

WORKER MISCLASSIFICATION

EMPLOYMENT AND TAX CONSIDERATIONS

FOR EMPLOYERS IN VIRGINIA

Presented by:

Elinor H. Clendenin & Amanda M. Weaver

October 27, 2015



WELCOME



Elinor H. Clendenin
Associate
Employee Benefits Section
Williams Mullen
eclendenin@williamsmullen.com
804.420.6469



Amanda M. Weaver
Associate
Labor & Employment Section
Williams Mullen
aweaver@williamsmullen.com
804.420.6226

OVERVIEW

- Introduction
 - What is Worker Misclassification (and why does it matter?)
- Federal Considerations
 - U.S. Department of Labor Interpretation
 - IRS and Misclassification
 - Effect on other Federal Obligations (ERISA and ACA)
- State Considerations
 - Virginia Misclassification Task Force
 - Virginia DOLI and VOSH Initiatives
 - Workers' Compensation and Unemployment Insurance
 - Virginia Tax Issues
- Case Example
- Practical Advice for Structuring or Revising the Relationship



HOUSEKEEPING

> Q&A's

- Please send us your questions using chat feature at left side of your screen
- We will answer them at the end of our presentation

> Virginia CLE

- You will be notified via of approval

> Presentation link will be sent to you following our broadcast

> Place any cell phones away from your landlines

INTRODUCTION



WHAT IS MISCLASSIFICATION?

“We have no liability because we ‘1099’ our employees.”

Company likely means:

- > It issues its workers a Form 1099 rather than a W-2;*
- > It classifies its workers as independent contractors;*
- > It does not provide workers’ compensation or unemployment insurance to its workers;*
- > It does not provide benefits to its workers; and*
- > It never withheld and/or remitted FICA, FUTA and Income Tax (collectively, “payroll taxes” or “employment taxes”).*

WHAT IS MISCLASSIFICATION?

Misclassification occurs when an employer improperly classifies a worker as an “independent contractor” when the worker should be classified as an employee.

Because employees are entitled by law to various benefits and protections to which independent contractors are not entitled, employers who misclassify may face significant liability.

WHAT IS MISCLASSIFICATION?

- > Some companies view independent contractor classification as attractive, because a company has limited obligations towards an independent contractor compared to an employee
- > However, disadvantages of independent contractor status include limited ability to control the manner and means of work and to restrict conduct during and after the relationship ends, and potential liability for misclassification.

WHY DOES MISCLASSIFICATION MATTER?

- > Use of Independent Contractors has continued to increase
- > An employer does not pay most employment-related expenses for independent contractors, such as payroll taxes, workers' compensation and unemployment insurance premiums, overtime pay, etc.
- > Because independent contractors do not receive these benefits, misclassified workers miss out on these legal protections and benefits.
- > In addition, federal, state and local governments see reduced tax revenue.
- > Finally, the money saved by employers who misclassify workers may gain an unfair competitive advantage over employers who comply with the law.

WHY DOES MISCLASSIFICATION MATTER?

EMPLOYEE

- > Entitled to minimum wage and overtime (if non-exempt) and other protections of FLSA
- > May be eligible for unpaid leave benefits under FMLA
- > Protected by federal and state anti-discrimination laws
- > Protected by state and federal OSHA laws
- > Employers responsible for withholding state and federal taxes, paying workers' compensation and unemployment insurance premiums
- > Eligible for benefits (requirement under Affordable Care Act)
- > I-9 requirements

INDEPENDENT CONTRACTOR

- > Minimal Liability under state and federal employment statutes
- > No payroll taxes, social security, Medicare
- > No income tax withholding (no W2)
- > Not eligible for benefits
- > I-9 requirements not applicable

EMPLOYEE V. INDEPENDENT CONTRACTOR

Although there are various tests for determining whether a worker is an employee or an independent contractor, generally a worker is an employee if **the realities of the relationship are such that the worker is economically dependent on the purported employer** (“economic realities” test) and/or the person for whom he or she works has **the right to direct and control the manner and means of the work performed** (“control test”).

EMPLOYEE V. INDEPENDENT CONTRACTOR

- > Whether or not a worker is an employee depends solely on the facts and circumstances of the relationship.
- > Therefore, the following actions alone are insufficient:
 - Calling a worker an independent contractor
 - Entering an Independent Contractor Agreement with the worker
 - Issuing a Form 1099 to the worker

FEDERAL LAW CONSIDERATIONS



U.S. DEPT. OF LABOR INTERPRETATION

- > On July 15, 2015, the U.S. Department of Labor (DOL) published Administrator's Interpretation No. 2015-1
- > The memo focuses on the FLSA's broad definition of "employ" and takes the position that by including this definition, Congress intended the FLSA to ensure as broad a scope of statutory coverage as possible
- > The DOL concludes that **"most workers are employees under the FLSA's broad definitions"**

U.S. DEPT. OF LABOR INTERPRETATION

- > The DOL memo outlines the multi-factor “economic realities” test applied by courts to determine whether a worker is an employee or an independent contractor under the FLSA.
- > Under this test, a worker is not an independent contractor unless the worker functions as if operating an independent business, or in other words, the worker is economically independent from the principal

DOL – ECONOMIC REALITIES TEST

Although some courts have applied variations of the economic realities test, the factors typically include:

- the extent to which the work performed is an integral part of the employer's business;
- the worker's opportunity for profit or loss depending on his or her managerial skill;
- the extent of the relative investments of the employer and the worker;
- whether the work performed requires special skills and initiative;
- the permanency of the relationship; and,
- the degree of control exercised or retained by the employer.

DOL – ECONOMIC REALITIES TEST

- The “economic realities” factors must be applied consistently with the broad definition of employee under the FLSA
- Each factor must be examined and exercised in relation to the others, and no single factor is determinative

DOL – ECONOMIC REALITIES TEST

- > *Integral to the Business* – a true independent contractor’s work is unlikely to be integral to the business, under the reasoning that a company will prefer to exert control over work that is integral to the business. Example: a painter performs work that is integral to a painting business; a web designer hired to design the company’s website does not.
- > *Opportunity for Profit/Loss* – an independent contractor’s managerial skill will typically affect his or her profitability (through controlling advertising, negotiating contracts, deciding which jobs to perform and when to perform them, deciding to hire helpers to assist with the work, and recruiting new clients); on the other hand, an employee whose work and schedule are controlled by the employer has far less control.

DOL – ECONOMIC REALITIES TEST

- > *Worker Investment* – a worker who is truly in business for himself should typically be financially invested in order for there to be an indication that he or she is an independent business. If the worker's investment is relatively minor, that suggests that the worker and the employer are not on similar footings and that the worker may be economically dependent on the employer.
- > *Special Skills and Initiative* – a worker's business skills, judgment, and initiative, not his or her technical skills, will aid in determining whether the worker is economically independent.

DOL – ECONOMIC REALITIES TEST

- > *Permanence/Indefiniteness* – a worker who is truly in business for himself or herself is unlikely to enter a permanent or indefinite relationship with an employer due to the dependence that comes with such permanence or indefiniteness. However, a lack of permanence or indefiniteness does not automatically suggest an independent contractor relationship (i.e., a temporary employee is still an employee).
- > *Degree of Control* – to be a true independent contractor, the worker must control meaningful aspects of the work performed such that it is possible to view the worker as a person conducting his or her own business.

IRS TEST

- > The IRS uses a 20-factor facts and circumstances test for Federal Employment Taxes and Income Taxes*
- > The 20 factors are effectively an expanded version of the common law “control test” and can be grouped into three main categories:
 - Behavioral control: Principal has the right to direct how the worker does the work, including instruction and training
 - Financial control: Principal has the right to direct the business part of the work, including the worker’s personal investment, expense reimbursement and opportunity for profit or loss
 - Relationship of the parties: The written contract and whether the worker receives benefits usually reserved for employees

*Rev. Rul. 87-41

ERISA PLAN IMPLICATIONS

- > Reclassified workers can seek benefits (owed matching contributions, health plan claims, etc.) under several theories
 - Fiduciaries have violated duties
 - Misclassification has violated worker's ERISA rights

HEALTH CARE REFORM MANDATE

>Health Care Reform Mandate

- Starting in 2015, employers with at least 50 full-time employees must offer health insurance to all employees
- Noncompliance leads to penalties
- IRS incentive to review classification before mandate effective date

STATE LAW

CONSIDERATIONS



VIRGINIA INTER-AGENCY TASK FORCE

- > In response to the frequency of employee misclassification in Virginia, an inter-agency task force on worker misclassification and payroll fraud was established in Virginia in 2014.
- > The Task Force includes the Secretary of Commerce and Trade, Department of Labor and Industry, Virginia Employment Commission, Department of Professional and Occupational Regulation, State Corporation Commission's Bureau of Insurance, Workers' Compensation Commission, and Department of Taxation
- > The goal of the task force is to develop procedures for more effective inter-agency cooperation and joint enforcement, as well as employer education

VA DOLI/VOSH INITIATIVE

- > In June 2015, the Virginia Department of Labor and Industry (“DOLI”) announced the implementation of a new Virginia Occupational Safety and Health (“VOSH”) policy directed at preventing the misclassification of workers in VOSH cases.
- > To determine employee status, VOSH looks at:
 - Who pays the worker
 - Who has the ability to control the worker
 - Whether the alleged employer has power to fire, hire, or modify the worker's employment conditions
 - Whether worker's ability to increase income depends on efficiency rather than initiative, judgment, foresight
 - How worker's wages are established

VIRGINIA DOLI/VOSH INITIATIVE

Effective July 1, 2015, the new policy provides that whenever VOSH has reasonable cause to believe that worker misclassification has occurred in a VOSH case, the following procedures will apply:

- VOSH citation penalty reductions for size and good faith will not be afforded to the employer.
- On construction multi-employer worksites, each contractor (e.g., general contractors, prime subcontractors and lower tier subcontractors) will be asked to provide proof of their DPOR contractor's license as well as proof that its subcontractors are also licensed by DPOR.
- When it is determined that a construction employer has contracted with an unlicensed subcontractor, VOSH will make a written referral to DPOR for the contractor and its unlicensed subcontractor. DPOR sanctions for contracting with an unlicensed subcontractor may include fines, probationary terms, license suspension or license revocation.
- In cases where the contract value for the specific subcontractor's job is less than \$1,000 (and, therefore, the subcontractor is not required to possess a DPOR license), VOSH will make a written referral to the either or both of the Virginia Employment Commission and the Virginia Workers' Compensation Commission for potential audits of the alleged employer's employment practices.

VIRGINIA TAX

> State Employment Tax & Unemployment Insurance

- Virginia defers to the Internal Revenue Service's 20 factor test for worker classification purposes.
- Follow Federal Income Tax Treatment of worker
 - *"Services performed by an individual for remuneration shall be deemed to be employment subject to this title unless the Commission determines that such individual is not an employee for purposes of the Federal Insurance Contributions Act and the Federal Unemployment Tax Act, based upon an application of the 20 factors set forth in Internal Revenue Service Revenue Ruling 87-41, issued pursuant to 26 C.F.R. 31.3306(i)-1 and 26 C.F.R. 31.3121(d)-1." Virginia Unemployment Compensation Act Section 60.2-212C*

VIRGINIA TAX

- > Virginia Department of Revenue issued guidance on IRS Revenue Service Ruling 87-41 (20 factor test) on July 14, 2015, to help employers determine how workers should be classified.
- > *20 factor test is to be used to classify a worker for Virginia income tax withholding and unemployment insurance*
 - “Not all factors must be present to find an employee/employment relationship, but the factors are guides to use to assess the likelihood”

VA WORKERS' COMPENSATION INSURANCE

- > An individual is an employee for the purposes of workers' compensation insurance if he works for wages or a salary and the person who hires him reserves the power to fire him and the power to exercise control over the work to be performed
- > Subcontractors
 - Business owners may forget to count subcontractors/independent contractors into their calculation. According to the Virginia Workers Compensation Commission ("VWCC"):

"If a business hires subcontractors to perform the same trade, business or occupation, or to fulfill a contract of the business, the subcontractor's employees are included in determining the total number of employees ... A business or contractor that hires subcontractors to assist in their work or fulfill a contract must count the subcontractor's employees as well as their own when considering if they have more than two employees, if yes, the business /contractor is required to carry workers' compensation coverage. This is true even if all subcontractors have their own coverage."
 - If an business owner hires contractors, the business owner should have every contractor show proof of coverage before commencing work as an independent contractor. The VWCC provides a form to establish proof of coverage. If the business owner does not obtain this evidence there will be little defense to the imposition of a civil penalty should it be determined that the worker/contractor is not independent but, in fact, an employee.

VA TAX & INSURANCE - ENFORCEMENT

- > In July 2014, Virginia raised the civil penalties for misclassifying an employee as an independent contractor under the Virginia Workers Compensation Act. Under the Act, Virginia can impose civil penalties of up to \$250 a day for each day (up to a penalty of \$50,000) that an employer has failed to insure a worker who should have been insured.
- > In September 2015, Virginia announced that it received nearly \$500,000 in federal funding to help combat worker misclassification for unemployment insurance.

CASE EXAMPLE



FEDEx CASE

- > Case example involving FedEx drivers in Kansas highlights the factual nature of the determination
- > Lower Court (N.D. Ind.) applied variation of control-test and concluded that drivers were independent contractors:
 - FedEx hasn't retained the right to direct the manner in which drivers perform their work
 - FedEx supervises the drivers' work and offers numerous suggestions and best practices for performance of assigned tasks, but the evidence doesn't suggest that FedEx has the authority to require compliance with its suggestions
 - the parties intended to create an independent contractor arrangement
 - the drivers have the ability to hire helpers and replacement drivers
 - Drivers are responsible for acquiring a vehicle and can use the vehicle for other commercial purposes
 - Drivers can sell their routes to other qualified drivers
 - FedEx doesn't have the right to terminate contracts at-will.

In re FedEx Ground Package Sys., Inc., 734 F. Supp. 2d 557, 559-60 (N.D. Ind. 2010)

FEDEX CASE

> Kansas Supreme Court (certified from the 7th Circuit) looked at the same facts and concluded that drivers were employees under a variation of the economic realities test:

- *In practice*, FedEx directed the drivers in the performance of their work (FedEx performed background checks, conducted training, imposed detailed appearance specifications and vehicle specifications, and imposed numerous manuals and policies directing the manner of delivering packages)
- FedEx drivers perform tasks which are integral to FedEx's business
- To meet FedEx's requirements and stay in compliance with the OA, a driver must work long hours that can include a time frame that is dictated by the company.
- Considerable hours requirements prevent drivers from working for anyone else.
- The duration and continuity of the relationship between FedEx and its drivers
- Ultimately, a driver's ability to make a profit is constrained by FedEx's control over the route assignments and the number of deliveries a driver can make, while the company's policies also serve to reduce a driver's risk of suffering a loss.
- Factors against employee status: FedEx allows its drivers to hire others to drive their trucks in the drivers' assigned service areas, subject to FedEx's approval and supervision; drivers also responsible for own expenses

Craig v. FedEx Ground Package Sys., Inc., 300 Kan. 788, 335 P.3d 66 (2014).

STRUCTURING THE RELATIONSHIP



INDEPENDENT CONTRACTOR AGREEMENTS

- > Remember that an independent contractor agreement does not *per se* create an independent contractor relationship, but it can help if the contract memorializes the relationship with the requisite level of independence
- > Therefore, the terms of the contract should be consistent with the common law and IRS tests for independent contractors

INDEPENDENT CONTRACTOR AGREEMENTS

An independent contractor agreement should state:

- > That the worker is an independent contractor
- > A description of the terms of the relationship and manner of payment
- > A waiver by the independent contractor concerning participation in employer-sponsored benefit plans
- > A requirement that the independent contractor purchase his own equipment or supplies which he may need to perform his tasks
- > That the independent contractor is not required to personally perform the work and is allowed to hire, supervise and compensate subcontractors or assistants
- > That the independent contractor is free to work for other companies
- > That the company will not reimburse the independent contractor for business expenses

INDEPENDENT CONTRACTOR AGREEMENTS

An independent contractor agreement may include:

- > No conflicts of interest provision
- > Non-solicitation of employees and customers provision
- > Nondisclosure of confidential information provision

INDEPENDENT CONTRACTOR AGREEMENTS

An independent contractor agreement should not include:

- > Specific work hours
- > Detailed description of the manner and means of how the work should be performed
- > Covenant not to compete

THE RELATIONSHIP IN PRACTICE

- > Implement what is set down in the contract
- > Avoid exercising direct control over the worker or his or her work
- > Review any companies policies or manuals to determine if revisions are needed
- > Document compliance with the independent contractor agreement

STILL UNSURE?

- > Complete the IRS Form SS-8 for classification for federal employment tax purposes and federal income tax withholding
 - As most Virginia agencies follow the IRS classification, determination is a good idea of whether the worker should be treated as an employee for all purposes.
 - The SS-8 asks questions that allow the IRS to analyze the 20 factors
- > A worker can also initiate the SS-8 program
 - The IRS will request a completed SS-8 from both parties

STILL UNSURE?

- >The IRS will issue a determination letter to the company and to the worker
- >The IRS's determination applies to the subject worker and all similarly situated workers
- >The SS-8 program process is not an audit
- >The IRS does not calculate tax owed or issue an assessment

HOW TO FIX IT?



ALREADY MISCLASSIFIED-NOW WHAT?

> *First things first, become compliant.*

Either:

- revise nature of relationship to a proper IC relationship moving forward, or
- begin treating the worker as an employee for all legal purposes

DETERMINING FEDERAL EMPLOYMENT TAX OWED (IRS)

- > Taxpayers that misclassify workers are responsible for adjusting payroll tax returns and paying tax, interest and penalties

POSSIBLE FIXES – FEDERAL TAXES

- > Voluntary Classification Settlement Program- Available outside of audit
 - Employer prospectively reclassifies workers as employees
 - Employer liability is 10% of the employment tax liability that may have been due on compensation paid to the workers under reduced rates of Section 3509 for the most recent tax year
 - No penalties or interest due

VOLUNTARY CLASSIFICATION SETTLEMENT PROGRAM

- Must have consistently treated workers in past as non-employees
- Must have filed 1099 forms for workers in the previous three years
- Does not provide relief from state tax or other state laws that are implicated by the reclassification
- Employer is not admitting wrongdoing for past classification of the workers

VIRGINIA EMPLOYMENT TAXES

- > No amnesty program in Virginia
- > Virginia may assess penalties for the under-withholding of tax, the failure to timely remit withholding tax and the failure to file periodic returns
- > Liability should hinge on whether the reclassified workers paid their state income taxes
 - Virginia Department of Revenue should not be able to collect twice

VIRGINIA UNEMPLOYMENT TAX

- > Employer paid tax
 - The first \$8000 of an employee's wages is taxable
- > Penalty for failure to file an employer's quarterly report timely
- > No Amnesty program available

VIRGINIA WORKERS COMPENSATION COMMISSION

- > As a general rule, a business with more than two employees is required by law to carry workers' compensation insurance
- > If a business hires contractors, the business should have every contractor show proof of coverage before commencing work as an independent contractor. The VWCC provides a form (Certification of Worker's Compensation Insurance Coverage Form 61-a) to establish proof of coverage.
- > No amnesty program available

WAGE AND HOUR

- > No federal or state amnesty program for misclassified employees
- > The federal statute of limitations for wage and hour claims is 2 years (3 years in the case of willful violations), meaning that under the FLSA, employers may be liable for up to 2 years of unpaid wages (3 years if willful)
- > The Virginia statute of limitations for unpaid wages is 3 years, or 5 years if there is a written employment contract signed by the employer

Moral of the story: it is vital to come into compliance as soon as possible.

QUESTIONS



Elinor H. Clendenin
Associate
Employee Benefits Section
Williams Mullen
eclendenin@williamsmullen.com
804.420.6469



Amanda M. Weaver
Associate
Labor & Employment Section
Williams Mullen
aweaver@williamsmullen.com
804.420.6226

Please note: This presentation contains general, condensed summaries of actual legal matters, statutes and opinions for information purposes. It is not meant to be and should not be construed as legal advice. Individuals with particular needs on specific issues should retain the services of competent counsel.

