Dangers of Employee Misclassification

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NOTICE

This presentation is intended to provide general information. No part of it should be construed as legal advice to be applied to any specific factual situation. For advice on any legal issues or matters, you should consult legal counsel.
The Dangers of Misclassification in Employee Benefit Plans

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Why is this topic important?

- Companies may face lawsuits from workers claiming benefits under retirement or health plans because they were misclassified.

- IRS and DOL may audit plans and companies can be liable for penalties and monetary corrections if workers are found to be misclassified.

- Companies may be subject to penalties under the Affordable Care Act if they do not offer health coverage to misclassified workers who are actually common law full time employees.
Covering Workers in Employee Benefit Plans

- Retirement plans must be for the benefit of a company’s employees
  - Covering independent contractors could be a qualification issue

- Health and welfare plans that cover workers other than common law employees, such as independent contractors or outside directors, may inadvertently become MEWAs
  - Considered “self-employed individuals” under ERISA

- Plan documents must specify which employees are eligible
  - Generally exclude workers who are classified by the company as independent contractors

- “Anti-Microsoft” clauses are usually added to plan documents to prevent retroactive coverage of misclassified employees
Consequences of Misclassification - Retirement Plans

**Employee eligibility**

- If the plan has Anti-Microsoft language, the reclassified employee will become eligible for the plan as of the date of reclassification.
- If the plan does not have Anti-Microsoft language, then the company may need to provide retroactive benefits for the period the employee was erroneously excluded from the plan.
- IRS has an Employee Plans Compliance Resolution System (“EPCRS”) under which companies may avoid penalties on audit by voluntarily filing corrections for such errors.
  - Some errors may be corrected without filing with the IRS under the Self Correction Program (“SCP”).
  - If SCP is not available, then file under the Voluntary Correction Program (“VCP”) with the accompanying compliance fee (which is generally based on the plan’s participant count).
- Rev. Proc. 2013-12 has correction procedures, calculations, and examples.
- Corrections must be adjusted for earnings.
Consequences of Misclassification - Retirement Plans (cont’d)

- **Corrective Contributions**
  - Defined benefit plan: must make a contribution to the plan to provide benefit accruals for the excluded employee
  - Defined contribution plan: must make a contribution to the plan for any missed elective deferrals, matching contributions, profit sharing contributions, and/or other employer contributions
    - Correction for elective deferrals is 50% of the missed deferral
    - Corrective contribution must be adjusted for earnings

- **Nondiscrimination Tests**
  - If an employee is misclassified the company may need to re-test the plan
    - If the plan fails testing due to the inclusion of the misclassified employee, corrective contributions or distributions may be necessary
Other Classification Issues—Retirement Plans

- **Temporary Employees**
  - Some companies classify workers as temporary employees when they are actually staffing firm or leased employees
  - Retirement plans may exclude leased employees but should be cautious with blanket exclusions for temporary employees
    - Minimum service rules prohibit hours-based exclusions
  - If the “temporary” employee ends up working 1,000 hours, there could be a problem
  - Companies should make sure they understand and document how they are classifying employees
    - Includes temporary, seasonal, part-time, and similar classifications
    - IRS pays attention to eligibility exclusions
Consequences of Misclassification – Health and Welfare Plans

- Employee eligibility
  - If the plan has Anti-Microsoft language, the reclassified employee will become eligible for the plan as of the date of reclassification.
  - If the plan does not have Anti-Microsoft language, then the company may need to provide retroactive coverage for the period the employee was erroneously excluded from the plan.
    - May also include coverage for employee’s dependents.
  - Can result in having to cover large medical bills if company has a self-insured plan.
  - Can affect insurance renewal rates.
Consequences of Misclassification – Health and Welfare Plans (cont’d)

**Employer Mandate Overview**

- Beginning in 2015, companies with 50 or more full-time equivalent employees must offer health coverage to their full-time employees ("FTEs")
  - Transition rule for 2015 only – mandate applies to companies with 100 or more full-time equivalent employees
  - Must offer minimum essential coverage that is affordable and provides minimum value, or face two possible penalties
  - Penalties apply only if at least one FTE purchases coverage through a Marketplace and receives a premium tax credit or other subsidy

- Mandate does not apply to workers who are truly independent contractors
  - Definition of “employee” for purposes of the mandate only includes common law employees

- If an employee is misclassified and should have been offered coverage, but purchases coverage from Covered California (or another Marketplace) and receives a tax credit or subsidy, penalties may apply
Consequences of Misclassification - Health and Welfare Plans (cont’d)

**Employer Mandate Penalties**

- Must offer minimum essential coverage to substantially all FTEs (and their dependents) or “No Coverage” penalty applies ($2,000/FTE/year, based on all FTEs minus 30)
  - “Substantially all” means 70% for 2015 and 95% thereafter
- Must offer affordable coverage that provides minimum value or “Insufficient Coverage” penalty applies ($3,000/FTE/year, only for FTEs who actually receive premium tax credit or other subsidy)
  - Minimum Value: Plan’s share of total costs of benefits provided must be at least 60% of such costs
  - Affordable Coverage: Employee’s required contribution for lowest cost option (single coverage) cannot exceed 9.5% of household income
Other Classification Issues - Health and Welfare Plans

- **Employer Mandate - Safe Harbor for Staffing Firm Workers**

  - Safe harbor available when the staffing firm is not the common law employer of a worker

  - If the worker receives an offer of coverage under the staffing firm’s health plan, that offer will be treated as an offer of health coverage by the recipient company so long as the staffing contract provides that the fee the recipient company pays to the staffing firm for employees enrolled in the health coverage is higher than the fee the recipient company would pay for the same employee if he or she did not enroll in the health coverage

  - Simply charging a higher fee for all staffing firm workers (and saying the fee is for purposes of the Affordable Care Act) is not enough – the fee must specifically apply to those employees enrolled in the health coverage

  - Regulations do not specify how much higher the fee must be

  - Not clear whether this safe harbor is available if both the recipient company and the staffing firm are considered to be an individual’s common law employer
Best Practices to Reduce Exposure

- Evaluate worker classifications and make corrections as necessary before the IRS and/or DOL audit your plans.
- Add Anti-Microsoft language to plan documents and summary plan descriptions.
- Review staffing firm agreements:
  - Ensure agreements include safe harbor for health coverage (client employer is paying a higher fee for employees enrolled in the PEO’s health coverage).
  - May want an affirmative statement that staffing firm satisfies employer reporting requirements.
Misclassification of Independent Contractors

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Why is this topic important?

- Aside from lawsuits that a company may face from workers claiming they were misclassified, companies can be audited by different government agencies at the state and federal levels.

- With state and federal governments in massive deficits, these governments consider improper independent contractor classification as a potential revenue making machine because of the opportunity to generate large tax revenues.

- **The burden is on the employer to show that it has correctly classified independent contractors.**
Why is this topic important? (cont’d)

- The federal government has increased enforcement initiatives targeting independent contractor misclassification: the federal government’s budget includes millions of dollars and nearly 100 additional enforcement personnel for the Labor Department, in conjunction with the US Treasury, to identify and penalize employers who improperly misclassify employees as independent contractors.

- It is expected that the federal government will increase treasury receipts by more than $7 billion over 10 years.

- California is one of many states that has entered into sharing arrangements with the IRS in the area of worker classification.
Why is this topic important? (cont’d)

- In 2012, new penalties were implemented to punish California employers who willfully misclassify individuals as independent contractors.

  - “Willful misclassification” under this new law means avoiding employee status for an individual by voluntarily and knowingly misclassifying that individual as an independent contractor.

  - The law also prohibits charging misclassified individuals for items that an employer is normally required to pay, such as employee business expenses, goods, materials, rent, services, government licenses, repairs, equipment maintenance, or fines arising from the individual’s employment.
Why is this topic important? (cont’d)

- **Violations can be significant.**

  - If Labor Commissioner or Court proceedings determine that a violation has occurred, the penalties range from $5,000 to $15,000 per violation.

  - If a pattern and practice of violations is found, penalties can range from $10,000 to $25,000 per violation.
Employee Classification: Employee vs. Independent Contractor

- Why Do Companies Prefer to Classify Their Workers as Independent Contractors?

  - If a worker is properly classified as an independent contractor, the company generally avoids obligations under many state and federal laws: e.g. wrongful termination etc.

  - Classifying a worker as an Independent Contractor means:
    - Employer is able to reduce its labor costs;
    - Employer avoids paying Social Security, Medicare taxes, *Workers’ Compensation* and Unemployment Insurance;
    - Employer does not have to pay any pension, medical insurance, vacation, sick leave, severance, and other benefits, including employee business expenses;
    - The worker has no protection under employment statutes;
    - Leaves of absences are not required.
Employee Classification: Employee vs. Independent Contractor

- Reasonable accommodation and return to work obligations under the disability laws do not apply;

- Anti-discrimination obligations of protected classes (e.g., age, race, sex, national origin, ancestry, disability, medical condition, sexual preference, religion, etc.) are not a concern (although independent contractors are protected under the sexual harassment laws);

- No collective bargaining or Union issues to worry about;

- Tax and trust fund obligations are of little concern (e.g., income tax, Unemployment Insurance, State Disability Insurance, Paid Family Leave, Employment Training Tax, Social Security, and Medicare);

- Wage and hour laws do not apply (e.g., minimum wage, overtime, rest / meal periods, etc.);

- Plant closure and mass layoff notice laws are not a worry;

- Wrongful employment termination and related causes of action do not exist.
How to Determine Independent Contractor Status

- There are several different tests for determining independent contractor status - various legal standards.

- *Each* government agency, statutory regulation, and common law / case law has its own variation of factors.

- There are multiple agencies and bodies of law that are relevant to Independent Contractor/Employee Classification. These are:
  
  - Federal and state courts (common law / economic realities test);
  
  - California agencies, including: Department of Fair Employment and Housing; Department of Labor Standards and Enforcement (aka Labor Commissioner); Unemployment Insurance Appeals Board; Workers Compensation Appeals Board; Employment Development Department; Franchise Tax Board; and Cal-OSHA;
  
  - Federal agencies, including: DOL; IRS; NLRB; and OSHA.
How to Determine Independent Contractor Status (cont’d)

- There is no universal, consistent set of principles. Businesses must weigh various factors:
  - Some factors may indicate that worker is an employee, while other factors may indicate that worker is an independent contractor;
  - There is no “magic” or set number of factors dispositive;
  - Common factor: whether the company has the right to direct and control the manner and means by which the work is performed;
  - When company has the “right of control” or “right of duration and control,” the worker will be deemed an employee most often, even if the company never actually exercises control;
  - If company does not have right of direction and control, worker may be an independent contractor;
  - **But, again, there is no individual deciding factor.**
  - Factors that are relevant in one situation may not be relevant in another.
How to Determine Independent Contractor Status (cont’d)

- **Summary of Classification Factors That Nearly All Courts and Agencies Consider:**
  
  - Whether the company has the right to control the manner and means of how the worker accomplishes the results desired;
  - The worker’s work is not the company’s primary work;
  - The worker is in a distinct occupation or separate business;
  - The worker’s relationship is short term and not a continuing one;
  - The worker decides where the work is to be done, and that is usually the worker’s facility, and sets his or her own hours;
  - The worker is paid by the job;
  - The worker uses his or her own tools;
  - The worker cannot be terminated at-will.
Summary of Classification Factors

- The worker is a highly skilled, works without supervision of the company and uses initiative, judgment and foresight for success of the independent operation;
- The worker has the right to hire and terminate others;
- The worker does not have a company title or business card;
- The worker acts like a separate business (e.g., entity, contracts, invoices, leases, insurances, employees, etc.);
- Whether the parties believe they are creating an employer-employee or company-independent contractor relationship;
- The worker has financial control of its business (i.e., significant investment in the business, opportunity for profit or loss, and pays own expenses).
Consequences of Misclassifying Workers as Independent Contractors

- **Burden of Proof**

  - In a dispute involving whether the worker is properly classified as an employee or an independent contractor, the burden falls on the employer.
    - *i.e.*, the employer is the one that has to prove independent contractor status.
  
  - **Under California law there is a presumption of employment.**
Consequences of Misclassifying Workers as Independent Contractors (Cont’d)

- **Common Classification Problems/Errors**
  - Ignorance – “but I did not know”;
  - Save Money;
  - Avoid Regulation;
  - Temporary Workers – company thinks that a temporary worker is not an employee;
  - Freelancers – same;
  - “Consultants” – same;
  - Industry Standard – same.
Consequences of Misclassifying Workers as Independent Contractors (Cont’d)

- **Tax liability**
  - Responsibility for tax amounts that should have been withheld, plus interest and penalties;
  - Federal Insurance Contribution Act (FICA) amounts;
  - Federal Unemployment Tax Act amounts;
  - State taxes;
  - Unemployment, disability, employment training withholdings; and
  - Penalties (increased penalties for willful violations).
Consequences of Misclassifying Workers as Independent Contractors (Cont’d)

- **Coverage under benefit plans**
  - **Example:** worker who is misclassified as an independent contractor and does not have health insurance. Employer has health insurance coverage for its employees, but because this individual is not properly classified as an employee, then employer may be facing some major liability, including some hefty medical bills.

- **Workers’ compensation costs** – penalties and liability for paying for injury.

- **Overtime and other wage and hour liability.**

- **Liability under FEHA/Title VII:** wrongful termination, discrimination, etc.
Consequences of Misclassifying Workers as Independent Contractors (Cont’d)

- Other statutes protecting employees (FMLA, CFRA, PDL);
- Tort Liability – Employers responsible for torts of employees;
- **Domino Theory:** one claim by one worker or any agency can lead to claims by other workers and agencies.

  • When the issue of independent contractor classification comes up in one jurisdiction, employees or the government are motivated to figure out a way for the issue to be raised in other jurisdictions as well.

  • It is not unusual for the issue to start with an unemployment claim after an independent contractor loses his/her job, followed by state tax, state Labor Board, federal tax scrutiny and civil litigation dominoes.
Best Practices to Reduce Exposure

- Disputes can drain time and money from a business.
  - Businesses that evaluate classification and the risks of attack now, can either modify these relationships to make them more defensible or determine that employee classification is both more realistic and reduces the risks attendant to improper classification.

- Written contracts with all independent contractors: essential but not dispositive. Some provisions to consider:
  - Use effective independent contractor language in agreement – spell out intent, authority, compensation, tax treatment;
  - Language should focus on results and avoid methods/means;
  - Duration should be for project (with end date) or for a limited period;
  - No automatic renewal;
  - Compensation by project preferable to salary;
  - No employee benefits;
  - Require independent contractor to carry insurance.
Best Practices to Reduce Exposure (Cont’d)

- **Do not allow:**
  
  - independent contractors to perform core work of business or work similar to the duties performed by regular employees;
  
  - independent contractors to utilize company tools or equipment, IT or email systems;
  
  - independent contractors to hold themselves out as representatives of the business – no company title, business cards, letterhead, or uniforms;
  
  - independent contractors to attend staff meetings or employee functions;
  
  - independent contractors to use employee work stations or work in locations in the same manner as employees;

- **Do not insist** on exclusivity – specify freedom to work for others;

- **Avoid** converting employees to independent contractors with no change in duties or responsibilities.
Best Practices to Reduce Exposure (Cont’d)

- **Compliance Controls:**
  - Conduct internal audit and reclassify where appropriate;
  - Establish independent contractor approval procedures and control points;
    - individual who reviews all proposed independent contractor arrangements and whose approval is necessary.

- **In the Face of an Audit or Agency Investigation:**
  - Consult with counsel;
  - Get your CPA involved;
  - Take response seriously;
  - Do not stonewall or close ranks;
  - Cooperate.
THANK YOU!

QUESTIONS?