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November 3, 2010

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Congressional Bills Intended to Clarify Independent Contractor Status Would Instead Create Confusion for Employers Seeking to Avoid Misclassification Liability

Richard J. Reibstein | reibsteinr@pepperlaw.com

Congress has introduced a labor bill and a tax bill that are intended to discourage businesses from misclassifying employees as independent contractors and end the issuance of Form 1099s to workers who are not legitimate independent contractors. The bills have the laudable goal of curtailing misclassification of employees as independent contractors, and the Obama administration has firmly endorsed both bills, making their passage likely. But the two bills, although related, contain different tests for determining who is an independent contractor or employee.

It can hardly be disputed that businesses that *intentionally* issue Form 1099s to workers contribute to the tax gap, deprive workers of federal, state, and local workplace protections, and place businesses that properly classify workers at a competitive disadvantage. But, what about *unintentional* misclassification by businesses confused by varying definitions and legal standards used to determine who is an independent contractor and who is an "employee" under an array of labor, tax, and benefits laws?

The Government Accountability Office (GAO) reported to Congress in 2006 that "the tests used to determine whether a worker is an independent contractor or an employee ... differ from law to law" among various federal labor, employment, and employee benefits laws. The GAO report notes that the NLRA, the Civil Rights Act, FLSA, and ERISA each use a different definition of an employee and various tests, or criteria, to distinguish independent contractors from employees. In a 2009 report to Congress, the GAO concluded that while "the independent contractor relationship can offer advantages to both businesses and workers" and "[m]any independent contractors are classified properly," Congress should take steps to help businesses that "may be confused about how to properly classify workers."

While the tax bill expressly seeks to clarify confusion over who is an employee or independent contractor under the federal *employment tax laws*, the labor bill seems to undermine this congressional objective by referring to a test at odds with the tax bill and inconsistent with the standards used by the courts applying most federal *labor and employment laws*.

Unless Congress recognizes and addresses the discrepancy between the two bills during the legislative process, passage of the two laws as drafted will contribute to an even more confusing legal landscape for the hundreds of thousands of businesses that treat certain workers as independent contractors.

The Fair Playing Field Act of 2010 Bill

The Fair Playing Field Act of 2010 is the more recent of the two bills addressing misclassification. It was introduced in both the Senate (S. 3786) and House (H.R. 6128) on September 15, 2010. The sponsors of the legislation, Sen. John Kerry (D-MA) and Rep. Jim McDermott (D-WA), have stated that the bill is intended to close a "tax loophole allowing businesses to misclassify workers as independent contractors." As set forth in the preamble of the bill, "misclassification for tax purposes contributes to inequities in the competitive positions of businesses and to the Federal and State tax gap, and may also result in misclassification for other purposes, such as denial of unemployment benefits, workplace health and safety protections, and retirement or other benefits or protections available to employees."

Section 530 of the Revenue Act of 1978 is the so-called "loophole" that the Fair Playing Field Act seeks to close. That law has afforded businesses for the past 30 years a "safe harbor" to treat workers as independent contractors for employment tax

purposes as long as the company has had a reasonable basis for such treatment and has consistently treated such employees as independent contractors by reporting their compensation on a Form 1099.

The Fair Playing Field Act bill recognizes that while "many workers are properly classified as independent contractors, in other instances workers who are employees are being treated as independent contractors." The bill also notes that "[w]orkers, businesses, and other taxpayers will benefit from clear guidance regarding employment tax status." The Act would therefore direct the Secretary of the Treasury to issue guidance in the form of regulations "allowing workers and businesses to clearly understand the proper federal tax classification of workers."

A key part of the bill provides that, in issuing such guidance, the term "employment status" for any individual shall be determined "*under the usual common law rules* applicable in determining the employer-employee relationship, as an employee or as an independent contractor (or other individual who is not an employee)." (Emphasis added.)

The courts and the IRS have historically used the "common law" test for determining independent contractor status under the Tax Code. Yet, as noted below, the other federal bill seeking to curtail misclassification not only refers to a different test for determining who is an employee and who is an independent contractor, but also is out of sync with prevailing judicial precedent.

The Employee Misclassification Prevention Act (EMPA) Bill

EMPA was introduced on April 22, 2010 by the Senate (S. 3254 - http://http/frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s3254is.txt.pdf) and House (H.R. 5107 -http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h5107ih.txt.pdf). The bill would amend an existing law, the Fair Labor Standards Act (FLSA), by creating a new labor law offense: misclassification of an employee as an independent contractor.

In addition, once enacted, EMPA would also impose strict record-keeping and notice requirements upon businesses with respect to workers treated as independent contractors, expose such businesses to fines of $1,100 to $5,000 for each misclassification of an employee as an independent contractor, and award triple damages for violations of the minimum wage or overtime provisions of the FLSA for misclassified employees.

EMPA specifically refers to the definition of "employee" found in the FLSA, a 1938 law that regulates child labor and mandates the payment of minimum wage and overtime for employees who work more than 40 hours in a workweek. The courts have interpreted the word "employee" in FLSA cases under an expansive legal standard that is commonly referred to as the "economic realities" test. As the Supreme Court noted in its 1992 opinion in *Nationwide Mutual Insurance v. Darden*, this expansive interpretation under the FLSA derives from laws that were intended to prevent child-labor violations, and "stretches the meaning of 'employee' to cover some parties who might not qualify as [an employee] under a strict application of traditional [common] law principles."

The EMPA bill as currently drafted, however, would arguably incorporate the FLSA's broad "economic realities" test into its definition of "employee." That test gives most weight to the economic dependence by workers on the business that has retained them. Such a test is inconsistent with the Supreme Court's most recent judicial precedents applying the "common law" test and is at odds with what the Court referred to as the "common understanding … of the difference between an employee and an independent contractor."

As the Assistant Secretary of Labor testified in writing before the Senate at a hearing held on EMPA on June 17, 2010, "Whether a worker is an employee [or independent contractor] depends on which law is applicable." He continued: "We recognize that it is conceivable for a worker to be correctly classified differently under the different standards that apply for different statutory purposes."

Absent a legislative "correction," therefore, a business that properly classified a particular worker under the "common law" test used to determine independent contractor status under the Tax Code, ERISA, and the nation's discrimination laws may be found to have misclassified the same worker under the new EMPA law if the "economic realities" test of the 1938 FLSA law is used.

The Need for Congress to Provide a Consistent Federal Definition of 'Employee' for Misclassification Purposes

The "common law" test for determining if an individual is an independent contractor or employee focuses on whether the business controls the manner and the means by which that work is accomplished. In the 1992 *Darden* case, the Supreme Court set forth 12 factors relevant to the issue of "control," but noted that there are many additional factors that can be useful in determin-

ing employee status, including the additional factors set forth in the IRS's so-called "20 factor" test.

The "common law," according to the Supreme Court, "comports … with our recent precedents and with the common understanding, reflected in those precedents, of the difference between an employee and an independent contractor." Those recent precedents include the Court's determination of whether a worker was an employee or independent contractor under ERISA, the federal pension law enacted in 1974, and the Americans with Disabilities Act (ADA), one of the most important discrimination laws enacted after the Civil Rights Act of 1964.

The Senate and House sponsors of EMPA, as well as witnesses who testified in favor of the bill's passage at a Senate committee hearing in June 2010, stated that EMPA is intended to serve a number of important objectives: closing the tax gap that has deprived the federal and state governments of tax revenues; affording protections to misclassified workers under an array of federal laws that govern employers and employees (including ERISA, FLSA, OSHA, and the federal discrimination laws); and promoting fair business competition by outlawing the practice of misclassification, which creates an unfair advantage for businesses that improperly avoid the payment of payroll taxes. Notably, these are the very same purposes set forth in the preamble of the Fair Playing Field Act. Thus, both misclassification bills are intended to serve the same broad tax, labor, and business purposes. There is no reason, therefore, for Congress to have two different and potentially conflicting tests for determining if a worker is an employee or independent contractor.

The FLSA is one of more than a dozen major federal labor and employment laws. It was not enacted as a misclassification statute. Indeed, if EMPA is passed, it will be the first law that makes misclassification a federal offense. Congress appears to have attached EMPA to the FLSA merely as a matter of legislative convenience. The value of piggy-backing new legislative initiatives on existing laws can have many benefits, such as eliminating the need for Congress to draft definitional, administrative, procedural, and other similar provisions for a new piece of legislation.

By piggy-backing on the FLSA, though, the EMPA bill would automatically incorporate special definitional sections within the FLSA that were enacted to serve congressional purposes that existed during the New Deal when the FLSA was enacted. The Congressional Declaration of Policy underlying the FLSA was to address "labor conditions detrimental to the maintenance of the minimum standard of living necessary for health, efficiency, and general well-being of workers." The broad purposes of EMPA have little if nothing to do with the narrow remedial purposes of the FLSA or the child-labor statutes that were used to craft the expansive definition of "employee" in the FLSA.

The congressional goal articulated in the Fair Playing Field Act of "allowing workers and businesses to *clearly understand* the proper federal tax classification of workers" is beneficial. If Congress allows EMPA to be passed with what appears to be a different definition of "employee" than what prevails under the Tax Code and most other federal labor and employment laws, Congress may have inadvertently created more confusion among businesses and workers.

In addition, in order to comply with all federal laws covering "employees," a prudent business may well choose to disregard the "common law" test applicable under most federal statutes, including the Fair Playing Field Act, and only treat workers as independent contractors if they would satisfy the narrower test under the New Deal child-labor and wage-and-hour law. This would have the effect of limiting the use of *legitimate* independent contractors, a result that Congress has never articulated as a purpose of either of the two bills. As stated in the preamble to the Fair Playing Field Act, it has found that "many workers are properly classified as independent contractors ..."

Congress can use the legislative process to take one of the following two steps to remedy this important discrepancy between the two bills:

- Modify the definition of "employee" within EMPA so that it uses the same wording found in the Fair Playing Field Act for determining employee or independent contractor status. Such determinations under that law should be made, as stated in the Fair Playing Field Act, "under the usual common law rules applicable in determining the employer-employee relationship, as an employee or as an independent contractor (or other individual who is not an employee)."
- Make it crystal clear in the legislative history of the bill, including the Senate and House committee reports, that the definition of "employee" for purposes of EMPA should be construed in a manner consistent with both the "common law" test – which is the prevailing judicial standard under most federal laws including ERISA, the ADA, and the Tax Code – and the "common understanding" of contemporary independent contractor relationships.

- A third approach would be to amend the definition of "employee" or "employ" under the FLSA to language that updates the New Deal definitional terms and, like the Fair Playing Field Act bill, incorporates the "common law" test that prevails under virtually every other federal law.

Conclusion

The need for federal legislation in the area of misclassification is hard to argue against. The one witness that testified in a critical manner about EMPA at the Senate hearing this past June did not suggest that federal legislation is not needed. Rather, he criticized the size of the proposed penalties for misclassification, the nature of the record-keeping requirements, the language of the proposed notice to be given to all workers, and the potential that the anti-retaliation provision could reward unethical conduct.

Whether an individual worker is an independent contractor or employee is more often than not in the "gray area" and presents a close question of law. Regardless of whether or not Congress conducts further hearings on EMPA, Congress can take corrective steps to avoid placing businesses and workers in an untenable position, where they may be found by the same court to have *properly* classified an individual under one of the two new proposed laws but *improperly* classified him or her under the other.

The views expressed in this commentary are those of the author and are not necessarily the views of Pepper Hamilton LLP or its clients.

Richard Reibstein heads Pepper's Labor and Employment Group in the firm's New York City office. Mr. Reibstein is co-chair of the law firm's Independent Contractor Compliance practice group, an interdisciplinary team of more than 25 labor, tax and employee benefits lawyers. He can be reached at www.IndependentContractorCompliance.com.