

10 pitfalls when hiring contractors under German law

Hiring a contractor is often an attractive and rather straightforward option for foreign clients to start their business in Germany without having their own employees on the ground. But this approach brings with it some significant risks when it is done not properly. German legal practice has developed various criteria to determine whether a contractual relationship should be regarded as an independent contractor relationship, or as an employment relationship. Accordingly, the underlying agreement must be carefully drafted and handled in such a way that it fulfils the criteria that are indicative of a contractor relationship (*freies Mitarbeiterverhältnis*) and avoids the characteristics of a dependent employment relationship (*Arbeitnehmerverhältnis*). Otherwise, misclassification issues with serious, costly and personal consequences might arise.

Should it turn out that a purported contractor is, in fact, an employee, the employer will be confronted with a number of risks with regard to protection against dismissal, social security, tax issues and even possible criminal charges.

1 Differentiating between an employee and a contractor

German law describes contractors (also known as consultants, self-employed persons or freelancers) as persons who carry out work under a private law contract and, crucially, who have the freedom to determine the content of their work and details regarding how they carry out their services. The performance of their services is usually regulated in a service contract (*Dienstvertrag*) or contract for work (*Werkvertrag*). The latter is used if a specific project can be defined and will be completed within a definable timeframe.

In contrast, employees are integrated into the employer's business and perform the work according to the employer's instructions and control.

2 Three main distinguishing factors: Instruction, Integration and defined scope of work

German legal practice has established certain criteria which need to be considered in order to assess whether someone's activities qualify as contractor status. Although none of the criteria are exclusively decisive when determining legal status, courts, social security authorities and tax authorities have developed two main criteria which tend to indicate freelance status.

- Firstly, the company may not give instructions with regard to the time, place and the way of performing the services; the contractor must be in a position to determine these aspects him or herself.

- Secondly, the contractor may not be integrated into the workforce/place of the company
- Thirdly, for work based on a contract for work, a detailed scope of work is agreed.

If one of these criteria is not met, it would constitute a strong argument in favour of dependent employment.

It requires proper contract drafting so that the governing contractor arrangements reflect the described criteria and avoid any indications of a dependent employment relationship.

3 Overall assessment is relevant – further criteria

Where members of the team receive individual instructions from the company and have no choice as to how to organise their work time, this may be a factor which tends to indicate employee status. Other factors indicating employee status include receiving certain benefits, such as company business cards or company e-mail addresses (without mentioning that they are external), company badges, access to their own office space or participation in company events such as Christmas parties or leisure events. Also, the contractor has to have a market presence and bear the entrepreneurial risk. Own resources and own office space is also a plus.

4 “Name” of the contract is irrelevant – substance prevails over form

When assessing the status of a person, the determining factor is the actual nature of the relationship and not only the written terms of the contract. Thus, it is not sufficient to conclude an agreement where the wording or title of the contract suggests that it is a contractor agreement, but the execution of the contract suggests that the relationship is actually one of dependent employment (e.g. because the person is integrated into the company itself and works according to company instructions).

The actual nature of the relationship will prevail over the legal terms of the contract

which is agreed. Nonetheless, the contractual regulations are still highly relevant in practice, as, for example, in the case of an audit (e.g. tax audit), the auditor will usually only see the contract but will, as a rule, not be in a position to understand the actual nature of the contract.

5 Contractor’s company does not mitigate associated risks over form

Some contractors wrongly assume that founding a company solves the risk of misclassification. A common approach is to found a so called “one-man-GmbH” which is the party contracting with the company. However, if the “one-man-GmbH” is technically a “one-man-contractor”, this does not easily mitigate the risk of misclassification. Market presence and entrepreneurial risk is only one of many factors to consider (see above).

6 Crowdsworker, Scrum and Modern Work – but still old fashioned differentiation criteria

Crowdworking, microtasking and scrum define modern work. Recent case law by Germany’s highest labour court ruled – (by using the well-known criteria) however – that crowdsworkers and microtaskers can also be seen as employees. If the platform/organisation requires them to continuously accept orders and offers the possibility of “levelling-up” when completing several orders, such incentives may integrate them into the workforce of the operator’s business.

Using Scrum in agile work environments requires close and frequent interaction. Mixing teams when completing projects increases the risk of misclassifying people. It is better to have individual external teams who will be managed by one single internal contact, i.e. product owner.

Legislative developments must be closely monitored in the future if such arrangements are to receive employee-like protection and fall

under a new status, as planned by the German Minister for Labor and Social Affairs. Therefore, it is advisable to double check the latest developments with external legal counsel before hiring in this area.

7 Risks of misclassification from an employment perspective

The contractor will be seen as an employee with all the rights and benefits that go with such a classification. This means the "contractor" can claim protection against unfair dismissal, holiday entitlement, compensation for untaken holiday, continued remuneration in case of sickness etc.

8 Liability for income tax and social security contributions

Generally, a contractor is responsible for handling taxes and social security contributions. If it turns out that the contractor is seen as an employee, the company could be required to reimburse the complete outstanding social security contributions (i.e. company's and employee's contributions) to the authorities retrospectively (for up to four years if the non-payment was unintended, and for up to 30 years if intention can be shown). In addition, a fine in the amount of four times the amount of social security withheld can be imposed. Of course, any income taxes must be reimbursed to the tax authorities. Recourse against the "contractor" is very seldom successful. The financial risk of a contractor being qualified as an employee is substantial.

9 Criminal offences

Criminal liability (which may even result in imprisonment) is being faced by both management as well as employees of the company who employs contractors. Sec. 266a of the German Criminal Code clearly states that the non-payment of social security contributions could qualify as an administrative, and even criminal offence. According to recent court rulings, the withholding of social security contributions in excess of EUR 1,000,000 may result in imprisonment without probation.

10 Legal Compliance: Possibility of "Statusfeststellungsverfahren"

The German statutory pension insurance (*Deutsche Rentenversicherung Bund*) offers a so called *Statusfeststellungsverfahren* (status classification clearance) which can be triggered by both the company as well as the contractor. Despite being offered solely in German, the examination may require hearings (in addition to documents) to be provided by the company and the contractor. The authority will then decide whether they find the relationship to be dependent, or not. This decision is binding and gives the company legal security. Retrospective claims for contributions can be avoided. However, it is notable that this process can only be started if no administrative procedures have been initiated. If an audit by the *Deutsche Rentenversicherung Bund* has been announced, it is too late.

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