

National Association of Home Builders

Independent Contractors and Employees: Recent Efforts by the DOL, IRS and State Agencies to Fight Misclassification

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What is the Issue/Problem?

3

- Worker misclassification
- Significantly increased focus on whether workers are properly designated as independent contractors (ICs) or if they instead should be considered company employees
- Focus of the Department of Labor (DOL) and Internal Revenue Service (IRS)
- Focus of states through their attorneys' general and other state agencies and authorities
- Agencies engaging in information sharing
 - September 2011 MOU between DOL and IRS
 - MOUs between federal and state agencies

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Employee Misclassification: Governmental Stakeholders

Federal and State Agencies Affected by Employee Misclassification	
Agency	Areas potentially affected by employee misclassification
IRS	<ul style="list-style-type: none"> Federal income and employment (payroll) taxes
DOL	<ul style="list-style-type: none"> Minimum wage, overtime, and child labor provisions Job protection and unpaid leave Safety and health protections Immigration/Form I-9 issues
IRS, DOL, and PBGC	<ul style="list-style-type: none"> Pension, health, and other employee benefit plans
Department of Health and Human Services	<ul style="list-style-type: none"> Medicare benefit payments
EEOC	<ul style="list-style-type: none"> Prohibitions of employment discrimination based on factors such as race, gender, disability, and age
NLRB	<ul style="list-style-type: none"> The right to organize and bargain collectively
SSA	<ul style="list-style-type: none"> Retirement and disability coverage and payments
State Agencies	<ul style="list-style-type: none"> Unemployment insurance benefit payments State income and employment taxes Workers' compensation benefit payments

Information Sharing Programs

5

- Seek governmental partnerships
- Facilitate the exchange of taxpayer data by leveraging resources and identifying/reporting information on emerging tax administration issues
- The three components are:
 1. Federal Information Sharing
 2. State Information Sharing
 3. Local Information Sharing

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Information Sharing Programs: IRS-DOL Memorandum of Understanding

6

The IRS and DOL announced a joint initiative to improve worker classification compliance in order to:

- Reduce incidences of worker misclassification
- Reduce the tax gap
- Reduce fraudulent filings
- Reduce abusive employment tax schemes
- Create educational materials and issue guidance
- Improve compliance with federal laws
- Strengthen IRS and DOL relationships
- Leverage existing resources
- Send a consistent wage and payroll tax message

Information Sharing Programs: IRS-DOL Memorandum of Understanding

7

DOL duties under the Memorandum of Understanding:

- Refer to the IRS wage and hour investigation information “and other data” that the DOL believes raise employment tax misclassification compliance issues
- Share DOL wage and hour training materials “and opportunities” with the IRS
- Participate in joint outreach events with the IRS

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Information Sharing Programs: IRS-DOL Memorandum of Understanding

8

- Evaluate DOL employment tax referrals for the purpose of conducting employment tax examinations
- Share DOL employment tax referrals with state and municipal taxing agencies under existing sharing agreements
- Provide the DOL with an annual report summarizing the results achieved using DOL referrals
- Share employment tax training materials “and opportunities” with the DOL
- Participate in joint outreach events
- Annually provide the DOL with aggregate data relating to trends in misclassification
- Provide the DOL with information (“other than taxpayer return information”) that may constitute evidence of a violation of criminal laws enforced by the DOL

Specifics of DOL Enforcement

9

- Targeting certain industries including home builders

“[T]he WHD is putting more of its resources into directed, national, regional and local enforcement initiatives and, with a focus on industries with a prevalence of low wage and vulnerable workers, strategically targeting industries when available data and evidence tells us that there are significant levels of non-compliance in those industries.”

» Testimony of Nancy J. Leppink, Deputy Wage and Hour Administrator before the Subcommittee on Workforce Protections of the Committee on Education and the Workforce, U.S. House of Representatives, November 3, 2011

DOL Enforcement

10

- In the past, investigations...
 - Usually complaint driven or targeting employers with prior violations (although some random audits conducted)
 - Usually targeted investigations
 - Usually reasonable documentation requests and time to produce
 - Usually announced in advance
 - WH-58s routinely issued
 - Not asking for Civil Monetary Penalties except with repeat offenders or willful violations

DOL Enforcement

11

- Now...
 - More focus on “unannounced,” on-site visits
 - Overbroad documentation requests
 - In some cases, requests are inconsistent with DOL recordkeeping requirements
 - Less flexibility given to employers to produce information
 - Recordkeeping requirements set 72-hour time frame; but not typically utilized by DOL in enforcement history
 - Not permitting “self-audits” after investigation commences
 - Refusal to issue WH-58s when back-pay agreed to
 - More use of Civil Monetary Penalties

Department of Labor

12

- “Plan/Prevent/Protect” Program
 - Notice of Proposed Rulemaking expected
 - Employers would have to conduct audits
 - Audit results would have to be shared with employees
 - For every individual designated as an IC, a classification analysis would have to be done; the results would be shared with the individual and would have to be retained

IRS Payroll Tax Audits: Tax Relief Provisions

13

- Significant Statutory and Administrative Payroll Tax Relief Exists:
 - Section 530 Relief
 - Section 3509 Relief
 - Classification Settlement Program Relief
 - Voluntary Classification Settlement Program

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IRS Payroll Tax Audits: Section 530 Relief

14

- “Off-Code” relief provision
- IRS bears burden of proof
- Under attack by Congress, Administration, and the IRS
- If applicable, reduces the employer’s federal employment tax exposure to zero for all past and future years
- If applicable, businesses can continue to treat their workers as independent contractors for payroll tax purposes
- Must have reasonable basis for that independent-contractor treatment

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IRS Payroll Tax Audits: Section 530 Relief

15

Statutory Relief: Section 530

- Provides employer-only relief
- Provides complete relief both retroactively and prospectively
- Three Tests
 - Reporting Consistency
 - Substantive Consistency
 - Reasonable Basis (prior audit, industry practice, “judicial” precedent, or any other reasonable basis)

IRS Payroll Tax Audits: Example of Tax Exposure and Tax Relief

16

- The annual “full rate” federal tax exposure for 60 misclassified independent contractors earning \$50,000 each is approximately \$1,250,000.
- Relief provisions can reduce the \$5 million four-year liability:

<u>Relief Provision</u>	<u>2010 Exposure*</u>	<u>Total Four-Year Exposure</u>
Statutory relief	320,400	1,281,600
100% CSP Offer	320,400	320,400
25% CSP Offer	80,100	80,100
VCSP Offer	32,000	32,000
Section 530 “Off-Code” Relief	0	0

*Calculations do not include FUTA, SUTA, and SITW liabilities

Voluntary Classification Settlement Program

17

- The Voluntary Classification Settlement Program (VCSP) seeks to encourage prospective worker reclassification
- VCSP is an alternative to the Classification Settlement Program, which only applies to taxpayers actually under audit
- The IRS will not conduct a payroll tax audit for workers covered by a VCSP agreement for prior years in exchange for:
 - a taxpayer's agreement to treat a class of workers as employees for future tax periods for payroll tax purposes, and
 - a payment of 10% of the Section 3509 rates

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Voluntary Classification Settlement Program

18

Important Characteristics

- Is an optional program
- Limited to federal payroll taxes
- Requires prospective reclassification
- Pays 10% of the Section 3509 tax calculations
- No interest or penalties
- Must execute a closing agreement
- Must extend the statute of limitations
- Provides no relief to the worker
- Will not be audited for worker classification for prior years

Voluntary Classification Settlement Program ¹⁹

Relevant Requirements

- Must prospectively reclassify independent contractors as employees
- Must have consistently treated the workers as “nonemployees”
- Must have filed all required Form 1099s for previous three years
- Must not currently be under any IRS audit (income tax, payroll tax, etc.)
- Must not currently be under any DOL or state agency audit addressing worker classification issues
- If previously under audit, must have complied with audit results

How Do Problems Arise?

20

- Governmental agency conducts an investigation or audit
- Unhappy employee or IC files a complaint, charge, or request for benefits/payments (overtime, pension, unemployment, disability, workers' compensation)
- Unsuccessful organizing activities
- Referrals from other DOL divisions
- Many similarly situated employees = class action

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Why Is This Issue So Significant? (The Risks of Misclassification)

21

- Benefits-related risks
- Tax and insurance-related risks
- Wage and hour-related risks
- Risk of other liability associated with “employer” status

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Why Does It Matter? Benefits and Business Expenses

Differences Among Benefits Responsibilities				
Type of Benefits	Employees		Independent Contractors	
Retirement plans	Employers sponsor benefit plans	Employers and employees contribute	Contractors sponsor plans	Contractors bear the full financial cost of the plans
Healthcare	Employers sponsor on a tax-free basis	Employers and employees contribute	Contractors obtain coverage	Contractors bear the full financial cost, but receive a tax deduction
Reimbursed expenses/ accountable plans	Employers can reimburse expenses	Nontaxable to the extent they are paid under an accountable plan	Service recipient can reimburse, although expenses are generally unreimbursed	Reimbursed expenses are nontaxable if they are under an accountable plan
Unreimbursed expenses	Many employers don't fully reimburse expenses	Unreimbursed expenses are subject to a 2% floor and AMT	Businesses don't generally reimburse expenses	Not subject to a 2% floor or AMT

Why Does It Matter? Payroll Taxes

Differences Among General Tax Responsibilities				
Type of Tax	Employees		Independent Contractors	
	Businesses' general responsibilities	Workers' general responsibilities	Businesses' general responsibilities	Workers' general responsibilities
Federal income tax	Withhold tax from employees' pay	Pay full amounts owed, generally through withholding	Generally, none	Pay full amounts owed, generally through estimated tax payments
Social Security and Medicare taxes	Withhold one-half of taxes from employees' pay and pay other half	Pay half of total amounts owed, generally through withholding	None	Pay full amounts owed, generally through estimated tax payments
Federal unemployment tax	Pay full amount	None	None	None
State unemployment tax	Pay full amount, except in certain states	None, except pay partial amount in certain states	None	None

Why Does It Matter? Payroll Taxes

24

- Federal Income Tax Withholding (FITW)
- Federal Insurance Contributions Act (FICA)
 - Social Security (OASDI)
 - Medicare (HI)
- Federal Unemployment Tax Act (FUTA)
- Self-Employment Contributions Act (SECA)
- Railroad Retirement Tax Act (RRTA)

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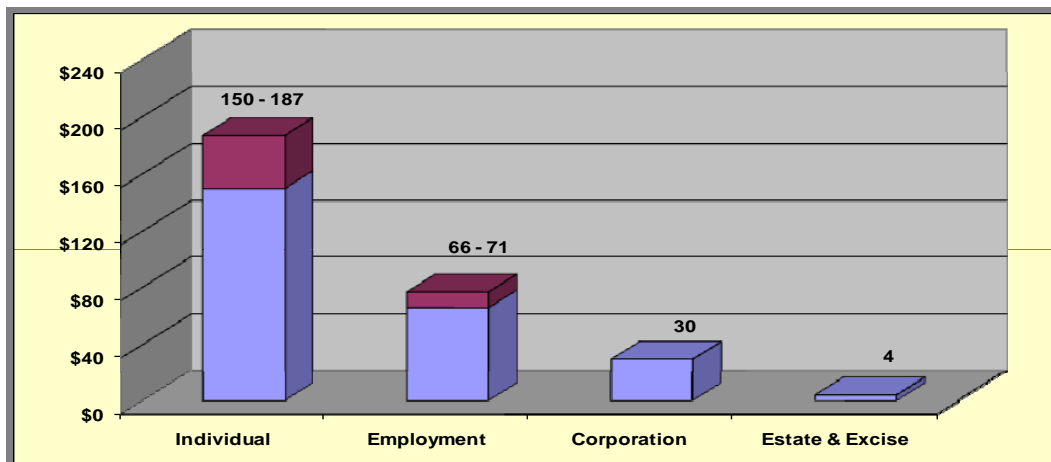
Why Does It Matter? Payroll Taxes

25

- Full-rate statutory liability equal to at least 40% of the compensation payments to independent contractors
 - 25% FITW exposure
 - 15.3% Employer and Employee FICA (Social Security and Medicare)
 - Social Security Taxable Wage Base (\$106,800 for 2011)
- Example of “full rate” exposure: the annual “full rate” federal tax exposure for 60 misclassified independent contractors earning \$50,000 each is approximately \$1,250,000

Why Does It Matter? Payroll Taxes and the Tax Gap

(Billions)



\$5 billion associated with FICA/FUTA

\$51 billion–\$56 billion associated with SECA

Other estimates place the annual “Employment Tax Gap” at \$15 billion (IRS, in introduction of NRP program), \$54 billion (Treasury study issued 9/26/06), or up to \$78 billion.

“Employer” Status Risks

27

- ICs are found to be employees
- Potential liability under employment-related laws, including for discrimination, harassment, and wage and hour issues
- Potential liability for wrongful acts of outside vendors or ICs against a company employee (e.g., discrimination)
- Potential liability for unpaid overtime, vacation, medical leave, and other unpaid wages

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Wage and Hour Related Risks

28

- Failure to pay applicable minimum wage or overtime under state and federal law (“unlimited exposure” if records do not exist, as recordkeeping is sole responsibility of employer)
 - High-stakes litigations: class actions, double damages, long statute of limitations periods, attorneys’ fees
- Violation of laws concerning meals, rest breaks, deductions from wages, reimbursement for business expenses
- Civil and criminal penalties
- Corporate officers may be ***individually liable***
 - Do you want to be the person who causes a company executive to be individually liable?

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Class Waiver Issue

29

- *D.R. Horton, Inc.*, 357 N.L.R.B. No. 184 (2012)
 - NLRB holds that the home builder violated the NLRA by conditioning employment on agreements providing that all employment disputes and claims would be resolved in arbitration, and foreclosing any litigation of class or collective claims in court or arbitration.
 - Creates further risk of liability for IC violations.

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IC Versus Employee 101: Classification Criteria — Employee or IC?

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IC Versus Employee 101: Typical Worker Categories

- **Regular Employee:** A person rendering an actual service in any business for an employer, whether gratuitously or for wages
- **Contingent Workers:** Part-time, temporary, seasonal, or specialized workers employed for a limited period of time or an identified project (nearly 25% of the nation's workers)
- **Joint Employee:** Workers typically supplied by employee leasing firms or temporary staffing agencies
- **IC:** A person who renders services for specified recompense or a specified result under the control of the user of services only as to the result of the work, and not as to the manner or means by which the result is accomplished

Classification Criteria: Employee or IC?

32

- There is neither a single nor simple test used to determine whether a worker is an IC or an employee. The tests applied are complex and subjective, and differ depending upon the law at issue. For example, the Civil Rights Act, the Fair Labor Standards Act, the National Labor Relations Act, and the Employee Retirement Income Security Act each use a different definition of employee and different tests or criteria to distinguish ICs from employees.

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Tests for Employment Status

33

- The government and courts use several different tests for determining employment status depending upon the law involved:
 - IRS 20-factor “Right to Control” test
 - “Economic Realities” test
 - 3-factor test
 - Hybrid test: combination of “Economic Realities” and “Right to Control” tests (or other tests)
- States can and do use other tests

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Employee or Independent Contractor: The Common Law Test

20-Factor Test

• instructions	• order or sequences set
• integration	• reports
• payments	• expenses
• training	• investment
• services rendered personally	• tools and materials
• hiring assistants	• profit or loss
• continuing relationship	• works for more than one person or firm
• set hours of work	• offers services to general public
• full-time work	• right to discharge
• work done on premises	• right to quit

Independent Contractor Tests: The IRS Three-Factor Test

- For audit purposes, IRS auditors use a modified version of the 20-Factor Test that focuses on three factors:
 - Behavioral Control Factors
 - Financial Control Factors
 - Relationship of the Parties Factors
- The IRS Three-Factor Test considers the work that is being performed and the business context in which it is being performed

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FLSA's Economic Realities Test

36

- Control over the worker
- Workers' opportunity for profit or loss
- Workers' investment in equipment or materials required for task
- Whether the services rendered require a special skill
- The degree of permanency and duration of the working relationship
- The extent to which the services rendered are an integral part of the employer's business operations

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Best Practices to Minimize or Eliminate Risks and/or Exposure

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Best Practices for Avoiding Employer Status

38

- Do not over-utilize contractors
 - Contractors should not be hired to perform work central to the business (e.g., perform construction or bookkeeping work) but rather for the “special expertise” they have
- Avoid hiring/retaining former employees as contractors
- Allow the IC (or vendor) to determine the method and means of accomplishing the project
- Have contractor use own equipment
- Do not restrict work to a specific individual...contract with the “vendor”
- Do not require exclusivity of work or allow IC to perform services for other companies
- Do not require individuals to provide daily or weekly reports of their hours worked
- Pay by the project; do not pay a day or hourly rate
- Do not allow ICs to perform work indefinitely
 - Should be for a discrete time frame
- Use of staffing agencies
 - But be careful to avoid joint employer status!

Best Practices for Avoiding Employer Status ³⁹

- Enter into written agreements with ICs before work begins
 - Identify individual as an IC
 - Specify complete list of tasks to be performed and results to be obtained and do not add tasks except by contract amendment
 - Provide payment by project and not by hour, and with no benefits or expenses
 - Specify a contract-termination term, usually under one year, and avoid “rollover” of agreements
 - Confirm that worker controls manner and means of performing work
 - Do not require exclusivity
 - Include indemnification provision
 - Confirm no benefits/expenses to be received

Presenter Contact Information

40

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41

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41

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