The Stakes Have Been Raised: Increased Government Scrutiny of Contingent Workers

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Introduction

The federal government estimates that 20 to 40 percent of all workers are misclassified as independent contractors, as opposed to employees. Federal and State-level task forces, commissions, and agencies are auditing unemployment insurance an workers' compensation data to document the scope of independent contractor misclassification. The Internal Revenue Service is currently auditing numerous employers nationwide in an attempt to address this misclassification issue. State and city taxing authorities – in need of money – are also aggressively challenging workers categorized as independent contractors in an attempt to recover what they perceive as lost revenue in the form of payroll taxes and unemployment benefits.

At the end of the day, the concept of contingent workers and independent contractors is here to stay and the law is rapidly evolving to address the potential liabilities for all parties concerned. With the increased spotlight on enforcement and proposed legislation to crack down on misclassifications, every employer should reduce their exposure by taking note of their obligations and potential liabilities for contingent workers.

Defining Contingent Workers / Independent Contractors

There is no universally accepted definition for "contingent workers," however, there are a number of concepts that generally illuminate our concept. For the most part, the contingent workforce concept can be boiled down to the following basic categories:

- **Independent Contractors:** Workers who are self-employed and provide specialized skills on a contract basis with little to no supervision by the hiring company.

- **Temporary Employees:** Workers who are provided and assigned by an agency to a specific employer for a limited period of time on a fill-in basis or for a finite project. The key attribute of temporaries is the *short-term nature* of their position.

- **Leased Employees:** Workers who are assigned by an agency to fill positions on a long term basis. These employees generally are not "permanent," but their employment is longer term than typical "temps."

- **Professional employer Organization ("PEO"):** All or most of an employer's workers are hired by the employer but then co-employed by the PEO, which assumes the employer responsibility for employment taxes, benefit plans, and other human resources related obligations.

- **Human Resources Outsourcing ("HRO"):** Human resources functions are assigned to an outside agency. The HRO agency does not assume the role of an employer in this model.

An independent contractor is an independent business or person hired to perform a specific service with little to no outside supervision. Of course, the legal definition is more complex, and there are many factors that go into determining whether someone is really an independent contractor.

Generally speaking, workers will be found to be employees rather than independent contractors if they are subject to

another's right to control the manner and means of performing the work. In contrast, independent contractors are individuals who obtain customers on their own to provide services. They may have other employees working for them, and they are not subject to close control over the manner by which they perform their services.

Increased Federal Scrutiny

There is a continually growing wave of wage and hour claims dealing with misclassification and the perception in government that the independent contractor concept is curtailing tax revenues and other required payments tied to employment status. Misclassification can lead to a variety of serious legal consequences, including liability for failing to withhold and to pay the employer's share of payroll taxes, exposure for failing to include the individuals in employee benefits plans, the tax qualification of retirement plans, back wages, and various damages and penalties for failing to comply with wage and hour requirements. The federal government has begun increased scrutiny of employers to uncover misclassification and impose even heavier penalties upon transgressors.

Proposed Federal Legislation

Employee Misclassification Prevention Act

The Employee Misclassification Prevention Act ("EMPA") was first proposed to Congress in April 2010. In October 2011, the EMPA was re-introduced in the U.S. House of Representatives (H.R. 3178). If passed, the bill would amend the Fair Labor Standards Act ("FLSA") to:

- Require organizations to keep certain records on and to provide various notices reflecting the employment status of each individual as an employee or independent contractor, and their right to challenge that classification. Notices to independent contractors would have to require the following statement: "Your rights to wage, hour, and other labor protections depend upon your proper classification as an employee or non-employee. If you have any questions or concerns about how you have been classified or suspect that you may have been misclassified, contact the U.S. Department of

Labor."

- Impose stricter penalties on employers who misclassify employees and are found to have violated employees' overtime or minimum wage rights. The penalty in the proposed legislation would range from $1,100 for first-time offenders to $5,000 for repeated violations.

- Establish administrative penalties for misclassifying employees, or paying unreported wages to employees without proper recordkeeping, for unemployment compensation purposes.

- Prohibit discriminatory actions against individuals on the basis that they have sought to be accurately classified.

- Mandate audits and investigative procedures conducted by state unemployment agencies to identify employers who misclassify workers and require that the U.S. Department of Labor ("DOL") monitor States' efforts to identify misclassification.

- Direct States to strengthen and establish penalties for worker misclassification.

- Increase coordination and referral of information regarding misclassification between the DOL and IRS.

Payroll Fraud Prevention Act

In April 2011, the Payroll Fraud Prevention Act (PFPA), as a trimmed down version of the EMPA, was introduced to amend the recordkeeping requirements of the FLSA. The PFPA would require employers to keep records relating to "non-employees" (independent contractors). The bill would require an employer to provide notice in writing of a worker's classification, and a misclassification of "employees" as "non-employees" would impose a civil penalty of up to $5,000 per worker for violation of the law.

The PFPA would also amend the Social Security Act to require

state unemployment insurance programs to implement investigative procedures and establish penalties for misclassification, require the DOL to measure state performance in its enforcement procedures when conducting unemployment compensation tax audits, require information sharing within the DOL and authorize such sharing with the IRS. It seems that at least part of this proposed bill was incorporated into the Memorandum of Understanding between the DOL and IRS.

Department of Labor

Misclassification Initiative

In 2010, the DOL initiated the Misclassification Initiative. While stating that individuals wrongly classified as independent contracts are denied benefits and protections they may have been entitled to as regular employees, the DOL noted that worker misclassification generated substantial losses to the Treasury and the Social Security, Medicare and Unemployment Insurance Trust Funds. In turn, the DOL's FY2011 budget allocated $25 million to a joint Labor-treasury initiative to strengthen and coordinate Federal and State efforts to enforce statutory prohibitions, identify, and deter misclassification of employees as independent contractors. An addition 90 full-time employees were requested to focus on misclassification during targeted wage and hour investigations. Part of the $25 million was allocated for competitive grants to States to increase their focus on misclassification and to reward the States that were most successful at detecting and prosecuting employers that failed to pay taxes due misclassification. The budget also separately requested $1.6 million and 10 additional attorneys for the Solicitor's office "to pursue misclassification litigation, including multi-State litigation to coordinate enforcement with States."

The DOL's FY2012 budget almost doubled the allocation of money to combat worker misclassification by investing $46 million for a multi-agency initiative of the Office of Federal Contract Compliance Programs, the Wage and Hour Division, Occupational Safety and Health Administration, the Office of the Solicitor, and the Employment and Training Administration, which will fund state grants that address worker

misclassification within the context of the unemployment insurance program.

The FY2013 budget commits $14 million to combat misclassification, as well as a request for $238 million for the Wage and Hour Division for increased enforcement of the FLSA and the Family Medical Leave Act ("FMLA"), which will assuredly include focus on the misclassification of workers. The Wage and Hour Division will allocate its funding toward the hiring of an additional 35 full-time investigators as part of its initiative to detect and deter "inappropriate misclassification of employees as independent contractors."

Memorandum of Understanding Between DOL and IRS

On September 19, 2011, the DOL announced that it entered into a Memorandum of Understanding ("MOU") with the IRS and others aimed at ending "the business practice of misclassifying employees [as independent contractors] in order to avoid providing employment protections." As the IRS' involvement suggests, this collaboration has much to do with enhancing the inflow of tax revenues and other sums to various governments as it does with "employee protections."

Other signatories included: Connecticut, Maryland, Massachusetts, Minnesota, Missouri, Utah, and Washington; State labor officials in Hawaii, Illinois, and Montana; and New York's General Attorney. The DOL stated that these arrangements would permit it to "share information and coordinate law enforcement with" the participants.

Specifically, the DOL will "refer to the IRS…Wage and Hour Division investigation information and other data that DOL believes may raise Internal Revenue employment tax compliance issues related to misclassification." The IRS, will in turn, "evaluate and classify employment tax referrals provided by the DOL and … [will] conduct examinations to determine compliance with employment tax laws."

With this joint DOL-IRS effort, every company and organization being investigated by the DOL should assume that information about independent contractors will be given to the

IRS, and potentially, to state and local agencies.

DOL Investigations

In 2011, the DOL collected over $5 million in back wages resulting from employees either being misclassified as independent contractors or otherwise not treated as employees. Investigations by the DOL have spanned across the country and hit every industry from nail salons to health insurance carriers and everything in between. The size of the employer has no bearing on the investigations either, where the DOL has recovered back wages and damages for as few as 11 employees to as many as 680 employees.

In November 2011, Alpha Management Corporation, a real estate and property management company agreed to pay $250,000 in back wages and liquidated damages to 42 employees following an investigation by the DOL. The DOL found that the company had violated the FLSA by misclassifying 42 workers as independent contractors and employing them for more than 40 hours per workweek without paying them overtime for the excess hours. The employees included painters, maintenance employees, janitors, electricians, plumbers, floor installers, and security guards.

Similarly, in July 2011, Parts Distribution Express (PDX) paid over $250,000 in back wages to 158 delivery drivers who were denied overtime wages as a result of being improperly classified as independent contractors. The drivers, who delivered automotive parts, were hired under a contractual agreement between PDX, automotive parts wholesaler, and Buy Wise, a retailer. The DOL investigators determined although the drivers were jointly employed by Buy Wise and PDX, they were required to sign an “independent contractor” agreement prior to being hired. They were subsequently paid “straight time” for all hours worked and were not paid any overtime for hours worked beyond 40 per week, as required under the FLSA. In addition to paying back wages, PDX re-classified all the drivers on its payroll as employees instead of independent contractors.

Internal Revenue Service

Typically, employees of a company have income taxes deducted from their payroll, which are then transferred to the IRS throughout the year. It is simple for the IRS to account for and collect money from employees. On the other hand, independent contractors are responsible for their own taxes. At the end of the year, if the independent contractor files anything at the end of the year, they may owe very little taxes due to numerous business deductions. Companies that hire employees as independent contractors avoid paying Social Security, Medicare, and unemployment insurance taxes for those workers. Companies do not withhold income taxes from contractors' paychecks, and studies have indicated that, on average, misclassified independent workers do not report 30 percent of their income. In light of what the IRS views as abuses of worker misclassification, it has increased its scrutiny through more audits, heavier penalties, and reduced opportunities for mitigation adjustments through settlement.

In 2010, the IRS began three-year audit program where 6,000 companies would be selected for comprehensive employment tax audits. With the Memorandum of Understanding with the DOL, the IRS will only increase its scrutiny of worker misclassification.

Interestingly, the IRS has developed a new program called the Voluntary Classification Settlement Program (VCSP). The program permits employers to voluntarily reclassify independent contractors as employees for federal employment tax purposes and future tax periods. Employers who chose to participate in the program will only have to pay 10 percent of the employment tax liability that may have been due on compensation, will not be liable for any interest and penalties on the liability, and will not be subject to an employment tax audit with respect to worker classification of the workers for prior years. Additionally, an employer participating in the VCSP must agree to extend the period of limitations on assessment of employment taxes for three years for the first, second, and third calendar years beginning after the date on which the employer has agreed under the VCSP to begin treating the independent contractors as employees.

To qualify for the program, the employer cannot currently be

under audit by the IRS, the DOL, or by a state government agency. The employer must also have consistently treated the independent contractors as non-employees, and must have filed all required Forms 1099 for workers for the previous three years.

However, in light of the MOU between the IRS, DOL, and other agencies, information given to the IRS will likely be shared. Participating in the VCSP could effectively operate as an admission of liability for parties other than the IRS. Employers should be aware that although this program may help avoid federal employment tax obligations, it may potentially open up liability in cases brought by the DOL and/or other state agencies.

OFCCP & OSHA

The Office of Federal Contract Compliance Programs (OFFCCP) and the Occupational Safety and Health Administration (OSHA) have been tapped as part of the DOL's multi-agency initiative geared towards identifying workers who are misclassified as contractors. Although misclassification of workers does not typically fall within the purview of these two agencies, as part of the Misclassification Initiative, they will begin developing investigative plans and training its compliance officers to look for workers misclassified as independent contractors.

Increased State Scrutiny

With part of the $46 million in the DOL's FY2012 budget allocated to state grants, many state government agencies have signed MOUs with the DOL and enacted misclassification laws of their own. Thus far, twelve states have signed MOUs with the DOL, including: California, Colorado, Connecticut, Hawaii, Illinois, Maryland, Massachusetts, Minnesota, Missouri, Montana, Utah, and Washington. The DOL is actively pursuing MOUs with additional states as well.

New York

In the past year, New York's Joint Enforcement Task Force on Employment Misclassification ("Task Force") identified over 18,500 instances of employment misclassification, discovered over $314 million in unreported wages, assessed over $10.5

million in unemployment taxes, over $2 million in unpaid wages, and over $800,000 in workers' compensation fines and penalties. The Task Force was established in 2007 to ensure that all employers complied with all of New York's employment and tax laws. Within four months of its inception, in 15 enforcement sweeps focused on the construction and restaurant industries, state investigators found $19 million in wages that were not reported to the state and $3 million in underpayments to workers. Nearly $1 million in taxes had not been paid to New York's unemployment insurance fund.

In August 2010, the New York State construction Industry Fair Play Act ("the Act") was signed into law to curtail worker misclassification in the construction industry. The Act amends the New York Labor Law, the New York Unemployment Insurance Law, and the New York Workers' Compensation Law. The Act also imposes notice requirements and subjects contractors to civil and criminal penalties for willful misclassification of workers.

California

On February 9, 2012, California became the newest state to enter into an MOU with the DOL regarding improper classification of employees as independent contractors, making it the twelfth state to enter into such an agreement with the DOL. California has also increased its efforts in its legislature to combat the misclassification of independent contractors.

Willful Misclassification of Independent Contractors

In October 2011, the newly added Labor Code sections 226.8 and 2753 imposed heavy penalties on employers who willfully misclassifies employees as independent contractors. Specifically, section 226.8 states that it is unlawful for any person or employer to willfully classify an individual as an independent contractor and prohibits businesses from charging fees or making any deductions from compensation for any purpose (including goods, materials licenses, fines, etc.) when such fees or deductions would have been impermissible if the individual had not been misclassified. For each violation, an employer can face penalties starting from $5,000 up to $25,000 if the California Labor and Workforce Development Agency

(LWDA) or a court find that an employer has engaged in a "pattern or practice" of violations.

Section 226.8 also provides for a non-monetary penalty where an employer must prominently display a notice on its website (or general public area if it does not have a website) which states:

1. That the employer has committed a serious violation of the law by engaging in the willful misclassification of employees.

2. That the employer has changed its business practices in order to avoid committing further violations.

3. That any employee who believes he or she is being misclassified as an independent contractor may contact the LWDA. The mailing address, email address, and telephone number of the agency must be included.

4. That the notice is being posted pursuant to a state order.

It is notable that Section 226.8 also targets successor companies and third party advisors, such as financial, accounting, and human resources professionals, as well. Section 2753 extends joint and several liability to any person who, for money or other valuable consideration, knowingly advises an employer to misclassify an individual as an independent contractor to avoid employee status. The joint liability expressly excludes attorneys providing legal advice and employees providing advice to their employer.

The California Labor Code establishes the California Labor Commissioner as the main enforcer of these rules. There is no express private right of action for individuals. However, an individual still may be able to pursue a claim under Section 226.8 under California's Private Attorneys General Act (PAGA), which allows a private citizen to pursue civil penalties on behalf of the LWDA.

Massachusetts

The Attorney General in Massachusetts has made aggressive enforcement efforts targeting independent contractor abuses in recent years. In 2008, the Office of the Attorney General ("AGO") issued an advisory on the Massachusetts Independent Contractor Law or the Massachusetts Misclassification Law and its enforcement guidelines. Since then, the AGO and its Joint Task Force on the Underground Economy and Employee Misclassification have recovered $2 million in new unemployment insurance taxes, $1.6 million in overdue taxes through review and investigation, $1.8 million in fines, and $1 million in other funds recouped through civil and criminal actions. Additionally, the AGO reached a $3 million settlement with FedEx Ground to settle claims that FedEx allegedly misclassified its drivers as independent contractors.

Connecticut's Attorney General announced its crackdown of independent contractor misclassification in March 2010. A civil penalty of $300 per violation for engaging in employee misclassification and misrepresentation of independent contractors was changed to $300 *per day* per violation.

Connecticut

In September 2011, Connecticut's DOL recovered more than $6 million in unpaid wages, including more than $3 million recovered by wage enforcement staff responding to nearly 2,500 complaints that owed wages had not been paid in fiscal year ending June 30, 2011. Additionally, the Connecticut DOL issued 23 Stop-Work orders against subcontractors working on a $26 million HUD project after finding that the subcontractors failed to have adequate workers compensation insurance and were misclassifying employees.

Other State Activity

In 2011, legislation regarding employee misclassification or the use of independent contractors was introduced in 30 states and the District of Columbia. Fifteen states passed laws. Some examples include:

- **California** – passed law prohibiting willful misclassification of employees as independent contractors and would require notification of state licensing authorities for violations.

- **Connecticut** – passed law requiring the Labor Commissioner to develop a plan to consolidate and promote efficiency of the department's investigative and enforcement provisions. Another bill addressed employer status of companies providing in-home care services.

- **Florida** – passed the One Stop Business Connect Act defining independent contractor for tax purposes.

- **Indiana** – passed a workers' compensation bill that includes an exemption for independent contractors.

- **Kansas** – passed law on prohibiting misclassification of employees as independent contractors in order to avoid required employment tax obligations.

- **Maine** – passed five laws related to employee misclassification, including laws relating to specific industries as well as employment classification as it relates to unemployment insurance and workers' compensation coverage.

- **Montana** – passed laws in regards to misclassification of independent contractors in specific industries as well as the definition of employee for purposes of payment of tax obligations and under the human rights law.

- **Virginia** – passed laws requiring public work contractors to use E-Verify for employees and independent contractors and requiring the Department of Labor and Industry to study the issue of employee misclassification.

This is in addition to states which have previously enacted laws addressing misclassification in the construction industry, an industry with a history of misclassification issues. By way of example, the Illinois Employee Classification Act, which became effective in January 2008, was enacted with the stated purpose of recapturing lost tax revenue. The Act restricts the ability of construction contractors to classify individuals as independent contractors. It also provides the Illinois Department

of Labor with broad investigatory and enforcement powers., and establishes up to $1,500 per day for violations, as well as liquidated damages. It also creates a private cause of action, with the right to backpay, lost benefits, and liquidated damages – which could lead to significant damages.

Pennsylvania enacted the Construction Workplace Misclassification Act which restricts the circumstances under which a construction worker may be classified as an independent contractor for purposes of workers' compensation and unemployment insurance. In Maine, the Act Concerning Independent Contractors in the Trucking and Messenger Courier Industries creates a rebuttable presumption of employee status for workers in the trucking and messenger service industries.

Other states, such as Iowa, Michigan, and Wisconsin, have also created taskforces whose purpose is to uncover misclassification. Nebraska enacted penalties for misclassification in both the construction and transportation sectors. The Connecticut legislature has passed increasingly stringent misclassification assessments. Iowa established an interagency Independent Contractor Reform Task Force, adopted online reporting methods for workers who believe that they have been misclassified, and is pursuing penalties, fines, back-tax collection and even criminal charges.

What this means for your business

With revenue shortfalls at both the state and federal level, scrutiny of worker misclassification will continue for the foreseeable future. With a $46 million budget specifically invested towards the elimination of worker misclassification, government agencies will continue the trend of increased and more serious worker misclassification investigations, as occurrences of misclassification often result in significant penalties.

As the DOL actively seeks to sign MOUs with more states, state and federal laws may be further amended to make the independent contractor classification more difficult and risky. Heightened governmental attention to these issues will also lead to more private civil lawsuits, as the damages available in such

cases make them attractive to plaintiff's attorneys.

In light of such scrutiny from both the federal and state governments, employers should carefully assess how employees are classified and ensure than any individuals deemed to be independent contractors are, in fact, properly classified. It is far better to internally uncover and proactively address misclassification issues, rather than to learn about them for the first time in a government audit or lawsuit. And because of the technical nature of assessing whether employees are properly classified and the potential for enormous liability, it is a good idea to seek the advice of knowledgeable employment counsel.