The Contingent Workforce within Health Care

Risks for Hospitals From the Increased Regulatory Focus on Contractor Misclassifications, Joint Employer Status, and Agency Employees

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I. Contingent Workers: An Old Issue With New Significance

A. New Enforcement Environment. Existing laws about independent contractor status have been enforced unevenly. The Obama Administration and many state governments have announced significant new initiatives to enforce these laws. Government officials have painted employers who misclassify employees as contractors as poor corporate citizens who are evading taxes and gaining an unfair competitive advantage. See U.S. Cracks Down on ‘Contractors’ as a Tax Dodge, N.Y. Times, Feb. 18, 2010, at A1.

B. Legislative and Regulatory Changes Are On The Way. A variety of new laws and regulations – some already passed, others still under consideration – will make it harder for hospitals and other businesses to deny that they are the “employers” of their contingent workers. These same laws also threaten to increase the risks of misclassifying contingent workers by increasing penalties.

C. Significant Risks. Hospitals make significant use of contingent workers, including not only independent contractors but also staffing firm / registry employees. Given the nature of health care delivery, many of these workers are under the close supervision of hospital personnel, which can blur the line between employees and non-employees. Each unrecognized employee can generate liabilities including claims for unpaid overtime (with penalties) and legal liability for adverse “employment” decisions, and in the case of contractor misclassification, there can also be back taxes and civil and/or tax penalties.

D. Not Too Late To Mitigate These Risks. Some of the most aggressive new laws and regulations have not yet been adopted. Increased enforcement efforts have thus far focused largely on certain “problem” industries such as construction. Health care organizations therefore still have time to review these issues and adopt measures to minimize their risks.

II. Defining the Contingent Workforce

A. National Statistics

1. The Bureau of Labor Statistics periodically measures the number of workers in the U.S. “nontraditional workforce.” The last such survey was conducted in 2005. In addition to part-time workers and multiple job holders, the nontraditional workforce includes “contingent workers” and “workers who have alternative work arrangements.”
2. “Contingent workers” are defined as workers who have jobs they do not expect to last more than another year. They comprised 4.1% of the 2005 national workforce. Contingent workers were reported to be more prevalent in health care than in the overall workforce.

3. “Alternative work arrangements” are situations where a worker provides services as an independent contractor, on-call worker, temporary agency worker, or contract firm employee. Workers in such arrangements comprised 10.7% of the 2005 national workforce. On-call arrangements are more prevalent in health care than in the overall workforce.

B. Use of Contingent Workers in Health Care.

1. Examples of direct independent contractor arrangements in health care include advanced practice nurses and medical transcription services.

2. Other contingent or “nontraditional” workforce arrangements include use of nurse registry, permanent part-timers, and per diems.

3. Many hospitals hire firms under contract to provide ancillary or support management services such as security, IT, or management of janitorial or dietary functions.

4. Employment-law issues with physicians can arise as well, whether or not they are directly employed.¹

III. Where “Employee” Status Matters.

A. National Labor Relations Act (Private-Sector Unionization)

1. Section 2(3) of the National Labor Relations Act states that “any individual having the status of an independent contractor” is excluded from the definition of an “employee.” NLRA § 2(3), 29 U.S.C. § 152(3).

2. Only “employees” have the right under the NLRA to join or form a union. As a result, petitions by unions to represent independent contractors will be dismissed by the National Labor Relations Board. See AmeriHealth Inc./AmeriHealth HMO, 329 NLRB 870, 870 n.1 (1999) (refusing to reverse decision by NLRB regional director that physicians under contract to an HMO were not employees of the HMO; accordingly, physicians were not entitled to select a union to bargain with the HMO).

¹ There are a number of issues that relate specifically to the desirability of direct physician employment. These range from “corporate practice of medicine” bans in some states to Stark Act compliance. Although this outline includes scenarios involving employment-law issues and physicians, the broader discussion about the pros and cons of physician employment lies beyond the scope of these materials.
B. **Wage-hour law (minimum wage, overtime).**

1. The Fair Labor Standards Act (FLSA) states that an employee is “any individual employed by an employer,” and that “employ” means to “suffer or permit to work.” 29 U.S.C. § 203(e) & (g).

2. The definition of “employee” is considered broader under the FLSA than under employment laws, and may encompass individuals who are deemed independent contractors under other laws. *See Hopkins v. Cornerstone America*, 545 F.3d 338 (5th Cir. 2008) (holding that former “sales leader” for insurance company could pursue claims for unpaid overtime, based on FLSA standard for determining independent contractor status, even though he may have qualified as an independent contractor under test applied under state law and/or other federal laws).

C. **Social insurance benefits.**

1. Unemployment, worker’s compensation, and other social insurance benefits (such as short-term disability benefits in some states) typically do not cover independent contractors.

2. Such benefits may be available optionally for the contractor.

D. **Discrimination law.** Many discrimination and harassment laws apply only to the employer-employee relationship. *See Cilecek v. Inova Health System Services*, 115 F.3d 256 (4th Cir. 1997) (dismissing Title VII claim by physician independent contractor against hospital); *Alexander v. Rush N. Shore Medical Center*, 101 F.3d 487 (7th Cir. 1996) (same); *Diggs v. Harris Hospital-Methodist, Inc.*, 847 F.2d 270 (5th Cir. 1988) (same); *Mitchell v. Frank R. Howard Mem’l Hosp.*, 853 F.2d 762, 766 (9th Cir. 1988) (same).

E. **Whistleblower protection.**

1. Most whistleblower statutes protect only employees, not independent contractors. *See, e.g., Demski v. United States Dep’t of Labor*, 419 F.3d 488 (6th Cir. 2005) (dismissing whistleblower claim by independent contractor who provided maintenance management services to a nuclear power plant through two different corporations; she alleged that her contracts were terminated because she reported “serious safety problems”).

F. Federal tax withholding and payroll taxes.

1. Withholding of taxes and payment of the employer share of payroll taxes (for FICA and FUTA) is required for “any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.” 26 U.S.C. § 3121(d)(2).

2. Although independent contractors are generally excluded from employment taxes and tax withholding, certain categories of employees/service providers are considered “statutory employees” and are automatically subject to these tax obligations regardless of “common law” characterization. For example, payments made to corporate officers for their services are generally considered wages subject to employment taxes and withholding. See 26 U.S.C. § 3121(d)(1); IRS Publication 15-A (Employer’s Supplemental Tax Guide) at 4 (2010). This can present a problem when an organization engages an interim CEO or other officer as an independent contractor.

G. Immigration Documentation / Form I-9.


2. Although documentation verification is not required for contractors, it is unlawful to engage an independent contractor who is known to be unauthorized. See 8 U.S.C. § 1324(a)(4) (“Use of labor through contract. For purposes of this section, a person or other entity who uses a contract, subcontract, or exchange, entered into, renegotiated, or extended after November 6, 1986, to obtain the labor of an alien in the United States knowing that the alien is an unauthorized alien . . . with respect to performing such labor, shall be considered to have hired the alien for employment in the United States in violation of paragraph (1)(A).”); see also I-9 Handbook, supra, at 5.

H. Liability to third parties.

1. At common law, an employer is vicariously liable for employee actions in the scope of employment.
2. An organization is generally not liable for the actions of an independent contractor, unless a separate legal doctrine (such as the “nondelegable duty” or “apparent authority” doctrines) requires it.

I. Benefit plan eligibility.

1. Independent contractors may lawfully be excluded from a benefits plan regulated by the Employee Retirement Income Security Act of 1974, as amended (“ERISA”).
   a. However, if the plan simply offers coverage to “employees” and excludes “independent contractors,” it may be concluded by a court that only properly classified independent contractors were intended to be excluded. This can result in surprising (and expensive) liability if a contractor classification is reversed and the new “employee” makes a claim to participate in the employer’s benefit plans. See Vizcaino v. Microsoft Corp., 97 F.3d 1187 (9th Cir. 1996).
   b. In response to the much-publicized Microsoft case, many ERISA plans were amended to include “inoculation” clauses that exclude all individuals designated as independent contractors from plan coverage. These clauses specifically provide that, even if a court or agency concludes that the contractor was misclassified, he or she is not eligible to receive benefits.

2. Treatment of other “contingent workers” (such as temporary or short-hour employees). Federal law currently does not require employees to provide retirement, health, or other benefits to employees, although the new federal health care legislation will introduce significant changes to that understanding. (The employer requirements under the new federal health law are discussed very briefly below in Section III.I.2.b(2).) However, once an employer decides to provide benefits to its employees, the ERISA and the Internal Revenue Code of 1986, as amended (the “Code”), impose limitations regarding which employees may be excluded from coverage under the employer’s applicable benefit plans.
   a. Retirement plans
      (1) Qualified retirement plans (Code Section 401(a))
         (a) ERISA and the Code generally preclude qualified retirement plans (such as a 401(k) plan) from conditioning an employee’s eligibility to participate on the completion of a period of service that extends beyond the later of (i) the date upon which the employee attains the age of 21 or (ii) the date
upon which the employee completes one “year of service” (generally defined as at least 1,000 hours of service during a 12-month period). 29 U.S.C. § 1052(a)(1)(A); 26 U.S.C. § 410(a) (minimum participation requirement). A plan may impose age and/or service eligibility requirements that satisfy these rules, such as a requirement that eligible employees must complete one year of service to commence participation in the plan.

(b) A qualified retirement plan generally may exclude from eligibility employees who fall within certain business-related classifications—such as job categories, nature of compensation (salaried versus hourly), and geographic location—but in doing so, the plan must satisfy technical nondiscrimination and coverage tests that preclude discrimination in favor of “highly-compensated employees” (for 2010, generally defined as employees who received compensation from an employer in 2009 in excess of $110,000). 26 U.S.C. § 410(b); Treasury Reg. §§ 1.410(b)-4, 1.410(a)-3(e)(2), ex. 3; IRS Quality Assurance Bulletin, FY-2006, No. 3.

(2) **Tax-sheltered annuities (Code Section 403(b))**

(a) Tax-sheltered annuities that are maintained by tax-exempt entities (other than a church or a qualified church-controlled organization) are subject to the minimum coverage and nondiscrimination tests applicable to qualified retirement plans (see Section II.I.2.a.(1)(b) supra) with respect to employer contributions and employee after-tax contributions made under the plan. 26 U.S.C. § 403(b)(12); Treasury Reg. § 1.403(b)-5.

(b) Subject to limited exceptions, the ability to make salary reduction elections under such a plan must be universally available to eligible employees of the employer. 26 U.S.C. § 403(b)(12)(A)(ii); Treasury Reg. § 1.403(b)-5(b); 29 U.S.C. § 1052(a)(1)(A).

(c) Eligible deferred compensation plans (Code Section 457(b))

i) Eligible deferred compensation plans are not subject to the applicable minimum participation, minimum
coverage or nondiscrimination tests that apply with respect to qualified retirement plans and tax-sheltered annuities. 26 U.S.C. § 457(b).

ii) Eligible deferred compensation plans maintained by tax-exempt entities must be unfunded. Treasury Reg. § 1.457-8(b). The rules under ERISA that govern “unfunded” deferred compensation plans generally limit participation to employees who are members of a select group of management or highly-compensated employees.

b. Health Benefits

(1) Current Law

(a) Federal law imposes nondiscrimination tests that apply with respect to eligibility to participate in, and benefits provided under, group health plans. Depending on the type of arrangement (self-funded versus insured), a failure to comply with the nondiscrimination requirements can result in taxation of benefits provided to highly-compensated individuals (self-funded plans) or an excise tax imposed on the employer (insured plans). 26 U.S.C. § 105(h); Treasury Reg. § 1.105-11; See Patient Protection and Affordable Care Act, H.R. 3590 § 1001, 111th Cong. (passed March 21, 2010) (amending Public Health Service Act to enact new 42 U.S.C. § 2716). For purposes of these rules, “highly-compensated individuals” generally include the highest-paid 25% of an employer’s employees. 26 U.S.C. § 105(h)(5); PHSA § 2716(b)(2).

(b) Some jurisdictions may impose coverage-related requirements directly on employers. For example, San Francisco enacted a “play or pay” law that requires covered employers to provide health coverage or pay into a fund. S.F. Admin. Code §§ 14.1-14.8 (San Francisco Health Care Security Ordinance).

(2) New Health Care Legislation. The health care reform legislation is extremely complex, and a detailed summary is beyond the scope of these materials, but notable provisions affecting larger employers with contingent workers include:
(a) The new health care reform law will generally require all employers with 50 or more full-time employees to either offer health insurance coverage constituting “minimum essential coverage” or be subject to a tax equal to $2,000 annually ($166.67 per month) for each full-time employee of the employer in excess of 30 employees. Many commentators have suggested that this could serve as a significant tax on employers who misclassify employees as contractors, since they would not have been offered health insurance coverage.

(b) The term “full-time employee” is defined as an employee working 30 hours or more each week.

(c) There is no permitted exclusion for “temporary” employees (although there is an exclusion for “seasonal” workers and retail employees hired only for the holidays). Moreover, the statute imposes a tax on employers who require “extended waiting periods” of more than 30 days before an employee may participate in a health plan.

c. **Nondiscrimination Requirements for Benefits other than Health or Retirement.** The Code imposes nondiscrimination, minimum coverage or key employee concentration tests with respect to a myriad of welfare plans that do not provide health benefits. Three examples include cafeteria plans, educational assistance programs and dependent-care assistance programs. See 26 U.S.C. §§ 125(b), 127(b)(2), 129(d)(2).

3. **Additional Considerations for Benefits**

a. **Controlled-group status.** For purposes of the applicable coverage and nondiscrimination tests that apply to many of the benefit plans maintained by employers, all employees of employers who are part of a “controlled group” of employers or an “affiliated service group” of employers must be treated as employees of the same employer when any of the plans maintained by any employer in the controlled group or affiliated service group are tested. 26 U.S.C. §§ 414(b), (c), (m), (t).

b. **Multiple employer plans.** If more than one employer maintains a retirement plan, the minimum participation rules summarized in above apply as if all employees of the employers that maintain the plan are employed by a single employer. 26 U.S.C. § 403(c)(1).
c. **Leased employees.** Individuals who constitute “leased employees” and who perform services for an entity that maintains benefit plans must be included as employees of that entity for purposes of the applicable minimum participation, minimum coverage and nondiscrimination tests that apply with respect to each such plan under the Code, even if the individuals are common law employees of the leasing organization. 26 U.S.C. § 414(n).

4. **Technical nature of benefit plan rules.** This summary necessarily avoids a detailed discussion of the technical rules that apply with respect to the issues outlined above. Employers should exercise caution in drafting benefit-plan eligibility and coverage provisions to ensure the provisions meet applicable requirements under ERISA and the Code, especially if the plans will exclude contingent workers such as part-time or temporary employees or individuals regularly used as leased employees.

J. **Ownership of Intellectual Property.** An employer may have greater claim to intellectual property created by an employee, which may include a right to claim outright ownership of the intellectual property, or at least a right to demand assignment or a license. See 17 U.S.C. § 101 (providing that employer owns copyright to any work “prepared by an employee within the scope of his or her employment”; the statute provides a more demanding test for work prepared by a contractor); *United States v. Dubilier Condenser Corp.*, 289 U.S. 178 (1933) (describing circumstances under which an employer acquires the right to demand assignment of a patentable invention or at least to practice a “shop right” permitting use of the technology without having to pay royalties to the employee).

IV. **How Courts and Agencies Decide Employee Status Questions.**

A. **IC vs. Employee Tests**

1. **“Control” Tests.**

   a. The common law Right to Control Test is based on the premise that employers have the right to direct and control the work of its employees—e.g., how work is done—in terms of final results as well as details like when, where and how the work is to be performed. Factors such as the following are considered:

   (1) The degree of control, which by agreement, the hiring party may exercise over the details of the work.

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2. **IRS Notice 84-11** provides guidance on how to identify leased employees and determine when they must be treated as a plan sponsor’s employees for these purposes. This guidance is especially important because the Code definition of a “leased employee” is narrow and non-intuitive. Among other things, it covers only individuals who are leased to a service recipient organization “on a substantially full-time basis for a period of at least 1 year.”
Whether the worker is engaged in a distinct occupation or business that is usually done by a specialist without supervision.

How the worker’s helpers are hired and whether they are paid by the hiring party or the worker.

Whether a high level of skill is required by the occupation.

Who supplies the means, tools, and place of work.

The length of time the services are provided.

Method of payment, by the job rather than the hour or day.

Whether the work is part of the regular business of the hiring party.

Whether the parties believe they created/intended to create an employment relationship.

Whether the hired party is a business entity.

Applying the above, the court in Critical Care Register Nursing, Inc. v. United States, 776 F. Supp. 1025 (E.D. Pa. 1991) held that the plaintiff had a “reasonable basis” for treating its nurses as ICs. It therefore qualified for the Safe Harbor available under Section 530 of the Internal Revenue Act. Critical Care provided nurses to hospitals in need of temporary staffing for emergency rooms and intensive care units. As ICs, the nurses:

Were not provided with uniforms, transportation or health and welfare benefits. Any training that was provided was given by the particular hospitals and not Critical Care.

Could work with other agencies and/or hospitals while working for Critical Care.

Chose when, where and how often they worked.

Performed no work for Critical Care on Critical Care’s premises.

Moreover, Critical Care did not prescribe, nor did it have the right to prescribe, the nurses’ duties or the methods or means of performing such duties in hospitals.

The safe harbor provision of Section 530 of the Internal Revenue Act, including proposed modifications, is discussed in Section V.C.2.b, below.
c. With respect to the intersection of state regulation in the health care industry and the issue of control, *Global Home Care, Inc. v. State of Florida, Department of Labor and Employment Security, Division of Unemployment Compensation*, 521 So. 2d 220 (2nd DCA 1988) explained that regulations imposed by governmental authorities do not evidence control by the employer for the purposes of determining a worker’s classification as an employee or IC.

d. Variations of the “Right to Control” test are used in many jurisdictions. However, jurisdictions vary widely in the weight that they give the relevant factors. In addition, some jurisdictions allow an alleged employer to rebut evidence of employer status by showing that it does not actually *exercise* a right to control.

2. **“IRS” test / 20-factors (Derived From But More Expansive Than Historical “Right to Control” Test)**

a. The Internal Revenue Service (“IRS”) considers what has come to be known as the “Twenty Factor Test” published in Rev. Rul. 87-41. Not all the factors must be present to find an employee/employment relationship, but the factors are guides to use to assess the likelihood as to whether an individual is an IC or employee.

b. According to the IRS’s Training Materials issued in 1996: “The twenty common law factors listed in Rev. Rul. 87-41 are not the only ones that may be important. Every piece of information that helps determine the extent to which the business retains the right to control the worker is important. In addition, the relative importance and weight of the twenty common law factors can vary significantly.” The factors are:

   (1) Instructions. An employee must comply with instructions about when, where and how to work. The control factor is present if the employer has the right to require compliance with the instructions.

   (2) Training. An employee receives on-going training from, or at the direction of, the employer.

   (3) Integration. An employee’s services are integrated into the business operations because the services are important to the business. This shows that the worker is subject to direction and control of the employer.
(4) Services rendered personally. If the services must be rendered personally, presumably the employer is interested in the methods used to accomplish the work as well as the end results. An employee often does not have the ability to assign work to other employees; an independent contractor may assign the work to others.

(5) Hiring, supervising and paying assistants. If an employer hires, supervises and pays assistants, the worker is generally categorized as an employee. An independent contractor hires, supervises and pays assistants under a contract that requires him or her to provide materials and labor and to be responsible only for the result.

(6) Continuing relationship. A continuing relationship between the worker and the employer indicates that an employer-employee relationship exists. The IRS has found that a continuing relationship may exist where work is performed at frequently recurring intervals, even if the intervals are irregular.

(7) Set hours of work. A worker who has set hours of work established by an employer is generally an employee. An independent contractor sets his or her own schedule.

(8) Full time required. An employee normally works full time for an employer. An independent contractor is free to work when and for whom he or she chooses.

(9) Work done on premises. Work performed on the premises of the employer for whom the services are performed suggests employer control, and therefore, the worker may be an employee. Independent contractors may perform the work wherever they desire as long as the contract requirements are performed.

(10) Order or sequence set. A worker who must perform services in the order or sequence set by an employer is generally an employee. Independent contractors perform the work in whatever order or sequence they may desire.

(11) Oral or written reports. A requirement that the worker submit regular or written reports to the employer indicates a degree of control by the employer.
(12) Payments by hour, week or month. Payments by the hour, week or month generally point to an employer-employee relationship.

(13) Payment of expenses. If the employer ordinarily pays the worker’s business and/or travel expenses, the worker is ordinarily an employee.

(14) Furnishing of tools and materials. If the employer furnishes significant tools, materials and other equipment by an employer, the worker is generally an employee.

(15) Significant investment. If a worker has a significant investment in the facilities where the worker performs services, the worker may be an independent contractor.

(16) Profit or loss. If the worker can make a profit or suffer a loss, the worker may be an independent contractor. Employees are typically paid for their time and labor and have no liability for business expenses.

(17) Working for more than one firm at a time. If a worker performs services for a multiple of unrelated firms at the same time, the worker may be an independent contractor.

(18) Making services available to the general public. If a worker makes his or her services available to the general public on a regular and consistent basis, the worker may be an independent contractor.

(19) Right to discharge. The employer’s right to discharge a worker is a factor indicating that the worker is an employee.

(20) Right to terminate. If the worker can quit work at any time without incurring liability, the worker is generally an employee.

c. **More Recent IRS Test.** More recently, the IRS restructured the Twenty Factor Test and created three categories of factual evidence to assess the degree of control and independence. *See IRS Publication No. 15-A Employers Supplemental Tax Guide* (rev. January 2004). This change is not a substantive change so much as it is an organizational revision meant to provide clarity.

(1) *Behavioral Evidence of Control* - Includes the type of instructions the business gives to the worker, such as when and where to do the work, and the training provided to the
worker by the business. The key consideration is whether
the business has retained the right to control the details of
the worker’s performance.

(2) Financial Evidence of Control - Addresses the business’s
right to control the business aspects of the worker’s job,
such as whether the business provides tools and supplies,
reimburses the worker for expenses and whether the worker
has the opportunity for profit or loss on the job.

(3) Evidence of the Relationship Of Parties - The nature of the
relationship may be evidenced by:

(a) A written contract evidencing the parties’ intent;

(b) The benefits the business provides to a worker, such
as paid vacation or health and welfare coverage;

(c) The permanency of the position; and

(d) The extent to which the services performed are a
key aspect of the regular business of the company.

d. The court in United States v. Crabbe, 2010 WL 318399 (10th Cir.
2010) applied the Twenty Factor Test while also recognizing that:
each factor need not have application in every situation; and in
most cases, the employer’s ability to control the hiring party’s
work is the most determinative factor.

(1) In Crabbe, the plaintiff owned and managed a company
(“Company”) that provided nurses to health care facilities
on short-term bases. Applying the twenty factors, the
Court of Appeals upheld a criminal conviction for failing to
remit employment taxes to the IRS that had been withheld
from the nurses’ checks.

(2) The court specifically found that by virtue of existing
contractual arrangements with the nurses, the Company
“had the contractual authority to control the manner of the
nurse’s work, even if that control was rarely, if ever
exercised.” The court also relied on the following facts:

(a) Written materials provided to the nurses declared
that the Company would make all appropriate
deductions from wages and declared the nurses
Company employees.
(b) The Company executed facility agreements with clients which stated that the Company would take responsibility for the nurses’ state and federal withholding taxes.

(c) The Company asserted very little control over a nurse once placed with a facility.

(d) The nurses wore Company name tags, were paid by the hour and were prohibited from discussing prospective employment opportunities with a facility while under contract with the Company.

(e) The nurses signed forms consenting to the Company’s authority to terminate their employment.

(f) The Company routinely reimbursed the nurses’ travel expenses and out of town housing.

3. **FLSA and the “Economic Realities” Test.**

   a. Under the Fair Labor Standards Act (“FLSA”), courts tend to focus on the “economic realities” test. The test seeks to answer the question whether the worker is economically dependent on the business she services, or is she in business for herself? It is often assumed that this test points to employment status more than the typical “control” tests. See Nationwide Mut. Ins. Co. v. Darden, 503 U.S. 318, 326 (1992) (the FLSA “stretches the meaning of ‘employee’ to cover some parties who might not qualify as such under a strict application of traditional agency law principles”).

   b. Six factors, none of which is dispositive, inform the inquiry:

   (1) The degree of control the business has over the way in which the work is performed;

   (2) The worker’s opportunities for loss or profit based on her managerial skill;

   (3) The worker’s investment in equipment, materials, or in hiring additional workers;

   (4) The degree of skill required for the work;

   (5) The permanence of the working relationship; and
(6) The degree to which the worker’s services are an integral part of the putative employer’s business.

c. The business’s control, the importance of the worker’s services to the business, and the permanence of the relationship weigh in favor of an employer-employee relationship, whereas the worker’s skill, investment, and opportunity for profit tend to indicate independent contractor status.

d. With regard to the application of the “economic realities” test, “subjective beliefs cannot transmogrify objective economic realities. A person’s subjective opinion that he is a businessman rather than an employee does not change his status. Furthermore, facile labels . . . are only relevant to the extent that they mirror economic reality.” Hopkins v. Cornerstone America, 545 F.3d 338, 346 (5th Cir. 2008) (internal quotations omitted) (holding that it was not “clearly inconsistent” for an insurance company sales leader to claim that he was an employee under the economic-realities test but not under other legal tests).

4. NLRB / “Entrepreneurial Opportunity” Test

a. The National Labor Relations Act (“NLRA”) was amended in 1947 to abandon the FLSA “economic realities” test for determining employee status. However, the NLRB’s “common law” test is more demanding than the “right to control” test, because it looks at factors more closely associated with the realities of the relationship than simple control.

b. The Board considers the following factors (none of which are determinative or controlling):

(1) The business’s control over the details of the work;

(2) Whether the worker is engaged in a distinct occupation or business;

(3) Whether the work is a kind of work that usually is performed without supervision;

(4) The skill required for the work;

(5) Who supplies the worker the materials, tools, and place of work;

(6) The duration for which the worker is engaged;

(7) Whether the worker is paid on the basis of time or per job;
Whether the work is part of the business’s regular work;

Whether the parties believe they are creating an employer-employee relationship; and

Whether the principal is in the business.

c. The court in *FedEx Home Delivery v. NLRB*, 563 F.3d 492 (D.C. Cir. 2009) recently explained the difference between the basic common law factors and the more refined “Entrepreneurial Opportunity” test used by the NLRB.

(1) “[B]oth this court and the Board, while retaining all of the common law factors, shifted the emphasis away from the unwieldy control inquiry in favor of a more accurate proxy: whether the putative independent contractors have significant entrepreneurial opportunity for gain or loss. This subtle refinement was done at the Board’s urging.” (Internal citations and quotations omitted).

(2) “Thus, while all the considerations at common law remain in play, an important animating principle by which to evaluate those factors in cases where some factors cut one way and some the other is whether the position presents the opportunities and risks inherent in entrepreneurialism.” (Internal citations and quotations omitted). *See Corporate Express Delivery Systems v. NLRB*, 292 F.3d 777, 780 (D.C. Cir. 2002) (“We agree with the Board’s suggestion that [entrepreneurial opportunity] better captures the distinction between an employee and an independent contractor.”).

(3) Entrepreneurialism is most often found where workers are paid by the job and are permitted to: employ others to perform work for the hiring party, work other jobs and use their own equipment during non-business hours and for other jobs. *See id.* at 492, 497-98 (citing cases).

5. **“ABC” Tests Under State Laws**

a. “ABC” tests presume that every individual who provides service is an employee unless three strict criteria (“A, B, and C”) are met. The presumption of employee status that comes with the strict three-part ABC test makes establishing an independent contractor relationship much more difficult than under the “control” or “economic realities” tests. ABC Tests are already in use in many states for worker’s compensation and/or unemployment insurance
coverage purposes; they are now beginning to be adopted for other employment-law purposes also.

b. **Illinois**: 820 I.L.C.S. 185/10, applicable to the construction industry, adopts a slightly modified ABC Test.

(1) An individual performing services for a contractor is deemed to be an employee of the contractor unless it is shown that:

(a) The individual has been and will continue to be free from control or direction over the performance of the service for the contractor, both under the individual's contract of service and in fact;

(b) The service performed by the individual is outside the usual course of services performed by the contractor; and

(c) The individual is engaged in an independently established trade, occupation, profession or business; or

(d) The individual is deemed a legitimate sole proprietor or partnership under factors set forth in 820 I.L.C.S. 185/10(c)(1) – (12).4

4 The factors to be evaluated to determine whether a legitimate sole proprietor or partnership exists are similar to the IRS test factors, namely: that the entity performs services free from direction and control, provides its own tools, can hire its own employees, makes its services available to the general public, has made a significant investment in the entity other than tools, is susceptible to profit and loss, etc.

5 Prior to 2004, the second part of the test required a business to establish that “such service is performed either outside the usual course of the business for which the service is performed or is performed outside of all

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c. **Massachusetts**: M.G.L. c. 149, §148B. Massachusetts applies a standard more stringent than the traditional ABC test.

(1) An individual performing any service, except as authorized under this chapter, shall be considered to be an employee under those chapters unless:

(a) The individual is free from control and direction in connection with the performance of the service, both under his contract for the performance of service and in fact; and

(b) The service is performed outside the usual course of the business of the employer;5 and,
(c) The individual is customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service performed.

d. **Maryland:** Md. Code Labor & Employment § 3-903. Maryland adopts a very detailed version of the ABC test for the construction and landscaping industries.

(1) Work performed by an individual for remuneration paid by an employer shall be presumed to create an employer–employee relationship, unless:

(a) The individual is an exempt person; or

(b) An employer demonstrates that:

i) The individual who performs the work is free from control and direction over its performance both in fact and under the contract;

ii) The individual customarily is engaged in an independent business or occupation of the same nature as that involved in the work; and

iii) The work is:

a) Outside of the usual course of business of the person for whom the work is performed; or

b) Performed outside of any place of business of the person for whom the work is performed.

(c) Work is outside of the usual course of business of the person for whom it is performed under paragraph (1) if:

i) The individual performs the work off the employer’s premises;

ii) The individual performs work that is not integrated into the employer’s operation; or

(continued…)

places of business of the enterprise.” Thus, the 2004 Amendment deletion affects businesses who use ICs to perform work at home, at the worker’s own place of business or at a client location.
iii) The work performed is unrelated to the employer’s business.

B. Tests for Deciding Whether Someone Else’s Employee Is Also Your Employee

1. **Joint Employer Test.** A contingent worker may have more than one employer, in which case both employers are considered “joint employers” and may share potential liability for unlawful employment actions.

   a. A worker placed by a temporary or other staffing firm is generally considered an employee of the staffing firm.  

   b. The fact that the worker is an employee of the staffing firm does not rule out the possibility that he or she may also be considered an employee of the “client” company. The general test for making this determination is one of control – the more control the client company has over the individual’s working conditions, the more he or she is likely to be deemed an employee of the client company.

2. **EEOC Guidance** (EEOC, Enforcement Guidance, Application of EEO Laws to Contingent Workers Placed by Temporary, Employment Agencies and Other Staffing Firms, Notice 915.002 (Dec. 3, 1997)). In its enforcement guidance on contingent workers and staffing firms, the EEOC suggested several factors for deciding whether the employee of a staffing firm is an employee of the firm, of the client – or both:

   a. the firm or the client has the right to control when, where, and how the worker performs the job;

   b. the work does not require a high level of skill or expertise;

   c. the firm or the client rather than the worker furnishes the tools, materials, and equipment;

   d. the work is performed on the premises of the firm or the client;

   e. there is a continuing relationship between the worker and the firm or the client;

   f. the firm or the client has the right to assign additional projects to the worker;

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6 There may be exceptions. For example, the staffing firm may exercise so little control over the employee such that only the client is said to employ the worker. For example, the EEOC has stated that an employee leasing company that places a client’s employees on its payroll solely for payroll administration and benefits purposes would not be considered a joint employer of those workers, since the only purpose of the arrangement is administrative ease.
g. the firm or the client sets the hours of work and the duration of the job;

h. the worker is paid by the hour, week, or month rather than for the agreed cost of performing a particular job;

i. the worker has no role in hiring and paying assistants;

j. the work performed by the worker is part of the regular business of the firm or the client;

k. the firm or the client is itself in business;

l. the worker is not engaged in his or her own distinct occupation or business;

m. the firm or the client provides the worker with benefits such as insurance, leave, or workers’ compensation;

n. the worker is considered an employee of the firm or the client for tax purposes (i.e., the entity withholds federal, state, and Social Security taxes);

o. the firm or the client can discharge the worker; and

p. the worker and the firm or client believe that they are creating an employer-employee relationship.

V. New Federal Legal Environment

A. Why the New Crackdown?

   a. A 1984 study suggested that even contractors receiving 1099’s reported only 77% of their compensation on individual tax returns. For those not receiving 1099’s, the percentage dropped to 29%. See 2009 GAO Report, supra, at 10-11.
   c. If even one percent of all employees are misclassified, that results in $200 million annually in lost unemployment taxes, nationwide. See 2009 GAO Report, supra, at 11-12.

2. Labor Movement Role. Unions claim that misclassification is used as an unfair shield against unionization.
3. **Perception of Widespread Problem.** There is a perception by the plaintiff’s bar and regulators that misclassification is widespread.


   b. Prior Studies.

      (1) The IRS estimated in 1904 that 15% of employers misclassified 3.4 million employees as independent contractors. See 2009 GAO Report, supra, at 10.

      (2) A 2000 study found that 10 to 30 percent of audited companies had misclassified at least one employee as an independent contractor. See 2009 GAP Report, supra, at 11.

      (3) Aggregated data from state unemployment insurance audits, covering the period from 2000 to 2007, showed that anywhere from 106,239 to 158,267 misclassified employees were identified every year. See 2009 GAO Report, supra, at 12-13.


B. **Increased Attention from Federal Agencies**

   1. **IRS Initiatives**


         (1) The ETNRP is a three year project in which issues surrounding misclassification of workers will be analyzed for purposes of a broader study of employment tax
compliance. The last employment tax study conducted by the IRS occurred in 1984.\(^7\)

(2) The IRS will randomly select 2,000 employers for each year, for years 2010 – 2013 to review compliance with employment, FICA, and Medicare tax obligations.

(3) The IRS will examine:

(a) A randomly selected sample of an employer’s tax returns for tax years 2008 – 2010.

(b) Information from employers’ Forms 1099, SS-8\(^8\) and 8919\(^9\).

(c) Employment agreements, company policies, track ICs who receive both 1099s and W-2s and perform interviews.

b. On February 1, 2010, the Treasury Department released the FY 2011 Revenue Proposals, also known as the “Greenbook.” The Greenbook outlines the major tax policy proposals of President Obama’s administration.

(1) One proposal in particular would allow the following:

(a) Permit the IRS to require prospective reclassification of workers who are currently misclassified and whose reclassification has been prohibited under current law.\(^10\)

(b) Assess reduced penalties where a business voluntarily reclassifies its workers prior to contact by the IRS or another enforcement agency and if the business meets certain other requirements.

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\(^7\) Other areas not directly relevant to this discussion will also be explored, namely executive compensation issues and fringe benefits.

\(^8\) A Form SS-8 is filed by a worker or employer to seek a classification determination as to a specific worker in question. Forms SS-8 are used by the IRS’s SS-8 unit to make a determination as to classification, but also to determine whether the IRS should further examine the employer.

\(^9\) A Form 8919 is filed by employee who believes she or he has been misclassified as an independent contractor. It provides the IRS with information about the employer which may be sufficient to trigger an audit. An employee can file this Form without employer consent, knowledge or approval. (It can also be used by the employee to report earnings from a misclassified relationship that has been granted Section 530 safe harbor relief.) A Form 8919 is used to credit a worker’s share of his or her social security and Medicare taxes to his or her social security record.

\(^10\) The safe harbor provision of Section 530 of the Internal Revenue Act, including proposed modifications, is discussed in Section V.C.1, infra.
(c) Permit the IRS to issue guidance on the proper classification of workers under common law standards.

c. The Questionable Employment Tax Practices (QETP) program, initiated in 2007, seeks to identify employment tax schemes and illegal practices that seek to avoid federal and/or state employment taxes.

(1) QETP allows the IRS and state workforce agencies to share and exchange information on worker classification matters.

(a) For example, after state agencies audit employers to determine whether their workers are properly classified and appropriate state unemployment taxes have been paid, that audit information is provided to the IRS. Likewise, the IRS shares Form 1099 data with state agencies to aid in identifying potential cases of misclassification.

(2) State agencies and IRS agents may conduct side-by-side examinations and joint-enforcement efforts.

(3) As of August 2009, 34 states were participating in the QETP program. Seven more indicated they were working to become members.

(4) The DOL, the National Association of State Workforce Agencies, the Federation of Tax Administrators and participating state workforce agencies have all endorsed QETP’s agenda.

2. DOL Initiatives

a. The FY 2011 DOL budget proposes to devote $25 million to a joint Labor-Treasury Misclassification Initiative to strengthen and coordinate Federal and State efforts to enforce statutory prohibitions, and identify and deter misclassification of employees.

(1) President Obama’s FY 2011 budget explains that the Initiative will “enhance[] the ability of both agencies to penalize employers who misclassify.”

(2) This Initiative is expected to increase Treasury receipts by more than $7 billion over 10 years.

(3) The Senate Finance Committee Chairman’s Mark, issued on April 21, 2010, signs on to the President’s budget
proposal of $25 million to fund the DOL’s efforts to identify and deter misclassification of ICs, stating: “Employers that engage in this activity do not pay taxes, such as Unemployment Insurance and Social Security, deny their employees legal protections, and disadvantage employers that follow the law.”

b. The Misclassification Initiative includes:

(1) Federal support of state audits of problem industries as part of a targeted effort to recoup unpaid payroll taxes.

(2) $12 million and 90 new investigators for the Wage and Hour Division. These resources will be used for training and to “support targeted investigations that focus on industries where misclassification is most likely.”

(3) $10.9 million for a pilot program to reward the states most successful or most improved with detecting and prosecuting employers who do not pay their share of taxes due to misclassification.

(4) $1.6 million and 10 employees for the Office of the Solicitor to support enforcement strategies and coordination with states for litigation involving the largest multi-state employers who routinely abuse IC classification.

(5) $150,000 for OSHA to train inspectors on worker misclassification issues.

c. In March, 2010, Labor Secretary Hilda Solis noted that for eight years during the Bush administration, DOL did not collect any data on the use of ICs.

d. As part of the Wage and Hour Division’s (WHD) Spring 2010 “Regulatory Agenda,” WHD has announced that it intends to propose new regulations that would update employers’ “recordkeeping” obligations under the FLSA.

(1) Current Recordkeeping Regulations.

(a) Currently, covered employers must provide notice to employees regarding the FLSA, and keep accurate records on employees and wages and hours.

(b) Required records generally include the employee’s: name, address, date of birth (if under 19 years of
age), hours worked per day and per week, regular rate of pay (non-overtime rate) when overtime is worked, amount of straight time earnings and overtime pay for each workweek, and deductions from or additions to pay.

(c) This information and an employee’s exemption status need not be disclosed to the worker.

(2) Potential New Regulations

(a) The new proposal under consideration would require the following:

i) Covered employers would be required to provide workers with the above information regarding hours worked and wage computation.

ii) Any employer that seeks to exclude workers from FLSA coverage (such as by treating them as contractors) would be required to perform a classification analysis, disclose that analysis to the workers, and retain that analysis to give to WHD enforcement personnel who might request it.

iii) The proposal will also address burdens of proof when employers fail to comply with records and notice requirements.

(b) Status. The rule is currently under development and it has not yet been determined exactly what will be proposed. The rule is expected in August, 2010.

(c) Rationale. According to the WHD: “Updating the recordkeeping requirements to promote transparency is expected to encourage greater levels of compliance by employers, to enhance awareness among workers of their status as employees or independent contractors and employee rights and entitlements to minimum wage and overtime pay, and to facilitate DOL enforcement.”

3. Middle Class Task Force.

a. The Middle Class Task Force, chaired by Vice President Joseph R. Biden, was established by the Obama Administration shortly after President Obama took office.
b. The Task Force was convened to work with federal agencies, propose Executive Orders and develop legislative and policy proposals in areas which are of importance to working families. Its first report was issued in February 2010.

c. While the report states that worker misclassification is a key issue for the Task Force, the report does not specify how the Task Force has yet addressed this issue.

C. Recent and Pending Legislation

1. New Law: Health Care Reform Legislation. The Health Care Reform Act contains at least two provisions that will have a significant impact on employers’ classification practices:

   a. As discussed above (see Section III.I.2.b(2)), the new law imposes what is essentially a “play or pay” requirement that requires all large employers to offer qualifying health benefits to their full-time employees or pay across-the-board taxes. This will reverse current benefits law, which (subject to “nondiscrimination testing”) gives employers latitude to exclude various employee classifications from their benefit plans. The new law gives workers who believe they are employees a significant new incentive to challenge their classification. It also creates a potential new tax consequence for misclassification.

   b. The new law also includes a section that will require Form 1099 information returns to be issued to corporations as well as other payees, for all payments after December 31, 2011. See Patient Protection and Affordable Care Act, H.R. 3590 § 9006, 111th Cong. (passed March 21, 2010) (amending provisions of Internal Revenue Code § 6041). This will give the IRS greater visibility to arrangements with incorporated independent contractors.

2. Taxpayer Responsibility, Accountability and Consistency Act, S. 2882 (Kerry (D-MA))

   a. History of the “Safe Harbor” provision of Section 530 of the Internal Revenue Act.

      (1) Section 530’s Safe Harbor was enacted in 1978 to protect taxpayers against inconsistent and sometimes overzealous actions by the IRS in reclassifying ICs.

      (2) Section 530 was originally scheduled to expire at the end of 1979. When Congress failed to pass new legislation to provide guidance on IC versus employee status, it was
extended permanently. It will remain in effect until Congress affirmatively removes it from the books.

(3) Congressional intent is that Section 530 be construed liberally in favor of taxpayers. The protection it provides is relied on by many taxpayers.

b. Operation and Effect of Section 530’s “Safe Harbor”

(1) When certain requirements are met, current Section 530 provides permanent protection, both prospective and retrospective, against the IRS from reclassifying otherwise misclassified workers for federal income tax purposes.

(2) Section 530 allows a taxpayer to retain the classification of misclassified ICs for federal employment tax purposes—regardless of actual status—if the taxpayer (and its predecessor where applicable): (i) consistently treated the worker and all other workers holding a substantially similar position as ICs (the substantive consistency requirement)\(^\text{11}\); (ii) provided all federal tax returns (including Form 1099) consistent with its treatment of the worker as an IC (the Form 1099 requirement)\(^\text{12}\); and (iii) had a “reasonable basis” for treating the worker as an IC.\(^\text{13}\)

(3) A “reasonable basis” exists if the taxpayer relied on: (i) a prior IRS audit of the taxpayer; (ii) published IRS rulings or judicial precedent; (iii) long-standing recognized practice in the industry of which the taxpayer is a member; or (iv) where a “reasonable basis” can be demonstrated in some other manner (e.g., advice of a business lawyer or accountant familiar with the business).

(4) Section 530 also prohibits the Department of Treasury and the IRS from publishing regulations and revenue rulings

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\(^{11}\) The substantial consistency requirement for workers for whom Section 530 protection is claimed must be satisfied for all tax years. The substantial consistency requirement for other workers who hold substantially similar positions must be satisfied for all tax years after 1977. Inconsistent treatment of one single worker can destroy application of the Section 530 Safe Harbor. See e.g., La Nails, Inc. v. United States, 1998 U.S. Dist. LEXIS 7733 (D. Md. 1998).

\(^{12}\) The Form 1099 requirement requires strict compliance. See e.g., Prince Cable, Inc. v. United States, 1998 U.S. Dist. LEXIS 5981 (D. De. 1998) (holding that where the taxpayer submitted Forms 1099 for its ICs, but not the Form 1096 which must accompany Forms 1099 submitted to the IRS, the taxpayer did not qualify for Section 530 protection).

\(^{13}\) Section 530 protections do not apply in the case of a worker who provides services as an engineer, designer, drafter, computer programmer, systems analyst or other similarly skilled worker engaged in a similar line of work. 26 U.S.C. 3401 (Section 530(d)).
with respect to the employment status of any worker for purposes of employment taxes.

(a) A taxpayer may seek a written determination from the IRS regarding the status of a particular worker for purposes of federal employment taxes and income tax withholding. The IRS will not issue a written determination for prospective employment status.


(1) The TRAC Act was introduced on December 15, 2009 by John F. Kerry (D-MA). It has been referred to the Committee on Finance.

(2) The Act demonstrates a strong bias in favor of classifying workers as employees.

(3) The proposed legislation would amend Section 530 such that the “reasonable basis” standard provided by the Safe Harbor provision would be significantly narrowed.

(4) Under the TRAC Act, a taxpayer would be permitted to retain the classification of misclassified ICs for federal employment tax purposes—regardless of actual status—only if the taxpayer meets a two part test as demonstrated by a preponderance of the evidence:

(a) The taxpayer (and its predecessor where applicable) did not treat any worker holding a substantially similar position as an employee for any period after December 31, 1977; and

(b) The IC classification of a worker is based on a reasonable reliance on either a written determination from the Department of Treasury concerning the worker in question (or a worker holding a substantially similar position) as based on FLSA criteria, or on an IRS examination concerning the worker in question (or a worker holding a substantially similar position).
A taxpayer would no longer be permitted to rely on a specific court case, past IRS rulings, industry practice or some other reasonable basis.

The Safe Harbor protections would be lost where it is determined that the taxpayer misrepresented the controlling facts and circumstances that formed the basis of determining IC status, that the facts and circumstances have changed, or if the Secretary of the Treasury subsequently issues relevant guidance to the contrary.

Additionally, the TRAC Act would:

(a) Give workers classified as ICs the right to seek a determination of their status for employment tax-purposes from the Secretary of the Treasury. The worker would be permitted to appeal a finding of IC status.

(b) Allow the IRS to issue regulations for the purpose of carrying out the Act. In so doing, the 31-year moratorium on the issuance of IRS regulations and rulings concerning worker classification would be lifted.

(c) Impose the following civil penalties:

i) A minimum of $250 per incorrect tax return up to a maximum of $3 million per year. (Current: $50/$250,000).

ii) For smaller employers (gross receipts not exceeding $5 million), the maximum fine per year would be $1 million (Current: $100,000)

iii) Lower penalties would be imposed if tax returns are corrected within a specified periods of time.

iv) In cases where an intentional disregard for the filing requirement is found, $500 per incorrect tax return (Current: $100) would be assessed. The $3 million maximum would not apply.

A companion Bill, H.R. 3408, was introduced in the House on July 30, 2009 by James McDermott (D-WA). It has been referred to the House Committee on Ways and Means.

d. Mandatory Cooperation between IRS and DOL
Currently, the IRS and DOL generally do not exchange information collected in misclassification matters. This is in part because of certain restrictions in section 6103 of the tax code.

The TRAC Act would allow, and require, that where a worker has been misclassified, information concerning the misclassification must be provided to the DOL and the misclassified worker must be notified of any eligibility for a refund of self-employment taxes.

3. Employee Misclassification Prevention Act (EMPA), S.3254 (Brown (D-OH))

a. EMPA was introduced on April 22, 2010 by Sen. Sherrod R. Brown (D-OH). A companion Bill was introduced in the House by Lynn Woolsey (D-CA). The Bill has been referred to the Senate Committee on Health, Education, Labor and Pensions.

(1) Three of EMPA’s six sponsors/co-sponsors are also sponsors of the TRAC Act: Brown (D-OH), Durbin (D-IL), Harkin (D-IA).

(2) Secretary of Labor Solis has voiced her support.

b. EMPA would amend the FLSA to impose strict recordkeeping and notice requirements on businesses who utilize ICs. Failure to maintain or provide the required information—even where workers are properly classified—would result in civil fines.

(1) Companies who are now required to keep records of the hours of work and wages of employees would be required to keep comparable records for ICs providing labor or services to the business.

(2) EMPA makes it a “prohibited act” under federal law to fail to accurately classify a worker as an employee.

c. EMPA promotes information dissemination and cooperation among state and federal agencies.

(1) The Secretary of Labor would establish a misclassification website to enable the filing of on-line worker complaints and to provide a centralized information center concerning misclassification rights.

(2) Employers would be required to notify all workers of their classification status, direct them of the Department of
Labor website for further information, and advise them to contact the Department of Labor with any questions regarding classification status.

(3) States would be required to conduct audits to identify employers who misclassify workers, and the Department of Labor would be charged with monitoring states’ efforts to do so.

(4) The Department of Labor would be directed to conduct targeted audits of industries with histories of frequent misclassification.

(5) The Department of Labor and IRS would be authorized to reciprocally report incidents of misclassification and misclassification information to each other.

(6) The Social Security Act would be amended to establish penalties for misclassifying employees or for paying unreported wages to employees for unemployment compensation purposes.

d. EMPA imposes civil penalties:

(1) Employers found to have misclassified their workers or who violate the notice or record keeping requirements would be fined up to $1,100 per employee for first-time violators, and up to $5,000 per employee for repeat violators.

(2) Triple damages would be imposed for violations of the minimum wage or overtime laws in cases where an employer willfully misclassified workers.

(3) States would be directed to strengthen their own penalties for worker misclassification.

(4) Sen. Brown believes the legislation could raise $7 billion over 10 years.

D. Expect Increased Litigation Under Federal Discrimination Statutes and Other Laws That Apply Even to Correctly Classified Independent Contractor Relationships

1. Section 1981 (Claims for Discrimination Based on Race).

a. Passed after the Civil War, the Civil Rights Act of 1866 (also known as “Section 1981” based on its legal citation, 42 U.S.C.
§ 1981), provides: “All persons within the jurisdiction of the United States shall have the same right in every State and Territory to make and enforce contracts . . . as is enjoyed by white citizens . . . .”

b. According to many courts, the statute’s reference to “contracts” authorizes independent contractors to sue for racial discrimination. See Brown v. J. Kaz Inc., 581 F.3d 175 (3rd Cir. 2009); Taylor v. ADS, Inc., 327 F.3d 579, 581 (7th Cir. 2003); Webster v. Fulton County, 283 F.3d 1254, 1257 (11th Cir. 2002); Danco, Inc. v. Wal-Mart Stores, Inc., 178 F.3d 8, 13-14 (1st Cir. 1999); see also Vakharia v. Swedish Covenant Hospital, 190 F.3d 799 (7th Cir. 1999) (dismissing Title VII claims by African-American anesthesiologists, because they did not have an employment relationship with hospital, but analyzing on the merits the anesthesiologists’ claims under Section 1981); see also Lufti v. Brighton Community Hosp. Ass’n, 40 P.3d 51 (Col Ct. App. 2001) (dismissing both Title VII and Section 1981 claims by physician removed from emergency room rotation; physician had no contract with the hospital but instead was an independent contractor for a staffing firm that in turn had a contract with the hospital).

2. Claims Under Modern Employment Discrimination Statutes (Such As Title VII or the ADA).

a. As noted above, discrimination claims by contingent workers under employment discrimination statutes can fail because there is no employer-employee relationship.

b. However, a contingent worker may be able to bring claims under the employment discrimination statutes under one of two theories:

(1) **Joint employer.** If the contingent worker is employed by a third-party staffing agency and can establish that he or she is jointly employed both by the “client” and “supplier” company, there can be a claim against the “client” company because it is deemed to be the worker’s legal “employer.” See Bradley v. California Dep’t of Corrections, 158 Cal. App. 4th 1612 (2008) (holding that licensed clinical social worker placed by a registry to work at a state agency could sue the state agency for sexual harassment and retaliation); see also Dortz v. City of New York, 904 F. Supp. 127 (S.D.N.Y. 1995) (holding that social worker employed by city hospital in an alcohol treatment program could sue both city hospital and affiliated medical school for sexual harassment, where medical school personnel were
“intertwined” in the operation of the alcohol treatment program and were involved in the alleged harassment).

(2) **Third-party “interference” claims.** Discrimination that results in a contractor losing employment with a third party may be actionable in some jurisdictions as a form of “employment” discrimination, despite the lack of a direct employer-employee relationship. *See Zaklama v. Mt. Sinai Med. Ctr.*, 842 F.2d 291 (11th Cir. 1988) (permitting jury to decide Section 1981 claim by Egyptian medical resident; although he was employed by another hospital and not the defendant hospital, his residency program dismissed him based on an adverse report from the hospital where he was rotating); *Caston v. Methodist Med. Ctr. of Ill.*, 215 F. Supp. 2d 1002 (C.D. Ill. 2002) (holding that minority temporary agency worker could state claim against hospital that refused to allow him to work on the property pursuant to its allegedly discriminatory rule against hiring felons). Acceptance of this theory is not universal. *See Clark v. Marietta Surgical Ctr.*, Case No. 1:97-CV-0790-JOF, 81 Fair Empl. Cas. (BNA) 255 (N.D. Ga. Mar. 18, 1999) (dismissing anesthesiologist’s sex discrimination claim relating to allegedly unfair scheduling and being frozen out of hospital’s new anesthesiology services contract; the hospital’s actions did not interfere with any “employment” arrangement, only with the volume of the physician’s clinical practice).

c. **Claims Based on Receipt of “Federal Financial Assistance”**

(1) Although employment discrimination laws generally do not apply to properly classified independent contractors (subject to the exceptions discussed above), other federal laws regulate the conduct of “programs” or “activities” that receive federal financial assistance. The most notable such laws are Titles VI of the Civil Rights Act of 1964 (prohibiting discrimination on the basis of race, color, national origin) and Section 504 of the Rehabilitation Act (prohibiting discrimination on the basis of disability). Title IX of the Education Amendments of 1972 prohibits sex discrimination in any educational program or activity receiving federal financial assistance.

(2) “Federal financial assistance” is a broad term that does not require a formal federal contract. For example, the U.S. Department of Health and Human Services has stated that a
hospital that receives Medicare Part A payments is considered to receive federal financial assistance.

(3) Courts are now split on whether independent contractor arrangements are subject to regulation under the Rehabilitation Act, which imposes nondiscrimination requirements on “employment” practices with respect to disability.14

(a) In Fleming v. Yuma Regional Medical Center, 587 F. 3d 938 (9th Cir. 2009), the court held that a hospital participating in Medicare could be sued under Section 504 for alleged disability discrimination against a physician who was an independent contractor. The plaintiff physician was an anesthesiologist who suffers from sickle-cell anemia. He claimed that his contract was terminated after the hospital learned of his illness and refused to accommodate his special call and surgery schedules.

(b) A different federal appeals court reached the opposite result in Wojewski v. Rapid City Reg’l Hosp., Inc., 450 F.3d 338, 345 (8th Cir. 2006). There, the court held that an employer-employee relationship was required for a contractor to bring a claim that he was denied an employment opportunity because of his disability.

3. NLRA Liability for Third-Party Interference. Even without a direct employer-employee relationship, an employer can violate the NLRA if it interferes with the federal labor rights of a different employer’s employees. Under this doctrine, an employer cannot require its business partners/contractors to commit an unfair labor practice. For example, companies have also been found liable for instructing their contractors to terminate pro-union employees. See Dews Construction Corp., 231 NLRB 182 fn. 4 (1977); Georgia-Pacific Corp., 221 NLRB 982 (1975).15 In a similar vein, a company that unlawfully terminated a union supporter was found to violate the NLRA when it refused to allow him to return to the company’s property as the employee of a contractor. See Austal USA L.L.C., 349 NLRB 561 (2007).

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14 Title IX imposes a similar requirement with respect to sex discrimination in employment. By its terms, Title VI regulates employment practices only when the “primary objective” of the federal financial assistance is to provide employment.

15 An employer is, however, free to refuse to do business entirely with another company because of its union status. Plumbers Local 447 (Malbaff Landscape Construction), 172 NLRB 128, 129 (1968).
4. **Franken Amendment to Defense Appropriations Bill.** Effective February 17, 2010, a provision of the Defense Department Appropriations Act prohibits federal defense contractors receiving more than $1 million from entering into or enforcing arbitration agreements that require arbitration of claims by either employees or independent contractors under Title VII of the federal Civil Rights Act of 1964, or for any tort related to or arising out of sexual assault or harassment (including assault and battery, intentional infliction of emotional distress, false imprisonment, or negligent hiring, supervision, or retention). This restriction, the so-called “Franken Amendment,” also applies to subcontractors effective June 17, 2010. It also applies to all employees of covered contractors or subcontractors, not just those working on a defense contract. The Amendment applies only during the term of the current defense appropriation bill and will be reviewed by Congress next year. The Defense Department issued an interim rule implementing the Amendment on May 19, 2010. *See Defense Federal Acquisition Regulation Supplement; Restrictions on the Use of Mandatory Arbitration Agreements* (DFARS Case 2010-D0004), 75 Fed. Reg. 27,946 (May 19, 2010) (adopting new 48 C.F.R. § 222.7400 to -.7404).

E. **New NLRB and Implications for Unionization.**

1. The National Labor Relations Board is now dominated by Obama Administration appointees sympathetic to organized labor. As a result, the NLRB is expected, at the first possible opportunity, to revive its Clinton-era decision of *M. B. Sturgis, Inc.*, 331 NLRB 1298 (2000).

2. *M.B. Sturgis* held that the NLRB can require an employer to recognize a bargaining unit that includes both directly-employed employees and employees of a third-party who work alongside the employees. For example, this would allow the NLRB to create a bargaining unit comprised of all registered nurses who are employed to work at a hospital—both those directly employed by the hospital and those who are assigned to the hospital by a third-party nurse registry. This doctrine was followed in a handful of cases but was then overruled during the Bush Administration. *See Oakwood Care Center*, 343 NLRB 659 (2004).

3. Current law – as stated in the *Oakwood Care* case – holds that such “multi-employer” bargaining units are not appropriate, unless all employers consent to them. (Obviously, few employers voluntarily consent to such bargaining units.)

4. Because the *M.B. Sturgis* doctrine was so short-lived, there are numerous open questions about how contracts would be bargained, particularly if the client and staffing firm disagreed on key issues such as wages or hours.
VI. Recent Changes to State Laws

A. Some states are moving towards adopting the “ABC” test or other more stringent test that presumes an employment relationship:

1. **Massachusetts.** M.G.L. c. 149, §148B. Independent Contractor Law. The original enactment of Massachusetts’s Independent Contractor Law took place in 1990. Amendments in 2004 adopted a standard more stringent than the ABC test. The amendments make the test essentially impossible to meet for a company with workers providing services that are within the company’s usual course of business.

2. **Illinois.** 820 I.L.C.S. 185, *et. seq.* The Employee Classification Act, applicable to the construction industry, adopts the ABC test.

3. **Maryland.** Md. Code Labor & Employment § 3-903. Workplace Fraud Act. This law adopts a detailed version of the ABC test for the construction and landscaping industries.


B. New Penalties for Willful Misclassification

1. **Colorado.** C.R.S. § 8-72-114. This statute establishes penalties for willful misclassification of workers in the amount of up to $5,000 per misclassified worker. A penalty of up to $25,000 per misclassified worker may be assessed for subsequent misclassifications.

2. **Connecticut.** C.G.S.A. § 31-69a. Under current law, employers engaging in misclassification or misrepresentation are liable for a single $300 civil penalty. The Bill increases the penalty by providing that each day of the violation constitutes a separate offense.

3. **Maryland: Workplace Fraud Act.** Md. Code Labor & Employment § 3-909. This law is applicable to the construction and landscaping industries. Employers who are found to have knowingly misclassified a worker will be assessed a civil penalty of up to $5,000 for each such employee. Double penalties will be assessed if the employer has previously violated the act.

4. **Massachusetts: Independent Contractor Law.** M.G.L. c. 149 §§ 27C (a)(1) and (2). The Independent Contractor Law established violations for both willful and unintentional misclassification. The former may result in
fines of up to $25,000 or imprisonment for first time violations. Subsequent violations may result in fines up to $50,000 or imprisonment. The latter may result in fines of up to $10,000 or imprisonment for first time violations. Subsequent violations may result in fines up to $25,000 or imprisonment.

5. **Illinois: Employee Classification Act.** 820 I.L.C.S. 185/45. This statute, applicable to the construction industry, provides for the imposition of double penalties and punitive damages in the cases of willful violations.

C. **Reporting, Disclosure and Notice Requirements.**

1. **Colorado.** Colo. Rev. Stat. § 8-72-114. Employers are required to post a notice explaining the rights of employees to be properly classified.

2. **Illinois.** 56 Ill. Adm. Code 240.400, 410. This regulation imposes recordkeeping requirements pertaining to ICs similar to those required under the FLSA for employees. Where practicable, a notice summarizing the requirements of the Illinois Employee Classification Act (applicable to the construction industry) must be posted. Where not practicable, notices must be provided to all individuals performing services who are not classified as employees.

3. **Maryland: Workplace Fraud Act.** Md. Code Labor & Employment § 3-914. This statute imposes recordkeeping requirements pertaining to ICs similar to those required under the FLSA for employees. Written notice of a worker’s IC status must be supplied to the worker at the time of hiring.

D. **Enforcement Initiatives at the State Level.**

1. **Connecticut.** In 2008, the state created a task force called the Joint Enforcement Commission on Worker Classification. Members include representatives from five state agencies as well as a joint business and labor advisory group. The Commission announced that in 2009, Connecticut’s Labor department reclassified 6,700 ICs, and that the state’s Department of Revenue Services recouped $1.2 million in additional taxes as a result of 61 audits related to misclassification.

2. **Iowa.** In 2008, the state implemented a task force charged with studying and identifying potential legislative, regulatory, communication, and enforcement changes and approaches to prevent worker misclassification. Iowa’s Task Force is comprised of leadership from the Governor’s office and Iowa Departments of: Workforce Development, Revenue, and Economic Development. The Task Force requested additional funding in 2010 to finance a unit of nine investigators for the establishment of a Misclassification Unit.
3. **Michigan.** Michigan was the first state to join the QETP program in 2007. At the same time, the state also implemented a Task Force comprised of three agencies from within the state’s Department of Labor & Economic Growth – Unemployment Insurance Agency, Wage & Hour Division, and Workers’ Compensation Agency. Members also include individuals from the state’s Departments of Treasury and Management & Budget. Michigan’s Task Force is charged with studying the problem of employee misclassification, developing ways of improving communication and public awareness of the problem, coordinating and strengthening enforcement mechanisms within the state and with other jurisdictions and making recommendations for legislative action where needed. A July, 2008 report revealed that from 2003 to 2007, $23.3 million in wages were misclassified, resulting in lost income and unemployment taxes.

4. **New Hampshire.** New Hampshire has established two task forces. One is charged with collecting public comments on issues surrounding worker misclassification. The other is charged with establishing cooperative enforcement efforts between state agencies concerning worker misclassification. The task forces are comprised of members of the legislature, Departments of Labor, Employment Security, Insurance, and Revenue Administration, the attorney general, building trades unions, contractors, insurance carriers and business owners.

5. **New York.** In 2007, New York was the first state to implement a task force to assess the misclassification of ICs. New York’s Task Force is headed by the Director of the Department of Labor. Members also include the state’s Attorney General and Comptroller of the City. Since late 2007, the Task Force has uncovered more than 31,000 instances of misclassification resulting in $11 million in unpaid unemployment taxes and $14.5 million in unpaid wages. The Task Force has reported that its activities include “sweeps” of employers, door-to-door auditing of employers in retail and commercial districts, and referrals of cases involving intentional misclassification for criminal prosecution.

E. **Direct Application of State “Employment” Laws to Contractors.**

1. **California.** The California Fair Employment and housing Act prohibits harassment of employees, applicants and independent contractors and requires employers to take all reasonable steps to prevent the same. See Cal. Gov’t Code § 12940(j)(1).

2. **New Jersey.** The New Jersey Law Against Discrimination makes it unlawful for any person to refuse to “contract” or otherwise “do business with” someone because of race, creed, color, national origin, nationality, ancestry, marital status, domestic partnership status, liability for service in the Armed Forces of the United States, age, sex, affectional or sexual
orientation, or disability or because of race, creed, national origin or other
protected characteristics of the person’s spouse, partners, employees,
business associates, suppliers or customers. N.J. Stat. Ann. § 10:5-12(l);
see also J.T.’s Tire Service, Inc. v. United Rentals North America, Inc.,
authorities and recognizing claim for sexual harassment arising from
business relationship).

VII. Consequences of Not Recognizing Employment Obligations

A. Back wages and overtime. Employees who are improperly classified as
independent contractors are entitled to overtime for all hours worked over 40,
unless they were overtime-exempt. In addition, “jointly employed” employees
may be entitled to aggregate the hours they worked for multiple employers to
create overtime liability.

B. Benefits. Employees may be entitled to “back benefits” under benefits they
otherwise would have been entitled to receive. As an extreme example, the
famous Microsoft benefits case settled for $97 million.

C. Tax audit and penalties. An employer who has misclassified employees as
contractors will owe at least the following federal taxes and penalties:

1. The full employer share of FICA/Medicare taxes.

2. 20% of the employee share of FICA/Medicare taxes (this increases to 40%
for intentional misclassification cases). The employer will also have
certain responsibilities to collect and pay the unpaid portion of the
employee share.

3. A 1.5% penalty on all income for failure to withhold income taxes
(increases to 3% for intentional misclassification penalties). If the
employee did not report and pay income taxes on his or her own Form
1040, the IRS can collect those taxes from the employer instead.

4. The collections limitations period runs at least three years (more if a return
was not filed).

5. State penalties would be assessed separately.

D. State-law willfulness penalties. As discussed above, states are beginning to
legislate penalty schemes for employers who misclassify employees as
contractors.

E. Possibility of injunctions. Although rarely sought in the past, government
agencies and plaintiff’s lawyers may increasingly seek injunctions to prohibit
employers from engaging in future misclassification
VIII. Defensive Measures

A. **Audit compliance, looking at all applicable legal standards.** In many or even most circumstances, it may be most appropriate to retain legal counsel to perform the audit under attorney-client privilege.

1. **Don’t stop with the IRS test.** The IRS test is a uniquely *permissive* standard, because the employer can be wrong but (currently) can still continue classifying the employee as a contractor if it has a “reasonable basis” under Section 530 for doing so. Other laws (such as FLSA) do not have such a safe harbor and/or may apply tougher standards.

2. **Recognize that contractor status may be justified under some definitions but not others.** For example, some states use a strict “ABC” standard for worker’s compensation and/or unemployment coverage, but a looser standard for employment discrimination laws. As a result, some individuals may appropriately be treated as contractors for the former but not the latter purposes.

3. **Don’t limit the inquiry to contractor misclassification.** With large numbers of temporary, registry, and on-call employees, hospitals use many different types of contingent workers, not just independent contractors. Hospitals should have an appreciation for the full scope of their contingent workforce and the legal obligations they have as a result.

B. **Ensure policies capture any obligations towards independent contractors and other contingent workers.** Both federal and state laws impose some obligations even with respect to legitimately classified contractors. They also impose obligations with respect to “jointly employed” individuals. Priority areas may include discrimination and harassment policies.

C. **Tighten policies and practices regarding “permanent” temps and other borderline situations.** Health care reform will bring added urgency to this effort, since misclassified contractors will have a greater incentive to challenge their status.

D. **Educate managers.**

1. Managers should know what they can do to minimize misclassification issues.

2. Managers should also be aware of legal obligations with regard to properly classified contractors (such as potential non-discrimination and harassment policies).

E. **Police arrangements with temporary and staffing companies.** Claims can arise when a temporary or staffing company is irresponsible, for example, not properly withholding taxes. This leaves the hospital as a “deep pocket” for either
the contingent worker or the state tax agency to pursue. For this reason, avoid working with staffing firms that engage in questionable employment practices (for example, if they improperly treat their employees as independent contractors). Agreements with staffing firms should clearly state their responsibility to comply with employment laws. It may also be wise to include indemnification provisions in those agreements or even to require proof that the firms carry employment practices liability insurance.

This outline is intended to provide a synopsis of developments in the law and should not be construed as legal advice or as a comprehensive summary of all laws in this subject area.

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