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ALERT

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Senate Bill Proposes to End Misclassification of Independent Contractors

By M. Christine Carty

The Senate Health, Education, Labor and Pension Committee is currently considering legislation introduced on April 8, 2011 intended to end misclassification of employees as independent contractors. Senate Bill 770 (S.770), known as the "Payroll Fraud Prevention Act" ("PFPA"), would amend and expand the Fair Labor Standards Act ("FLSA") to include "non-employees" within the ambit of the FLSA minimum wage, hours and overtime protections. On its face, the PFPA is straightforward legislation, but the implications of some of its provisions are far-reaching and its activist approach conflicts with existing protections for companies that include independent contractors within their workforces.

The direct effect of S. 770, if enacted, will be to (i) require all employers to provide written notice to all employees and "non-employees" (i.e. independent contractors) of their status[1] and refer the recipients to the U.S. Department of Labor ("DOL") website for information about their rights, (ii) impose penalties of up to $5,000 for each misclassification, (iii) increase audits of companies in targeted industries, and (iv) increase referrals of perceived violations to the Wage and Hour Division from other divisions within the DOL. The proposed language of the mandatory notice is very specific: "Your rights to wage, hour and other labor protections depend upon your proper classification as an employee or non-employee. If you have any questions or concerns about how you have been classified or suspect that you have been misclassified, contact the Department of Labor." The PFPA also would require the DOL to set up a web page within six months that explains workers' rights regarding classification. Finally, S. 770 establishes a private right of action for workers to enforce the provisions of the PFPA.

While these provisions are straightforward, other provisions of this legislation have less obvious and potentially more far-reaching effects. S. 770 directs that if an employer does not provide the required notice to a "covered individual" (i.e. independent contractor), there is a presumption that the individual is an employee, which can be rebutted only by "clear and convincing" evidence that the person is not an employee. This clear and convincing standard is much higher than the preponderance of the evidence standard (generally understood to be "more likely than not") required to prove most civil suits. Further, if reclassified, a worker will be entitled to other FLSA protections, including a review of his or her wages for up to three years for compliance with minimum wage, hours and overtime requirements. If it is found that a company failed to comply with any of the minimum wage, hours or overtime requirements in compensating a reclassified worker during the three year period reviewed, the S. 770 prescribes that the employer must pay a "special penalty" in the amount of four times the actual unpaid minimum wages or overtime compensation. Of course, it is unusual for a company to pay overtime to an independent contractor, making the risk of exposure to a substantial penalty greater for entities that rely heavily on independent contractor relationships. Thus, potentially, a mistaken failure to provide an independent contractor with the statutory notice of rights could result in the worker's reclassification as an employee by presumption followed by a significant financial penalty for each reclassified worker. The "special penalties" could easily become significant if the employer failed to give notice to a group of workers.

Further, the PFPA would amend the Social Security Act to require each state as a condition of receiving Federal Unemployment Tax Act ("FUTA") monies to support the state unemployment fund to establish "administrative penalties for misclassifying employees… for unemployment compensation purposes." The DOL also would be required to include in its audits of states' unemployment programs, "a specific measure of their effectiveness in identifying the under-reporting of wages and the underpayment of unemployment compensation contributions." The natural consequence of these provisions, if enacted, will be to increase pressure on the states to investigate and find that workers

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1. The U.S. Department of Labor has announced plans to propose a rule in the near future to require employees to notify all workers classified as independent contractors or exempt employees of their classification and the basis for that classification.

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have been misclassified as independent contractors, whether by application of existing standards or new ones, and to impose penalties for misclassification. Currently, if workers are reclassified as employees in New York by the New York State Department of Taxation and Finance, employers are assessed an amount equal to the missed contributions to the Unemployment Insurance Fund for a period of up to six years, plus interest and a statutory penalty for failure to make the payments timely. However, there is no administrative penalty in New York specific to misclassification *per se*. If the PFPA is enacted, in addition to increased operational costs for FLSA compliance, employers should expect an increase of worker, federal and state challenges to non-employee classification.

The PFPA's goals stand in stark contrast to the mandate of Congress in enacting the "safe harbor" provision of Section 530 of the Revenue Act of 1978 ("Section 530"), federal legislation directly addressing the classification of certain workers. While the PFPA encourages aggressive agency intervention through federal and state audits to reclassify workers as employees, even by presumption, by contrast, Section 530 affirmatively limits the authority of the Internal Revenue Service ("IRS") to audit and reclassify workers as employees by providing a "safe harbor" for categories of workers historically classified as independent contractors. The Section 530 "safe harbor" protects companies that have consistently and reasonably treated workers as independent contractors from reclassification audits and from federal income tax withholding, FICA and FUTA levies.[2]

The 1996 amendments to Section 530 prohibit the IRS from promulgating any regulations or revenue rulings "with respect to the employment status of any individual for purposes of the employment taxes," including the "safe harbor," and also require the IRS to first determine if a company is entitled to the Section 530 "safe harbor" treatment before beginning a classification audit. The amendments were enacted by Congress to reverse the IRS's prior narrow construction of Section 530 as an exception to a misclassification determination. Before the 1996 amendments, the IRS would first conduct an audit and determine if the workers were correctly classified as independent contractors, and, after a finding of misclassification, the IRS would allow the company to petition to have the misclassified workers included in the "safe harbor" under Section 530. Such companies typically faced an IRS assessment of back taxes, with steadily accruing interest and penalties if they did not change the classification of the workers while the IRS considered the petition for Section 530 treatment — a risky proposition. Obviously, the IRS approach also was time-consuming and expensive for companies and, created uncertainty for an extended period of time about classification. Congress banned the IRS approach by the 1996 amendments.

Congress's affirmative protection of the "safe harbor" to prevent reclassification of independent contractors in 1996 contrasts sharply with the express intention to encourage reclassification now found in S. 770 fifteen years later. The PFPA would provide (i) financial incentives to workers and the DOL to seek reclassification in the quadruple "special penalties" available to them, (ii) financial incentives to the states to impose "administrative penalties" for misclassification and increased classification audits for unemployment purposes in the threat of a cut-off of FUTA funding by the DOL, and (iii) mandates to the DOL to conduct "targeted" classification audits and referrals to its Wage and Hour Division of information suggesting misclassification.

To be sure, the PFPA and the Section 530 "safe harbor" concern two different types of federal requirements for employers that do not overlap. The PFPA would affect the FLSA minimum wage, hours and overtime requirements. The Section 530 "safe harbor" affects federal employment taxes. Thus, the two could co-exist side-by-side, albeit uneasily. That is, were the PFPA enacted, a company in an industry that has historically categorized a worker group as independent contractors could find itself in the incongruous position of having a class of workers deemed employees for FLSA (minimum wage, hours and overtime) and state unemployment purposes, but as independent contractors under the Section 530 "safe harbor" for federal income tax, FICA and FUTA. Such a company would be reporting and paying into its state unemployment fund and paying FLSA minimum wages and overtime for a class of workers, but not remitting federal employment taxes. At a minimum, the complexity of compliance would inevita-

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2. Ironically, companies covered by the Section 530 "safe harbor" are likely to be in the very industries targeted for audit by the DOL under the PFPA, as Section 530 protection is only available to companies in those industries that historically classify certain categories of workers as independent contractors. S. 770 requires that "[t]he audits of employers subject to the [FLSA] that are conducted by the [DOL] shall include certain industries with frequent incidence of misclassifying employees as non-employees, as determined by the Secretary of Labor."

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bly increase the costs of administration for such companies and, very likely, would result in numerous errors and consequent fines and penalties.

The PFPA is one more in a line of efforts to reclassify independent contractors as employees, following last year's unsuccessful efforts to enact the "Employee Misclassification Prevention Act." It has been reported that the budget compromise reached by the President and the Congress on April 18, 2011 funds no less than $21.3 million to the Secretary of Labor to continue "initiatives related to the identification and prevention of worker misclassification." We do not expect to see a slowdown in reclassification efforts at the state level, either, given the high unemployment rates, the strain on the unemployment insurance funds of the states and the budget shortfalls that many states are experiencing. We will continue to monitor and report on new initiatives regarding worker classification. ◆

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