

Morgan Lewis

webinar

# Independent Contractors: What You Should Know from Inside the Beltway

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# Agenda

- Employee or Independent Contractor?
- Who Are Governmental Stakeholders?
- Independent Contractor Tests
- Why Does Classification Matter?
- IRS Programs
- DOL Programs and Requirements
- What to Do Next?

# Employee or Independent Contractor?

- Common Law Employee
- Independent Contractor
- Dual-Status Worker
- Corporate Officer and Other “Statutory Employees”
- “Statutory Nonemployee”
- Section 218 Agreement Employee
- Leased Employee
- Agent
- Terminated/Rehired Worker

# Employee Misclassification: Governmental Stakeholders

## Federal and State Agencies Affected by Employee Misclassification

| Agency                                      | Areas potentially affected by employee misclassification  |
|---|---|
| IRS   | <ul style="list-style-type: none"> <li>• Federal income and employment (payroll) taxes</li> </ul>   |
| DOL   | <ul style="list-style-type: none"> <li>• Minimum wage, overtime, and child labor provisions</li> <li>• Job protection and unpaid leave</li> <li>• Safety and health protections</li> <li>• Immigration/Form I-9 issues</li> </ul> |
| HHS (Department of Health & Human Services) | <ul style="list-style-type: none"> <li>• Medicare benefit payments</li> </ul>   |
| DOL, IRS and PBGC                           | <ul style="list-style-type: none"> <li>• Pension, health, and other employee benefit plans</li> </ul>   |
| EEOC  | <ul style="list-style-type: none"> <li>• Prohibitions of employment discrimination based on factors such as race, gender, disability, or age</li> </ul>   |
| NLRB  | <ul style="list-style-type: none"> <li>• The right to organize and bargain collectively</li> </ul>  |
| SSA   | <ul style="list-style-type: none"> <li>• Retirement and disability coverage and payments</li> </ul>   |
| State agencies                              | <ul style="list-style-type: none"> <li>• Unemployment insurance benefit payments</li> <li>• State income and employment taxes</li> <li>• Workers' compensation benefit payments</li> </ul>  |

# Employee or Independent Contractor: The Common Law Test

## 20-Factor Test

- |                                |  |
|--------------------------------|--|
| • instructions                 | • order or sequences set                 |
| • integration                  | • reports                                |
| • payments                     | • expenses                               |
| • training                     | • investment                             |
| • services rendered personally | • tools and materials                    |
| • hiring assistants            | • profit or loss                         |
| • continuing relationship      | • works for more than one person or firm |
| • set hours of work            | • offers services to general public      |
| • full-time work               | • right to discharge                     |
| • work done on premises        | • right to quit                          |

# Independent Contractor Tests: The IRS Three-Factor Test

- For audit purposes, IRS auditors use a modified version of the 20-Factor Test that focuses on three factors:
  - Behavioral Control Factors
  - Financial Control Factors
  - Relationship of the Parties Factors
- The IRS Three-Factor Test considers the work that is being performed and the business context in which it is being performed

# Varying Misclassification Tests

- 20-Factor Test is Unique to the IRS
- The DOL applies “economic reality” test applicable to the FLSA
  - Same is true for ERISA benefits claims
- Many states apply a version of the “economic reality” test
- Some states have much more demanding tests, including versions of the “ABC” test

# Independent Contractor Tests: The ABC Test

- Used in a growing number of states
- Trend started in Massachusetts, where its independent contractor law creates a presumption of employee status for purposes of the state's wage and hour laws and imposes on businesses the burden of proving they meet a strict three-part (A-B-C) test to overcome this presumption
- The test can be a serious challenge for a company with workers providing services that are within the company's usual course of business



# Independent Contractor Tests: The ABC Test, cont.

- This stringent state law test creates a presumption of employee status for purposes of wage and hour laws:
  - (A) the worker is free from the company's control and direction in performing the service, both under a contract and in fact
  - (B) the service provided by the worker is outside the employer's usual course of business
  - (C) the worker is customarily engaged in an independent trade, occupation, profession, or business of the same type
- Prior to 2004 in Massachusetts, (B) included the language: "or is performed outside of all places of business of the enterprise." The deletion of this language significantly impacts a broad range of businesses that use independent contractors.

# Why Does It Matter?

## Benefits and Business Expenses

| <b>Differences Among Benefits Responsibilities</b> |   |  |   |  |
|--|---|--|---|--|
| <b>Type of Benefits</b>                            | <b>Employees</b>                              |  | <b>Independent Contractors</b>  |  |
| Retirement plans                                   | Employers sponsor benefit plans               | Employers and employees contribute                               | Contractors sponsor plans   | Contractors bear the full financial cost of the plans                    |
| Healthcare   | Employers sponsor on a tax-free basis         | Employers and employees contribute                               | Contractors obtain coverage   | Contractors bear the full financial cost, but receive a tax deduction    |
| Reimbursed expenses/<br>accountable plans          | Employers can reimburse expenses              | Nontaxable to the extent they are paid under an accountable plan | Service recipient can reimburse, although expenses are generally unreimbursed | Reimbursed expenses are nontaxable if they are under an accountable plan |
| Unreimbursed expenses                              | Many employers don't fully reimburse expenses | Unreimbursed expenses are subject to a 2% floor and AMT          | Businesses don't generally reimburse expenses                                 | Not subject to a 2% floor or AMT   |

# Why Does It Matter? Payroll Taxes

## Differences Among General Tax Responsibilities

| Type of Tax                        | Employees   |   | Independent Contractors              |   |
|------------------------------------|---|---|--------------------------------------|---|
|                                    | Businesses' general responsibilities                              | Workers' general responsibilities                             | Businesses' general responsibilities | Workers' general responsibilities                               |
| Federal income tax                 | Withhold tax from employees' pay                                  | Pay full amounts owed, generally through withholding          | Generally, none                      | Pay full amounts owed, generally through estimated tax payments |
| Social Security and Medicare taxes | Withhold one-half of taxes from employees' pay and pay other half | Pay half of total amounts owed, generally through withholding | None                                 | Pay full amounts owed, generally through estimated tax payments |
| Federal unemployment tax           | Pay full amount   | None  | None                                 | None  |
| State unemployment tax             | Pay full amount, except in certain states                         | None, except pay partial amount in certain states             | None                                 | None  |

# Why Does It Matter?

## Payroll Taxes, cont.

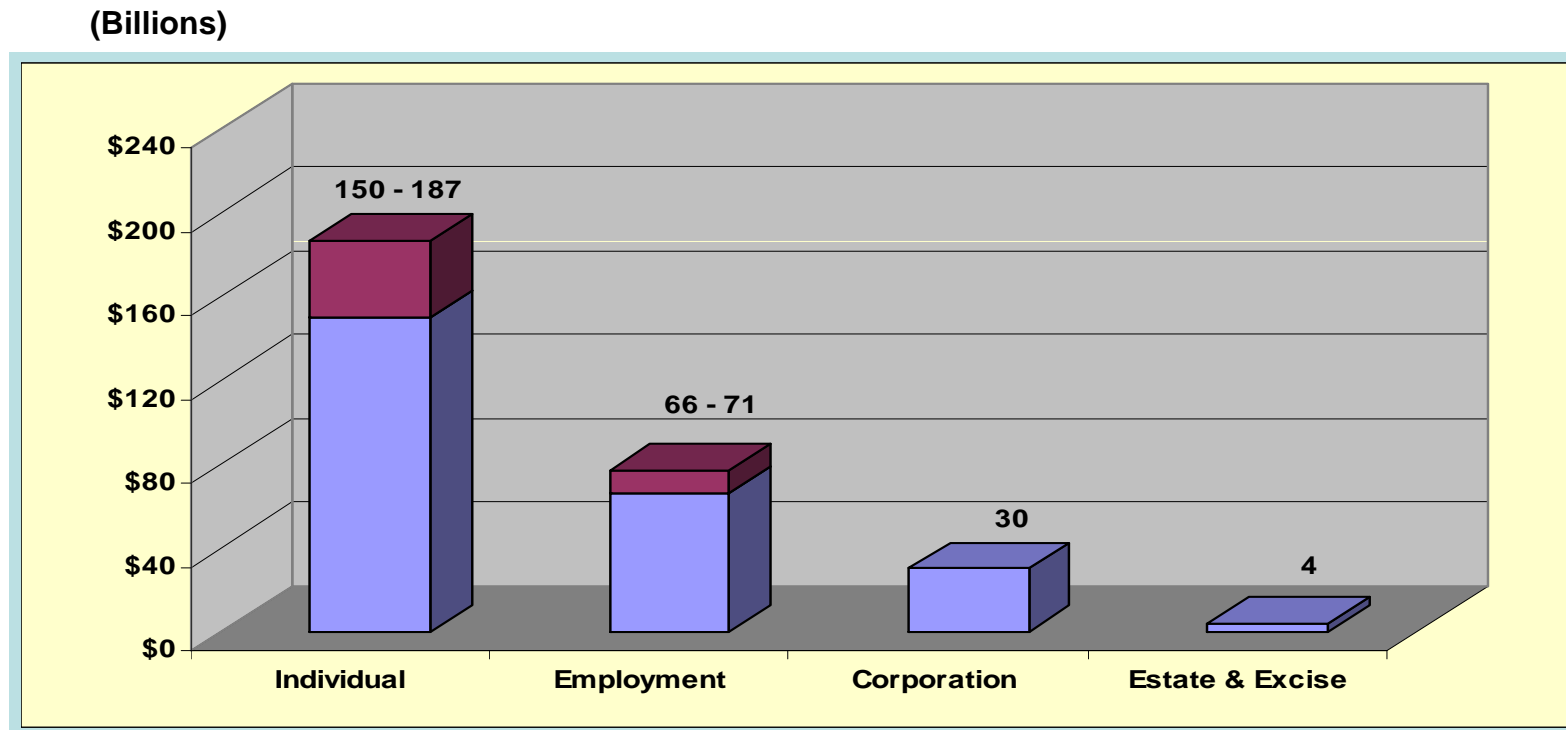
- Federal Income Tax Withholding (FITW)
- Federal Insurance Contributions Act (FICA)
  - Social Security (OASDI)
  - Medicare (HI)
- Federal Unemployment Tax Act (FUTA)
- Self-Employment Contributions Act (SECA)
- Railroad Retirement Tax Act (RRTA)

# Why Does It Matter?

## Payroll Taxes, cont.

- Full-rate statutory liability equal to at least 40% of the compensation payments to independent contractors
  - 25% FITW exposure
  - 15.3% Employer and Employee FICA (Social Security and Medicare)
  - Social Security Taxable Wage Base (\$106,800 for 2011)
- Example of “full rate” exposure: the annual “full rate” federal tax exposure for 60 misclassified independent contractors earning \$50,000 each is approximately \$1,250,000

# Why Does It Matter? Payroll Taxes and the Tax Gap



\$5 billion associated with FICA/FUTA

\$51 billion to \$56 billion associated with SECA

Other estimates place the annual "Employment Tax Gap" at \$15 billion (IRS, in introduction of NRP program), \$54 billion (Treasury study issued 9/26/06), or up to \$78 billion

# Why Does It Matter? Wage and Hour Risks

Misclassification of a worker as an independent contractor has many significant risks and significant potential exposure:

- Multimillion-dollar wage and hour and other employment claims, which carry civil and criminal penalties, liquidated or treble damages (e.g., in Massachusetts), and the right to recover attorneys' fees and costs (plaintiffs' lawyers are watching the developments in this area)
- Liability for federal and state payroll taxes subject to withholding from the "wages"
- Employer FICA and FUTA contributions
- State unemployment insurance payments
- Workers' compensation insurance premiums (and potential liability for workplace injuries)
- Immigration issues
- AG suits and DOL audits and enforcement actions
- Eligibility for benefits under existing employee benefit plans

# IRS Payroll Tax Audits: Tax Relief Provisions

Significant Statutory and Administrative Payroll Tax Relief Exists:

- Section 530 Relief
- Section 3509 Relief
- Classification Settlement Program Relief
- Voluntary Classification Settlement Program



# Voluntary Classification Settlement Program

- The Voluntary Classification Settlement Program (VCSP) seeks to encourage prospective worker reclassification
- VCSP is an alternative to the Classification Settlement Program, which only applies to taxpayers actually under audit
- The IRS will not conduct a payroll tax audit for workers covered by a VCSP agreement for prior years in exchange for:
  - a taxpayer's agreement to treat a class of workers as employees for future tax periods for payroll tax purposes, and
  - a payment of 10% of the Section 3509 rates

# Voluntary Classification Settlement Program, cont.

## **Important Characteristics**

- Is an optional program
- Limited to federal payroll taxes
- Requires prospective reclassification
- Pays 10% of the Section 3509 tax calculations
- No interest or penalties
- Must execute a closing agreement
- Must extend the statute of limitations
- Provides no relief to the worker
- Will not be audited for worker classification for prior years

# Voluntary Classification Settlement Program, cont.

## **Relevant Requirements**

- Must prospectively reclassify independent contractors as employees
- Must have consistently treated the workers as “nonemployees”
- Must have filed all required Forms 1099 for previous three years
- Must not currently be under any IRS audit (income tax, payroll tax, etc.)
- Must not currently be under any DOL or state agency audit addressing worker classification issues
- If previously under audit, must have complied with audit results

# IRS Payroll Tax Audits: Example of Tax Exposure and Tax Relief

- The annual “full rate” federal tax exposure for 60 misclassified independent contractors earning \$50,000 each is approximately \$1,250,000
- Relief provisions can reduce the \$4.8 million four-year liability:

| <b><u>Relief Provision</u></b> | <b><u>2010 Exposure*</u></b> | <b><u>Total Four-Year Exposure</u></b> |
|--------------------------------|------------------------------|--|
| Statutory relief               | 320,400                      | 1,281,600                              |
| 100% CSP Offer                 | 320,400                      | 320,400                                |
| 25% CSP Offer                  | 80,100                       | 80,100                                 |
| VCSP Offer                     | 32,000                       | 32,000                                 |
| Section 530 “Off-Code” Relief  | 0                            | 0                                      |

\*Calculations do not include FUTA, SUTA, and SITW liabilities

# IRS Information Sharing Programs

- Seek governmental partnerships
- Facilitate the exchange of taxpayer data by leveraging resources and identifying/reporting information on emerging tax administration issues
- The three components are:
  - Federal Information Sharing
  - State Information Sharing
  - Local Information Sharing

# Information Sharing Programs: Federal Intergovernmental Partnering Program

## **IRS Federal Intergovernmental Partnering Program (FIPP)**

- Seeks to strengthen existing relationships and develop new relationships with other federal agencies
- Increases collaboration and enhances tax administration by:
  - Complementing efforts to identify and address noncompliance
  - Leveraging outreach resources
  - Assisting other federal agencies in achieving their goals
- Has established a number of initiatives with other federal agencies providing information sharing programs, outreach programs, and data-matching activities

# Information Sharing Programs

## IRS-State Program: QETP Initiative

- Developed through efforts of the IRS and CA, MI, NJ, NY, and NC
- Centralized data exchange agreements used to leverage resources and encourage businesses to comply with federal and state employment tax requirements
- 37 states have entered into individual information sharing agreements with the IRS
- QETP is looking for “new opportunities for collaboration and to work toward improved employment tax”

# Information Sharing Programs

## IRS-State Program: QETP Initiative, cont.

- The IRS-state information sharing program facilitates and expands joint tax administration relationships between the IRS and state and local taxing authorities such as departments of revenue and state workforce agencies
- MOU allows the IRS and state workforce agencies to:
  - Exchange audit reports and audit plans
  - Exchange individual and business tax return information
  - Exchange employment tax information
  - Participate in side-by-side examinations



# Information Sharing Programs: IRS-State Program: QETP Initiative, cont.

- Results of QETP Initiative:
  - IRS Audits
  - State Audits
- Exposure to Businesses:
  - Financial Risk
  - Compliance Risk

# Information Sharing Programs: IRS-DOL Memorandum of Understanding

The IRS and DOL announced a joint initiative to improve worker classification compliance in order to:

- Reduce incidences of worker misclassification
- Reduce the tax gap
- Reduce fraudulent filings
- Reduce abusive employment tax schemes
- Create educational materials and issue guidance
- Improve compliance with federal laws
- Strengthen IRS and DOL relationships
- Leverage existing resources
- Send a consistent wage and payroll tax message

# Information Sharing Programs: IRS-DOL Memorandum of Understanding, cont.

## DOL duties under the Memorandum of Understanding:

- Refer to the IRS wage and hour investigation information “and other data” that the DOL believes raise employment tax misclassification compliance issues
- Share DOL wage and hour training materials “and opportunities” with the IRS
- Participate in joint outreach events with the IRS

# Information Sharing Programs: IRS-DOL Memorandum of Understanding, cont.

## IRS duties under the Memorandum of Understanding:

- Evaluate DOL employment tax referrals for the purpose of conducting employment tax examinations
- Share DOL employment tax referrals with state and municipal taxing agencies under existing sharing agreements
- Provide the DOL an annual report summarizing the results achieved using DOL referrals
- Share employment tax training materials “and opportunities” with the DOL
- Participate in joint outreach events
- Annually provide the DOL with aggregate data relating to trends in misclassification
- Provide the DOL with information (“other than taxpayer return information”) that may constitute evidence of a violation of criminal laws enforced by the DOL

# DOL Wage & Hour Division Partnership with State Labor Agencies

- Labor commissioners and other agency leaders representing seven states signed memorandums of understanding with the DOL's Wage & Hour Division (WHD) and, in some cases, its Employee Benefits Security Administration, Occupational Safety and Health Administration, Office of Federal Contract Compliance Programs and Office of the Solicitor
  - Coincided with the DOL/IRS partnership announced on September 19, 2011

# DOL Wage & Hour Division Partnership with State Labor Agencies, cont.

- Signatory states:
  - Connecticut, Maryland, Massachusetts, Minnesota, Missouri, Utah, and Washington
  - Agreements have also been announced for the WHD to enter memorandums of understanding with the state labor agencies of Hawaii, Illinois, and Montana as well as with New York's attorney general
  - Memorandums of Understanding arose as part of the DOL's Misclassification Initiative, which was launched under Vice President Biden's Middle Class Task Force with the goal of preventing, detecting, and remedying employee misclassification

# State Cooperation Snapshot: New York

- Cooperation between the DOL and New York had already begun before the partnership was announced in September 2011
  - In 2007, the state created a Joint Enforcement Task Force on Employee Misclassification (JETF).
- In 2010, the JETF identified more than 18,500 instances of misclassified employees and \$314 million in unreported wages, and assessed more than \$10.5 million in unemployment taxes, \$2 million in unpaid wages, and more than \$800,000 in workers' compensation fines and penalties

## State Cooperation Snapshot: New York, cont.

- The number of investigations rose exponentially after the DOL began assisting the JETF with its efforts under the information sharing agreement
- Of the 4,524 investigations conducted by the JETF since its creation in 2007, 2,111 were conducted in 2010 with the DOL's assistance



# The DOL's "Plan/Prevent/Protect" Strategy Requirements

- Requires employers and regulated entities to:
  - Create “plans” for identifying and remediating risks of violations and make the plans available to workers so they can participate in their creation, understand them, and monitor their implementation
  - Thoroughly and completely implement the plans in a manner that “prevents” legal violations
  - Ensure that the plans’ objectives are met on a regular basis so that they actually “protect” workers from violations of their workplace rights

# Proposed Regulation – Right to Know Under the Fair Labor Standards Act

- Not yet submitted to the public for comment
- Updates the recordkeeping regulations under the FLSA in order to enhance the disclosure to workers of their classifications
- Requires employers to perform a written analysis of a worker's status under the economic realities test before declaring that he or she is not an employee

# Proposed Regulation – Right to Know Under the Fair Labor Standards Act, cont.

- Analysis would have to be disclosed to the worker concerned and also kept on file
- Does not change criteria for classification but would require more disclosure
- Implications for attorney-client privilege

# Proposed Regulation – Right to Know Under the Fair Labor Standards Act, cont.

- Risk that even when the DOL does not investigate a claim, a private attorney could seek information compiled under the right-to-know regulations
- Potential for a negative presumption against employers that fail to perform required analyses

# Options to Address Misclassification

| Options  | Labor groups | Independent contractor groups | Other groups |
|--|--------------|-------------------------------|--------------|
| 1. Clarify the distinction between employees and independent contractors within federal law                |              | Support                       | Support      |
| 2. Allow workers to challenge determinations in Tax Court  | Support      | Oppose                        | Support      |
| 3. Ensure that workers have protection for filing a Form SS-8  | Support      | Support                       | Support      |
| 4. Determine misclassification as a violation under FLSA   | Support      | Oppose                        |              |
| 5. Narrow the definition of “a long-standing recognized practice of a significant segment of the industry” |              | Oppose                        | Support      |
| 6. Lift the ban on IRS clarifying employment status  |              | Support                       | Support      |
| 7. Require service recipients to give workers documents that explain classification                        | Support      | Support                       |              |
| 8. Expand IRS outreach   |              | Support                       | Support      |

# Options to Address Misclassification, cont.

| Options  | Labor groups | Independent contractor groups | Other groups |
|--|--------------|-------------------------------|--------------|
| 9. Create an online classification system  |              | Oppose                        | Support      |
| 10. Increase the use of IRS notices  | Support      | Support                       | Support      |
| 11. Require service recipients to withhold taxes for certain independent contractors | Neutral      | Oppose                        | Support      |
| 12. Require universal tax withholding for payments made to independent contractors   |              | Oppose                        | Support      |
| 13. Require service recipients to withhold taxes at independent contractor request   |              | Neutral                       | Support      |
| 14. Measure the extent of misclassification at the national level                    | Support      | Neutral                       |              |

# Options to Address Misclassification, cont.

| Options   | Labor groups | Independent contractor groups | Other groups |
|---|--------------|-------------------------------|--------------|
| 15. Require each independent contractor to apply for a separate business TIN                  |              | Support                       |              |
| 16. Expand IRS' CSP   |              | Support                       |              |
| 17. Require service recipients to submit Form SS-8 for newly retained independent contractors |              | Oppose                        | Support      |
| 18. Enhance coordination between IRS, DOL, and other federal agencies                         | Support      | Neutral                       |              |
| 19. Enhance coordination between IRS, states, and selected local governments                  | Support      | Neutral                       |              |

# Benefits and Drawbacks to the Options

## Types of Benefits and Drawbacks—Stakeholders Identified Across the 19 Options

| Examples of types of benefits identified   | Examples of types of drawbacks identified  |
|--|--|
| <ul style="list-style-type: none"><li>• Improved tax compliance</li></ul>                    | <ul style="list-style-type: none"><li>• Higher financial costs/burdens for businesses</li></ul>        |
| <ul style="list-style-type: none"><li>• Greater equity/justice for workers</li></ul>         | <ul style="list-style-type: none"><li>• Inequities among those using independent contractors</li></ul> |
| <ul style="list-style-type: none"><li>• More consistency/uniformity in classifying</li></ul> | <ul style="list-style-type: none"><li>• Economic disruption/upheaval</li></ul>                         |
| <ul style="list-style-type: none"><li>• More education/understanding</li></ul>               | <ul style="list-style-type: none"><li>• More litigation</li></ul>                                      |
| <ul style="list-style-type: none"><li>• More worker protection</li></ul>                     | <ul style="list-style-type: none"><li>• Less freedom of choice</li></ul>                               |
| <ul style="list-style-type: none"><li>• Less misclassification</li></ul>                     | <ul style="list-style-type: none"><li>• Deters use of independent contractors</li></ul>                |
| <ul style="list-style-type: none"><li>• Less manipulation of classification rules</li></ul>  | <ul style="list-style-type: none"><li>• More manipulation of classification rules</li></ul>            |



# What Are Some Steps We Can Take to Minimize Our Risks and Exposure?

- Do not rely solely on the common law test
- Conduct compliance reviews
- Conduct training
- Audit positions to ensure you know what work contractors are performing
- Do not have independent contractors without contracts
- Review your contracts with independent contractors
- Review the nature and extent of relationships with temporary staff

# What Are Some Steps We Can Take to Minimize Our Risks and Exposure? cont.

- Review agreements/indemnification from vendors using independent contractors
- Prepare/revise contracts, policies, and practices for the company or between the company and its vendors
- Obtain advice on reclassification if necessary
- Review immigration issues relating to workers and state and federal inquiries
- Review your benefits policies to ensure that anyone designated as an independent contractor is excluded



# Questions?

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