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Avoiding Misclassification Mishaps

How Employers Can Protect Themselves from Employee Misclassification

Executive Summary

The independent contractor workforce offers employers significant flexibility and cost savings, a potential boon in today's tough economy. However, the U.S. Department of Labor has launched a multi-layered initiative to identify and investigate employers who incorrectly classify employees as contractors. Organizations found to be misclassifying employees face high financial stakes including state and federal fines and fees and potential litigation from misclassified workers for back pay and benefits.

Because there is no single criterion used to differentiate an independent contractor from an employee, many employers are unsure how to protect themselves against misclassification. Examining existing contractor relationships, auditing all employee classifications, reviewing pay policies, maintaining FLSA records on both non-exempt and exempt employees and ensuring youth labor provisions are followed are just a few ways organizations can help avoid costly misclassification mishaps.

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The Rise of the Independent Contractor

In the midst of a slowly recovering economy, many organizations downsize and hire independent contractors for extra help when necessary. Other organizations cannot afford the pay and benefits required for a full- or part-time employee and instead turn to contractors to do the work.

Advantages of working with independent contractors are many. Contractors are flexible, bringing much-needed scalability to an organization's workforce. Depending on the type of work, many contractors own and operate their own equipment, assigning them a lower overhead versus an employee. Organizations hiring contractors are not bound by minimum wage or overtime pay requirements; do not need to provide contractors with health insurance, retirement benefits, or paid or unpaid leave; and avoid paying payroll taxes, Social Security, unemployment and workers' compensation insurance. Organizations working with independent contractors are estimated to save 20-30% of the cost of hiring full-time employees.[i]

However, sometimes the working relationship between an organization and a contractor functions too similarly to an employer-employee relationship. The U.S. Department of Labor (DOL), identifying this confusion as "employee misclassification," saw it as a growing problem and set out to aggressively curtail it.

Misclassification Demystified

Employee misclassification occurs when an employer incorrectly classifies a worker as an independent contractor instead of an employee. When this occurs, the worker misses out on benefits, protections and overtime pay—and the government misses out on taxes paid by the employer for the employee.

In its FY 2011 budget, the DOL set aside $25 million for a multi-agency misclassification initiative to "strengthen and coordinate Federal and State efforts to […] identify and deter misclassification of employees as independent contractors."[ii]

The DOL breaks down the $25 million among four agencies, with just under half ($12 million) going to the Wage and Hour Division to focus on misclassification during targeted investigations. The Employment and Training Administration receives $11.25 million to fund grants to increase state focus on misclassification and reward those states that most successfully detect and prosecute employers who fail to pay taxes due to misclassification. $1.6 million is allotted to the Solicitor of Labor to pursue misclassification litigation in coordination with state enforcement. The Occupational Safety and Health Administration (OSHA) receives $150,000 to better train OSHA inspectors to identify and report potential misclassification to the Wage and Hour Division.[iii]

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In FY 2012, the DOL almost doubled its 2011 budget, earmarking $46 million to continue the misclassification initiative by funding grants to states that "address worker misclassification within the context of the unemployment insurance program."[iv]

The DOL has also proposed the "Right to Know Under the Fair Labor Standards Act," suggesting the Fair Labor Standards Act's (FLSA) recordkeeping provisions be updated to "enhance transparency and disclosure" of worker classification.[v] Specifically, it would require employers to conduct a classification analysis for every worker the organization considered excluded from FLSA coverage[vi] (which includes independent contractors and exempt employees) and be prepared to provide their findings to the worker in question as well as Wage and Hour Division investigators in the face of an audit.[vii]

It seems pressure on employers to correctly classify workers—and avoid costly litigation—will only increase.

Will the Real Contractor Please Stand Up?

The real difficulty is that there is no single measure or list of criteria that distinguishes an independent contractor from an employee.

The Internal Revenue Service states if a worker "perform[s] services that can be controlled by the employer (what will be done and how it will be done)," then that worker is an employee, not an independent contractor. The IRS further elaborates: "What matters is that the employer has the legal right to control the details of how the services are performed."[viii]

The FLSA provides several factors the U.S. Supreme Court has considered significant in misclassification decisions, including:

- How integral the worker's services are to the business,
- The permanency of the working relationship,
- How much money the worker has invested in facilities or equipment, and
- The nature of the work and the degree of control the business has over the work performed.[ix]

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Clearly, it is not only the details of the working relationship but also the nature of the relationship overall that determines whether a worker is correctly classified as a contractor or employee.

Misclassification—What's At Stake

Penalties for misclassifying workers can be high. IRS fines can range from $1,000 to $5,000 per misclassified employee, not counting state penalties. The misclassified employee could also sue for unpaid overtime or benefits, adding litigation to the list of costs.[x]

An employer who misclassifies could also face FLSA fines. Once an employer-employee relationship is determined to exist, the employer is held responsible for complying with FLSA provisions for that employee (assuming they are non-exempt) including appropriate recordkeeping, minimum wage and overtime regulations.

Another risk for employers to keep in mind: if one employee is misclassified, there's a good chance others will be also.[xi] When more than one employee is misclassified, fines and fees quickly compound.

The DOL's initiative to "catch" employers who misclassify workers dramatically increases the risk of classification-related litigation. The financial impact of state and federal fines, legal counsel fees and settlements ups the stakes further.

How can savvy organizations protect themselves from misclassification?

Protective Measures

As of publication, "Right to Know," the DOL's proposal to amend FLSA recordkeeping to require employers to provide classification documentation, has not been finalized. This means many organizations are left with question marks when it comes to protecting themselves from misclassification.

At the 2011 Employment Law and Legislative Conference hosted by the Society for Human Resource Management, Howard Radzely, a partner with the Washington, D.C.-based law firm Morgan, Lewis and Bockius, recommended precautionary actions such as examining existing relationships with independent contractors, self-auditing employee classifications, and reviewing pay policies.[xii]

Examining Existing Contractor Relationships

Working relationships with existing independent contractors must be differentiated from a typical employer-employee relationship. Ultimately, both the IRS and FLSA agree that contractors must have a significant level of control over how they perform their services. Radzely recommends making sure contractors are not over-utilized, do not perform core functions, and are not treated like employees.[xiii]

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Classification Self-Audits

A regular review of employee job descriptions and responsibilities can catch potential misclassifications before they become a problem. Documenting the audit process and any changes that emerge from it can also be helpful in the event of misclassification allegations.

Reviewing Pay Policies

Organizations must ensure their pay policies are accurate, especially when it comes to bonuses and deductions, salary calculations and overtime pay. Employers using a timekeeping system can re-visit their customized pay rules to ensure employees' salaries or wages are calculated correctly and that any additions (bonuses, overtime) or deductions are accurate.

Other protective measures include keeping FLSA records on all non-exempt and exempt employees. Although FLSA only requires certain records to be kept on non-exempt employees such as name, address, Social Security number, pay rate, work schedule and hours worked, the same information could easily be gathered for exempt workers in the event an exempt employee's classification changes. Again, a timekeeping system is a helpful tool not only to track time and attendance data but also maintain updated personal information. Integration with existing HR and payroll systems means up-to-date data can be easily sourced from the timekeeping system without managing multiple updates in separate databases.

In the event of a misclassification investigation, other FLSA compliance issues could come to light. Organizations that regularly employ youth (under the age of 18) must ensure they are complying with the recordkeeping and work guidelines for young employees. This can also include regularly auditing minors' work schedules and pay rules, and updating their personal data.

Finally, organizations with questions or concerns about employee classification should consult legal counsel to ensure they are operating within FLSA provisions.

Avoiding Misclassification Mishaps

Due to their flexibility and cost savings, the independent contractor workforce continues to gain ground in today's sluggish economy. However, the Department of Labor's multi-agency misclassification initiative could slap employers with escalating fees and fines and draw them into costly litigation. Employers can take steps to protect themselves by examining existing contractor relationships, auditing all employee classifications, reviewing pay policies, maintaining FLSA records on both non-exempt and exempt employees and ensuring youth labor provisions are followed to avoid misclassification mishaps.

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This document simplifies a complex Act as it is understood by Attendance on Demand, Inc. It is not to be taken as legal advice. For further information about FLSA compliance, please contact the U.S. Department of Labor at www.dol.gov or 1-866-4-USWAGE.

[i] Pazzanese, Christina. "Worker Classification Enforcement on the Rise." New England In House. 13 Jun 2011. <http://newenglandinhouse.com/2011/06/13/worker-classification-enforcement-on-the-rise/>.

[ii] U.S. Department of Labor. "FY 2011 Budget in Brief." Accessed 24 Aug 2011. <http://www.dol.gov/dol/budget/2011/bib.htm>.

iii *Ibid.*

iv U.S. Department of Labor. "FY 2012 Budget in Brief." Accessed 19 Aug 2011. <http://www.dol.gov/dol/budget/2012/bib.htm>.

v U.S. Department of Labor. "WHD Unified Agenda: Right to Know under the Fair Labor Standards Act." Fall 2010. <http://www.dol.gov/whd/regs/unifiedagenda/fall2010/1235-AA04.htm>.

vi Maurer, Roy. "'Right to Know' Could Have Huge Impact on Employers." Society for Human Resource Management. 23 Mar 2011. <http://www.shrm.org/about/news/Pages/RightToKnowImpact.aspx>.

vii Minnesota Business. "Proposed Employer Record Keeping Requirements Related to Worker Classification." 11 Aug 2010. <http://www.minnesotabusiness.com/experts-forum/proposed-employer-record-keeping-requirements-related-worker-classification>.

viii Internal Revenue Service. "Independent Contractor Defined." Accessed 22 Aug 2011. <http://www.irs.gov/businesses/small/article/0,,id=179115,00.html>.

ix U.S. Department of Labor. "Fact Sheet #13: Employment Relationship Under the Fair Labor Standards Act (FLSA)." Accessed 3 Aug 2011. <http://www.dol.gov/whd/regs/compliance/whdfs13.pdf>.

x Pazzanese, Christina. "Worker Classification Enforcement on the Riase." New England In House. 13 Jun 2011. <http://newenglandinhouse.com/2011/06/13/worker-classification-enforcement-on-the-rise/>.

xi Carlock, Catherine. "The Economics of Litigation: In a Tough Economy, Employers Should Guard Themselves Against Litigation." The Business Journal. 17 Jun 2011. < http://www.bizjournals.com/triad/print-edition/2011/06/17/the-economics-of-litigation-in-a.html>.

xii Maurer, Roy. "'Right to Know' Could Have Huge Impact on Employers." Society for Human Resource Management. 23 Mar 2011. <http://www.shrm.org/about/news/Pages/RightToKnowImpact.aspx>.

xiii *Ibid.*

About Attendance on Demand, Inc.

Attendance on Demand employee time and attendance service supports the labor management needs of thousands of companies and a quarter of a million employees across North America. Launched in 2006, Attendance on Demand is a rapidly deployed, cloud-based solution that minimizes a company's risk and technology investment while providing advanced features for securely managing labor data—calculating pay rules, scheduling employees, budgeting labor, and automating record keeping for labor law compliance. With over 99.9962% uptime and above average customer retention rates, Attendance on Demand removes the worry of maintaining expensive infrastructure. An extensive North American distribution network helps organizations use Attendance on Demand to reduce labor expenses and improve decision making.

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9/11