fears for New Jersey employers is the prospect of having to increase their UI payments to shore up that fund.

“New Jersey has always been aggressive” in going after contract workers, “and from what I’m hearing, the feds are becoming much more aggressive, as well,” said **Daniel Gibson**, a partner in the CPA firm **Amper, Politziner & Mattia**, in Bridgewater.

Jerry Bobal, a tax partner at WeiserMazars, confirmed an increase in federal activity. He said the Internal Revenue Service is launching a three-year initiative to randomly audit 2,000 employers a year nationwide in an effort to find misclassified contract workers.

Gibson said he’s handled more than a dozen contractor cases in the past couple of years. Most are settled because they typically involve only a few thousands dollars in backtaxes and penalties, and aren’t worth the expense of a legal fight. For instance, one of his clients, a radiologist, contracted work out to a half-dozen other radiologists; Labor claimed these doctors were his employees. While Gibson felt he had a good case, the dollars didn’t justify litigation, so the radiologist settled for about \$10,000.

There are plenty of fields where contract work is the norm and doesn’t conflict with the law, such as freelance journalism, public relations, accounting, medicine and law.

Bruce Freeman, who runs a public relations firm out of his Livingston home, works as an outside contractor for his clients, and hires contractors, such as writers and web designers. He founded his firm, **ProLine Communications**, in 1991, and said he loves the freedom of working for himself and doesn’t miss having a boss. “For one thing, I know I’m never going to look in the mirror and say ‘you’re fired,’” he said.

Attorney **Joseph P. Paranac Jr.**, of Newark-based **LeClairRyan**, said in one of the biggest contract worker cases he’s ever handled, New Jersey sought about \$500,000 in back payroll taxes and penalties on behalf of several hundred office workers who had been misclassified as contractors. The employer settled for \$300,000 in back payroll taxes and penalties.

Paranac said he’d rather negotiate a settlement with Labor than go through the hearing process, “because it’s very tough, in a lot of situations, to prove that the workers were independent contractors.”

T.J. Moore, a partner in the accounting firm **Citrin Cooperman**, recalled a case of 10 architects who spent two years designing a new office building in New York. When the job was done, they were let go, and filed for unemployment. After being audited, the employer paid about \$50,000 in back payroll taxes.

Moore said the architects might have met the legal test for contract workers if the employer “had the proper paperwork: contracts stating the architects were being hired for a certain time period, that they were responsible for their own insurance and licensing fees, and that they were not employees.”

E-mail to bfitzgerald@njbiz.com