Avoiding Penalties When Classifying Independent Contractors

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Over the last several years, members of Congress (including U.S. Sen. Bob Casey, D-Pennsylvania) have introduced and reintroduced the Payroll Fraud Prevention Act, designed to target employers that intentionally misclassify employees as independent contractors. If passed, the law would amend the Fair Labor Standards Act to mandate that businesses provide notice to all individuals of whether they are classified as an "employee" or "non-employee" and to subject businesses to civil penalties for each instance in which they violate the law. More importantly, however, the law would permit the Department of Labor to conduct targeted audits of industries "with frequent incidence" of misclassification and would authorize the DOL to report misclassification incidents to the Internal Revenue Service.

Although the proposed law has not yet been the subject of a vote in either the U.S. Senate or the U.S. House of Representatives, the DOL's "Key Enforcement Initiatives," released in February, list "Addressing the Fissured Workforce" (which is a synonym for independent contractor misclassification) as the first initiative. Considering the DOL's recent history—which includes recovery of more than $1.3 billion in back wages for individuals since 2009—employers that use independent contractors in the construction, home health care, staffing, transportation, security, hospitality, custodial and medical industries (to name only a few) should be extremely diligent in their classification of contractors, as the DOL has indicated it will focus on these industries. As the federal government and plaintiffs attorneys increase the focus on how businesses pay and classify their workforces, businesses must be diligent in confirming that independent contractors are not actually employees.

Unfortunately, this is easier said than done. While the U.S. Court of Appeals for the Third Circuit and Pennsylvania courts have articulated tests and criteria to define whether an independent contractor is an employee, there is no one-size-fits-all consensus on how the tests should be analyzed or which issues are most important.

For instance, the Third Circuit utilizes the "economic realities" test to determine whether an individual is an employee. Under this test, the Third Circuit analyzes the following factors to determine whether an individual is an employee under the FLSA: (1) the degree of the alleged employer's right to control the manner in which the work is to be performed; (2) the alleged employee's opportunity for profit or loss depending upon his or her managerial skill; (3) the alleged employee's investment in equipment or materials required for his or her task or his or her employment of helpers; (4) whether the service rendered requires special skill; (5) the degree of permanence of the working relationship; and (6) whether the service rendered is an integral part of the alleged employer's business, as in *Donovan v. DialAmerica Marketing*, 757 F.2d 1376 (3d. Cir. 1985).

Although similar, Pennsylvania courts have utilized the following tests to determine whether an individual is an employee under the state's wage laws, as in *Morin v. Brassington*, 871 A.2d 844, 850 (Pa. Super. Ct. 2005): "the control of the manner that work is to be done; responsibility for result only; terms of the agreement between the parties;

the nature of the work or occupation; the skill required for the performance; whether one employed is engaged in a distinct occupation or business; which party supplies the tools; whether payment is made by the time or by the job; whether the work is part of the regular business of the employee; and the right to terminate the employment at any time."

Courts have made it clear that no one factor is dispositive of this issue and they will have to look at the situation as a whole in order to make the determination of whether an individual is an employee or an independent contractor.

Although courts have determined that the issue of whether an individual is an employee is a question of law, the fact that each situation is unique and will be analyzed by the courts on a case-by-case basis depending on those particular factors leaves businesses without much practical guidance when they attempt to use independent contractors in their businesses. As a result, while these tests provide some instruction on what may ultimately be litigated by plaintiffs, their attorneys or the DOL, the lack of practical direction exposes businesses to litigation with these contractors or the DOL. In light of this, businesses that utilize independent contractors—particularly in the industries the DOL has targeted for audits and investigation—must be diligent in making certain that they are appropriately differentiating between employees and their contractors.

Businesses that engage someone as an independent contractor should, first and foremost, have an independent contractor agreement with that individual (or, ideally, that individual's business). This agreement should specify the contracted services and what the contracted rate is for those services. This agreement should identify how long the duration of the agreement will be—since an agreement without a defined ending date or one that exceeds several months looks more like an employer-employee relationship than an independent contractor relationship. In addition, businesses should identify that the contractor should have his or her own insurance for purposes of providing those services. Of course, businesses must confirm that the insurance is actually in place or risk facing uncomfortable questions if the contractor relationship is challenged in litigation. While an independent contractor agreement will not be dispositive of all of the issues, it provides an important first step for businesses to protect themselves from misclassification claims.

Second, businesses must allow contractors to dictate how services are performed. Courts have frequently denied a business' claims that an individual was an independent contractor when there is evidence that the business is controlling the means and methods for how the individual performs the work. Indeed, permitting contractors to determine when they perform the services, how they perform the services and who they may hire to assist them in performing the services is another important factor in achieving a determination that the individual is an independent contractor. Moreover, businesses are on stronger footing with the DOL if they can also show that contractors use their own tools or materials and if they perform the services at their own location or office. In fact, businesses tend to lose these cases when there is evidence that the business mandates exactly when an individual must show up or leave, or requires them to follow all of its employment rules and guidelines and then disciplines them, similar to an employee, for failing to comply with those rules or guidelines.

Third, businesses should not engage contractors for assignments that mirror (or closely resemble) the tasks and responsibilities performed by those already classified as employees by the business. Indeed, the more that a business' engaged contractors look like they are performing the same (or similar) tasks as employees, the more likely the DOL will have cause to audit the business to determine whether there are instances of misclassification.

Next, the independent contractor agreement should specify how payment is made and that the business will issue the contractor a Form 1099 at the end of the year. Similarly, the agreement should also identify that the contractors are responsible for their own expenses—including mileage, tolls, phone and Internet—particularly if the business reimburses those expenses to its

employees. If litigation occurs, businesses should obtain the tax returns for these individuals to determine whether or not they deducted these business expenses on their tax returns. Importantly, if there is an employee handbook that provides for the receipt of certain benefits, businesses must make certain that they do not provide these identical benefits to their contractors, as it should be the contract itself that controls what the contractor receives or does not receive.

Moreover, businesses should, at all costs, avoid paying their engaged contractors a static, weekly payment for the performance of their services. The more that it looks like a salary and that the individual is receiving all of his or her pay from one source, the more likely the DOL will find that the individual is an employee. From this, businesses should strive to pay for the job performed, which would ideally be accompanied by an invoice submitted by the contractor for the services performed. Similarly, businesses should support the individual's pursuit of other contracts with other businesses, as that further supports the fact that the individual is truly independent.

While these are just a few suggested methods to avoid the ire of the DOL, they are not all-encompassing and, as noted above, Pennsylvania state and federal courts will continue to analyze these issues on a case-by-case basis. Of course, consistency in demonstrating that engaged independent contractors are different from hired employees and are, in fact, independent in the manner and method in which they perform services will go a long way to defeating potential allegations of misclassification of employees and might avoid a DOL investigation.

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