



Minimizing the Risks of Independent Contractor Misclassification

By Laura L. Edwards

Federal and state legislators and government agencies are increasingly cracking down on misclassifications of employees as independent contractors. Misclassification may be on the rise because employers must generally withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment and workers' compensation premiums based on wages paid to an employee. Employers generally do not have to withhold or pay any taxes on payments to independent contractors, making independent contractors an attractive option in challenging economic times.

Employee or Independent Contractor?

There is good cause for confusion. Currently, different federal agencies apply very different tests to determine who is an employee versus an independent contractor. For example, the IRS applies a twenty-factor test, and the Department of Labor ("DOL") applies a seven-factor test. To further "muddy the waters," state laws apply further different tests employers must comply with in addition to federal regulations. This jumble of tests makes it possible for a worker to be classified as an independent contractor under one law, but as an employee under another. In order to make a determination, an employer should examine the specific tests used under the federal and state laws that apply to them. However, generally applicable factors include: whether the worker is licensed as an independent business; the location where the worker performs the work; whether the worker uses his or her own tools; whether the employer sets the worker's hours; whether the employer has the right to control the manner in which the worker achieves the end result; and whether the worker is paid by time or assignment.

Federal Legislation and Regulation

The U.S. House of Representatives and Senate recently introduced the Employee Misclassification Prevention Act ("EMPA")(H.R. 5107 and S. 3254), aiming to end the misclassification of employees as independent contractors. Upon its likely enactment later this year, EMPA would amend the Fair Labor Standards Act and impose additional compliance and record-keeping requirements on employers to rein in the misclassification of employees. Under EMPA, employers must provide written notice to each individual hired of her/his classification as an employee or independent contractor. Employers that do not comply with the notice and record-keeping requirements or that misclassify employees are subject to civil penalties of up to \$5,000. Willful misclassification of employees may result in triple damages.

Federal agencies are already mobilized to participate in this heightened attack on misclassification. DOL recently spent millions to hire new Wage and Hour Division investigators to assist in regulating employee misclassification. In late 2009, the IRS launched a nationwide tax audit program focused on identifying employers that misclassify workers and improperly fail to withhold taxes and pay Social Security and Medicare premiums on their wages.

State Legislation

EMPA additionally requires all states to correct employee misclassification through enforcement programs such as auditing. Even without EMPA, state agencies have become increasingly aggressive in addressing employee misclassification in recent years. Many states have passed laws to enforce proper employee classification by imposing sanctions, including per-day penalties for each employee that has been misclassified.

Some states have created task forces responsible for enforcing state labor laws. Washington State's Employment Security Department ("ESD") has taken a particularly aggressive stance, describing itself as "a fraud-fighting machine" in a February 2010 press release addressing misclassification, titled "Cheaters, beware! The Employment Security Department is on your tail." ESD enforces Washington's independent contractor exemption laws, RCW 50.04.140 and 50.04.145, and assesses back taxes, penalties, and interest to employers in violation.

The Threat of Class Actions

In addition to seeking past benefits and overtime wages on their own behalf, workers who believe they have been improperly classified may bring a class action. For example, *Vizcaino v. Microsoft Corp.* involved workers classified as independent contractors who had tenures as long as many permanent employees but did not receive the same benefits. 97 F.3d 1187 (9th Cir. 1996); 120 F.3d 1006 (9th Cir. 1997). These "permatemps" objected to being shut out of a benefits program allowing permanent employees to buy Microsoft stock at a discount. The Ninth Circuit Court of Appeals held that the workers were employees who could not be excluded from participation in the program, in part because they worked on site, shared the same supervisors, performed the same functions, and worked the same core hours as regular employees. In another case, *Anfinson v. FedEx Ground Package Sys.*, more than 320 contract FedEx drivers alleging they were actually employees sued for overtime and reimbursement for uniforms. 2009 WL 2868681 (Wash. Super. Ct. April 20, 2009). A Washington jury determined that because the FedEx drivers could operate multiple routes, hire extra drivers, and sell their routes without company permission, they were properly labeled independent contractors. Regardless of the outcome, class action litigation is an expensive and time-consuming distraction that is never really a win for employers.

Advice for Employers

Misclassification can thus generate costly consequences, ranging from paying penalties to facing a class action lawsuit for unpaid benefits and overtime. Given increased enforcement of proper worker classification at both state and federal levels, employers would be well advised to analyze their relationships with each person that provides services to the organization. A person is not an independent contractor simply because the parties agree to that classification. Whether a person is an employee or an independent contractor depends on the nature of relationship between the parties, the amount of control imposed by the employer, the permanency of the relationship, and a number of other factors depending on the jurisdiction.

One way to minimize the risk of misclassifying workers is to restructure the employer's relationship with its independent contractors. Employers may need to adjust their level of control over the manner and means by which independent contractors accomplish their work. This could include, for example, allowing independent contractors to work from home, set their own schedules, or work for other entities. It is also important for an independent contractor's agreement to accurately state the nature of the relationship between the parties and make clear that the legal parameters for independent contractor status are satisfied. Employers wanting to review or restructure their relationships with independent contractors may wish to consult legal counsel.

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