CLIENT UPDATE

EMPLOYEE CLASSIFICATION: AN OLD ISSUE GETTING RENEWED ATTENTION

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The question of whether a person providing services is truly an employee or an independent contractor is one that human resources professionals and tax lawyers have long grappled with. The issue is getting renewed attention as both the IRS and the DOL have made it clear that they intend to allocate significant resources to ensure that workers are classified properly. And the stakes will only increase with the Patient Protection and Affordable Care Act (the "ACA"), which requires many employers to provide employees with adequate health care or face substantial penalties.

Worker classification analysis requires a proper assessment of facts and circumstances. For many years, employers have often reached the wrong conclusion, whether or not intentionally. When left unchallenged, a decision to treat a person who should be characterized as an employee as an independent contractor costs the federal and state governments a good deal in uncollected taxes and other social charges, especially when the independent contractors don't properly report their earnings. For an employer that is challenged on its classification practices and loses, the cost of correction can be significant.

Federal and state officials confronting budget deficits have focused on the significant amount of revenue lost when workers are misclassified. At the federal level, the IRS and DOL have formed a

united front to curb what they perceive as the widespread misclassification of workers. In connection with the DOL's 2011 Misclassification Initiative, the two agencies signed a Memorandum of Understanding under which they agreed to work together and share information to reduce the incidences of misclassification. The IRS has also implemented a Voluntary Classification Settlement Program which permits companies that meet certain criteria to voluntarily elect to reclassify employees for future tax periods and pay a fraction of the payroll tax liability for prior periods when misclassification occurred. While a professed purpose of these actions is to ensure that the affected workers can get the benefits they deserve, they will also allow the government to recoup millions of dollars it loses in revenue each year.

Each of the IRS and DOL has its own tests to determine when a service provider is an employee or an independent contractor. While separate, both tests focus on the amount of control the employer has over the worker and no single factor is dispositive; instead, the agencies look at the entire business relationship, considering the degree of control and independence among the worker and the employer.

Initially, the IRS utilized a twenty-factor test, but employers would often utilize some of the less significant factors to support the conclusion the employers wanted to achieve. The IRS has since streamlined its analysis into three key factors: (1) *behavior control*, (2) *financial control* and (3) *type of relationship*. These three factors essentially focus on different aspects of the same question: what is the level of control the company has over a worker? The IRS will also look at factors such as the length of the relationship between the worker and the employer, whether it is ongoing or on a temporary or project-based basis and whether the worker has the ability to work for other employers as well.

The DOL utilizes an approach known as the 'economic realities' test, which also focuses on the amount of control the employer has over the worker. The following factors are considered significant under the economic realities test: (1) the extent to which the services rendered are an integral part of the principal's business, (2) the permanency of the relationship, (3) the amount of the worker's investment in facilities and equipment, (4) the nature and degree of control by the principal, (5) the worker's opportunities for profits and loss, (6) the amount of initiative, judgment, foresight in open market competition with others required for the success of the claimed independent contract and (7) the degree of independent business organization and operation.

If pursuit by the government were not enough, plaintiffs' lawyers have found misclassification class actions to be an additional path to enhanced revenues. Employers in many industries have had their employment classification successfully challenged by

the individuals who had been classified as independent contractors. For example, several class action suits were recently successfully brought by exotic dancers challenging the seemingly industry-wide misclassification of their positions, and claiming that their misclassification deprived them of certain protections, including payment of minimum wage and overtime pay and other benefits. Additionally, a New York appellate court recently affirmed a decision that home tutors were employees. Several of these class action suits resulted in million dollar settlements, and that doesn't include the extent of the repercussions that should follow from the IRS and state authorities.

Another factor that will increase governmental scrutiny and the potential cost of employee misclassification is the commencement of the so-called "employer mandate" under the ACA. During 2015, the mandate will require employers with at least 100 full-time employees to provide suitable healthcare coverage to their full-time employees, and after 2015, the mandate will require employers with at least fifty full-time employees to provide such coverage to their full-time employees. If an employer fails to provide adequate coverage to a full-time employee – for example, if the employer did not make health insurance available to the individual because he or she was misclassified as an independent contractor – the employer could be subject to penalties if the employee acquires coverage in a healthcare exchange.[1] So, in addition to the other headaches of employee misclassification discussed above, employee misclassification could also result in an employer's failure to provide the required coverage to its employees and cost the employer a substantial amount in penalties under the ACA.

So, with the threat of stepped up enforcement, the risk of additional exposure associated with ACA coming live in 2015 and the increase in class action law suits by potentially misclassified employees, a company may face significant liabilities if it is determined to have misclassified workers. Depending on how its employee benefits plans (including medical, dental, pension, retirement, etc.) are drafted, the misclassified employees may also have a claim for unpaid or accrued benefits, which can be a significant expense to employers and a surprise for the financial statements. Although tax issues may be more difficult to address, benefits issues may be fixed, or at the very least mitigated, by careful drafting of employee benefit plan eligibility provisions.

Following the old adage that "a stitch in time saves nine," companies may wish to re-examine their employment practices and policies to make sure there are no latent classification issues, and be proactive in addressing any issues that may be found. The

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[1] For more information regarding the "employer mandate," please see our Client Alert, dated July 23, 2014, *Do as I (Meant to) Say: Reach of Healthcare Employer Mandate in Doubt at* http://www.debevoise.com/clientupdate20140723b/.

proper corrective action will vary by circumstance. Restructuring uncertain relationships should at least avoid potential exposure to future risks, even if the analysis of the facts and circumstances surrounding the past relationship is found to present an unclear answer.

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Please do not hesitate to contact us with any questions.

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