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September 22, 2010 VOLUME 9 ISSUE 38

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This Week's Double Feature

Misclassifying Employees as Independent Contractors Is High on Agenda

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It is no secret that the government is cracking down on employers' misclassification of employees as independent contractors. The reason for the increased efforts to ensure that individuals are classified properly is not surprising: the government wants to collect taxes it would not otherwise receive. Employers are not required to pay income tax, Social Security, Medicare, unemployment and workers' compensation insurance, or overtime for independent contractors. Independent contractors, who often are individuals, many times do not accurately report their own income. In addition, independent contractors are not entitled to protection under certain federal employment statutes, such as minimum wage, overtime, nondiscrimination, and health and safety laws.

How Do Employers Classify Workers Properly?
Studies suggest that as many as 30% of employers misclassify workers as independent contractors. So how do employers know whether to classify someone as an employee or an independent contractor? The answer depends on which government agency or statute is involved since different tests exist for making that determination. For example, the Internal Revenue Service uses the "common law test" for federal income tax purposes, which examines the degree of control over the worker under three categories: behavioral, financial, and type of relationship. State Departments of Labor have their own specific standards for determining whether an individual qualifies for unemployment insurance as an employee or is an exempt independent contractor.

Even federal employment statutes use different tests to determine whether an individual is a covered employee or an independent contractor who is not entitled to the statute's protections. The Fair Labor Standards Act requires the "economic realities test," in which courts examine the economic realities underlying the work relationship to determine whether the individual may be susceptible to the discriminatory practices the statute was designed to eliminate or is dependent on the business to which he or she renders services. For other employment laws, such as Title VII, the Age Discrimination in Employment Act, and the Americans with Disabilities Act, jurisdictions differ in which test they apply. Some use the common law test, some use the economic realities test, and still others use a hybrid of the two.

Although the tests applied by government agencies and courts do vary, the overarching consideration is the amount of the employer's control over the individual, both financially and in the manner of work. Common factors include payment to

the individual (per hour or a fixed fee; the tax form used to report income; the individual's opportunities for profit or loss); whether equipment, supplies, and facilities are provided by the employer or the individual; instructions or training provided to the individual; permanency of the relationship; existence of a contract governing the relationship; and whether the individual's work is an integral part of the employer's core business.

In fact, the Ninth Circuit Court of Appeals recently recognized that different formulations of the test to determine whether an individual is an employee or an independent contractor exist, but are functionally equivalent. As a result, the Court adopted a single test, the common law test, that applies to determine a worker's status when the employment statute in question utilizes ERISA's definition of "employee" and application of the test would not be inappropriate under the statute, including for claims under Title VII and the ADEA. *See Murray v. Principal Financial Group, Inc.*, 613 F.3d 943 (9th Cir. Jul. 27, 2010).

Given the lack of consistency in the appropriate method for determining whether an individual is an employee or an independent contractor, it is not surprising that many employers misclassify workers unintentionally simply due to misunderstanding or misapplying the law. However, employers often misclassify workers deliberately to reduce labor costs and to avoid liability for workers' claims. Either way, proposed laws in the labor and tax areas as well as increased enforcement efforts by government agencies are targeting misclassification with more government oversight and stiffer penalties for employers.

New Bills Seek to Regulate and Penalize Misclassification

For several years, Congress has attempted to pass legislation to regulate the misclassification of workers as "independent contractors." One such effort, the Employee Misclassification Prevention Act ("EMPA"), was introduced in April and seeks to amend the Fair Labor Standards Act, the federal law that regulates minimum wage and overtime, to require employers to keep records of contractors and to penalize employers who misclassify employees as independent contractors. H.R. 5107, 111th Cong. (2010); S. 3254, 111th Cong. (2010). The Department of Labor and the AFL-CIO, the country's largest federation of unions, support the passage of the EMPA.

Specifically, the EMPA would make it unlawful for employers to fail to classify accurately an employee or "non-employee" (contractor) and to discriminate against a person who has filed a complaint or opposed a practice regarding an individual's classification. The Act also would require employers to keep records of non-employees who perform labor or services for payment and to provide notice to each new worker of his or her classification as an employee or non-employee. Significantly, the Act would double the amount of liquidated damages for minimum wage and overtime violations where the employer also failed to accurately classify the worker. The amount of the civil monetary penalties for minimum wage, overtime, recordkeeping, and classification violations also would increase from $1,100 to $5,000 for repeated or willful violations.

More recently, on September 15, 2010, the Fair Playing Field Act of 2010 was introduced to close a tax loophole that permits employers to misclassify workers as independent contractors for federal employment tax purposes. H.R. 6128, 111th Cong. (2010); S. 3786, 111th Cong. (2010). The bill proposes to end the moratorium on IRS guidance addressing worker classification; require the Secretary of Treasury to issue annual reports on worker misclassification and prospective guidance clarifying individuals' employment

status for federal employment tax purposes; amend the Tax Code provisions that provide for reduced penalties for failure to deduct and withhold income taxes and the employee's share of FICA taxes; and require employers who regularly utilize independent contractors to provide written notice to each contractor of the federal tax obligations of independent contractors, the labor and employment law protections that do not apply to contractors, and the right of the contractor to seek a status determination from the IRS.

Even the White House is campaigning against misclassification. President Barack Obama has created a Middle Class Task Force, which is aimed at restoring security to the middle class worker and includes stopping worker misclassification as a priority. Vice President Joe Biden, who chairs the Task Force, has publicly endorsed the Fair Playing Field Act.

Government Agencies Ramp Up Enforcement Efforts

While these bills are pending, government agencies charged with collecting certain taxes from employers and enforcing employment laws are wasting no time increasing their enforcement efforts. The President has allotted $25 million in the Fiscal Year 2011 budget for a joint initiative between the Department of Labor and the Department of the Treasury to address worker misclassification. The DOL's efforts to deter misclassification include proposals to require employers to record, disclose, and retain their analysis of a worker's status in order to create more transparency in employment relationships. The DOL also has allocated funds to hire and train new investigators to detect misclassification issues. In addition, the DOL's Wage and Hour Division has launched a campaign to educate "low wage, vulnerable" workers of their rights and benefits. The campaign focuses on industries that commonly misclassify employees as independent contractors, including construction, janitorial work, hotel/motel services, food services, and home health care. *See* http://www.dol.gov/wecanhelp.

The DOL also will partner with states and other federal agencies to share information about potential misclassification issues. Further, the DOL will provide grants and other incentives to states to detect and address misclassification through their unemployment insurance programs. In fact, numerous states, including Iowa, Maine, Massachusetts, Michigan, New York, and New Hampshire, have created their own task forces to identify and combat worker misclassification.

The costs to employers of misclassifying a worker can be substantial. The scrutiny that federal and state governments—and eager plaintiffs' lawyers—are giving to misclassification issues is only going to increase, leaving employers vulnerable to government investigation, monetary penalties, and lawsuits by workers who claim they wrongfully were denied benefits and protections reserved for employees. Accordingly, defense counsel should advise their clients to conduct a compliance audit to identify potential issues. Particularly, clients should review carefully their classification policies and procedures, their job descriptions, and the degree of control they assert over workers to ensure that they are classifying workers appropriately and consistently.

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