

The Misclassification of Employees

6 Factors to Consider in Determining Independent Contractor Status

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Now more than ever employers in all industries need to carefully examine whether their independent contractors can satisfy the “new” U.S. Department of Labor (DOL) test for independent contractor status. This is because it is becoming increasingly a matter of when, not if, that status will be challenged.

Background

On July 15, 2015 the Administrator of the Wage and Hour Division of the U.S. Department of Labor issued Administrator’s Interpretation No. 2015-1. In this Interpretation, the Administrator sets forth the test for

independent contractor status that the DOL will use in its enforcement actions. The DOL’s enforcement authority derives from its enforcement of the Fair Labor Standards Act (the “FLSA”). The FLSA requires certain employees, but not independent contractors, to receive a minimum wage and overtime. State minimum wage laws also require employers to pay non-exempt employees a minimum wage and overtime.

Since 2011 the DOL and the IRS have had an information sharing agreement. This means that if one of the agencies finds a worker misclassification violation it will inform the other. The IRS is interested in making sure all taxes are

paid and has its own test of determining whether a service provider is an employee or an independent contractor (the “20 Factor Test”). In addition, the DOL has a memorandum of understanding with more than twenty state unemployment agencies (Michigan does not currently) that they too will share and receive information about violations found by the other. Those states also have one or more tests depending on the interested state agency. What all this means is that if an issue is identified by the IRS, the DOL or by a state unemployment agency, all the others will be informed. Therefore, each time an independent contractor is misclassified, there are at least three governmental agencies that are interested.

Consequences of Misclassification

If a service provider is misclassified as an independent contractor, the employer can be exposed to damages or claims for several past years (varies according to the claim or damage) which includes such items as unpaid minimum wage and overtime; unpaid employment taxes, penalties and interest (federal and state); unemployment insurance taxes; workers compensation premiums and benefits; contributions to tax-qualified retirement plans; and

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claims for all employee benefits such as stock options, vacation pay and similar items of compensation. In addition, the service providers would be covered under non discrimination laws. And finally, there could be I-9 consequences which include criminal sanctions for failure to document the employment eligibility of employees.

Determining Independent Contractor Status Under 2015-1

The DOL's test begins with the FLSA's very broad statutory language of the definition of *employ* which is "to suffer or permit to work." The test is what is used by the courts to interpret this broad definition. The test is known as the "economic realities" test." The economic realities test focuses on whether the worker is economically dependent on the employer or in business for him or herself. The test is both multifactorial and fact specific (must be determined for each and every service provider individually). Before describing the factors, the following principles have to be understood. All the factors are to be considered in each case; no one factor, particularly the control factor, is determinative; factors are to be applied with the principle that the scope of the employment relationship is very broad (and therefore employee status may be a presumption); factors are not to be applied in a mechanical fashion, such as a checklist. The list requires a qualitative not a quantitative analysis. Labels, contractual provisions, and tax treatment are not determinative (and are barely persuasive). Finally, the DOL has the view that it is a "narrow subset of workers" who are truly independent contractors.

Factor 1 – Is the work integral to the business?

If the work performed by a worker is integral to the employer's business, it is more likely that the worker is economically dependent on the employer. Work can be integral to an employer's busi-

ness even if it is performed away from the employer's premises. The DOL provides the following examples:

- "Work performed by cake decorators 'is obviously integral' to the business of selling cakes which are custom decorated."
- "It does not take much of a record to demonstrate that picking the pickles is a necessary and integral part of the pickle business..."
- Carpenters are integral to the employer's business of framing residential homes.
- A software developer who creates software to assist the construction company in tracking bids, scheduling projects and crews, etc. is performing work that is not integral to the construction company's business.

Factor 2 – Worker's Profit or Loss

This factor examines whether the worker's managerial skill affects the worker's opportunity for profit or loss.

- Ability to hire others, purchase materials or equipment, advertise, rent space, and manage time tables.
- Worker's ability to work more hours has nothing to do with managerial skill.
- Being more technically proficient is unrelated to ability to earn or lose profit via managerial skill.
- Look at whether there is an opportunity for loss.

Example:

A worker provides cleaning services for corporate clients. The worker performs

assignments only as determined by a cleaning company. He does not independently schedule assignments, solicit additional work from other clients, advertise his services or endeavor to reduce costs. The worker regularly agrees to work additional hours at any time to earn more. The worker does not exercise managerial skill that affects his profit or loss.

Factor 3 – Worker's & Employer's Investment

This factor looks at the worker's relative investment and compares it to the employer's investment.

- Worker should make some investment and therefore undertake at least some risk for a loss in order for there to be an indication that he or she is an independent business.
- It is relative investments that matter – if worker's investment is relatively minor then that suggests that the worker and employer are not on similar footings and the worker may be economically dependent on the employer.
- Look not at the level of the job but overall investment in the relative enterprises.

DOL examples:

The company provides the vehicle, insurance and all equipment and supplies and the worker occasionally brings her own preferred cleaning supplies to certain jobs (relative investment is indicative of employment relationship). Compare to worker who receives referrals and sometimes works for a local cleaning company. The worker invests in a vehicle not



suitable for personal use, rents space to store the vehicle and materials, advertises and hires a helper for larger jobs. Brings her own equipment and supplies to the jobs. DOL's conclusion is that her level of investments is similar to the investments of the local cleaning company for whom she sometimes works (relative investment is indicative of an independent contractor).

Factor 4 – Special Skill and Initiative

This factor looks at whether the work performed requires special skill and initiative. The factor looks at business, not technical skills. Skills must be used in some independent way, such as demonstrating business-like initiative.

DOL example:

- When a carpenter does not make any independent judgments at the job site beyond the work that he is doing for that job; he does not determine the sequence of work, order additional materials, or think about bidding the next job, but rather is told what work to perform where – this worker does not demonstrate the skill and initiative of an independent contractor.
- In contrast, a highly skilled carpenter who provides specialized services for a variety of area construction companies, for example, custom, handcrafted cabinets that are made-to-order, may be demonstrating the skill and initiative of an independent contractor if he markets his services, determines when to order materials and the quantity of the materials to order, and determines which orders to fill.

Factor 5 – Temporal Aspect of Relationship

This factor looks at whether the relationship between the worker and the employer is permanent or indefinite. Permanency and indefiniteness suggests the worker is an employee; however, lack

of permanency or indefiniteness does not automatically suggest an independent contractor relationship. One must look at whether the reason indicates that the worker is running an independent business. The key is whether the lack of permanence or indefiniteness is due to “operational characteristics” intrinsic to the industry (for example, employers who hire part-time workers or who use staffing agencies) or the worker’s “own business initiative.”

DOL example:

- Where an editor has worked for an established publishing house for years and her edits meet the house's specifications, she uses its software and only edits books provided by the publishing house, the relationship indicates permanence.
- If an editor works intermittently for fifteen different publishing houses over the past several years, markets her services to numerous houses and negotiates her rates and turns down work if she is too busy, the relationship indicates a lack of permanence.

Factor 6 – Control

This factor looks at both the nature and the degree of control. The worker must control meaningful aspects of the work such that it is possible to view the worker as a person conducting his or her own business. The worker's control must be more than theoretical – it must be exercised. Lack of control of employees who work from home or off site is not particularly telling (no need to be looking over the worker's shoulder). Control over hours worked is not indicative of independent contractor status. Importantly, the DOL emphasizes that the control factor is not to play an “oversized” role in the analysis.

How Do Potential Issues Arise?

Potential issues frequently arise when workers and former workers,

even inadvertently, apply for unemployment. In addition, government agency audits and investigations, and again the state unemployment agencies are active in conducting audits and investigations. Also, issues can arise in the merger or acquisition context and cause difficulties.

Steps Toward Compliance

Conduct a privileged self-audit (have legal counsel direct the audit). In that audit each job function where contractors are used should be reviewed and the factors described above should be applied in a non-mechanical way and on an individual basis for each worker. If in the final analysis the worker is economically dependent on the agency then some consideration should be given to using the IRS Voluntary Classification Settlement Program, which can significantly reduce federal taxes and penalties. ■

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