

**AMERICAN BENEFITS COUNCIL  
TELECONFERENCE REGARDING WORKER  
CLASSIFICATION**

*Allan Bloom  
Eric Keller  
Brigen Winters*

# Overview

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- ▶ Introduction
  - ▶ Tests for Determining Worker Status
  - ▶ Misclassification Consequences and Mitigation Strategies
  - ▶ Obtaining Contingent Workers from Staffing Agencies
  - ▶ Defending Contingent Worker Claims
  - ▶ Legislative Proposals
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# *Introduction*

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- ▶ How and Why Employers Use Contingent Workers
- ▶ How Misclassification Issues Arise

# *How and Why Employers Use Contingent Workers*

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- ▶ Contingent worker = a worker treated as something other than the employer's own full-time common law employee
  - ▶ Contingent Worker Models
    - Part-time, temporary, seasonal and “on call” employees
    - Independent contractors
    - Employees retained through an agency (e.g., temp or staffing agencies, PEOs)
      - Latter two create potential worker misclassification issues.
  - ▶ Contingent workers are utilized by companies for many reasons including
    - More flexibility
    - Often cheaper source of labor
    - Helps employers compete in the global marketplace
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# *How Potential Misclassification Issues Arise*

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- ▶ Claims by workers
- ▶ Government agency audits
- ▶ Audits by outside auditor
- ▶ Due diligence in commercial transactions

# *Judicial and Regulatory Tests* PaulHastings

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- ▶ No one common set of factors used to determine whether someone is an independent contractor or an employee.
  - ▶ Courts and agencies looking at whether someone is properly classified as a contractor focus on the totality of the circumstances.
  - ▶ Generally speaking, employers may classify workers as independent contractors only where the company relinquishes the right to control the manner and means by which the worker achieves his or her work objectives.
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# Control Governs

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- ▶ Common misperception: the existence of a written agreement governs whether someone is or is not a contractor
    - Not true
  - ▶ The focus is on control
  - ▶ Who controls the manner and means by which the worker accomplishes his or her assigned tasks?
  - ▶ CHIEF QUESTION: Does the worker control his or her own work, like an independent business person, or is he/she controlled by an employer, like an employee?
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# *Factors Suggesting a Contractor*

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*Paul Hastings*

- ▶ A court or agency is more likely to find that a worker is an independent contractor where the worker:
    - Sets his or her own work schedule
    - Is permitted to turn down work
    - Is permitted to work simultaneously for the company and its competitors
    - Is responsible for carrying his or her own workers' compensation, disability, and unemployment insurance
    - Pays his or her own employment taxes (no withholding)
    - Pays his or her own business and travel expenses
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# *Factors Suggesting a Contractor*

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*Paul Hastings*

- ▶ A court or agency is more likely to find that a worker is an independent contractor where the worker:
    - Furnishes the tools and materials needed to do the work
    - Hires and pays his or her own assistants
    - Is not required to comply with the company's rules, practices, or procedures in performing their duties
    - Is not covered by the company's employee benefit plans
    - Is not regularly supervised by a representative of the company
    - Is not regularly required to attend company meetings, conferences, or trainings
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# Factors Suggesting a Contractor

Paul Hastings

- ▶ In determining whether a worker is acting for another in the capacity of servant or employee on the one hand, or as an independent contractor on the other, the following factors are considered:
  - The extent of **control** which, by the agreement, the company may exercise over the details of the work;
  - Whether or not the worker is engaged in a distinct occupation or business;
  - The kind of occupation (including whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision);
  - The skill required in the particular occupation;
  - Whether the employer or the worker supplies the instrumentalities, tools, and a place of work for the worker;
  - The length of time for which the worker is engaged;
  - The method of payment, whether by the time or by the job;
  - Whether or not the work is a part of the regular business of the employer;
  - Whether or not the parties believe they are creating the relation of master and servant; and
  - Whether the worker is or is not in business.

# *Joint Employment/ Co-Employment “Killers”*

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- ▶ Degree of supervision
  - ▶ Length of service
  - ▶ Integral nature of work
  - ▶ Work common to contingent workers and employees
  - ▶ Badges/emails/desks/perquisites/other indicia
  - ▶ Manager involvement in vendor-contingent worker relationship (including with respect to pay)
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# *General Labor and Employment Law*

## *Consequences of Misclassification*

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- ▶ Wage and Hour Risks
    - Minimum Wage
    - Overtime
    - Penalties/Liquidated Damages
  - ▶ Equal Employment Opportunity/Discrimination Claims
  - ▶ Workers' Compensation/Unemployment/Short-Term Disability
  - ▶ Broader Audit by Government Agency
  - ▶ Immigration Law Risks
    - Failure to verify employment verification
    - Unauthorized employment for foreign nationals
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## *Mitigation of Risks*

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- ▶ Conduct early status assessments
  - You should know the moment someone begins their relationship with you whether they are an employee or a contractor.
  - If you're going to make the argument that the person is a contractor, you should start taking proactive steps to protect that classification.

## *Mitigation of Risks*

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- ▶ Conduct *privileged* self-audits
    - Where and how are you using contractors?
    - How do the risk factors look?
  - ▶ Conduct *privileged* audits of vendors
    - Are they properly classifying the contingent workers they supply?
    - Are they even employing them?
    - Are they paying overtime?
    - At what rate?
    - Are they disclosing the nature of their relationships with contingent workers to you?
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## *Mitigation of Risks*

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- ▶ Have written agreements with independent contractors/contingent workers
    - Those contracts should always have certain language and provisions in them to reinforce independent contractor status.
    - It's best to avoid words that suggest an employment relationship.
  
  - ▶ Written agreements with vendors that supply contingent workers should contain provisions regarding:
    - Indemnification
    - No subcontracting
    - Insurance coverage
    - Right to inspect/audit
    - Promise to properly classify and pay
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## Controls and Best Practices

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- ▶ Hold your independent contractor at arm's length
  - Ensure that your managers who interact with independent contractors focus on work *results*, rather than work methods.
  - One helpful way of looking at it is that a company should deal with an independent contractor as it would any other supplier with which it has a business relationship.
  - The contractor should decide how many hours to work and set his or her own starting and quitting times.
  - Do not integrate the contractor into your operations.
  - Contractors should neither report to your managers nor supervise your employees.



## *Controls and Best Practices*

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- ▶ Contractors shouldn't be subject to employee performance review standards.
  - ▶ The contractor should be treated as a guest, rather than as an employee, for such purposes as use of parking spaces, issuance of security badges, use of office facilities, etc.
  - ▶ It's best not to provide contractors with the "perqs" that employees enjoy
  - ▶ The contractor should be responsible for deciding on the tools and instruments by which the work is done.
  - ▶ The contractor should provide and maintain such equipment at his or her own cost.
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## *Controls and Best Practices*

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- ▶ If the contractor needs other individuals to help with a project, he or she should hire these other individuals or engage them as subcontractors, at his or her own expense.
  - ▶ The contractor should be responsible for providing his or her own insurance, retirement benefits, workers comp, disability, unemployment, etc.
  - ▶ Contractors should not receive benefits typically given to employees such as vacation days and paid sick days.
  - ▶ Avoid long-term relationships with contractors.
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# *Benefits Consequences*

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- ▶ ERISA claims
- ▶ Benefit plan participation
- ▶ Tax-qualification rules
- ▶ Employer risk mitigation

# Claims for Benefits under ERISA

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- ▶ Classification of worker as employee important for purposes of eligibility to participate in employee benefit plans and for ERISA claims purposes
  - ▶ Only participants have standing to bring ERISA claim for benefits
  - ▶ Participant broadly defined as employee or former employee who may become eligible to receive a benefit
  - ▶ Supreme Court in Darden adopted common law test for determining employee status under ERISA
  - ▶ Common law employee status does not mean individual automatically entitled to benefits
  - ▶ *Vizcaino v. Microsoft* – most widely-noted reclassification, class action benefit claim case
    - 401(k) plan
    - Employee stock purchase plan
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# Other Possible ERISA Claims *PaulHastings*

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## ▶ Fiduciary claims

- *E.g., Herman v. Time Warner*
- DOL lawsuit claims fiduciary breach in failing to properly identify plan participants

## ▶ ERISA section 510 claims

- Prohibits any person from interfering with any right to which participant is or may be entitled under plan

# *Benefit Plan Participation*

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- ▶ Even if worker deemed an employee under common law test, may not be entitled to benefits
  - ▶ Plan terms generally govern eligibility
    - Plan terms may properly condition eligibility/exclude class of workers
    - Subject to ERISA limitations on minimum age or service requirements
  - ▶ Most courts defer to and follow plan terms, including reasonable interpretation
  - ▶ *E.g., Wolf v. Coca Cola* – plan includes regular employees and excludes leased and temporary employees
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# *Tax-Qualification Rules*

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- ▶ Federal tax law incentives to encourage employer sponsorship of retirement plans
  - ▶ Series of "qualification" requirements to get tax benefits, including ones to encourage coverage of rank-and-file employees
  - ▶ Exclusive benefit rule
    - Exclusive benefit of employees
    - Employer's plan generally not permitted to cover independent contractors or workers of another organization
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# *Tax-Qualification Rules*

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- ▶ Minimum coverage rules
  - Ratio test or average benefit percentage
  - Employees include common law employees and “leased employees” (defined in Code section 414(n) as not employees of service recipient)
- ▶ Other tax-preferred employee benefits also limited to employees and/or subject to similar IRS minimum coverage requirements



# *Risks of Worker Misclassification on Qualified Status*

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- ▶ Failure to satisfy minimum coverage rule taking into account all common law employees and leased employees
  - ▶ Plan not covering worker who is eligible under terms of plan (e.g., one classified as independent contractor but reclassified as employee as legal matter)
  - ▶ Plan covering worker whom employer classifies as employee, but who is reclassified as independent contractor as legal matter
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# Employer Risk Mitigation

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- ▶ Plan terms may restrict participation to particular classification of employees, not just common law employee status
  - ▶ Many employers have amended plans to clarify which workers are eligible for plan benefits to protect against reclassification resulting in retroactive benefit liabilities and/or disqualification
    - *Vizcaino* led to widespread use of plan amendments to carefully establish eligibility provisions
    - 2000 IRS TAM confirms such plan provisions are consistent with qualification rules, employer's "legitimate business interests" in knowing costs
  - ▶ Contractual waivers of benefit plan participation
    - Substantial authority under ERISA that individual can waive right to participate if certain requirements met
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## *Tax Consequences of Misclassification* Paul Hastings

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- ▶ Income and employment taxes that should have been withheld
  - ▶ Civil Penalties
  - ▶ Possible Criminal Penalties
  - ▶ A majority of federal courts to address the issue (including the 3<sup>rd</sup> and 11<sup>th</sup> Circuits) have held there is no private right of action for failing with withhold FICA and FUTA contributions. A few district courts have held to the contrary.
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# Mitigation of Tax Consequences

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- IRS Classification Settlement Program under Section 530 of Revenue Act of 1978
    - Reporting consistency – filed appropriate returns based on intended classification (e.g., 1099 MISC)
    - Substantive consistency – consistently treated similarly situated workers as independent contractors
    - Reasonable basis – have reasonable basis for not treating as employee (e.g., judicial precedent, published ruling, private ruling issued to taxpayer, results of past IRS audit or longstanding recognized industry practice)
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# Mitigation of Tax Consequences

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## ▶ Code 3509

- Reduces liability for failing to withhold employment and income taxes due to misclassification, *provided employer did not intentionally disregard*
  - If employer issued 1099, income tax withholding liability for income taxes limited to 1.5% of wages, and liability for *employee's* share of FICA limited to 20% of amount otherwise due (1.45% for Medicare and 6.20% for Social Security, i.e., 1.53% of payment)
  - Above rates are doubled if no 1099 was issued
  - 3509 provides no relief for employer's share of FICA
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# *Mitigation of Tax Consequences*

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## ▶ Controls and Best Practices

- Review tax cases and rulings in the employer's industry and worker's job category to determine if intended classification has authority
  - Be consistent in treatment for similarly situated workers (be aware of predecessor's prior treatment)
  - Comply with 1099 and other tax reporting requirements
  - Use caution when rehiring former employees as independent contractors or engaging in dual classification
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# Obtaining Contingent Workers from Staffing Agencies

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## ▶ Contracting Issues

- Know who you are contracting with – do your due diligence
- Avoid “co-employer” labeling
- Don’t reserve too much control over workforce
- Obtain robust indemnity and verify vendor has adequate insurance
- Require notification of governmental audits or other events that could lead to classification questions (e.g., a leased employee files a request for determination of worker status with IRS)
- Require vendor cooperation/assistance if litigation or other dispute arises with respect to worker classification

## ▶ Monitoring and Auditing Vendors

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# *Hiring Employees Formerly Working Through Staffing Agencies*

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- ▶ Leased Employee Issues under Code Section 414(n)
    - Formerly leased employees hired as actual employees must be given prior service credit for eligibility and vesting purposes in qualified plans for time worked as formerly leased employees
  - ▶ FMLA Implications
    - Prior service credit must also be taken into account for determining whether a formerly leased employee has satisfied 12-months of service requirement for FMLA leave eligibility
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# *Defending Contingent Worker Claims*

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- ▶ Typically, claims are two-pronged:
    - Claim of employment relationship
      - Joint employment/co-employment
      - “True” employment
    - Claim for substantive deprivation of rights
      - Wages
      - Benefits
      - Discrimination
      - Other rights
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## *Defending Contingent Worker Claims*

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*Paul Hastings*

- ▶ Vehicle for claims is often a federal and state law class action
  - ▶ Threshold question: who's responsible?
    - Typical indemnity provisions in vendor services agreements
    - Common law indemnification/contribution
    - If you get sued, can you pass the liability to the vendor on the theory that the vendor is the contingent worker's "real" employer?
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# *Practical Considerations in Contingent Worker Lawsuits*

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- ▶ Data (hours/length of service/rates)
  - ▶ Bill rate versus pay rate
  - ▶ Absence of records
  - ▶ Lack of vendor cooperation
  - ▶ Communications issues/training
  - ▶ Personal relationships
    - Between vendors and managers
    - Between contingent workers and managers
  - ▶ Tracing historical teams
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# *Narrowing the Scope of the Putative Class*

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- ▶ Plaintiffs will try to argue for the broadest possible class (including for discovery purposes) by claiming that there need not be a similarity in duties between the representative plaintiffs and the putative class members.
- ▶ The defendant needs to keep the focus on duties and discrete/small teams.

# *Legislative Proposals*

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- ▶ Obama Administration budget proposals
- ▶ Fair Playing Field Act
- ▶ Employee Misclassification Protection Act
- ▶ Payroll Fraud Prevention Act

# Obama Administration Budget Proposals

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- ▶ FY 2012 (and 2011) budget proposed major worker classification reforms
  - ▶ Repeal section 530 of Revenue Act of 1978 employment tax relief for employers with “reasonable basis” to treat workers as independent contractors
  - ▶ Repeal 1978 Revenue Act restrictions on new IRS guidance on worker classification, opening door to guidelines potentially classifying more workers as employees
  - ▶ Limit reduced retroactive tax rates under current law (Code. sec. 3509) to employers that voluntarily reclassify workers (not through IRS audit)
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# Obama Administration Budget Proposals

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- ▶ Require businesses to notify independent contractors of their status and explain tax, workers' compensation, and wage and hour implications
  - ▶ Allow independent contractors receiving at least \$600 in payments to require business to withhold federal tax at flat rate contractor selects
  - ▶ Permit IRS to disclose information to DOL on reclassification
  - ▶ JCT scores as raising \$7.5 billion/10 years
  - ▶ Request additional funds for enforcement initiatives
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# *Fair Playing Field Act*

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- ▶ S. 3786 introduced by Sen. Kerry and H.R. 6128 introduced by Rep. McDermott in 111th Congress
- ▶ Proposals similar to Obama Administration budget
- ▶ Repeal safe harbor in Section 530 of 1978 Revenue Act
- ▶ Amend IRC to authorize IRS to issue new prospective guidance on worker classification
- ▶ Prohibit retroactive tax assessments with respect to misclassification where employer had reasonable basis and met Federal tax reporting obligations
- ▶ Require businesses to notify independent contractors of Federal tax obligations, labor and employment law protections, right to seek IRS status determination
- ▶ Annual Treasury reports on worker misclassification



# *Employee Misclassification Protection Act of 2010*

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- ▶ S. 3254 introduced by Sen. Brown and H.R. 5107 introduced by Rep. Woolsey in 111th Congress
- ▶ Increases penalties on employers that misclassify employees and are found to have violated overtime or minimum wage rights
- ▶ Requires employers to notify workers of classification and keep records, with rebuttable presumption of employee status and penalties for violations
- ▶ States to strengthen unemployment compensation audits
- ▶ DOL coordination, reports on misclassification to IRS
- ▶ DOL to perform targeted audits, focus on industries that frequently misclassify

# *Payroll Fraud Prevention Act*

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- ▶ S. 770: Sen. Sherrod Brown (D-OH) with 3 co-sponsors
- ▶ Would expand the Fair Labor Standards Act.
- ▶ Would require that employers keep accurate classification records (employee vs. independent contractor) of every worker who performs labor and services for their company and why.
- ▶ Would require that employers explain to workers their classification status, and to direct them to the U.S. Department of Labor if they suspect employee misclassification.
- ▶ Employers that misclassify employees would be subject to a civil penalty, not to exceed \$1,100 per each employee or other individual who was the subject of such a violation. Repeating violators would be subject to a higher civil monetary payment amount of up to \$5,000.

# Contact Information

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Allan Bloom

Paul Hastings

212-318-6377

[allanbloom@paulhastings.com](mailto:allanbloom@paulhastings.com)

Eric Keller

Paul Hastings

202-551-1770

[erickeller@paulhastings.com](mailto:erickeller@paulhastings.com)

# Contact Information

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Brigen L. Winters  
Groom Law Group, Chartered  
1701 Pennsylvania Ave, NW  
Washington, DC 20006  
(202) 861-6618  
bwinters@groom.com

Groom Law Group, Chartered is a Washington, DC-based law firm of over 50 attorneys that focuses exclusively on employee benefits issues. More information about the firm and its attorneys can be found at <http://www.groom.com>.

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*Paul Hastings*



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# Our Offices

Paul Hastings

## NORTH AMERICA

### Atlanta

600 Peachtree Street, N.E.  
24th Floor  
Atlanta, GA 30308  
Telephone: +1 404 815 2400  
Facsimile: +1 404 815 2424

### Chicago

191 North Wacker Drive  
30th Floor  
Chicago, IL 60606  
Telephone: +1 312 499 6000  
Facsimile: +1 312 499 6100

### Los Angeles

515 S. Flower Street  
25th Floor  
Los Angeles, CA 90071  
Telephone: +1 213 683 6000  
Facsimile: +1 213 627 0705

### New York

Park Avenue Tower  
75 East 55th Street, 1st Floor  
New York, NY 10022  
Telephone: +1 212 318 6000  
Facsimile: +1 212 319 4090

### Orange County

695 Town Center Drive, 17th Floor  
Costa Mesa, CA 92626  
Telephone: +1 714 668 6200  
Facsimile: +1 714 979 1921

### Palo Alto

1117 S. California Avenue  
Palo Alto, CA 94304  
Telephone: +1 650 320 1800  
Facsimile: +1 650 320 1900

### San Diego

4747 Executive Drive  
12th Floor  
San Diego, CA 92121  
Telephone: +1 858 458 3000  
Facsimile: +1 858 458 3005

### San Francisco

55 Second Street  
24th Floor  
San Francisco, CA 94105  
Telephone: +1 415 856 7000  
Facsimile: +1 415 856 7100

### Washington, D.C.

875 15th Street, N.W.  
Washington, DC 20005  
Telephone: +1 202 551 1700  
Facsimile: +1 202 551 1705

## ASIA

### Beijing

19/F, Yintai Center Office Tower  
2 Jianguomenwai Avenue  
Chaoyang District  
Beijing 100022, China  
Telephone: +86 10 8567 5300  
Facsimile: +86 10 8567 5400

### Hong Kong

21-22/F, Bank of China Tower  
1 Garden Road  
Hong Kong  
Telephone: +852 2867 1288  
Facsimile: +852 2526 2119

### Shanghai

35/F Park Place  
1601 Nanjing West Road  
Shanghai 200040, China  
Telephone: +86 21 6103 2900  
Facsimile: +86 21 6103 2990

### Tokyo

34F Ark Mori Building  
12-32 Akasaka 1-chome  
Minato-ku, Tokyo 107 6034, Japan  
Telephone: +81 3 6229 6100  
Facsimile: +81 3 6229 7100

## EUROPE

### Brussels

Avenue Louise 480  
Boîte 5B  
1050 Brussels, Belgium  
Telephone: +32 2 641 7460  
Facsimile: +32 2 641 7461

### Frankfurt

Siesmayerstrasse 21  
60323 Frankfurt am Main  
Germany  
Telephone: +49 69 90 74 85-0  
Facsimile: +49 69 90 74 85-499

### London

Ten Bishops Square, 8th Floor  
London E1 6EG  
United Kingdom  
Telephone: +44 203 023 5100  
Facsimile: +44 203 023 5109

### Milan

Via Rovello, 1  
20121 Milan, Italy  
Telephone: +39 02 30414 000  
Facsimile: +39 02 30414 005

### Paris

96, boulevard Haussmann  
75008 Paris, France  
Telephone: +33 1 42 99 04 50  
Facsimile: +33 1 45 63 91 49

For further information, you may visit our home page at  
[www.paulhastings.com](http://www.paulhastings.com) or email us at [info@paulhastings.com](mailto:info@paulhastings.com).