

Free Agents: Benefits & Perils of Seasonal & Contingent Labor

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Code Red Alert

What Is a “Contingent Worker”?

- Independent Contractors
 - Self-employed worker hired to perform services for another company
 - Controls the manner and means of the services performed
 - Responsible for his/her own taxes
- Leased Employee
 - Worker paid by an employee leasing company (e.g., temp agency, PEO) to perform services for a client of the leasing company
 - May be common law employees of the client company
 - May be common law employees of leasing and client companies under “joint employment”
- Temporary Employee
 - Worker performing services for company on short-term basis, often working on particular project
 - Temporary employee may be independent contractor, a leased employee or regular (short-term employee)

Code Red Alert

Independent Contractor Use Is Facing a Crackdown

“The Internal Revenue Service and 37 states are cracking down on companies that try to trim payroll costs by illegally classifying workers as independent contractors, rather than as full employees.”

Associated Press, 2/16/10

Feds Crackdown on Independent Contractors

- **\$7 billion in lost employment tax revenue over next 10 years just by reducing the misuse of independent contractors**
- **2011 federal budget proposes up to \$3.8 trillion in spending measures to eliminate or reduce misclassification of independent contractors**
- **Finding misclassification is like shooting fish in a barrel**
 - U.S. Bureau of Labor Statistics estimates there were 10.3 million workers treated as independent contractors in 2009
 - General Accounting Office study found 30% or more of businesses misclassify workers as independent contractors

Feds Crackdown on Independent Contractors

Internal Revenue Service

- Audit at least 6,000 randomly-selected companies
- IRS leans to finding employee status
- Information-sharing agreements with state agencies

Feds Crackdown on Independent Contractors

Department of Labor

- 2011 federal budget authorizes \$25 million to Department of Labor to target employee misclassification
 - DOL will hire 90 new wage and hour investigators and 10 additional lawyers to just target worker misclassification

Feds Crackdown on Independent Contractors

Congress

- Numerous bills introduced in 110th Congress on worker misclassification
 - Employee Misclassification Prevention Act (HR 5107; S 3254)
 - Amend Fair Labor Standards Act to require employers to advise all workers performing services of whether they are classified as employees or contractors and provide an explanation for such determination (like the DOL proposed rule)
 - Fine businesses from \$1,100 up to \$5,000 per employee for each violation of the law
 - Modify independent contractor rules to make it more difficult to qualify as a contractor
 - Require the IRS and Labor Department to share information
 - Taxpayer Responsibility, Accountability, and Consistency Act (HR 3408; S 2882)
 - Limit availability of so-called “safe harbor” provision in Section 530 of the IRC, which many businesses relied on to designate workers as independent contractors for federal employment tax purposes
 - Give workers the right to petition IRS for a determination of the worker’s status
 - Increase penalties for filing incorrect 1099’s
 - Note: These bills were similar to legislation that then-Senator Barack Obama introduced before elected president.

State Crackdown on Independent Contractors

- **Colorado**

Establishes penalties for willful misclassification of employees, including back taxes owed and interest

- **Connecticut**

Increases penalty for misclassifying employees by specifying that each day of the violation is a separate offense for purposes of the \$300 per violation civil penalty

- **Delaware**

Provides for civil and administrative penalties, including fines, stop-work orders, and debarment, for construction contractors

- **Illinois**

Individuals performing services for state contractor in construction industry deemed an employee unless specific criteria met. Provides for civil penalties for misclassification, including double penalties and punitive damages for willful violations

- **Indiana**

Defines “contractor” in construction context to mean sole proprietor, partnership, form corporation or other legal entity. Allows state agencies to share information regarding contractor misuse

- **Maryland**

Prohibits employers from improperly classifying employees

- **Minnesota**

Creates presumption of employee status for workers in construction industry. Subjects violators to criminal and/or civil penalties, including private right of action for treble damages and attorneys’ fees

- **New Jersey**

Applies unemployment ABC test to determine independent contractor status under state employment and tax laws. Criminal sanctions against officers, managers and workers may result from improper classification, as well as administrative penalties and disbarment from public contracts

State Crackdown on Independent Contractors (cont.)

- **New York**

Presumes that all construction workers are employees unless they meet ABC unemployment test for independent contractor

- **Rhode Island**

Requires contractors and subcontractors with public contracts to classify workers as employees, not independent contractors

- **Washington**

Establishes more restrictive definition of independent contractor for unemployment and workers' compensation. Amends prevailing law to include independent contractor. Requires contractors to maintain a list of direct subcontractors and their certificates of registration. Failure to maintain records results in penalty up to \$250 dollars or 200% of quarterly tax for each offense

Lawyers Are Bringing Claims for Misclassification of Independent Contractors

- **High-Profile Worker Misclassification Lawsuits**
 - *Vizcaino v. Microsoft* – settled in 2001 for \$97 million
 - *Herner v. Time Warner* – settled for \$5.5 million
 - *Clark v. King County* – settled for \$18.6 million
 - *Logan v. King County* – settled for \$24 million
 - FedEx Ground cases
 - 20 state class actions and individual cases in 9 states alleging misclassification of 15,000 ground drivers
 - Seeking recovery of payment of wages and reimbursement of expenses, including cost of vehicles

What's Driving Independent Contractor Crackdowns and Lawsuits?

- **Stated reasons:**
 - Misclassified workers denied protection under discrimination laws, wage and hour laws, leave laws, workers compensation
 - Misclassification reduces federal, state and local tax withholding and revenues
 - Employers who misclassify workers have a competitive advantage over rivals who classify same type of worker as employees

What's Driving Independent Contractor Crackdowns and Lawsuits?

- **Unstated (Cynical) Reasons:**
 - Crackdown on independent contractor misclassification is an easy way to reduce federal and state budget deficits
 - Current tests for independent contractors are so vague and subject to interpretation that likelihood of finding misclassification is great
 - Unions can't organize independent contractors
 - **Reclassification of independent contractors as employees is a potential boost to increasing union membership**

Independent Contractors: Rewards v. Risks

Benefits of Using Independent Contractors

- **Cost savings**
 - No employer-provided benefits
 - No office space or equipment
 - Social Security and Medicare tax savings (7.65% of employee's total compensation)
 - No payment of unemployment taxes
 - Not included in workers compensation

Net Savings: 20%-30% or more



Independent Contractors: Rewards v. Risks

Benefits of Using Independent Contractors (cont.)

- **Flexibility in staffing project**
 - Greater leeway in hiring and firing workers (especially for employers with fluctuating workloads)
 - Worker knows he will be let go at end of project
 - No trauma when employee let go (and no lawsuits)
- **Efficiencies**
 - Contractors bring specialized expertise to job
 - Immediately productive
 - Little or no training time and cost
 - Expand and contract workforce without taking on unnecessary workers



Independent Contractors: Rewards v. Risks

Benefits of Using Independent Contractors (cont.)

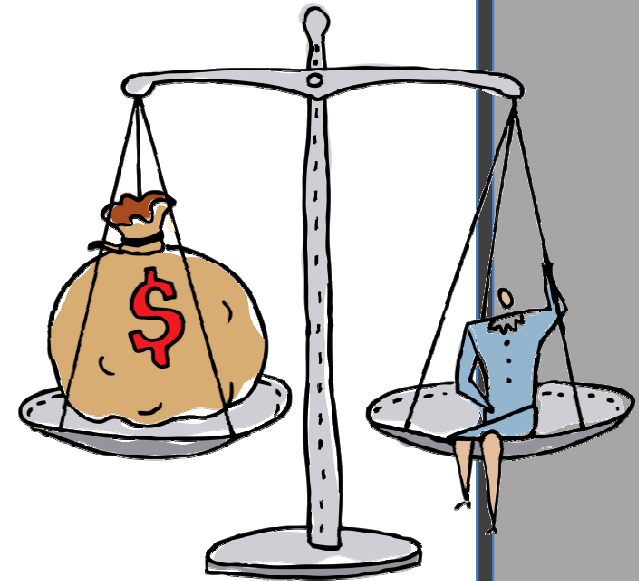
- **Risk Reduction**
 - Contractors not protected by discrimination laws, wage and hour laws, and leave laws
 - Depending on contract, contractors may not be able to sue for wrongful termination
- **Unions**
 - Contractors can't be members of a union
- **Solution to Budget Pressures**
 - Adds worker without increasing headcount
 - Expensed differently than employee on balance sheet



Independent Contractors: Rewards v. Risks

Risks of Using Independent Contractors

Misclassification and the Parade of Horribles



Misclassification and the Parade of Horribles

- **Federal Tax Liability for Misclassification (unintentional)**
 - 1.5% of or 3% of amounts paid to the reclassified employee, in lieu of federal income tax withholding
 - 20%-40% of employee's share of FICA taxes
 - 50% of employer's share of FICA
 - Failure to file 1099: 3% and 40% of FICA taxes
 - All amounts plus interest
- **Federal Tax Liability for Misclassification (intentional)**
 - Full amount of income taxes that should have been withheld (less any self-employment tax and/or individual income tax paid by employee)
 - Additional penalties plus criminal sanctions
 - Personal liability for any "responsible corporate officer"
- **Section 530 "Safe Harbor" Protection**
 - Company may avoid retroactive tax assessment for misclassification if it had reasonable basis for treating worker as non-employee (e.g., court case, published ruling, past audit, industry practice)
 - But no 530 protection if employer treated other workers similarly situated to contractor as employee
- **Applicable state and local taxes/penalties**

Misclassification and the Parade of Horribles

- **Statute of Limitations for Federal Tax Liability**
 - SOL for tax penalties is normally 3 years
 - But if no return is filed, assessment can be made at any time
 - According to some courts, independent contractor misclassification amounts to filing no return because 1099 is not the proper form
 - So all years may be open for potential assessment!

Misclassification and the Parade of Horribles

- **Wage and Hour Issues**

- If contractor has been misclassified and is a non-exempt employee under federal or state wage and hour laws, overtime may be owed for hours worked in excess of 40
 - Add to that potential for liquidated damages, attorneys' fees and costs

- **Work-Related Expenses**

- If contractor has been misclassified, employer may be required to reimburse expenses previously borne by worker

- **Health, Pension and Other Employee Benefits**

- ERISA provides a private cause of action
- Benefits that should have been provided can be element of damages for plaintiff(s) claiming misclassification
- Example: In addition to making substantial payment to IRS, Microsoft paid \$97 million to settle benefits case with temps not covered by company's stock purchase plan
- Fix: Amend plan to exclude workers later determined to be employees

Misclassification and the Parade of Horribles

- **Employee Benefit Plan Problems**

- Exclusion of workers who turn out to be employees can lead to plan disqualification if failure to provide benefits to those workers causes plan to fail to meet nondiscrimination standards

- *Kenney v. Comm'n'r*, 70 T.C. 614 (1995)

- Inclusion (as employees) of individuals who turn out to be non-employees can also result in plan disqualification

- *Professional & Executive Leasing, Inc. v. Comm'n'r*, 862 F.2d 751 (9th Cir. 1988)

Misclassification and the Parade of Horribles

- Reclassification of Contractors Can Push Small Employers Into Coverage Under Certain Federal and State Laws

Examples:

- Title VII, ADA: 15 or more employees
- ADEA: 20 or more employees
- FMLA: 50 or more employees
- COBRA: 20 or more employees

What To Do?

- Know the Tests for Independent Contractors
- Audit Independent Contractors Used By Company
- Take Remedial Steps When Necessary

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IRS Three Main Elements Based on Traditional 20-Factor Right to Control Test

1. BEHAVIORAL CONTROL

- Instructions and training given
- When and where to do work
- What tools or equipment to use
- What order or sequence to follow

2. FINANCIAL CONTROL

- Method of Compensation
- Reimbursement of Expenses

3. RELATIONSHIP OF PARTIES

- Exclusivity of relationship
- Continuity of relationship

DOL and Other Agencies: Economic Realities Test

FOCUS:

- How economically dependent is individual on business?
- Does individual derive substantial portion of income from business?

FACTORS:

- Skill required in occupation
- Is work integral part of business?
- Does business pay Social Security taxes and provide benefits?

Colorado Unemployment and Workers' Comp Test

- Company and contractor must sign independent contractor agreement
- Contractor may not be required to work exclusively for company
- Company may not establish a quality standard or oversee how work is to be performed, although two can agree services are to be performed within generally accepted industry standards
- Company may not pay the contractor a salary or hourly rate
- Company may not terminate contractor's services unless contractor fails to meet specifications of agreement
- Company may not provide more than minimal training
- Company may not provide tools or benefits to contractor
- Company may not dictate time of performance, except completion schedule and range of mutually agreed work hours through written agreement
- Company must pay contractor to the trade or business name of the contractor, not pay contractor individually
- Company and contractor may not combine businesses in any way

Existence of any one of the above is not conclusive evidence that worker is an employee

Audit Yourself

- Combine factors recognized in various tests used to determine independent contractor status
- Work with in-house or outside counsel

Audit Yourself

- Identify types of contractors
 - Consultants
 - Temporary support
 - Others?
- Identify contractors
 - Name
 - Entity
 - Duties/function
 - Service period
 - Prior employment relationship

Audit Yourself

- Who retains contractors?
 - Supervisors of a certain level?
 - HR?
 - Legal?
- What process do they follow?

Audit Yourself

- Identify obstacles to proper classification
 - Budgets/forecasts
 - Lack of knowledge
 - Custom/practice
- Importance of consistency in hiring contractors
 - Establish a process for proper retention of independent contractor

When in doubt, use a checklist

- Use the checklist
 - Training
 - Entity vs. individual (for payment and services)
 - Length of service
 - Future employment/former employee
 - Assistants
 - Profit/loss

Use a checklist

- Exclusivity
- Detailed instructions
- Set hours
- Established sequence
- Written reports
- Same function as employee(s)
- Own tools/equipment
- Written contract

What to Do With Classification Problems – Remedial Steps

1. Make sure Legal is notified and involved
2. Consider whether the relationship can be restructured
 - Adjust extent of control over manner and means by which contractor accomplishes work
 - Remove set work hours
 - Require contractor to work remotely, focus on end result
 - Allow contractor to work for others
3. If restructure doesn't work, consider voluntary reclassification
 - Consider only if contractor cannot pass checklist test
 - Far less painful and costly than being forced by government to reclassify contractor
 - Check effect of reclassification on benefit plans
4. If restructure or reclassification doesn't work, consider leasing or other staffing alternatives

General Practical Tips

- Avoid exercising substantial control over contractor
- Avoid contractor relationship where contractor is overly economically dependent on you
- Don't let contractors supervise employees
- Don't let contractors work side-by-side with employees
- Treat contractors like visitors, not employees (badges, uniforms, etc.)
- Don't give contractors "new hire paperwork"

General Practical Tips

- Don't give them employee handbooks – only policies consistent with contractor status; avoid extensive training/required hours
- Think twice before letting contractors perform “core” functions
- Make sure contractor supplies own equipment and has own facilities
- Consider engaging only incorporated contractors
- Make payment directly to entity, not individuals
- Require invoices for services

General Practical Tips

- Keep contractor files separate from employee files
 - Contents:
 - Signed, dated, and notarized independent contractor agreements
 - Any confidentiality or proprietary information agreement signed by contractor
 - Contractor's workers' compensation certificate of coverage
 - Contractor's EIN
 - Any policies or procedures given to contractor to follow
 - Passwords, access codes, etc. given to contractor
 - Documents showing how payments made
 - 1099 Forms

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