

## The Employee Classification Act (Effective January 1, 2008)

As of January 1, 2008, The Employee Classification Act (formerly House Bill 1795) will become effective. The Act applies to all private sector general contractors, 1099 subcontractors and other companies engaged in construction work and related transportation activities in Illinois. This new state law, which was heavily endorsed by organized labor and signed by Governor Rod Blagojevich in August, is designed to prevent misclassifying employees as independent contractors to avoid payroll, Social Security and unemployment insurance taxes. The Act establishes serious penalties for employers that violate its requirements.

Illinois lawmakers who supported the law, which was heavily pushed by organized labor, say that it will prevent contractors engaged in construction work and related transportation activities in Illinois from leaving employees without protections such as minimum wage, overtime pay and unemployment. If so, it stands to improve the collection of employee taxes and keep employers from bypassing the responsibility for workers' compensation and medical insurance coverage. Some construction and employers' groups argue, however, that the law will wreak havoc on small contractors and their suppliers who will not be able to interpret or meet the stringent and ambiguous tests.

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### The "Independent Contractor" Test

The Illinois law presumes an individual performing work for a construction contractor is an employee unless the individual meets each of the following criteria:

- The individual must be free from control or direction over the performance of his/her work by the contractor.
- The individual must perform work outside the usual course of business of the contractor.
- The individual must be in an independently established trade, occupation, profession or business.

If the individual does not meet each of the aforementioned criterion, the only way he/she can be an independent contractor under the Act is if he/she is a "legitimate sole proprietorship or partnership," for which exceptions are strictly limited under the Act. Specifically, in order to be considered a "legitimate sole proprietorship or partnership" under the Act, the proposed independent contractor must meet each of the following 12 factors:

- Be free from control or direction of the contractor in the performance of his/her work;

- Have a business is that not subject to cancellation or destruction upon the severance of the relationship;
- Have substantial investment of capital in sole proprietorship beyond ordinary tools and equipment;
- Own capital goods and gains the profits and bears the losses of the sole proprietorship;
- Make services available to the general public or business community;
- Include services rendered on a Federal Income Tax Schedule;
- Perform services under the Sole Proprietorship's name;
- Obtain and pay for licenses, when applicable;
- Furnish tools and equipment necessary to provide services;
- If necessary, hire its own employees without contractor approval and pay employees without contractor reimbursement; and,
- Be able perform the same services for others.

## Section 530 Safe Harbor

The legislation aims to close what its sponsors perceived to be a loophole in federal tax law. Often called the "Section 530 Safe Harbor," this provision allows employers to classify certain workers as independent contractors rather than as employees. By classifying a worker as an "independent contractor" instead of an "employee," an employer does not have to pay employment taxes or provide workers' compensation insurance for the worker. Rather, the independent contractors are responsible for applicable taxes and insurance. With respect to properly classified independent contractors, the government receives its taxes from the independent contractors. Misclassified workers, those that are treated as independent contractors when they are actually employees, have the employer's tax burden shifted onto them as if they were self-employed. These workers may also be denied certain employee entitlements, such as workers' compensation coverage and overtime pay.

## Penalties and Enforcement of the Act

The Illinois Department of Labor (IDOL) has serious tools for enforcing the new legislation. It is reportedly hiring several new investigators, an attorney and a complaint processor to enforce the Act. The agency is also establishing an online complaint system. IDOL may also assess penalties of up to \$1,500 for each violation found in a first audit and up to \$2,500 for each repeat violation within five years. Each day that an individual is wrongly classified as an independent contractor constitutes a separate violation under the Act. For any second or subsequent violations within five years, IDOL may bar an offending employer from receiving any state contracts for four years.

Penalties under the Act can be severe and it creates a broad private right of action. The law also contains something of a "whistleblower" provision which allows "interested parties" to bring actions to enforce violations of the Act. Moreover, employees' rights under the Act cannot be waived, even if they agree to an independent contractor relationship.

## Proposed Federal Legislation

Illinois is among a handful of states focusing on the employee misclassification issue. A similar law is being proposed on the federal level by United States Senators Barrack Obama, Richard Durbin, Edward Kennedy and Patty Murray. The proposed law, called the Independent Contractor Proper Classification Act of 2007, would allow the government to collect the taxes employers owe and would also address additional industries beyond those covered by the Illinois Act.

## Action Items

Contractors and other employers affected by the Act will want to carefully review their employee classification procedures, including a review of any current or prospective independent contractors. They should work with the appropriate legal, accounting and insurance professionals to ensure compliance with the Act.

The Act also poses foreseeable insurance implications. For example, it may create coverage questions about whether an "employer's" policy or an independent contractor's policy applies and will be hit with any applicable "experience." Policies may also have to be reevaluated to address exclusions and covered persons. Finally, underwriting for contractors and related employers might need to be revisited, now that more losses to the employee and/or to third parties may be considered to have been caused by their "employees" for whom the insured is responsible and to cover the risks associated with liability under the Act.

Please contact your Mesirow Financial representative if you have any questions or concerns about this topic.

*Source: Goldberg Kohn*

*This article is intended as an overview and should not be viewed as legal advice. Please consult with your attorney if you have any questions.*