Independent Contractor Misclassification Presents DOL/IRS Dual Threat

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On July 15, U.S. Department of Labor (DOL) Wage and Hour Division (WHD) administrator David Weil issued an administrator’s interpretation on the application of the Fair Labor Standards Act’s (FLSA) definition of “employ” on the identification of employees who are misclassified as independent contractors. The administrator’s interpretation (AI) concludes that “most workers are employees under the FLSA.” The AI was issued in the context of the DOL’s larger Misclassification Initiative, which provides for the collaboration of the DOL, Internal Revenue Service and 26 states through information-sharing and coordinated enforcement.

The DOL’s AI comes at a time where worker classification has become not only the focus of government agencies, but also an area of increased wage-and-hour litigation and public conversation. While the AI sets out a multifaceted test to determine whether a worker qualifies as an employee under the FLSA, it almost singularly focuses on a worker’s economic dependence on the business in question. Simply stated, according to the DOL, if a worker is economically dependent on the business in question, then that worker is an employee of that business.

Although it remains to be seen how much deference courts will give to the AI, the AI will govern how the DOL carries out what Weil recently referred to as the DOL’s “nationwide, data-driven strategic enforcement initiative.” Accordingly, employers should ensure that worker status in light of the AI to mitigate against the potential significant financial impact of a finding of misclassification by the DOL or a court.

What’s more, the ability of employers to assess worker status will be complicated by the fact that the IRS uses a different test to assess the same question. As confirmed by a fact sheet released by the IRS in August, the test used by the IRS is less broad than the AI’s test, and focuses on the issue of control, not economic dependence. It is unclear whether the broader DOL test will drive, as a practical matter, employment tax assessments by employers and the government.

How We Got Here

The FLSA defines “employ” as including “to suffer or permit to work.” Citing to this definition, the AI reasons that the economic realities test (with its focus, according to the DOL, on economic dependence) should be used, rather than the common-law control test (used by the IRS as well as in analyzing worker status under other employment statutes).

Weil attributes his perceived rise in worker misclassification to what he refers to as the “fissuring” of the American workplace—that is, where “employers have increasingly contracted out or otherwise shed activities to be performed by other entities through, for example, the use of subcontractors, temporary agencies, labor brokers, franchising, licensing and third-party management.”

In his book, titled “The Fissured Workplace: Why Work Became So Bad for So Many and What Can Be Done to Improve It,” Weil advocates for “public agencies to change the way workplace policies are implemented” by “realigning the incentives driving businesses at the lead of industries.” The AI is one step in Weil’s efforts to effectuate such realignment.

The MultiFactored DOL Test

While emphasizing the central focus of a worker’s economic dependence and stating that no one factor is determinative, the AI sets out the following six-part test:

• The extent to which the work performed is an integral part of the employer’s business.
• The worker’s opportunity for profit or loss depending on his or her managerial skill.
• The extent of the relative investments of the employer and the worker.
• Whether the work performed requires special skills and initiative.
• The permanency of the relationship.
• The degree of control exercised or retained by the employer.

All factors are not created equal, with the AI strongly de-emphasizing the control exercised or retained.

Another central theme of the AI is the focus on the worker’s managerial (and marketing) efforts in assessing whether the worker is “truly in business for him or herself.” The AI makes clear that a worker’s technical skills (rather than “business skills, judgment, and initiative”) are not relevant in assessing worker status. In looking at a worker’s investment in a business, the AI concludes that this investment must be weighed against the “employer’s investment in its overall business” rather than “the employer’s investment in the particular job performed by the worker.”

This is true even where worker investment is considered substantial.

The last two factors in the test are largely discounted (except as set forth below). With regard to the permanency factor, the AI reasons that “even if the working relationship lasts weeks or months instead of years, there is likely some permanence or indefiniteness to it.” The AI emphasizes that the lack of permanence or indefiniteness does not “automatically” suggest independent contractor status, and that the reason for such a lack of permanence or indefiniteness should be “carefully reviewed.
to determine if the reason is indicative of the worker’s running an independent business.” “The key,” according to the AI, “is whether the lack of permanence or indefiniteness is due to ‘operational characteristics intrinsic to the industry’ ... or the worker’s ‘own business initiative.’” While the control factor is discussed, the AI emphasizes that it “should not overtake the other factors” and should be analyzed with a focus on determining whether the worker is economically dependent on the employer. In fact, the AI specifically states that “the FLSA covers workers of an employer even if the employer does not exercise the requisite control over the workers, assuming the workers are economically dependent on the employer.”

In a thinly veiled reference to the “sharing economy,” the AI references “technological advances and enhanced monitoring mechanisms” that “may encourage companies to engage workers not as employees yet maintain stringent control over aspects of the workers’ jobs, from their schedules, to the way they dress, to the tasks that they carry out.” Throwing down the gauntlet, the AI states that the reasons for the control are not relevant, whether it be customer satisfaction, business or regulatory requirements. If control is exercised over a worker, whatever the reason, the DOL takes the position that “the worker is an employee.”

Employee Under FLSA, But Not Internal Revenue Code?

Employers should also expect increased IRS scrutiny of workers classified as independent contractors rather than employees. In theory, this is an area in which the DOL and IRS can work in concert. However, the IRS still retains its traditional test, which emphasizes control and is narrower than the DOL’s AI. Accordingly, a worker potentially could qualify as an employee under the FLSA, but not under the Internal Revenue Code (IRC).

The IRS released a fact sheet (FS-2015-21) in early August, which reminded businesses of the factors used by the IRS to determine whether workers should be classified as employees or independent contractors. If a worker is an employee, the IRC requires a business to withhold income taxes, withholding and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to employees. A business also must report wages and withholdings on quarterly payroll returns and issue each employee a Form W-2. In contrast, a business does not have to withhold or pay taxes on compensation paid to an independent contractor, although it must issue a related Form 1099.

The IRS classifies a worker as either an employee or an independent contractor under either statutory definitions (for example, an officer of a company is an employee) or, more often, common-law considerations. The common law sets forth three categories of facts regarding the control of the business and the independence of the worker:

- Behavioral: Does the business control or have the right to control what the worker does and how the worker does her job?
- Financial: Are the business aspects of the worker’s job, such as how the worker is paid, whether expenses are reimbursed, and who provides tools or supplies, controlled by the business?
- Type of relationship: Are there written contracts or employee-type benefits such as pension plan, insurance or vacation pay? Will the relationship continue and is the work performed a key aspect of the business?

To assess whether a business is an employer, the IRS employs a test involving 11 factors that flow from the three broad categories described. The IRS and courts will assess the specific facts of each case, and no one factor is dispositive.

Independent Contractor Misclassification Focus

As evidenced by its issuance of the August fact sheet, the IRS continues to police worker classifications and payroll taxes. Potential worker misclassification can come to the attention to the IRS not just through a typical audit or referral—as with the DOL, a worker may report perceived violations directly to the IRS. As noted by the fact sheet, workers who believe they have been classified improperly as independent contractors can file a Form 8919 with the IRS and report their perceived shares of unreported Social Security and Medicare taxes due on their compensation.

The potential penalties under the tax code for misclassifying workers can be substantial, and they will apply in addition to any potential penalties imposed under the FLSA and state law for the same conduct. In addition to penalties assessed against a business for not timely filing a payroll return or paying taxes, a business owner or executive who is deemed to be a “responsible person” and who acted “willfully” will be liable personally for a penalty equal to 100 percent of an unpaid payroll tax (similar to the FLSA, which also provides for individual liability). Further, in June, passage of the Trade Preferences Extension Act quietly doubled the maximum penalty for failing to file an information return, such as a Form W-2 or Form 1099. In particularly egregious cases, there is the possibility of criminal investigations and prosecutions.

A business seeking to mitigate perceived tax-related risk regarding its treatment of a worker as an independent contractor has the option of filing with the IRS a Form SS-8 and describing the circumstances of the employment; after a review, the IRS will issue its determination of the worker’s status. Further, eligible businesses may reclassify their workers as employees and receive partial relief from federal employment taxes for future tax periods under the IRS Voluntary Classification Settlement Program, if they agree to a closing agreement with the IRS and to prospectively treat relevant workers as employees.

What Employers Should Do Next

Given the significant regulatory focus of both the DOL and IRS in the area of independent contractor misclassification, employers need to review all independent contractor (or temporary worker) relationships for compliance with the AI and recent IRS guidance, and assess what, if any, modifications to make to worker classification. Any such analysis should be conducted under the ambit of attorney-client privilege to protect that process, to the maximum extent feasible, from later disclosure.

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