Bill Addresses Independent Contractor Misclassification

On April 22, a bill was introduced in Congress to make misclassification of employees as independent contractors a federal labor law violation. The Employee Misclassification Prevention Act (EMPA) would also impose record-keeping and notice obligations upon companies and subject them to hefty penalties for noncompliance with the proposed new law. Upon the likely enactment of EMPA sometime this year, businesses will be confronted with an anticipated onslaught of private actions by workers claiming they are misclassified “employees” who have been improperly paid on an Internal Revenue Service (IRS) Form 1099 basis.

Prior to the enactment of EMPA — and, to a lesser extent, prior to the date when businesses will be required under EMPA to provide a mandatory notice to their workers stating whether they have been classified as “employees” or “non-employees” (six months following enactment of the law) — there is a window of opportunity for companies to enhance their compliance with existing and proposed laws governing independent contractors. Three options for companies to minimize their exposure to misclassification liability are bona fide restructuring of their relationships with their independent contracts, reclassifying workers and choosing employee leasing or other staffing options.

Under current law, companies are permitted to use independent contractors, as long as such workers are not “employees” under existing tax, employee benefit, and labor and employment laws. If independent contracts are correctly classified, they may be paid on a Form 1099 basis without the withholding or payment of any employee taxes, Federal Insurance Contributions Act (FICA) allocations or unemployment or workers’ compensation premiums. They may also be excluded from participation in a company’s employee benefit plans.

In contrast, employees misclassified as independent contractors under current laws can lead to costly liabilities, even if the employees have been mistakenly misclassified. For those companies whose business models rely on the use of independent contractors, the potential costs of misclassification can be extremely high. Risks include liability for years of unpaid federal, state and local income tax withholdings; Social Security and Medicare contributions; unpaid workers’ compensation and unemployment insurance premiums; and unpaid work-related expenses and overtime compensation. Another costly liability risk arises when misclassified employees, who may be entitled to coverage under employee benefit plans, have not been provided with health, pension and other employee benefits.

Recent Enforcement Actions

The enactment of many state laws during the past two years regulating the use of independent contractors has made misclassification an even greater liability risk. Some new state laws severely limit the type of workers who may qualify as independent contractors and impose extraordinarily high penalties for misclassification of employees, including disbarment from state contracts and loss of licenses to do business in the state.

The long-awaited EMPA bill recently introduced in Congress by both the House and Senate would amend the federal Fair Labor Standards Act (FLSA) to make misclassification a federal labor offense. Under current law, failure to withhold or failure to file a W-2 is a federal offense, but not the misclassification itself. The EMPA bill would also impose strict record-keeping and notice requirements upon businesses with respect to workers treated
as independent contractors, expose such businesses to fines of $1,100 to $5,000 per employee for each violation of the law and double the liquidated damages provisions under the FLSA.

The EMPA is one of two bills introduced in this legislative term that deals with misclassification of employees. In 2009, both the House and Senate introduced the Taxpayer Responsibility, Accountability, and Consistency (TRAC) Act. If enacted, the TRAC Act would limit the availability of the so-called “safe harbor” provisions relied upon by many businesses to designate workers as independent contractors for federal employment tax purposes, afford workers the right to petition the IRS for a determination of their status and increase penalties upon companies for filing incorrect Form 1099s.

Businesses that use independent contractors have also been targeted by plaintiffs’ class action lawyers, focusing on companies that make use of independent contractors as part of their business model. The lawsuits seek damages for unpaid employee benefits such as medical and pension benefits, as well as unpaid overtime and unreimbursed employee expenses.

**Three Options for Employers**

No states have outlawed the use of independent contractors, and the proposed federal legislation continues to permit businesses to utilize independent contractors — provided they are properly classified. Nonetheless, most lawyers routinely advise businesses to reclassify their independent contractors as employees to avoid the potential for misclassification liability. There are, however, no fewer than three measures that businesses can take to minimize or avoid the risk of future liability — and one of these allows companies to maintain their business models that rely upon the use of independent contractors. The three options are bona fide restructuring of the relationship between a company and its independent contractors, employee leasing and voluntary reclassification.

Most companies concerned about the potential for misclassification liability recognize that their independent contractors probably fall within the proverbial “gray area,” presenting businesses with a real dilemma. But rather than changing a successful business model, a company may wish to consider undertaking a bona fide restructuring of its independent-contractor relationships, using independent-contractor diagnostics to determine the extent that restructuring of the independent-contractors position will minimize or avoid future misclassification liability. As described below, independent-contractor diagnostics refers to a process beginning with an examination of whether the position would pass the applicable independent-contractor tests under governing state and federal laws, using each of the applicable 48 factors used by different decision-making bodies in determining independent-contractor status.

A 2006 Government Accountability Office 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.” With the exception of a few state laws, most tests used by the courts and administrative bodies 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. For companies interested in maintaining their use of independent contractors but eager to minimize or avoid future misclassification liability, the first step in restructuring their independent-contractor relationships is to consider what adjustments they are prepared to make to their present level of control over the manner and means by which their independent contractors accomplish their work.

At the end of the independent-contractor diagnostics process, the company’s degree of compliance with each of the applicable laws can be measured on an “IC Compliance Scale.” This process can provide a company with an informed means by which to determine the extent that the restructuring alternative may minimize or eliminate future misclassification liability.

If independent-contractor diagnostics indicate that the bona fide restructuring option is a sound choice, the business can proceed with this alternative and memorialize the bona fide restructuring in a modified independent contractor agreement. Companies must ensure that the words used in the independent-contractor agreement will be actually implemented in the field and are not empty recitals, which the law disregards. Other steps may include reviewing and revising company operating manuals and procedures, documenting the implementation of certain of the provisions in the independent-contractor agreement and putting safeguards in place to ensure that actual business practices conform to the terms of the modified independent-contractor agreement. If, however, independent-contractor diagnostics suggest that, even with restructuring, the workers will not likely pass the governing tests for determining independent-contractor status when measured on the IC Compliance Scale, the business has at least two other alternatives to avoid or minimize future risks of misclassification liability.
Although employee leasing or other staffing alternatives cannot completely eliminate all potential liability for misclassification, the use of a responsible and sophisticated 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. When an employee-leasing organization hires some or all of a company’s independent contractors as their employees, the leasing company withholds income taxes, makes Medicare and Social Security contributions, pays workers’ compensation and unemployment insurance premiums, provides an array of benefits to the former independent contractors, including health insurance under a plan maintained by the leasing company, and handles the employee relations of the leased employees.

Although use of an employee-leasing or -staffing company can substantially lessen the risk of future misclassification liability if all legal documentation and procedures are carefully observed, it is not a panacea. For example, a business that contracts with an employee-leasing organization may still need to account for the leased employees in the employer’s benefit-plans language and perform “nondiscrimination” testing required under the Employee Retirement Income Security Act (ERISA).

If legislation at the federal level is enacted as expected, companies will be obligated to notify all independent contractors that they have the right to a governmental determination as to whether they have been properly classified as an independent contractor. Voluntary reclassification is likely to be far less painful and costly than being forced by a government agency or court to reclassify in connection with an order to make payment of back taxes, unpaid Social Security and Medicare contributions, and unpaid unemployment insurance and workers’ compensation premiums.

Reclassification, whether voluntary or compelled by a state or federal agency or court, requires businesses to consider relevant federal and state tax, employee-benefits and employment laws, and is labor intensive. Reclassification, however, does not require that all workers previously excluded from an employee-benefit plan must be included in the future. Exclusions are permissible if the governing documentation for the company’s plans is drafted properly and the exclusion does not violate applicable tax or ERISA rules.

There are a number of alternatives from which businesses can choose to reduce or eliminate the risk of future misclassification liability. In view of the current legislative, regulatory and judicial landscape, the only unacceptable alternative is inaction.