

## Independent Contractor Misclassification

The idea of using independent contractors, rather than hiring employees, has been embraced by employers large and small. Companies such as Microsoft, Uber, and FedEx all use independent contractors. The reason, of course, is simple—the use of independent contractors can dramatically reduce administrative burdens and costs associated with hiring employees. For example, by using independent contractors, employers can reduce costs related to minimum wage, overtime compensation, unemployment insurance, employment related taxes, and retirement plan coverage. But most workers are employees, not independent contractors, and employers who use or are considering using independent contractors must be diligent when classifying workers because there are significant legal differences.

Worker complaints and lawsuits alleging improper classification of workers are continuing and employers are spending significant time and expense defending them. The U.S. Department of Labor (DOL) and the Internal Revenue Service (IRS) are actively investigating and auditing companies where independent contractor misclassification is prevalent. To assist employers in properly classifying workers, the DOL released Administrator's Interpretation No. 2015-1. The guidance, issued July 15, 2015, describes the "economic realities test" developed from the Fair Labor Standards Act (FLSA) to assist employers in properly classifying workers.

Employers' misclassification is not surprising considering there is no one definition of "independent contractor" under federal or state laws. In addition, the relationship between workers and companies can change over time and may result in the change of a worker's classification. Therefore, it is common for an employer to incorrectly determine that a worker is an independent contractor, when in fact, that person is an employee. Corporations have been subjected to class action litigation by workers claiming entitlement to employee benefits—some of which are governed by ERISA. Many employers issuing IRS Forms 1099-MISC, *Miscellaneous Income*, and the individuals who receive them are not familiar with the recent DOL guidance and continue to believe that Form 1099-MISC is the sole factor determining employment status. Now that the 2015 tax filing season has arrived, another review of the rules for determining employment status may prove helpful to some.

### Economic Realities Test

The FLSA standard is a very broad definition and depends upon an individual's economic dependence on the employer or employers to which she provides services. In addition, it covers all work that the employer directs or allows to occur. A brief review of the multi-factor test is provided below. Each factor is analyzed in conjunction with the other factors and no one factor is more determinative than the others.

1. **The extent to which the work performed is an integral part of the employer's business. If the work performed by the worker is integral to the employer's business, it is more likely that the worker is an employee; the work can be integral even if it's just one component of the business or performed by many other workers.**

**Example:** For a construction company that frames residential homes, carpenters are *integral* to the employer's business because the company is in business to frame homes, and carpentry is an integral part of providing that service.

In contrast, the same construction company may contract with a software developer to create software that, among other things, assists the company in tracking its bids, scheduling projects and crews, and tracking material orders. The software developer is performing work that is *not integral* to the construction company's business, which is indicative of an independent contractor.

- 2. The worker's opportunity for profit or loss depending on his managerial skill. An independent contractor can face the possibility of making a profit but also experience a loss directly associated with his managerial skills. Managerial skills include the decision to hire others, purchase materials and equipment, rent space, advertise, market the business, etc.**

**Example:** A worker provides cleaning services for corporate clients. The worker performs assignments only as determined by a cleaning company; she does not independently schedule assignments, solicit additional work from other clients, advertise her services, or endeavor to reduce costs. The worker regularly agrees to work additional hours at any time in order to earn more. In this scenario, the worker does not exercise managerial skills that affect her profit or loss. Rather, her earnings may fluctuate based on the work available and her willingness to work more. This lack of application of managerial skills is indicative of an employment relationship between the worker and the cleaning company.

In contrast, a worker provides cleaning services for corporate clients. She produces advertising, negotiates contracts, decides which jobs to perform and when to perform them, decides to hire helpers to assist with the work, and recruits new clients. This worker exercises managerial skills that affect her opportunity for profit and loss, which is indicative of an independent contractor.

- 3. The extent of the relative investments of the employer and the worker. The investment, even if substantial, must be compared to the employer's overall investments in the company, not just to the worker's job. Independent contractors make investments that extend beyond supporting a business and seek to expand business capacity, reduce costs, or to extend the reach of the independent contractor's market.**

**Example:** A worker providing cleaning services for a cleaning company receives a Form 1099-MISC each year and signs a contract stating that she is an independent contractor. The company provides insurance, a vehicle to use, and all equipment and supplies for the worker. The company invests in advertising and finding clients. The worker occasionally brings her own preferred cleaning supplies to certain jobs. In this scenario, the relative investment of the worker as compared to the employer's investment is indicative of an employment relationship between the worker and the cleaning company. The worker's investment in cleaning supplies does little to further a business beyond that particular job.

In contrast, a worker providing cleaning services receives referrals and sometimes works for a local cleaning company. The worker invests in a vehicle that is not suitable for personal use and uses it to travel to various worksites. The worker rents her own space to store the vehicle and materials. The worker also advertises and markets her services and hires a helper for larger jobs. She regularly (as opposed to on a job-by-job basis) purchases material and equipment to provide cleaning services and brings her own equipment (vacuum, mop, broom, etc.) and cleaning supplies to each worksite. Her level of investment is similar to the investment of the local cleaning company for whom she sometimes works. These types of investments may be indicative of an independent contractor.

- 4. Whether the work performed requires special skills and initiative. A worker's business skills, judgment, and initiative—not merely technical skills—will aid in determining whether a worker is economically dependent; special technical skills do not indicate independent contractor status, especially if those skills are used to perform the work for the employer.**

**Example:** A highly skilled carpenter provides carpentry services for a construction firm; but such skills are not exercised in an independent manner. For example, the 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 and where. In this scenario, the carpenter, although highly-skilled technically, is not demonstrating the skill and initiative of an independent contractor (such as managerial and business skills). He is simply providing his skilled labor.

In contrast, a highly skilled carpenter provides a specialized service for a variety of area construction companies. For example, custom, handcrafted cabinets that are made-to-order, may demonstrate the skill and initiative of an independent contractor if the carpenter markets his services, determines when to order materials and the quantity of materials to order, and determines which orders to fill.

**5. The permanency of the relationship. Permanency or indefiniteness indicates an employer/employee relationship with economic dependence.**

**Example:** An editor has worked for an established publishing house for several years. Her edits are completed in accordance with the publishing house's specifications, using its software. She only edits books provided by the publishing house. This scenario indicates a permanence to the relationship between the editor and the publishing house that is indicative of an employment relationship.

In contrast, another editor has worked intermittently with fifteen different publishing houses over the past several years. She markets her services to numerous publishing houses. She negotiates rates for each editing job and turns down work for any reason, including because she is too busy with other editing jobs. This lack of permanence with one publishing house is indicative of an independent contractor relationship.

**6. The degree of control exercised or retained by the employer. A worker must control meaningful aspects of the work performed so that it is possible to view the worker as a person conducting her own business.**

**Example:** A registered nurse who provides skilled nursing care in nursing homes is listed with Beta Nurse Registry in order to be matched with clients. The registry interviewed the nurse before she joined the registry, and also required the nurse to undergo multi-day training presented by Beta. Beta sends the nurse a listing each week with potential clients and requires the nurse to fill out a form with Beta before contacting any clients. Beta also requires that the nurse adhere to a certain wage range and the nurse cannot provide care during any weekend hours. The nurse must inform Beta if she is hired by a client and must contact Beta if she will miss scheduled work with any client. In this scenario, the degree of control exercised by the registry is indicative of an employment relationship.

In contrast, another registered nurse who provides skilled nursing care in nursing homes is listed with Jones Nurse Registry in order to be matched with clients. The registry sends the nurse a listing each week with potential clients. The nurse is free to call as many or as few potential clients as she wishes and to work for as many or as few as she wishes; the nurse also negotiates her own wage rate and schedule with the client. In this scenario, the degree of control exercised by the registry is not indicative of an employment relationship.

The DOL's Interpretation is neither a rule, nor a policy statement, but instead sets forth the DOL's broad interpretation under the FLSA. But many practitioners have noted that this interpretation by the DOL, in conjunction with its increased enforcement efforts, signals the agency's position that most workers are considered employees under FLSA, and that FLSA will be the likely standard the DOL uses when reviewing worker classification.

### Effect on Retirement Plans

Misclassification of workers can result in claims for benefits under the employer's benefit plans. If an employer misclassifies workers as independent contractors and those workers are later determined to be employees, they may be entitled to benefits under a retirement plan. An employer can limit exposure to a lawsuit from misclassified workers by examining the eligibility provisions of its benefit plans. Many retirement plans allow an employer to properly exclude those workers to whom the employer does not wish to provide benefits. By drafting a retirement plan to exclude these workers, an employer can reduce, if not eliminate, its exposure to benefit claims for periods before the reclassification as an employee.

A common exclusion found in many retirement plan documents is for those workers “incorrectly determined not to be an Employee.” In short, if an employer incorrectly determines that a worker is an independent contractor but it is later determined that the worker is in fact an employee, this exclusion from eligibility will limit the employer’s exposure to claims for benefits. The worker would be eligible to participate in the plan upon reclassification but there would be no claim for benefits before that date nor would a correction be necessary. Without such a provision, an employer would need to use the IRS’ Employee Plans Compliance Resolution System to correct its failure to cover misclassified employees.

Finally, many workers who believe they are independent contractors (e.g., because they receive a 1099-MISC) look to establish and fund employer retirement plans. Such plans cannot, however, be established by workers who have been misclassified as independent contractors but are really employees of the company for which they provide services.

### Summary

The determination of whether a worker is an employee or an independent contractor is complex. As illustrated above, many factors can be used to determine the classification and no one “bright-line rule” exists. Extreme care must be taken by employers and workers to closely examine their relationships. Employers should be cautioned to consult with their legal or tax advisors to obtain an opinion if there is a possibility of misclassifying its workforce as the ramifications of misclassification can be extremely costly.