

Independent Contractor Misclassification: How Companies Can Minimize the Risks

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Misclassifications of employees as independent contractors are the new watchwords among state and federal legislators and regulators as well as plaintiffs' class action lawyers. State task forces have been formed to crack down on businesses that do not pay unemployment insurance and workers compensation premiums for workers who the states believe are employees and not independent contractors (ICs).¹ Class action lawyers have been targeting some of those same types of companies, seeking unpaid employee benefits and overtime for workers who are not treated as employees.²

With funds authorized by the Obama Administration in its budget released in January 2010, the U.S. Department of Labor is hiring more investigators to pursue businesses that fail to properly pay overtime or afford statutory benefits to workers.³ The IRS has initiated a comprehensive nationwide employment tax audit program aimed in part to catch companies that improperly fail to withhold taxes and pay Social Security and Medicare premiums on the wages of workers misclassified as ICs.⁴ On April 22, 2010, a bill was introduced in Congress to make misclassification of employees as ICs a federal labor law violation, impose record-keeping and notice obligations upon businesses – even those that properly classify their ICs – and subject businesses to hefty penalties for non-compliance with the proposed new law.

The U.S. Bureau of Labor Statistics has estimated that more than 10.3 million workers in the United States (7.3 percent of the workforce) are treated by businesses as ICs.⁵ A U.S. Department of Labor study in 2000 found that as many as 30 percent of businesses misclassified employees as ICs, and the Government Accountability Office (GAO) recently determined that the number of misclassified workers has expanded by 50 percent in the interim.⁶ These statistics demonstrate that hundreds of thousands of businesses have exposure to considerable financial liability

for non-compliance with existing state and federal tax and labor laws and with respect to their employee benefit plans.

Yet, with all the media attention that has been focused on this issue in recent years, including articles in daily newspapers and trade publications,⁷ few companies have diagnosed their potential liability. Fewer still have modified their workforce models to minimize or eliminate the risks of costly government regulatory and class action litigation attacks. For companies that would like to continue their current workforce strategies instead of being required to reclassify every IC as an employee under government or court compulsion, there is still time to restructure or redesign their business models and enhance corporate compliance with the laws governing the permissible use of ICs.

MISCLASSIFICATION LIABILITY: HOW THE RISK TYPICALLY ARISES

Use of ICs has increased dramatically over the past decade in large part due to the economic advantages of using ICs, whose earnings are reported to the IRS on a Form 1099 basis instead of a Form W-2. Employers are not required to withhold taxes, make Social Security and Medicare contributions, or pay unemployment and workers compensation premiums for ICs. Similarly, employee benefit plans including group health insurance and 401(k) plans only cover employees, not ICs. These economic inducements have led many businesses to unwittingly classify many workers as ICs even though they may fall within the definition of employees under the tax and labor laws. Undoubtedly, some businesses knowingly misclassify employees as ICs, but many pay insufficient attention to this subject or have mistaken conceptions of the laws in this area. Lax enforcement by revenue and workforce agencies has contributed greatly to the misclassification of ICs.

Typically, ICs are referred to as freelancers, consultants, per diems, contractors, project workers, temps, specialists and the

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like. ICs are found in virtually every industry, and often work as information technology professionals, Internet and telecommunications experts, marketing specialists, copywriters, analysts and workers with specialized technical or professional skills. Other employers treat their delivery or sales force as non-employees. Some companies used temporary employment agencies to supply long-term temps. Other companies use ICs to supplement their workforce, while other businesses, such as transportation companies, often have more ICs than employees.

THE COSTLY CONSEQUENCES OF MISCLASSIFICATION

The laws permit the use of ICs, as long as such workers are not “employees” under existing tax, employee benefit, and labor and employment laws. As long as an IC is correctly classified, he or she is not eligible to participate in an employee benefit plan and may be paid on a Form 1099 basis without any employee tax or FICA withholdings or unemployment or workers compensation contributions.

In contrast, employees misclassified as ICs under current laws can be costly, regardless of whether the employees have been mistakenly or intentionally misclassified. For some businesses, particularly those highly reliant on ICs, the potential costs of misclassification could be extremely high. Risks include liability for many years of unpaid federal, state and local income tax withholdings and Social Security and Medicare contributions, unpaid workers compensation and unemployment insurance premiums, and even unpaid work-related expenses and overtime compensation. Any one of these types of liabilities (plus interest and penalties for non-compliance) can be potentially devastating for businesses that make substantial use of ICs.

Another costly liability risk arises where misclassified employees who are otherwise entitled to coverage under employee benefit plans have not been provided with health, pension, and other employee benefits. The Microsoft case in the 1990s demonstrates how costly misclassification can be, no matter how unintended, when workers classified as ICs are recharacterized by the courts or regulatory agencies as employees. In addition to satisfying a very substantial payment obligation to the IRS, Microsoft paid \$97 million to settle a benefits case brought by its long-term temps who were not afforded coverage under Microsoft’s stock purchase plan.

THE TARGETING OF BUSINESSES IN THE PAST TWO YEARS

The enactment of many state laws regulating the use of ICs over the past two years has made misclassification an even greater

liability risk. Some new state laws severely limit the type of worker who may qualify as an IC, and impose extraordinarily high penalties for misclassification of employees as ICs, including disbarment from state contracts, and loss of licenses to do business in the state.

On April 22, 2010, a long-awaited bill addressing the issue of misclassification of employees as independent contractors was introduced in Congress by the House (Rep. Lynn Woolsey, D-CA) and Senate (Sen. Sherrod Brown, D-OH). The bills, H.R. 5107 and S. 3254, are called the Employee Misclassification Prevention Act (EMPA). They would amend the federal Fair Labor Standards Act to impose strict recordkeeping and notice requirements on businesses with respect to workers treated as independent contractors, and expose such businesses to fines from \$1,100 up to \$5,000 per employee for each violation of the law.

EMPA does not prohibit businesses from continuing to use independent contractors, provided they are properly classified as such; it only prohibits companies from misclassifying workers as independent contractors when such workers are not really ICs but rather employees.

All businesses would, nonetheless, be affected by EMPA, because it imposes upon every company that uses either employees or independent contractors a recordkeeping and a notice requirement. In addition, any business that fails to provide the required notice under EMPA would be subject to fines, even if its independent contractors are properly classified.

EMPA also would: direct the Secretary of Labor to establish a misclassification Web site to enable workers to file complaints online, and notify them that employees may have greater rights under state or local laws; authorize the Department of Labor to report misclassification information to the IRS; and direct the Department of Labor to conduct “targeted audits” of certain industries “with frequent incidence of misclassifying employees as non-employees.”

The proposed legislation also seeks to pierce the corporate veil of corporations, partnerships and LLCs owned in whole or part by the worker and used to avoid the issuance of Form 1099s.

EMPA is one of two bills introduced in this legislative term that deals with misclassification of employees. In 2009, the House and Senate introduced the Taxpayer Responsibility, Accountability, and Consistency (TRAC) Act of 2009 (S. 2882 and H.R. 3408). If enacted, the TRAC Act would limit the availability of

the so-called “safe harbor” provisions in Section 530 of the Revenue Act of 1978, which many businesses relied on to designate workers as independent contractors for federal employment tax purposes. The TRAC Act also would afford workers the right to petition the IRS for a determination of the worker’s status, and increase penalties for intentional disregard by taxpayers filing incorrect Form 1099s.

This effort by Congress to refocus upon employee misclassification has been prompted by three developments.

First, in 2009 the GAO issued a comprehensive report titled “Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention.”⁸ The report recommended to Congress that it consider the options of (a) enacting laws limiting the availability of the Section 530 “safe harbor” provisions and defining misclassification as a violation of the federal wage and hour laws, (b) enhancing IRS and Department of Labor enforcement activities in the area of misclassification, and (c) improving coordination of information among the IRS, Department of Labor, and state workforce and revenue agencies.⁹

Second, the IRS announced in February 2010 that it was commencing an Employment Tax National Research Project to conduct line-by-line audits of 6,000 businesses focusing on, among other things, employee misclassification.

Third, the Obama Administration’s proposed budget for fiscal year 2011 authorized \$25 million to the Department of Labor to target employee misclassification through the hiring of 90 additional investigators and 10 additional lawyers to pursue “a joint proposal that eliminates incentives in law for employers to misclassify their employees” and “enhances the ability of both agencies to penalize employers who misclassify.”¹⁰

Businesses that use ICs also have been targeted in two other arenas. Plaintiffs’ class action lawyers have focused on employers that make use of ICs as part of their business model. FedEx Ground and FedEx Home Delivery have been battling a nationwide class action by a host of plaintiffs’ lawyers that have alleged that drivers for these FedEx divisions are not ICs, as the company classifies them, but rather employees for purposes of federal and state employee benefit and labor laws. The lawsuits claim damages for unpaid employee benefits, such as medical and pension benefits, as well as unpaid overtime and unreimbursed employee expenses, such as the costs of leasing, insurance and fuel.¹¹ Similar types of class action lawsuits have been filed against companies in an array of other industries.¹²

Finally, unions have urged state and federal government regulators to vigorously prosecute businesses suspected of misclassification of employees as ICs as part of a concerted effort by organized labor to increase the number of employees that they currently represent. Simultaneously, labor unions have strongly lobbied for legislation at the state and federal levels that would limit the use of ICs by businesses and, as a result, expose more workers to union organizing.

STEPS BUSINESSES CAN TAKE TO MINIMIZE OR AVOID FUTURE MISCLASSIFICATION EXPOSURE

No states have outlawed the use of ICs, and the proposed federal legislation continues to permit businesses to use ICs, provided they are properly classified. Nonetheless, some lawyers and legal commentators routinely advise businesses to reclassify their ICs as employees to avoid the potential for misclassification liability. Businesses can use a number of alternative steps to minimize or avoid the risk of future liability while maintaining their use of ICs. Three such options are bona fide restructuring of the relationship between a business and its ICs, voluntary reclassification or employee leasing.

BONA FIDE RESTRUCTURING AND THE USE OF ‘IC DIAGNOSTICS’

Any business concerned with the potential for misclassification liability recognizes that, at best, its ICs probably fall within the “gray area,” where some facts favor IC status while other facts indicate employee status. The 2006 GAO Report addressing employee misclassification stated that “the tests used to determine whether a worker is an independent contractor or an employee are complex, subjective, and differ from law to law.”¹³

With the exception of a few state laws, though, most tests are based in whole or large part on whether the hiring party has the “right to control the manner and means” by which the worker accomplishes the end product of his or her work.¹⁴ In determining whether a business has the right to control the worker’s manner and means of performing his or her tasks, some federal and state agencies list as many as two dozen factors that may indicate whether or not the hiring party has such control. Except for a few states with laws that essentially prohibit the use of ICs for businesses operating in some industries, the courts and government agencies have repeatedly stated that no one factor determines whether the worker is an IC or employee. For example, the IRS has stated that it will consider “all information that provides evidence of the degree of control and the degree of independence.”¹⁵ A review of the factors used by the courts and by

various state and federal agencies reveals that, collectively, more than 48 factors are used by different decision-making bodies in determining IC status.

The first step that lawyers typically recommend to companies concerned about misclassification liability is to diagnose whether the company's ICs are properly classified. That step, however, may be premature for any business that wishes to consider a bona fide restructuring of its relationship with its ICs. For companies that are willing to make certain adjustments to their level of control over the manner and means by which their ICs accomplish their work, adjustments can be made to a number of the 48 factors that the courts and regulatory agencies have determined are indicators of IC or employee status. For example, a company may be willing to allow its ICs to set their own hours of work, perform services from home, supervise their own projects, and work for other companies (subject to applicable confidentiality restrictions). If the nature of the work is susceptible to being performed in a meaningful manner with substantially less indicia of control than currently, such changes can be implemented and memorialized in a written IC agreement.

Many ICs work without an IC agreement, or work under agreements that do not reflect the true relationship between the IC and the company. A contract that misstates the true relationship between the parties (such as one that states that the worker is not subject to the supervision of the company, yet he or she is regularly supervised by a superior at the company and given yearly evaluations) is of little or no benefit. Similarly, a contract that recites that the worker is an IC offers no protection if whatever factors are used by the court or government agency demonstrate otherwise. Part of a bona fide restructuring includes a studied review of, and revisions to, the IC agreement. A close review of the agreement also is imperative because many IC agreements, even those drafted by sophisticated corporations, include language that a good plaintiff's lawyer may use to support his or her argument that the business has a right to control the manner and means by which the worker performs the agreed upon tasks.¹⁶

Once a company has determined how it would restructure its relationship with its ICs, it is beneficial to perform "IC diagnostics." This is a process that examines whether the position would pass the applicable IC tests under governing state and federal laws, using each of the applicable 48 factors indicating IC or employee status, and then measures the company's compliance with each of the applicable laws on an "IC compliance scale." Unless

certain states require a strict test for determining IC status, IC diagnostics provide a comprehensive examination of how much the restructuring alternative will minimize or eliminate future misclassification liability.

If IC diagnostics indicate that the restructuring alternative is a sound choice, the business can proceed with this alternative. The next step is implementing the restructuring. Companies must ensure that what is set forth in the IC agreement will be implemented in the field and is not merely an empty recital. Other steps may include reviewing and revising company operating manuals and procedures, documenting the implementation of certain of the provisions in the IC agreement, and putting safeguards into place to ensure conformity with the restructured relationship with the ICs.

If, however, IC diagnostics suggest that, even with restructuring, the workers will not likely pass the governing tests for determining IC status, the business has at least two other alternatives to avoid or minimize future risks of liability: voluntary reclassification or employee leasing.

VOLUNTARY RECLASSIFICATION

Businesses that are at risk for misclassification liability likely will eventually have to defend their classification of their ICs. More and more companies are receiving notices from state unemployment agencies that question whether a former worker classified as an IC should be reclassified as an employee, opening the risk of liability for any prior misclassification. Some businesses also have received notices from state workers compensation agencies inquiring whether an entire group of workers are ICs or employees. If legislation at the federal level is enacted as expected, companies will be obligated to notify all ICs that they have the right to a governmental determination as to whether they have been properly classified as an IC, and many ICs likely will request an official determination.

If IC diagnostics reveal that a company's ICs may not pass the governing tests for IC status, businesses should consider voluntary reclassification. This step is likely to be far less painful and costly than being forced by a government agency to reclassify by an order to make payment of back taxes, unpaid Social Security and Medicare contributions, and unpaid unemployment insurance and workers compensation premiums, along with applicable penalties and interest.

Reclassification can be implemented in a number of ways. Some types of announcements are less likely to provoke dismay from

those 1099ers who want to remain in that classification, or concern on the part of some who welcome the reclassification but fail to understand why they were not treated as employees from the beginning of their tenure with the company. Implementation, whether voluntary or compelled by a state or federal agency or court, requires businesses to consider relevant federal and state tax, employee benefits, and labor laws.

Reclassification does not require that all workers previously excluded from an employee benefit plan be included in the future. Exclusion would be permissible if the governing documentation for the company's plans is drafted properly and the exclusion does not violate applicable tax or ERISA rules.¹⁷

EMPLOYEE LEASING AND OTHER STAFFING ALTERNATIVES

Where voluntary reclassification is not a practical or viable alternative, another choice is employee leasing or other staffing alternatives. This alternative cannot completely eliminate all potential liability for misclassification, but the use of a responsible staffing organization can dramatically reduce the risk of such liability as well as the likelihood of a lawsuit challenging the classification of a group of workers paid on a 1099 basis.¹⁸

Employee leasing organizations are not payroll companies. When an employee leasing organization hires some or all of a company's ICs as their employees, the leasing company withholds income taxes, makes Medicare and Social Security contributions, pays workers compensation and unemployment insurance premiums, and also can provide an array of benefits to the former ICs, including health insurance under a plan maintained by the leasing company.

The most immediate advantage of using an employee leasing or staffing company is that the federal and state governments receive withholding taxes and the other contributions and premiums that they do not receive from companies who pay workers on a Form 1099 basis. While use of an employee leasing or staffing company can substantially lessen the risk of future misclassification liability, it is not a panacea. For example, a business that contracts with an employee leasing organization may still have to account for the leased employees in the employer's benefit plan language and discrimination testing. Nonetheless, this alternative may still be far preferable to voluntary reclassification for a number of legal and business reasons.

CONCLUSION

The use of ICs is still a viable means to supplement a company's workforce in most states, and Congress has never considered a

prohibition on the use of ICs. All a business is required to do is not misclassify employees as ICs. Lax enforcement of the tax and labor laws as they apply to ICs has placed most businesses in the position where misclassification liability is a genuine risk. It is certainly not too late to reduce or eliminate the risk of this type of future liability, and businesses can choose from a number of alternatives to do so.

The use of IC diagnostics is most useful when applied after the first of those alternatives – bona fide restructuring – is considered. If restructuring is suitable from a business standpoint, IC diagnostics can serve as a beneficial risk management tool to project whether this alternative will likely reduce or eliminate future misclassification liability or whether a business needs to consider the other alternatives discussed above. In view of the current and pending legislative, regulatory, and judicial landscape, the only undesirable alternative is inaction.

ENDNOTES

- 1 New York was one of the first states to create a misclassification task force, which was launched in September 2007. The task force was headed by M. Patricia Smith, then New York State Commission of Labor, who was recently appointed by President Obama and confirmed by the Senate as Solicitor General of the U.S. Department of Labor. Other states with misclassification task forces include New Jersey, Massachusetts, Michigan, Maine, New Hampshire, Ohio, Maryland, Iowa, Illinois, and Oregon.
- 2 See citations of cases at notes 14 and 15 below.
- 3 See Budget of the U.S. Government, Fiscal Year 2011, at 100.
- 4 IRS Headliner Volume 280 (Nov. 9, 2009).
- 5 GAO Report 09-717 (Aug. 10, 2009) at 1.
- 6 GAO Report 09-717 at 11-13.
- 7 See, e.g., Steven Greenhouse, "Investigating Mislabeling of Workers," *New York Times* (June 9, 2007); Richard Reibstein, et al., "Independent Contractor High Alert – The IRS and State Labor Departments Take Aim at Employee Misclassifications," *HR Advisor* (Jan./Feb. 2008); Richard Reibstein, et al., "The Risk of Using Independent Contractors," *New York Law Journal* (May 15, 2008); Laurence Davidson and Bob Van Voris, "FedEx Loses Investors as Courts Upend Founder's Model," *Bloomberg.com* (Aug. 20, 2008); "Employers and Workers Clash in Court Over 'Con-

- tractor' Label," *Wall Street Journal* (Oct. 20, 2009); Steven Greenhouse, "U.S. Cracks Down on 'Contractors' as a Tax Dodge," *New York Times* (Feb. 18, 2010).
- 8 GAO Report 09-717 (Aug. 10, 2009).
 - 9 See GAO Report 09-717 at 32-39. On March 25, 2010, the Congressional Research Service issued a report on employee misclassification and particularly the effect of the pending bills in Congress on elimination of the "safe harbor" provisions in the tax laws. The report concluded that a reduction in employee misclassification would reduce federal, state, and local tax gaps and provide other important benefits, yet at the same time impose significant costs; that there is no accurate data on the current size of the tax gap caused by misclassification, and the magnitude of many of the effects of improved classification are unavailable or inherently suspect; and that "whether or not the benefits of curtailing misclassification of workers outweigh the costs is a value judgment."
 - 10 See FY 2011, Congressional Budget Justification, Wage and Hour Div. (U.S. Dep't of Labor), at WHD-23. See also FY 2011 Department of Labor, Budget in Brief, at 44 (Wage and Hour Division).
 - 11 See, e.g., *In re FedEx Ground Package System, Inc. Employment Practices Litigation*, No. 3:05-MD-527 RM (MDL-1700), Opinion and Order (Oct. 15, 2007) (granting certification of national ERISA class action), Opinions and Orders (Mar. 25, 2008, July 27, 2009) (granting certification of class action in 28 states), *Estrada v. FedEx Ground Package System, Inc.*, 64 Cal. Rptr.3d 327, 330 (Cal. Ct. App. 2nd Dist. 2007), aff'd 2007 Lexis 13422 (Cal. Sup. Ct. 2007).
 - 12 For selected benefit cases, see, e.g., *Romero et al. v. Allstate Insurance Co.*, Nos. 07-4460, 07-4461 and 08-1122 (3d Cir. July 29, 2009) *Martin v. PSE&G Pension Plan*, 271 Fed. Appx. 258 (3d Cir. Mar. 31, 2008) *Berger v. AXA Network LLC*, 459 F.3d 804 (7th Cir. 2006) *Belluardo v. Cox Enterprises, Inc.*, 157 Fed. Appx. 823 (6th Cir. 2005) *Flanagan v. Allstate Insurance Co.*, 580 F. Supp.2d 663 (N.D. Ill. 2008) *Thompson v. Linvatec Corp.*, Civ. A. No. 06-cv-0404, 2008 U.S. Dist. LEXIS 13959 (N.D.N.Y. Feb. 25, 2008). For selected wage payment cases, see, e.g., *Labrie v. UPS Supply Chain Solutions, Inc.* No. 4:08-cv-03182 (N.D. Cal. 12/4/09); *Chaves v. King Arthur's Lounge Inc.*, No. 07-2505, (Mass. Super. Ct., 8/7/09).
 - 13 GAO Report No. GAO-06-656 at 25.
 - 14 *Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318, 322 (1992).
 - 15 See IRS Publication 15-A, Employer's Supplemental Tax Guide (2010) at 6.
 - 16 For example, in the FedEx Ground ERISA class action decision in 2007, the court granted class certification in large part on evidence that, under the FedEx Ground Operating Agreement, which all drivers were required to sign, FedEx reserved the right to exercise control over certain of the drivers' functions, such as the right to "determine whether the truck used by the driver . . . is suitable . . ."; "determine what logs, inspection reports, and shipping documents the driver must provide [to FedEx] at the conclusion of each day"; "determine whether the driver's personal appearance meets the 'consistent image' that [FedEx] wishes to project to its customers"; . . . "determine and assign the routes that will be covered by the drivers"; and "determine, in its sole discretion, the compensation that will be paid to the driver for his services." *In re FedEx Ground Package System, Inc. Employment Practices Litigation*, No. 3:05-MD-527 RM (MDL-1700), Opinion and Order (Oct. 15, 2007) at 22-23, 36-40.
 - 17 Employers should review the language of their plan documents. A pension, profit-sharing, or other benefit plan is generally allowed to exclude certain classes of employees provided that the exclusion is not discriminatory based on compensation or other employment laws. One proactive approach is to use approved language that excludes workers who are not characterized, treated and paid as employees by the employer. With this type of exclusion, the worker may not be entitled to benefits under the plan even if he or she is subsequently re-characterized as an "employee" as a result of a subsequent government audit or private litigation. This distinction was particularly acute in the *Microsoft* case, in which the workers were re-characterized as employees and, as such, were then entitled to participate in Microsoft's stock plans retroactive to the date of hire.
 - 18 The IRS and Congress have long accepted the concept of leased employees. See, e.g., Section 414(n) of the Internal Revenue Code (referring to "leased employees" in determining if an employee retirement benefit plan satisfies the nondiscrimination mandates of the tax laws).