M&A Nuggets: Be Prepared for Due Diligence, Before You Go to Market Part 4 – Employee vs. Contractor Classification

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This is Part 4 of a series on steps business sellers should take to make sure their house is in order before going to market. One of the hot button issues that buyers examine when conducting due diligence is whether the seller has properly classified a worker as an independent contractor versus an employee. The contractor versus employee issue has always been a target of the Internal Revenue Service and United States Department of Labor. If a worker improperly classified as a contractor is in fact an employee, the consequence can be a finding that the employer owes back payroll taxes, interest and penalties. Some employers stretch their classifications of workers as independent contractors to avoid having to pay payroll tax and provide coverage under the employer's employee benefit plans, thereby saving costs that would be incurred if the person was classified as an employee. Regardless of an employer's past practice, potential buyers are certain to examine the issue and, if a buyer believes that there is the potential for misclassification, a specific indemnification by the seller of the buyer will be required. Prior to going to market, sellers should review any classification of workers as independent contractors. The factors looked at to determine whether a worker is an independent contractor or an employee, although not crystal clear, depend in large part on whether the employer controls the worker's schedule, provides all of the resources the worker needs to work and restricts the worker from engaging in competition. Independent contractor relationships should be properly documented with contractor agreements. The factors that determine worker status should be reviewed as they apply to each contractor and, if necessary, the relationship between the worker and the company should be adjusted to either make clear that the factors weighing in favor of a contractor determination will be satisfied, or to shift the worker to an employee. By examining the contractor versus employee issue proactively, a seller can not only provide comfort to interested buyers that this issue has been dealt with, but also avoid potential payroll tax and other regulatory issues later.