Welcome to:
Independent Contractors vs. Employees Misclassification

The Webinar will begin shortly. Thank You!

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"Employee Misclassification" is an Issue Whose Time is Now

Preventing worker misclassification is red hot in Congress.

Section 1807 of the April 8, 2011 Congressional budget compromise provides that not less than $21.3 million is to be used by the Secretary of Labor for "program evaluation, initiatives related to the identification and prevention of worker misclassification, and other worker protection activities."

Department of Labor's Strategic Plan for Fiscal 2011-2016 targets specified industries (construction, janitorial, home health care, child care, transportation and warehousing, meat and poultry processing, and other professional and personal service industries) for misclassification investigation

The issues:
- Independent contractors
- Exempt *vs*. nonexempt
- *Per diems*
- Interns

The Stakes are High

- Significant amounts of taxes and wages unreported and lost on a nationwide basis owing to the improper classification of employees as independent contractors

- Significant litigation concerning:

  Independent contractors

  Exempt status (drug company detail men and automobile dealers' service advisors, for example)

  Contingent and *per diem* workers rights to benefits under employers' existing benefit plans (the *Microsoft* case*, for example)*

States' Desperate Need to Raise Money Fuels a Rush to Turn Employee Misclassification into a New Revenue Stream

What's Going On?

- Creation of a dozen or more state "task forces" *targeting* various industries (such as construction and restaurants) for audit and enforcement
- Increased DOL and state nationwide audit activity in general to uncover misclassification
- Development of more comprehensive state and federal databases
- Recent legislation
- Pending legislation

Example Task Force

- New York:

  Initial audit and investigation targeted 300 businesses in retail and commercial industries (67% in violation). Targeted additional 600 businesses primarily in construction (7,800 employees misclassified)

  Since 2007 enforcement and data sharing identified 50,000 instances of employee misclassification. New York has assessed:

  - $21.5 million in unemployment taxes
  - Over $1.85 million in unemployment insurance fraud penalties
  - $16.5 million unpaid wages
  - Over $2.3 million in workers' compensation fines and penalties

Development of More Comprehensive State and Federal Data Bases

- Questionable Employment Tax Practices (QETP) Initiative: As of 2009 IRS and 34 states shared information on misclassification-related audits
- IRS National Research Program: examination of randomly selected employers tax returns for years 2008 to 2010
- Bureau of Labor Statistics surveys contingent workers (jobs for limited time)
- DOL requires states to report summary information regarding misclassification audits for employers' unemployment tax payments
- DOL tracks misclassification in its Wage and Hour Division database
- States receive Form 1099 MISC Data from IRS

Recent Legislation

- Example: Maryland Workplace Fraud Act of 2009

  Applies to construction services and landscaping services

  Presumption of employer employee relationship

  Civil Penalties $1,000 each misclassified employee

  $5,000 if knowingly, but see safe harbor provisions

  Restitution to employees (and additional amount up to three times due)

  Administrative penalties (can be doubled)

  Civil action if no final administrative or court order; attorneys fees and costs

  Notification of Comptroller, Office of Unemployment Insurance, the Insurance Administration, and
  Workers' Compensation Commission to enable these agencies to ensure compliance

Pending Legislation (federal)

The Payroll Fraud Prevention Act (S. 770) (“PFPA”)

Introduced in the Senate on April 8, 2011.

Trimmed-down version of the Employee Misclassification Prevention Act bill

introduced in Congress in 2010.

The PFPA would:

- Expand the FLSA to cover “non-employees” who perform labor or services for businesses, even if the “non-employees” are properly classified as independent contractors

- Create a new definition of workers called “non-employees”

- Pierce the “corporate veil” by including in the definition of “non-employees” persons who provide services through a corporation or LLC if they are required to create or maintain such entities as a “condition for the provision of such labor or services”;

- Require every business to provide a prescribed written notice to all persons performing labor or services that

  - ❑ they have been classified by the business either “as an employee or non-employee”

  - ❑ directing them to a DOL website for further information about the rights of employees under the law, and

  - ❑ informing them to contact the DOL if they “suspect [they] have been misclassified”; Impose an obligation on employers to provide a classification notice for both “non-employees” and “employees”

- Impose a penalty of up to $5,000 *per worker* for a violation of the notice requirements or for misclassifying an “employee” as a “non-employee”

- Create a *presumptio*n that a “non-employee” is an “employee” if the business fails to provide the worker with the prescribed notice at the time the “non-employee” begins providing services

- Make it a “special prohibited act” under federal law to “wrongfully classify an employee as a non-employee”

- Impose fines up to $5,000 per worker for each violation

- impose triple damages for willful violations of the minimum wage or overtime laws where the employer has misclassified the employee affected

- Additionally, the PFPA would:

  - ❑ direct the Secretary of Labor to establish a misclassification website

  - ❑ impose additional penalties upon employers that misclassify employees for unemployment compensation purposes

  - ❑ authorize the DOL to report misclassification information to the IRS, and

  - ❑ direct the DOL to conduct “targeted audits” of certain industries “with frequent incidence of misclassifying employees as non-employees.”

Classification of Workers Often Determines Their Right to Benefits

The practice of classifying freelance, *per diem*, contingent, project and special workers as independent contractors

- Leased employees
- The impact of *Vizcaino v. Microsoft Corp.*, 173 F.3d 713 (9th Cir. 1999)
- Participation in employer 401(k), pension and health plans

Key Case

- The key case in determining the status of an individual as an employee or independent contractor for purposes of employee benefits is *Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318, 112 S. Ct. 1344 (1992).

- In *Darden*, an insurance agent sued for violations of ERISA with respect to the deferred compensation plans of the agents

- The Supreme Court adopted a common-law test to determine who is an employee under ERISA

Key Case

- The Supreme Court in *Darden* set forth the following criteria to determine if an individual is providing services as an employee:
  - ❑ Hiring party's right to control the manner and means by which the product is accomplished
  - ❑ The skill required
  - ❑ The source of the instrumentalities and tools
  - ❑ The location of the work
  - ❑ The duration of the relationship between the parties
  - ❑ Whether the hiring party has the right to assign additional projects to the hired party
  - ❑ The extent of the hired party's discretion over when and how long to work
  - ❑ The method of payment
  - ❑ The hired party's role in hiring and paying assistants
  - ❑ Whether the work is part of the regular business of the hiring party
  - ❑ Whether the hiring party is in business
  - ❑ The provision of employee benefits
  - ❑ The tax treatment of the hired party

  The U.S. District Court for the Southern District of Ohio looked at this criteria one by one in determining that a route supervisor of a waste disposal company was an employee and not an independent contractor Rumpke v Rumpke Container Service 240 F. Supp 2d 768 (2002)

Key Case

The *Darden* court also referenced the IRS 20 Factor Test as set forth in IRS Revenue Ruling 87-41

- Instructions—Must the worker comply with instructions?
- Training—Does the worker receive ongoing training?
- Integration—Are the services of the worker integrated into the business?
- Services rendered personally—Does the worker provide the services personally?
- Hiring, supervision, and paying assistants—Is this the responsibility of the worker or the business?
- Continuing relationship—Is there a continuous relationship between the worker and the business?
- Set hours of work—Does the worker have set hours of work?
- Full-time required—Is the worker employed full time?
- Doing work on employer's premises—Is the work performed on the premises of the business?
- Order or sequence test—Does the business set the order or sequence in which the work is performed?
- Oral or written reports—Does the worker submit regular oral or written reports to the business?
- Payment by the hour, week, or month—Is the worker paid by the hour, week, or month?
- Payment of business and/or traveling expense—Does the business pay the business and/or travel expenses?
- Furnishing tools and materials—Are the significant tools, materials, and other equipment of the worker furnished by the business?
- Significant investment—Does the worker have a significant investment in the facilities where the worker performs services?
- Realization of profit or loss—Can the worker make a profit or suffer a loss?
- Working for more than one firm at a time—Does the worker perform services for a number of unrelated firms at the same time?
- Making service available to the general public—Are the services of the worker available to the general public on a regular and consistent basis?
- Right to discharge—Can the business discharge the worker at any time?
- Right to terminate—Can the worker quit work at any time without incurring liability?

Leased Employee

- A “leased employee” is not an employee of the recipient of the services of the person but is treated as an employee if

  A. The services are provided through an agreement between the recipient and the leasing organization
  B. The person has performed the services for the recipient on a substantially full-time basis for a period of at least 1 year; and
  C. The services are performed under the primary direction or control of the recipient

- “Leased employees” are considered employees under IRS qualified-retirement plans unless they

  A. Constitute less than 20% of work force
  B. Receive a 10% money purchase pension plan benefit from the leasing organization

- Most qualified retirement plans exclude “leased employees” from plan participation

Vizcaino v. Microsoft

- Background

  - Microsoft hired the workers in question and required the workers to sign agreements that they were independent contractors and responsible for their own insurance and benefits

  - The workers were paid through the accounts payable department and not through the payroll department

  - The IRS audited for payroll taxes and subsequently classified the workers as common-law employees rather than independent contractors for tax purposes

Vizcaino v. Microsoft

- Court Decision
  - After resolving the tax issue, Microsoft made some of the workers employees
  - Other workers filed claims that they were employees and should participate in the savings plan and stock purchase plan of Microsoft
  - The plan administrator denied the claims of the workers and suit was filed
  - The Ninth Circuit found that the classification of the workers as independent contractors was a mutual mistake
  - Ultimately, the Ninth Circuit remanded the eligibility of the workers under the savings plan to the plan administrator for an initial determination
  - With respect to the stock purchase plan, the Ninth Circuit found that the misclassified workers were employees and eligible to participate
  - Microsoft settled as to the stock purchase plan and paid the class of 8,000-12,000 misclassified workers approximately $100 million

Benefit Plans Impact

- To avoid a result similar to Microsoft employee benefit plans must define an “employee” as a common-law employee under the payroll practices of the company and exclude independent contractors

- An agreement between a worker and a business that the worker will be an independent contractor and will not be entitled to employee benefits will not necessarily defeat a claim by the worker for benefits

- Reemploying immediately or almost immediately employees who have terminated or retired as independent contractors without the right to employee benefits but doing the same work is not good practice

- If for business reasons it is necessary to reemploy recently terminated or retired employees as independent contractors,

  - ❑ Provide for a break of at least three months since their last date of employment
  - ❑ Rehire the former employees through a leasing agency

Additional Employee Benefits Plans Guides

- An employer generally can exclude whoever the employee wishes to exclude from qualified retirement plans as long as the plan still can meet a non-discrimination coverage test under the Internal Revenue Code
- The IRS will require a plan that excludes temporary, part-time or other contingent workers from a qualified retirement plan to provide that these individuals will participate in the plan upon completion of 1,000 hours of service
- Under Department of Labor regulations, the benefits payable under defined benefit pension plans to participants who are reemployed after commencing a benefit or after reaching normal retirement age can be suspended as long as the participants are properly notified
- Under IRS Revenue Procedure 2008-50, corrective contributions can be made on behalf of employees who are improperly excluded form qualified retirement plans
- Employees are eligible for health and welfare plans to the extent provided the plan document
- Under the Patient Protection and Affordable Care Act, excluding employees may trigger penalties
- Internal Revenue Code Section 409A which covers non-qualified deferred compensation plans applies to independent contractors

The Deck is Always Stacked Against Employers

- The weight of government
- Increasingly adopted legislative presumption that worker is an employee rather than an independent contractor (under New York law, for example, applicable to construction contractors and subcontractors)
- Disparate tests applied by different governmental agencies (such as the IRS, state unemployment divisions, the NLRB or the EEOC) to determine whether a worker is an employee or an independent contractor may spell different results:
  - ❑ "Economic reality" test
  - ❑ "Right of control" test
- Having an independent contractor agreement: is it worth the paper on which it's written? Well, like chicken soup for a cold, it can't hurt.
- The disproportionate costs of misclassification

Don’t Stop At IRS and Federal Common Law Tests

- Pay Attention To State Statutes and Common Law

  e.g. Wisconsin has multiple statutory definitions and a common law test:

  Chapter 102 Governing Workers’ Compensation

  Chapter 103 Governing Employment Regulations

  Chapter 108 governing Unemployment Insurance and Reserves

  Chapter 111 Governing Employment Relations

  Wis. Common law test

Is An Independent Contractor Agreement Worth The Paper?

- Depends on the circumstances and jurisdiction

  See IRS 11 factor test

  See e.g. Pennsylvania Construction Workplace Misclassification Act

  > Having a written contract to perform services is a factor considered for Workers' Compensation, Unemployment Compensation and Improper Classification

  See e.g. Minnesota courts consider, but not dispositive

  Bottom Line: the courts will consider substance over form and an independent contractor agreement should not be solely relied upon

Disproportionate Costs of Misclassification

- Payment of back taxes
  Payroll and income taxes (even if contractor has been paid)
  Worker's compensation
  Unemployment (state and federal)

- Fair Labor Standards Act exposure
  Class Action
  Overtime
  Minimum Wage
  Record keeping violations

- Payment of Denied Benefits
- Civil Penalties
- Jail Time

What Can Businesses Do?

- Don't do anything and hope that nothing happens, but be aware that:
  - ❑ Seemingly innocuous unemployment claims often expose misclassification of employees
  - ❑ Plaintiffs' lawyers increasingly add misclassification claims to wrongful discharge suits
- Conduct critical self-audits to determine whether your workers are correctly classified
  - ❑ Discoverability of self-audits
  - ❑ Implementation of the self-audits' findings
- Review IRS Form SS-8 (Determination of worker status for purposes of Federal Employment Taxes and Income Tax Withholding)
- "Bite the bullet" and *change* your business model for dealing with independent contractor and FLSA-exemption issues
  - ❑ The risks
  - ❑ Statutes of limitation
  - ❑ How to go about it to limit liability

Section 530 of the Revenue ACT of 1978 " Safe Harbor"

- If worker misclassification occurs, try to come within the "Safe Harbor" by showing:
  - ❑ There was a reasonable basis for treating worker as an independent contractor
  - ❑ The business has treated substantially similar positions consistently
  - ❑ The business has filed all required federal tax returns consistently with its treatment of workers

Questions?

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