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Employers Need to Know
Employment Law Alerts from Ober|Kaler's Employment Group

Independent Contractor or Employee? State and Federal Agencies are Asking - Is Your Answer Correct?

You own and operate a commercial flooring supply company. You have always hired subcontractors to install any flooring sold. These installers supply their own tools, trucks and carry their own business cards. Most have a crew and work for other flooring supply companies. For each installation job, you instruct the installers where to install the flooring, generally when to arrive and afterwards, check the work for consistency with the order. You have always considered the installers to be independent contractors. However, you just received an audit notice letter from a state agency seeking to confirm this classification.

This letter will not be the last. As described below, state and federal agencies are going out of their way to reclassify independent contractors as employees and levying fines, penalties, and interest in their wake. The federal and state governments' reasoning is as follows:

- When an employer fails to properly classify workers as "employees," the employer avoids paying their share of payroll taxes; unemployment insurance taxes; and workers' compensation premiums.
- It puts competitors at a disadvantage because they have to cover the unpaid costs of those who cheat.
- It deprives the general fund and the Unemployment Insurance Trust Fund of critical revenues.

- It denies workers access to protections only guaranteed to employees.
- Government is broke and it needs increased cash flow and greater revenue. It is easier and more inexpensive for government to mandate private sector businesses to collect and to remit taxes to it than for government to "chase" individuals to pay "their fair share of taxes."

If Your Business Utilizes Independent Contractors, Expect to Be Audited

State and federal agencies are working together to stop misclassification of employees as independent contractors. For example, the Maryland legislature enacted the Workplace Fraud Act of 2009 to focus on landscape and construction employer compliance. The Act also imposes notice and record retention requirements on these employers. And when a Workplace Fraud audit is initiated, many times, the Comptroller and the Unemployment Division will also complete parallel audits. This is because in 2009 Maryland's governor also established the Joint Enforcement Task Force on Workplace Fraud to coordinate investigation and enforcement of misclassification by any employer. The members of this Task Force include:

- The Secretary of Labor, Licensing and Regulation;
- The Attorney General;
- The Comptroller;
- The Chair of the Workers' Compensation Commission;
- The Insurance Commissioner;
- The Commissioner of Labor and Industry; and
- The Assistance Secretary for the Division of Unemployment Insurance.

At the federal level coordination is likewise increasing. On September 19, 2011, the Department of Labor (DOL) agreed with the Internal Revenue Service (IRS) to share information with each other and many state agencies in a coordinated attempt to enforce correct classification. The agencies hope broad compliance will reduce the tax gap between law-abiding employers and those in violation. Also, compliance increases tax revenue for state unemployment trust funds, as well as, unemployment compensation and workers' compensation protection for re-classified individuals. Currently, signatory states include Connecticut, Maryland, Massachusetts, Minnesota, Missouri, Utah, and Washington. Additionally, the DOL's Wage and Hour Division reached agreements with state agencies in Hawaii, Illinois, Montana, and New York.

Accordingly, employers must err on the side of caution in the face of these multi-agency initiatives when classifying individuals as independent contractors. However, in many cases it is difficult to determine correct classification.

What is the current law?

Laws governing the status of a worker have been held to "encourage ambiguity" – indicative of the case-by-case inquiries necessary to make this determination. Nonetheless, nearly all tests focus heavily on the employer's "right to control the way in which the work involved is done."

State Law

In Maryland, a worker's status as an employee or independent contractor is governed by the "ABC Test." The ABC Test is utilized by the Department of Labor, Licensing and Regulation (DLLR) in response to instances of "workplace fraud" and also unemployment insurance compensation.

Under the ABC Test, the state government presumes that an employee-employer relationship exists unless an employer can prove that the employee is exempt or that the worker qualifies as an independent contractor. To qualify a worker as an independent contractor, the employer must first establish that the worker is "free from control and direction." Second, the worker must be "engaged in an independent business or occupation of the same nature as that involved in the work." Finally, the work must be "outside of the usual course of business of the employer or performed outside of any place of business" of the employer. This test, like the majority of "employee vs. independent contractor" standards, places heavy emphasis on the employer's right to control how work is performed, though no one factor is determinative. Interestingly, most cases describing compliance, relied on by DLLR, are decades old. This test has not readily been challenged by employers. However, now, with increasing costs associated with forced compliance, challenges may be more economical for employers.

Similarly, in Illinois — another state aiming to reduce the misclassification of employees as independent contractors — "an individual performing services for a contractor is presumed to be an employee unless (1) the individual is free from control or direction over the performance of the service for the contractor; (2) the service performed is outside the usual course of services performed by the contractor and (3) the individual is engaged in an independently established trade, occupation, profession or business."

New York — another state committed to the DOL and IRS initiative — does not have an "absolute rule for determining whether one is an independent contractor." In lieu of an "absolute rule," New York emphasizes the employer's right to control how work is completed; including factors such as, but not limited to, how services

are performed, whether or not facilities and equipment are provided by the employer, and whether or not the employer sets the worker's pay and hours.

Federal Law

DOL follows the "economic realities test" to assess the employee-employer relationship under the Federal Labor Standards Act. Similar to previously discussed state law, the test focuses on the specific facts to determine a worker's status. In particular, the DOL test assesses degrees of control by an employer, the employee's opportunities for profit and loss, investment in facilities by the employer, permanency of the relationship between the employer and the worker, and the skill needed by the worker. Even with these factors guiding a determination, however, a worker's status is dependent upon the circumstances of the entire relationship.

The IRS also emphasizes the control held by the employer over a worker. Specifically, whether the employer controls the worker's behavior, how the employer controls the finances of the work being performed, and the type of relationship between the parties. Analyzing behavioral control, the IRS specifically looks at the instructions given to a worker, as well as whether or not training was provided. According to the IRS, extensive instructions and specific training are factors indicative of employee status. Assessing financial control, the IRS looks to the employee's investment in their work, their opportunity for profit or loss, and whether or not expenses are reimbursed. For example, workers who invest in their work, provide for their own business expenses, and incur profits or losses from their work are more likely to be classified as independent contractors. Finally, analyzing the relationship between the parties, the IRS looks to benefits provided to the worker, as well as the language used in any written contracts. Providing benefits suggests a worker's status as an employee and written contracts may provide intent of the parties.

So what? — The law hasn't changed . . . Why worry?

The agreement between the DOL and the IRS does not change the laws governing a worker's status as an employee or an independent contractor, but it does suggest a trend in enforcing compliance. Specifically, the agreement sets forth an initiative to "leverage existing resources [of the DOL and IRS] and send a consistent message to employers about their duties to properly pay their employees and to pay employment taxes" through coordinated national outreach activities. (emphasis added). DOL and IRS will now share materials (e.g. DOL Wage and Hour Division training materials, as well as annual tax reports and aggregate data relating to trends in misclassification from the IRS). In the past several months the IRS has hired over 10,000 auditors to review employers classifying workers as independent contractors instead of employees. And participating states will also trade information with these agencies; complementing already existing standards in which

some state agencies, as in Maryland, team-up with each other and/or the federal government to crack down on employee misclassification.

My state isn't a signatory state – am I "in the clear?"

No. The agreement between the DOL and the IRS is an initiative of the federal government. All employers are subject to the heightened law enforcement of these agencies. Additionally, employers may not be "in the clear" under state law even if their particular state did not sign the agreement. Currently, 11 states have entered into agreements with federal agencies. As the movement to end the misclassification of employees gains support, this number is certain to grow. Even in states that have not announced objectives to increase compliance, residual effects of the government initiative may still influence that state's police efforts.

I'm worried. What should I do?

Though each test assesses the employer's "right to control," a set number of factors, or a specific set of factors, are not needed to qualify a worker as an employee or an independent contractor. Rather, under every individual test, employee-employer relationships are assessed holistically. Thus, factors applicable to one situation may not matter in the next.

For protection in this increasingly policed employment community, employers should educate themselves on the significant factors viewed under law applicable in their jurisdiction. Ultimately, employers must err on the side of caution when attempting to classify a worker as an independent contractor. Just as the government has increased compliance efforts, employers must follow suit: making the necessary changes to ensure they are complying.

The IRS is also offering a Voluntary Classification Settlement Program for those employers who believe they are not in compliance and that penalties are inevitable. Eligible employers can agree to voluntarily classify all or groups of staff as employees going forward. The employer will have to pay a penalty. But, the penalty is only 10% of the employment taxes that would have been due if the employees were correctly classified in the past year. No additional penalties or interest will be incurred. However, employers currently under a federal audit are not eligible. Employers can apply to the program on the IRS website.

For assistance in making sure your business is correctly classifying its independent contractors, please contact Jerald Oppel of the Employment Group at Ober|Kaler.

For more information on this Act and how it applies to your business please contact your Ober|Kaler Employment and Labor attorney (www.ober.com/practices/employment-attorneys).

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