

EMPLOYEE OR INDEPENDENT CONTRACTOR: THE CHALLENGES OF WORKER CLASSIFICATION

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Today's Speakers



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Agenda

- Department of Labor's New Initiative
- Independent Contractor Defined
- Common Mistakes When Classifying Employees and Independent Contractors
- Consequences of Misclassification
- Practical Pointers

Employee Classification: The Hot Topic in Labor & Employment Law

Benefits of Independent Contractors

- Reduced obligations and expenses related to labor and employment laws
- Not eligible for employee benefits
- Significant tax advantages
- Allows flexibility in staff size
- Limits exposure to tort claims

Why Do Workers Care?



- Independent Contractors are not entitled to:
 - Minimum wage and overtime pay
 - Health and safety protections
 - Job-protected family and medical leave
 - Protection of antidiscrimination laws
 - Right to join a union
 - Unemployment insurance
 - Workers compensation
 - Social Security and Medicare

Why Do Federal and State Governments Care?

- Governments lose money when businesses avoid tax obligations

- 2006 – lost **\$2.72 billion** in federal social security, unemployment and income taxes
- Misclassification of employees will cost more than **\$7 billion** in lost payroll tax revenue over the next 10 years

- Workers lose protections



Why Do Federal and State Governments Care?

- States are addressing the misclassification problems themselves
 - Interagency and joint task forces
 - Several states have passed legislation
 - From 2001 to 2005, Illinois lost an estimated \$124.7 million in income tax annually
 - In 2005, Illinois lost an estimated \$53.7 million in unemployment tax
 - Illinois Employee Classification Act (construction)

Department of Labor's New Initiative

FY 2011 Budget Targets Employee Misclassification

- \$25 million for a multi-agency initiative to address misclassification of employees as independent contractors
- 100 additional enforcement personnel
- \$1.6 million and 10 FTEs for OFCCP to coordinate with states on litigation

Impact of New Initiative

- Plaintiffs' bar (individual and class actions)
- Heightened scrutiny from federal and state authorities
- Exposure to government audits and enforcement actions
- Fines and penalties
- Criminal prosecution (*Crabbe v. U.S.*)

Independent Contractor Defined



EMPLOYEE OR INDEPENDENT CONTRACTOR

- The definition of “independent contractor” varies – there is no Bright Line Test
- The determination cannot be based on isolated factors or a single characteristic, but generally depends upon the circumstances as a whole
- It's Complicated
 - Federal and state agencies consider different criteria
 - Need to determine which test applies to the situation

Traditional FLSA Test: Economic Realities

- The degree of control exerted by the alleged employer over the worker
- The worker's opportunity for profit or loss
- The worker's investment in the business
- Duration of the working relationship
- The degree of skill and independent initiative required to perform the work
- Extent to which the work is an integral part of the employer's business

ERISA Cases: Right to Control Test

- Right to control the matter and means by which services is rendered
- Skill required
- Sources of investments and tools
- Location of work
- Duration of relationship
- Right to assign additional projects
- Discretion over where and how long to work
- Method of payment
- Role in hiring and paying assistants
- Work is part of regular business
- Employee benefits
- Tax treatment

Title VII Cases: Hybrid Test

- Degree of control over how the work is performed/supervision
- Method of payment
- Who supplies the materials or equipment
- Type of occupation/skill level
- Degree of permanence of the working relationship
- Extent to which the worker's service is an integral part of the employer's business
- Intention of the parties
- Manner in which the relationship is terminated
- Whether annual leave is provided
- Accrues retirement benefits
- Employer paid Social Security taxes

IRS 20-Factor Test

- No instructions
- No training
- Work not essential to hiring firm
- Services don't have to be rendered personally
- Control own assistants
- Not a continuing relationship
- Set own work hours
- Paid by job
- Job location
- Order of work
- No interim reports
- Paid by job
- Business expenses
- Have own tools
- Significant investment in their business
- Can make profit or loss
- Work for multiple firms
- Offer services to general public
- Fired at will
- No compensation for non-completion

Some Practical Factors to Consider

Independent Contractor

- Self-directed; controls details of how the work is performed
- Works for multiple employers
- Paid on a project basis
- Does not receive training from employer
- Does not receive benefits
- Uses own equipment

Employee

- Works for one employer
- Employer provides work direction and tools
- Paid a guaranteed regular wage
- Employment related out-of-pocket expenses are paid by employer
- Training from employer
- Receives benefits

Common Mistakes

Hypothetical #1

- A Company has classified 100 workers, who are all doing the same job, as independent contractors. Five years earlier, the same 100 workers, who performed substantially the same job as they do now, were classified as employees.

Common Mistakes

Hypothetical #2

- The Company decided to conduct an internal audit. The Company discovered that two workers were being paid as independent contractors and 45 workers, holding positions substantially similar to the positions held by the two independent contractors, were being paid as employees.

Common Mistakes

Hypothetical #3

- Company A, the pioneer in the industry, began selling its product in 2008, treating all of its salespeople as independent contractors. Company B, the second business to enter the industry, started its operations in 2010. Company B copies Company A's treatment of its workers as independent contractors.

Common Mistakes

Hypothetical #4

- A manufacturing company hires Tek as a management consultant for its sales department. According to the Company, Tek's responsibilities are:
 - to ensure that the sales department is fully staffed
 - to ensure that all materials used by the sales agents are stocked and available
 - to review all sales contracts

- The Company requires Tek to secure prior approval:
 - to hire and/or fire within the sales department
 - to purchase additional materials, as needed by the sales agents
 - to accept any sales contract prepared by the sales department

Common Mistakes

Hypothetical #5

- Pat is a truck driver. Pat who makes delivery runs for Mother-May-I Manufacturing Company is required to report to the warehouse every morning to pick up his delivery assignment. Mother-May-I instructs Pat on which deliveries he is to make, which route to take and what order he is to deliver the goods. Pat only works for Mother-May-I.

Common Mistakes

Hypothetical #6

- Dave owns his own landscaping company. Dave is a highly skilled landscape artist and is known for shaping hedges into the characters from the Harry Potter series. Dave advertises his services in the Yellow Pages and on his website. A toy company hires Dave to perform landscaping services on its grounds at headquarters. Such services consist of weekly lawn mowing and the annual trimming and shaping of their hedges into Harry Potter characters. The toy company loves Dave so much that it negotiates a long-term contract with Dave to maintain all the landscaping at all of the toy company's business locations. The Company requests that Dave not work for any other toy companies.

Common Mistakes

Hypothetical #7

- Tek, a computer programmer, for the Company is laid off when the Company downsizes. The Company rehires Tek as an independent contractor so that he can complete a few projects he was working on before he was laid off. Tek signs a contract acknowledging that he is an independent contractor for the Company. Tek continues to receive salary and only his vision benefits. Tek does the work on the Company's new high-end computer. Tek is expected to attend meetings of the software development group and he is supervised by a Company manager.

Common Mistakes

Hypothetical #8

- Pat, a retired court reporter for the Cook County Circuit Court, works as a court reporter for a private court reporting business. Pat is engaged regularly by the court reporting business. The court reporting business determines the fee and rate for Pat to attend depositions and hearings. Pat purchases her own supplies and equipment, performs the services at home and is under no direct supervision. When Pat is required to travel, the court reporting business reimburses Pat for her expenses.

Common Mistakes

Hypothetical #9

- Dr. Brown owns and operates Z medical center, which provides a variety of medical services. To better serve his patients, Dr. Brown purchased an x-ray machine and hired Dr. Cohen to read the x-rays. Dr. Cohen is a highly skilled and highly trained professional in the field of radiology. Dr. Brown determines the fees for Dr. Cohen's radiological services. Dr. Brown and Dr. Cohen verbally agreed that Dr. Cohen would be paid \$200,000 annually regardless of the number of x-rays he reads. Dr. Cohen will also continue acting as an x-ray consultant and expert for personal injury cases.

Common Mistakes

Hypothetical #10

- Pat is a backhoe operator for a distributing company. The Company treats Pat as an independent contractor. The Company claims that Pat has a significant investment in the \$75,000 backhoe that Pat uses. In reality, Pat leases the backhoe at less than fair rental value and can return it at any time without liability for further payments. The Company pays for the liability insurance and regular maintenance on the backhoe.

Consequences of Misclassification

\$\$\$ CONSEQUENCES \$\$\$

- Wages (back pay and/or overtime)
- Taxes (local, state and federal)
- Payment of federal and state unemployment taxes
- Benefits: payment of benefits provided to employees such as retirement contributions, payment of medical expenses and disability pay

Consequences of Misclassification

- **IRS Safe Harbor 530**
 - Reasonable basis for determination
 - Court case, ruling by IRS
 - IRS audit conducted with similar employees, industry standards and attorney's advice
 - Substantive Consistency
 - Must have always treated similar class of workers as independent contractors
 - Filed 1099 Forms
 - NOTE: Only protects against federal income tax obligations

Nightmare Scenarios for Companies

- **FedEx**
 - FedEx recently agreed to a \$26.8 million settlement for lawsuit contesting its delivery drivers were independent contractors
- **Microsoft Case (1980s)**
 - IRS determined that Microsoft should have been withholding employees' taxes
 - Employees also sought benefits from Plan
 - Eventually settled for \$97 million

Practical Pointers

- ✓ Evaluate and identify classification at outset of relationship
- ✓ Stay up to date on caselaw and industry standards
- ✓ Review eligibility of employee benefit plans
- ✓ Self-audit
- ✓ Resist the urge to demand exclusivity

Practical Pointers

- ✓ Resist the urge to control every aspect of relationship
- ✓ Err on side of classifying worker as an employee
- ✓ Be wary of independent contractor relationships that extend indefinitely
- ✓ No benefits
- ✓ Contractors should be ready to work upon hire – no training, no resources and no oversight

Practical Pointers

Good mantra to remember:

- Contractors should be accountable for outcomes, not the means by which they are achieved

Practical Pointers

- If you go the independent contractor route...
 - Plan ahead—don't wait until the last minute
 - Continually audit—if relationship evolves, classification status should change
 - Draft sound contractor agreements
 - Add indemnification provision regarding local, state and federal taxes

Thank you for your time

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Any issues, contact
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