

# Employee Misclassification

...a wake-up call from the GAO

By Dan Busby, President, ECFA



The General Accountability Office (GAO) submitted a hard-hitting report in May 2007 to several committees of the House of Representatives entitled *Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification*.

The report estimated that \$4.7 billion was not paid in income taxes last year because of misclassification. The loss in income taxes is based on the assumption that (1) compensation reported on Form W-2 is more likely to be reported on Form 1040 than compensation reported on Form 1099-MISC, and (2) if compensation is not reported on Form W-2, it may not be reported on Form 1099-MISC, even if the annual reporting threshold of \$600 is reached.

In June 2007 the GAO submitted a more detailed report to the Committee on Ways and Means entitled *Tax Compliance: Thousands of Organizations Exempt from Federal Income Tax Owe Nearly \$1 Billion in Payroll and Other Taxes*. The title of the report was somewhat misleading in that, of the 1,280 charities reviewed, 80% of the charities owed less than \$10,000 and only 7% owed more than \$50,000. So,

only approximately 90 charities were responsible for about 85% of the total owed.

Isn't this a matter of a few bad apples in the secular marketplace—some major abusers bilking the tax man big-time? Or are these reports an alert to the evangelical world?

While these reports could be easily dismissed, they may serve as a wake-up call for our community. While most ECFA members are diligent in determining whether workers are employees

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*“Misclassifying employees can have negative outcomes for workers and organizations.”*

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or independent contractors, we are aware of some cavalier approaches to worker classification that could be challenging to defend in a tussle with the IRS.

When employees are misclassified as independent contractors, they may be inappropriately excluded from coverage under key laws designed to protect workers and may not have access to employer-provided health insurance coverage and retirement arrangements.

Here are some of the key issues:

**1. The challenges of worker classification.** No definitive

test exists to distinguish whether a worker is an employee or an independent contractor. The tests often used to determine whether a worker is an independent contractor or an employee are complex, subjective, and differ from law to law.

Several criteria have been developed by the courts. One test looks at whether the worker is economically dependent upon the principal or is in business for him or herself. Other tests focus on the degree of control exercised by the employer over the worker. Christian leaders must make a good faith effort to apply the worker classification tests in spite of the difficulty in doing so.

**2. The economic incentives to misclassify workers.** When workers are misclassified, employers are not obligated (until they are caught!) to make certain financial expenditures for independent contractors that they make for employees, such as paying certain employment taxes, providing workers' compensation insurance, paying minimum wage and overtime wages, or including independent contractors in employee benefits plans. But is economic gain to the organization a justification to misclassify workers? No. Christian leaders should properly classify workers without regard to the economic incentives.

**3. The proper protection of workers.** Because most laws are based on the traditional employer-employee relationship, they generally cover only workers who are employees; independent contractors, therefore, are not covered.

Some of the key laws designed to protect workers but that only apply to employees include:

- Fair Labor Standards Act—establishes minimum wage, overtime, and child labor standards;
- Family and Medical Leave Act—requires employers to allow employees to take up to 12 weeks of unpaid, job-protected leave for medical reasons related to a family member's or the employee's own health;
- Unemployment Insurance—pays benefits to workers in covered jobs who become unemployed and meet state-established eligibility rules; and
- Workers' Compensation—provides benefits to injured workers

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*“Employee misclassification may lead to the violation of several laws.”*

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while limiting employers' liability strictly to workers' compensation payments.

Additionally, employees who are misclassified as independent contractors may be denied access to certain employer-provided benefits, such as health, life, and dental insurance coverage and retirement plans. Because of cost of health insurance alone, misclassifying an employee who would qualify for this coverage is a significant injustice to the worker and not an example of biblical justice.

**4. The risks of misclassifying workers.** It is a mistake to misclassify even one worker, but the larger risk to an organization is

the misclassification of an entire group of workers.

In the most significant situations, the IRS can display some muscle in going after charities with unpaid payroll taxes relating to misclassifying workers. Tax liens are sometimes filed against the charity and it may impose trust fund recovery penalties against officers of the charity, which hold the individual responsible for the unpaid payroll taxes.

While employee misclassification alone is not a violation of the Fair Labor Standards Act (FLSA), it may contribute to FLSA minimum wage and overtime pay violations. For example, if an employee is improperly classified as an independent contractor, he or she would not be paid overtime.


In addition to the FLSA risks, there may be an underpayment of workers' compensation premiums (plus the liability for claims that should have been covered under the policy) and a liability for the payment of contributions to a retirement plan and medical insurance premiums.

But the risk of being penalized if caught should not be the incentive for Christian leaders to strive for proper classification of workers. Christian leaders do what is right because it is what integrity requires! We must do the right thing because it is the right thing.

**Summary.** The key risk of misclassifying an employee as an independent contractor is unfairly treating a worker—one of the most important assets of your organization.

How can organizations “apply a higher standard” with respect to the worker classification issue?

- **An understanding of the overall issue by the board.** Boards should have an awareness of how the organization addresses the employee vs. independent contractor issue. What organizational policies relate to this issue? Have workers recently complained about not being classified as employees? Have any workers filed complaints with the Department of Labor concerning possible FLSA violations? Does an organization, such as certain churches, have a sound basis for exemption from the FLSA?

- **Consistent application of worker classification policies and procedures by the staff.** At the staff level, a periodic review of policies and procedures is appropriate to determine if there is a consistency in the organization's practices in the worker classification area. If there are situations that are a close call between employee or independent contractor classification, does the organization take the conservative position in favor of employee status? 

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