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HASTINGS

**AMERICAN BENEFITS COUNCIL
TELECONFERENCE REGARDING WORKER
CLASSIFICATION**

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Overview

- ▶ Legislative and Regulatory Climate
- ▶ New IRS Voluntary Worker Classification Settlement Program (VCSP)
- ▶ What Should Employers Do in Light of VCSP?

Legislative and Regulatory Climate

- ▶ Obama Administration budget proposals
- ▶ Fair Playing Field Act
- ▶ Employee Misclassification Protection Act
- ▶ Payroll Fraud Prevention Act
- ▶ MOU Between IRS, DOL and 7 States
- ▶ California SB 459, Criminalizing Misclassification

Obama Administration Budget Proposals

- ▶ 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)

Obama Administration Budget Proposals

- ▶ 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

- ▶ 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

- ▶ 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

- ▶ 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 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.

California SB 449

- ▶ New California law designed to criminalize intentional worker misclassification
 - Now illegal for an employer to:
 - Willfully misclassify an individual as an independent contractor
 - Charge a willfully misclassified individual a fee or make any deduction from compensation (e.g., rental fees) that would violate the law if the individual was classified as an employee

California SB 449

- Hefty penalties
 - Civil penalty between \$5,000 and \$15,000 per violation
 - Civil penalty between \$10,000 and \$20,000 per violation for pattern or practice offenders
 - Must display a statement on company website for one year that:
 - ◆ The employer has committed a serious violation of the law by willfully misclassifying employees
 - ◆ The employer has changed its business practices to avoid willfully misclassifying employees
 - ◆ Any employee who believes he or she is misclassified can contact the Labor and Workforce Development Agency
 - ◆ The notice is posted pursuant to a state order

California SB 449

- ▶ Provides that civil penalties and posting requirements will continue to apply to a successor corporation, owner and business entity, if it:
 - Has one or more of the same principals or officers as the employer subject to the penalty or posting requirement; and
 - Is engaged in the same or similar business as the employer subject to the penalty or posting requirement

California SB 449

- ▶ Further provides that anyone who for money or other valuable consideration knowingly advises an employer to treat an individual as an independent contractor to avoid employment status for that individual is jointly and severally liable with the employer for misclassification
 - Excludes the employer's employees and attorneys

New IRS Voluntary Worker Classification Settlement Program

► Overview

- Permits employers to pay reduced liability for employment taxes (10% of amount that would have been due for most recent tax year)
- Not subject to interest or penalties
- Not subject to employment tax audit for three years

New IRS Voluntary Worker Classification Settlement Program

▶ Requirements

- Consistently treated workers as non-employees
- Filed Form 1099s for the workers for 3 prior years
- Not currently Under Audit by the IRS for any reason for by the DOL or a state agency for worker classification

New IRS Voluntary Worker Classification Settlement Program

▶ VCSP Requirements Continued

- Must agree to prospectively treat the class of workers as employees for all future tax years
- Must agree to extend statute of limitation for assessing employment taxes by three years for the first three years (i.e., extended to 6 years)
- Must enter into closing agreement with IRS

New IRS Voluntary Worker Classification Settlement Program

- ▶ VCSP Drawbacks
 - IRS Has Discretion to Decline Application
 - Unclear if Relief Extends to Income Taxes
 - VCSP Does Not Cover
 - IRS classification of other workers
 - DOL or other federal or state agencies
 - Private litigants (e.g., workers)

IRS-DOL Memorandum of Understanding (MOU)

- ▶ Memorandum of Understanding Between IRS and DOL signed September 19, 2011
- ▶ Purpose – reduce misclassification of employees, reduce the tax gap, and improve compliance with federal labor laws
- ▶ Enhanced information sharing –
 - Step 1: DOL refers wage and hour case to IRS
 - Step 2: IRS conducts employment tax examination on taxpayer
 - Step 3. IRS shares with state and municipal taxing agencies

What Should Employers Do In Light of VCSP?

- ▶ Determine whether there is a potential misclassification risk
- ▶ Identify both tax and non-tax costs of reclassifying
- ▶ Determine if tax costs can be minimized through other means
- ▶ Does additional VCSP savings, if any, outweigh other costs?

Determine whether there is a misclassification risk

What are the legal standards for determining whether a person is an employee or independent contractor?

Judicial and Regulatory Tests

- ▶ 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

- ▶ 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?

Factors Suggesting a Contractor

- ▶ 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

- ▶ 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

Factors Suggesting a Contractor

- ▶ 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.
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Joint Employment/ Co-Employment “Killers”

- ▶ 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)

Identify Non-Tax Costs of Reclassifying

- ▶ General Labor and Employment Law
- ▶ Employee Benefits

General Labor and Employment Law

Risks of Reclassification

- ▶ Wage and Hour Risks
 - Minimum Wage
 - Overtime
 - Penalties/Liquidated Damages
- ▶ Equal Employment Opportunity/Discrimination Claims
- ▶ Workers' Compensation
- ▶ Unemployment Taxes
- ▶ Broader Audit By Governmental Agency

Employee Benefit Consequences of Misclassification

- ▶ Claims for retroactive benefits
- ▶ Impact on tax-qualification rules

Claims for Retroactive Benefits

- ▶ Even if a worker is an employee, 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
- ▶ Plans could be written to limit participation to prospective period treated by employer as an employee

Tax-Qualification Rules

- ▶ 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

Tax-Qualification Rules

- ▶ 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 Reclassified Workers on Qualified Status

- ▶ Failure to satisfy minimum coverage rule by previously taking into account employees
- ▶ Even prospective inclusion of employees could pull in prior service for eligibility, vesting and benefit accrual

Tax Costs Associated with Reclassifying

- ▶ Income and other taxes that should have been withheld for state and local governments

How May Federal Tax Costs Be Mitigated Outside VCSP?

- 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)

How May Federal Tax Costs Be Mitigated Outside VCSP?

▶ 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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