Misclassification of Independent Contractors
Increased Government Scrutiny Increases Risks and Costs

Summary

The U.S. Department of Labor (DOL) recently announced a campaign to aggressively pursue employers who misclassify workers as independent contractors when they should, in fact, be classified as employees. Misclassification can lead to liability for unpaid taxes, penalties for failure to withhold, interest, overtime pay and benefits, and statutory penalties. Even misclassifying one employee can be extremely expensive. Accordingly, it is more important than ever for a company to audit its workforce to determine whether its workers are properly classified. An employer must analyze the specific job duties of each independent contractor and review certain factors to determine whether the "economic reality" of the relationship supports the classification of independent contractor in order to withstand the scrutiny of the Department of Labor and/or the courts.

The U.S. Department of Labor (DOL) recently announced a campaign to aggressively pursue employers who misclassify workers as independent contractors when they should, in fact, be classified as employees.

From an employer's perspective, classifying a worker as an independent contractor can result in cost savings of 20 percent to 30 percent.[1] That's because a worker who is classified as an independent contractor does not participate in employee health and benefit plans and is not paid overtime. Employers also are not responsible for payroll taxes, unemployment taxes or workers' compensation insurance for its independent contractors. However, an employer can't classify a worker as an independent contractor solely to avoid paying taxes and benefits.

At this time, misclassification itself is not a violation of the Fair Labor Standards Act (FLSA) or any other federal labor law.[2] But, misclassification can lead to liability for unpaid taxes, penalties for failure to withhold, interest, overtime pay and benefits, and statutory penalties. Even misclassifying one employee can be extremely expensive. The plaintiffs' bar clearly has realized the potential for large awards in such instances; an increased number of misclassification cases are being filed.

Misclassification is so widespread that the Obama administration anticipates it will collect approximately $7 billion in currently unpaid taxes during the next 10 years from the increased enforcement effort.[3] Many states also have boosted enforcement efforts, and some states have increased penalties under state law for misclassifying workers.

The DOL's Wage and Hour Division plans on issuing a proposed rule on misclassification of employees under the FLSA. The new rule would require, among other things, that employers who

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[1] How can my company save money by hiring independent contractors?, www.shrm.org. July 29, 2010.
[2] Legislation is pending to amend the FLSA to include penalties for misclassification. See HR 5107, Employee Misclassification Bill, introduced April 22, 2010.
[3] Steven Greenhouse, U.S. Cracks Down on "Contractors" as a Tax Dodge, *New York Times,* February 10, 2010.

classify workers as independent contractors perform a classification analysis, provide that analysis to the worker, and retain that analysis to provide to the DOL upon request.[4]

Who is an independent contractor?

In light of the heightened scrutiny of government agencies and the plaintiffs' bar, it is more important than ever for an employer to audit its workforce to ensure that its worker classifications can withstand examination. Unfortunately, the number and complexity of laws and regulations governing independent-contractor classification makes it extremely difficult for an employer to properly classify its workers.

Complicating the matter is that there is no universal test for determining whether a worker is an independent contractor. In fact, agencies and courts use many different tests depending on which law is involved. A worker who may be considered an independent contractor under the Internal Revenue Code may not be considered an independent contractor under the FLSA. The remainder of this article will focus on the test used to determine whether a worker is an independent contractor under the FLSA.

The definition of "employee" under the FLSA is extremely broad, and courts have noted that employees "are those who, as a matter of economic reality, are dependent upon the business to which they render service."[5] In general, an independent contractor is engaged in a business of his/her own, whereas an employee is dependent on the business that he/she serves. Because an independent contractor is an autonomous agent, he/she retains the right to control the manner and means by which he/she performs services, typically free from control of the employer except with respect to the final result.

Determining whether a worker is an independent contractor requires a fact-intensive inquiry into the duties of the specific worker. The parties' designation of a worker as an independent contractor, even if agreed upon, is not dispositive.

The test under the FLSA

In interpreting the FLSA, the courts use an "economic reality" test, focusing on whether the worker is economically independent from the recipient of his/her services. Whether a worker is an independent contractor depends upon the circumstances of the whole relationship and is not based on isolated factors or upon a single characteristic. The factors which are considered significant are:

- The extent to which the worker's service are an integral part of the employer's business;
- The length and/or permanency of the relationship;
- The amount of the worker's investment in facilities and materials;
- The nature and degree of control by the company;
- The worker's opportunities for profit and loss; and
- The level of skill required in performing the job and the amount of initiative, judgment or foresight required.[6]

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[4]U.S. Department of Labor Regulatory Agenda Narrative, Spring 2010, at http://www.dol.gov/regulations/2010RegNarrative.htm.

[5] Sec'y of Labor v. Lauritzen, 835 F.2d 1529 (7th Cir. 1987)

[6] See, e.g., Baystate Alternative Staffing, Inc. v. Herman, 163 F.3d 668 (1st Cir. 1998)

Among the jobs most often misclassified are truck drivers, construction workers, home health aides and high-tech engineers. Misclassification is particularly problematic in light of the fact that 50 percent of the jobs created during the economic recovery are contingent labor.[7]

If an employer provides training and supervises the worker, sets the hours of work and the work is continuous, with no definite end date, it is more likely that the worker is an employee. Provision of equipment is also important, as independent contractors tend to supply their own equipment whereas equipment is usually provided by employers to employees. Conversely, if an employer does not supervise a worker or provide training or instruction, it supports the proposition that the worker is an independent contractor. Discrete projects, with definite ending dates, also weigh in favor of an independent contractor relationship. A high level of skill, initiative and judgment required to perform the job also tends to favor independent-contractor status. In fact, one court has held that "routine work which requires industry and efficiency is not indicative of independence and nonemployee status."[8]

Consider a situation in which a company calls a plumber to fix a leaking pipe.

- The company is not in the plumbing business and none of its employees perform the functions of a plumber. Therefore, the plumber's service is not an integral part of the company's business.
- The plumber arrives at the company's office, wearing a uniform with the name of his own business and with his own tools. He bears the risk of success or failure of his business, works for others and may even advertise his services.
- The plumber is assigned the discrete project of fixing the leaking pipe, and once that is completed, his relationship with the company ends.
- Although the company may provide some general parameters about when they need the leak to be fixed, or regarding certain standards of quality that need to be met, the company does not provide any other direction, training or control regarding how the plumber should fix the leak.

These facts, taken as a whole, suggest that the plumber could be properly classified as an independent contractor. However, many situations are not as clear-cut and may create problematic situations. For example, it has been common in recent years for employers to engage the services of former employees as independent contractors. If a worker is doing the same job as he/she was performing when he/she was an employee, there is no discreet end date for the job, and he/she is working for no one other than the employer, it is likely to be found that he/she is an employee, not an independent contractor. Also consider situations in which two workers are performing the same job, wearing the same uniform, using the company's equipment and are subject to the same policies -- but one worker is classified as an employee and the other as an independent contractor. It is likely that the Department of Labor or a court would find that both workers are employees.

What should an employer do now?

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[7] Courtney Rubin, Obama Cracks Down on Use of Contractors, *Inc.com*, February 18, 2010

[8] *See* Hopkins v. Cornerstone America, 545 F. 3d 338 (5th Cir. 2008)
citing Usery v. Pilgrim Equip., 527 F.2d 1308 (5th Cir. 1978)

It is more important than ever for a company to audit its workforce to determine whether its workers are properly classified. An employer must analyze the specific job duties of each independent contractor and review the factors set forth herein to determine whether the "economic reality" of the relationship supports the classification of independent contractor.

If independent contractors are hired, companies should:

- Make sure the independent contractors control the methods and means of work;
- Pay them per project or task;
- Not provide employee benefits, tools, equipment or training;
- Avoid allowing them to perform the same/similar tasks as employees, wear uniforms/tags with the company name, or use company letterhead or business cards;
- Train managers to limit control; and
- Have a good contract (not dispositive, but may be helpful).

Any worker classified as an independent contractor must perform job duties which support that classification in order to withstand the scrutiny of the Department of Labor and/or the courts. As this is very a complicated area of law, consulting with an experienced employment attorney may be appropriate.

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For additional resources:

From the U.S. Department of Labor:
http://www.dol.gov/whd/regs/compliance/whdfs13.pdf
http://www.dol.gov/regulations/2010RegNarrative.htm

Text of the Fair Labor Standards Act:
http://www.dol.gov/whd/regs/statutes/FairLaborStandAct.pdf

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