Top Echelon

Fourth Quarter
2015

Contracting Corner

The Perm Recruiter's Contracting Resource

Don't Gamble with the Government!

When it comes to worker misclassification, they hold all the winning cards.

"Even those who have managed to avoid consequences thus far are not safe in the coming years, thanks to an evolving regulatory landscape."

Worker misclassification has been a hot topic for years, but lately it's reached a whole new level of scrutiny—both in the media and in the courts. The crackdown on this practice is picking up speed, which is bad news for employers who misclassify workers as 1099 independent contractors (ICs) rather than W-2 employees, knowingly or not. Worse, the consequences of being caught are increasing.

Even those who have managed to avoid consequences thus far are not safe in the coming years, thanks to an evolving regulatory landscape. Let's take a look at the factors at play.

Misclassification Initiative: Throwing a Wider Net

The U.S. Department of Labor (DOL), in partnership with the IRS, announced a joint Misclassification Initiative in late 2011. The two agencies agreed to share information and coordinate enforcement to combat worker misclassification.

This collaboration has resulted in an increase in back wages and penalties recovered by the Wage and Hour Division: the collected back wages alone have averaged 86.7 million annually. That's not to mention the back taxes, penalties, and fines that the IRS has collected. And, in 2014, the IRS announced an increase in audits of S-corporations due to findings of many misclassified 1099 ICs in these organizations.

The IRS and the DOL have added more players to their team—the state governments. The Wage and Hour Division has signed Memorandums of Understanding with 26 states to date: AK, AL, CA, CO, CT, FL, HI, ID, IL, IA, KY, LA, MD, MA, MN, MO, MT, NH, NY, RI, TX, UT, VT, WA, WI and WY. The states have a strong financial incentive to participate in the Initiative.

Tightening Guidelines: The "Economic Realities" Test

In July 2015, the DOL issued a new Administrative Interpretation of the "economic realities" test. This test is commonly used to determine the correct classification of a 1099 IC. What impact does the new guidance have? It boils down to this: **The majority of workers who have been assumed to be appropriate 1099 ICs under the Fair Labor Standards Act (FLSA) are no longer correctly classified.** The guidance also makes it clear that a contract stating that a worker is a 1099 IC "is not indicative of the economic realities of the working relationship and is **not relevant to the worker's status.**"

While the new guidance "does not have the force of law," the courts will likely give the DOL's interpretation heavy weight in legal proceedings. The key factor is **determining whether a worker is economically dependent on the employer or is truly operating an independent business of their own.**

(888) 627-3678

Media Coverage, Lawsuits, and the "Gig Economy"

Growing media coverage is shining a spotlight on worker misclassification. Shipping giant FedEx recently settled one of 28 multi-state misclassification suits with a group of former California delivery drivers for a whopping **$228 million**. This suit is an example of the long shadow misclassification casts: FedEx changed their controversial driver policy in 2011, but will still be tied up in litigation and financial battles for years to come.

The spotlight is also shining on the "Gig Economy," particularly app-based services which mobilize an on-demand workforce. The prime example is Uber, but other examples include Lyft, Homejoy, Luxe, Shyp, and Instacart. These service platforms have a tendency to view themselves as technology companies creating apps, not as W-2 employers. They classify their human service providers as 1099 ICs, regardless if that classification is strictly accurate.

This move could come back to haunt even the largest app-based services. Uber is currently fighting a class-action lawsuit leveled by California drivers who believe they should have been treated as W-2 employees. In a separate case, the Wall Street Journal reported that one Uber driver was recently ruled an employee, not a 1099 IC, by the California Labor Commissioner. While this decision does not directly affect the class of drivers, it will likely add weight to their case.

Due to their highly public nature, these cases serve as a clanging alarm. Some app-based service providers are preemptively reclassifying some or all of their workforce as W-2 employees (Luxe, Shyp, and Instacart), while others have shut down altogether (Homejoy).

Added Complications from the ACA

Come January 1, 2016, the minimum health insurance coverage requirements of the ACA may prove costlier to employers than ever before. Medium-sized employers with 50 to 99 employees must offer minimum essential coverage (MEC) to 70% of employees. Large employers with 100 or more employees must offer MEC to 95% of employees. The penalty for non-compliance with the ACA MEC requirements is a fee of 1/12 of $2,000 per full-time employee, minus the first 30 employees, per month that: 1) They did not offer minimum essential coverage to the necessary percentage of employees, and 2) At least one full-time employee received a premium tax credit for purchasing individual coverage on an insurance exchange.

In the recent past, employers have tried to use 1099 ICs to avoid the ACA compliance required of companies with 50 or more W-2 employees. However, if an employer's 1099 ICs are found to have been misclassified, they are reclassified and added to the total employee count. If they were close to the MEC requirement lines already, a few misclassified workers can set off a domino effect ending in a crippling fine. **Consider the example offered by PricewaterhouseCoopers in a 2014 article on employers' ACA exposure: An employer with 500 full time employees offers MEC to 95% of those employees (480). They also engage ten 1099 ICs who are ineligible for employer-sponsored healthcare. If these ten are reclassified as employees, the percentage of coverage offered drops to 94% of total employees. The employer could owe an excise tax penalty of $960,000 for the year – all due to ten misclassified 1099 ICs.** At the medium-sized employer level, even one could make the difference. Employers who try to stay under the ACA employee limits using 1099 ICs may find this backfiring in a major way.

Significantly, the ACA will not count the Revenue Act of 1978's Section 530 "Safe Harbor" protections for determination

of MEC and penalties. Section 530 "prevents the IRS from retroactively reclassifying 'independent contractors' as employees and subjecting the principal to federal employment taxes, penalties and interest for such misclassification" if specific requirements are met. However, Section 530 relief can only protect against retroactive federal employment taxes, penalties, and interest.

Consequences for Recruiters and Clients Alike

So why do companies still misclassify their workers? For one thing, they may not be fully aware of the extensive consequences, or they may think they are safe thanks to Section 530. Recruiters, in particular, may not realize they could be held liable even if they are placing a misclassified 1099 IC at a client facility. Possible consequences, as compiled in a recent ERE Media article, include:

- **Wage law violations.** Including criminal penalties and liability for back wages. Other charges include unpaid overtime costs, minimum wage deficits, liquidated damages and attorney's fees.
- **Tax penalties.** Failure to withhold state and federal payroll taxes, including failure to make matching social security and Medicare tax payments.
- **I-9/E-verify violations.** Failure to comply with Federal requirements.
- **Unemployment insurance shortfalls.** Retroactive penalties for failure to pay correct amounts.
- **Worker's Comp violations.** Penalties for violating laws and liability for unpaid premiums.
- **Exclusion from benefit plans.** Improper exclusion from benefit plans for which the misclassified employee should have been eligible. (This is a particularly hot area of enforcement with many lawsuits being filed.)
- **Antidiscrimination, FMLA, USERRA, and WARN Act law violations.**
- **Affordable Care Act (ACA) excise taxes and fines.**

Solutions and Options

Recruiters and client companies alike would be wise to conduct a careful internal audit of any 1099 ICs. Are they classified correctly by both federal and state standards? If there is any question whatsoever, reclassifying them as W-2 EEs may be the safest bet. The IRS offers a Voluntary Classification Settlement Program (VCSP) through which eligible employers who reclassify can have federal tax interest and penalties forgiven and pay only 10% of employer tax liability that would have been due for the most recent tax year.

Recruiters, you can give your clients the best of both worlds by offering to convert their 1099 ICs to W-2 EEs and outsource the administrative, legal, and financial liability to a reputable, ACA-compliant back-office—such as Top Echelon. Your clients will stay **free of the burdens of employing additional workers and the risk of engaging them as 1099 ICs.**

Q&A

What are the 6 Factors of the "Economic Realities" Test?

The July 2015 *U.S. Department of Labor Administrative Interpretation* No. 2015-1 (AI) lists the six factors of the "Economic Realities" test as follows:

1. **Is the work performed an integral part of the employer's business?**
2. **Does the worker's managerial skill affect the worker's opportunity for profit or loss?**
3. **How does the worker's relative investment compare to the employer's investment?**
4. **Does work performed require special skill and initiative?**
5. **Is the relationship between the worker and the employer permanent or indefinite?**
6. **What is the nature and degree of the employer's control?**

Critically, according to the AI, "The control factor should not overtake the other factors" or "play an oversized role" in worker classification. An employer or employee's level of control over work is irrelevant unless it shows a worker is operating a business independent from the employer.

The bottom line of the AI is this: "…most workers are employees under the FLSA's broad definitions. The very broad definition of employment under the FLSA as 'to suffer or permit to work' and the Act's intended expansive coverage for workers must be considered when applying the economic realities factors to determine whether a worker is an employee or an independent contractor."

Find the Interpretation here: http://www.dol.gov/whd/workers/misclassification/AI-2015_1.htm

This general summary of law should not be used to solve individual problems since changes in fact situation may require a material variance as to the applicable law. This newsletter is for information purposes only and should not be construed as legal advice.

Top Echelon

4883 Dressler Road, NW, Ste. 200
Canton, OH 44718

Contracting Corner

The Perm Recruiter's Contracting Resource

Fourth Quarter
2015

RECRUITERS' ROUNDTABLE:

It happens to recruiters all the time: A client tells you that they want a contract candidate paid as a 1099 independent contractor (IC), to save on taxes and insurance or for other reasons, and you feel obligated to comply. After all, it's the client's choice whether or not to pay workers on a W-2…right? Actually, it's not.

What about when a candidate pushes to be paid as a 1099 IC instead of a W-2 employee for a contract assignment? Maybe it's because tax-deductible business expenses are attractive to them, or even just because they've been a 1099 IC on a past assignment. Either way, it's not the candidate's choice any more than it is the client's.

How about situations where there is contractual language in place that says the worker is a 1099 IC and not a W-2 employee? Nope, the label given to the worker does not trump the legalities tied to worker classification.

Recruiters NEED to Know About Worker Misclassification

Worker classification is NOT up to the client or the candidate—or even the recruiter! According to the U.S. Department of Labor Administrator's Interpretation No. 2015-1, "In order to make the determination whether a worker is an employee or independent contractor under the FLSA, courts use the multi-factorial "**economic realities**" test, which focuses on whether the worker is economically dependent on the employer or in business for him or herself." **See the Q&A inside for the six factors.**

In this issue, we discuss the crippling (and increasing) consequences of misclassification—and why the spotlight on this topic is only getting brighter. All parties involved **could end up facing audits, fines, penalties, and back wages.**

WHAT'S INSIDE:

(888) 627-3678