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# DOL, IRS, and 11 States Enter Agreement to Work Together against Misclassification

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On September 19, 2011, the United States Department of Labor (DOL) and Internal Revenue Service (IRS) signed a memorandum of understanding to improve the agencies' coordination of efforts to combat employee misclassification, recoup wrongfully withheld payroll taxes, identify workers entitled to overtime, and better improve compliance and education. Seven states have signed a similar memorandum with DOL and IRS. The signatory states are Connecticut, Maryland, Massachusetts, Minnesota, Missouri, Utah and Washington. Four states – Hawaii, Illinois, Montana, and New York – are expected to sign similar agreements in the very near future. This most recent development in interagency cooperation highlights that businesses that utilize independent contractors ( *e.g.*, consultants, freelancers) should be prepared for increased scrutiny.

Under the new agreements, a state will now share information with the DOL that a business failed to remit unemployment insurance or workers' compensation premiums, which might well lead the DOL to audit that employer for possible federal wage-hour violations. The IRS, in turn, also would receive information about the violation, which would give that agency the opportunity to seek unpaid taxes and associated penalties. Thus, an employer risks being hit three times, instead of just once, for the same, possibly inadvertent, violation.

With increased scrutiny paid to worker misclassification, employers subject to the Family and Medical Leave Act should keep in mind that their health insurers or third-party administrators also may be tempted to designate temporary workers who have been engaged for many months or even years as covered "employees" under the FMLA regulations pursuant to 29 C.F.R. § 825.106. While we are by no means suggesting an uptick in such activity, there have been some reported decisions on these issues and, consequently, employers should not be shocked if this should arise.

**Motivation To Misclassify**

Many employers have long appreciated the advantages of "alternative" work arrangements with independent contractors, contingent workers, consultants, "freelancers", and temporary staff because these arrangements often produce cost savings and increased flexibility. The temptation to classify a worker as an independent contractor can be great, considering that employers do not pay unemployment insurance taxes, workers' compensation premiums, or the employer's portion of Social Security and Medicare taxes for independent contractors. Also, such workers generally are not eligible for fringe benefits such as insurance and retirement benefits. True independent contractors also are not protected by most employment laws – such as Title VII, the FLSA, and ERISA. Hence, these workers often forego overtime wages, pensions, and protections from unlawful discrimination.

**Stepped-Up Enforcement from State and Federal Government**

The problem of employee misclassification is so pervasive – and its impact on federal and state government agencies' tax collections is so significant – that the Government Accountability Office ("GAO") has estimated that worker misclassification costs the federal treasury alone several billion dollars annually in income tax revenues.[1] Because of this significant loss of revenue, governmental agencies (at all levels) have intensified efforts to "crack down" on the practice of misclassifying workers. At the federal level, as part of the budget for fiscal year 2011, the Obama administration allocated nearly $25 million to a worker misclassification initiative, targeting employers that have improperly classified workers as independent contractors, to be carried out by the Labor and Treasury Departments.[2] In November 2009, the IRS announced that it would be commencing a nationwide audit of 6,000 randomly selected companies to determine, among other potential tax violations, whether all employment taxes are properly accounted for and paid. The initiative will span three years, with approximately 2,000 audits occurring annually.[3] Also, in April 2009 through the first quarter of 2010, the DOL collected $172,600,000 in back wages for more than 219,000 workers nationwide. [4]

On the state level, many legislatures have enacted laws seeking to curtail misclassification, often creating strict requirements and hefty penalties for employers. Massachusetts is one of those states. It has enacted an independent contractor law that creates a "presumption" of employee status for purposes of the Commonwealth's wage laws and requires businesses to meet a strict three-part test to overcome this presumption. In 2010, New York joined the ranks of states that seek to impose harsh penalties for misclassification. First, it enacted the New York State Construction Industry Fair Play Act targeting the construction industry for wrongfully classifying far too many workers as independent contractors when the reality is that many are employees**.** (Our July 14, 2010 client alert: New York State Takes Aim at Independent Contractors in the Construction Industry). Second, the state enacted the New York State Wage Theft Prevention Act which amended several provisions in the New York Labor Law by imposing stringent pay notice requirements on employers both upon hire and throughout the employment relationship. (for related client alerts, December 15, 2010: New York's Wage Theft Prevention Act Increases Employer Obligations and Penalties and March 30, 2011 Update on NYS Wage Theft Prevention Act). As a result of having to meet these notice requirements, employers are prompted to undertake investigations of their workers' current classification status and will, accordingly, be deemed "on notice" of any misclassifications. In contrast to employees, independent contractors will *not* receive pay notice information from the business with whom they are engaged. As such, any future misclassifications will likely be considered "willful violations," and may subject employers to heightened penalties, such as liquidated damages of 100 percent of the wages (including overtime) due. Other states that have enacted misclassification statutes include Illinois, New Jersey, Minnesota and Wisconsin.

Several states, including New York, California, Connecticut, Iowa, Maryland, Massachusetts, Michigan, Minnesota, Nevada, New Hampshire, New Jersey, Oregon, Rhode Island, Utah, Vermont, and Wisconsin also have created misclassification "task forces," to combat employers who seek to circumvent state and federal wage-hour, health and safety, unemployment, and workers' compensation laws. This strategy has seen great success in uncovering violations. For example, during the 16 months between its formation and the issuance of its 2009 Annual Report, the New York Task Force identified 12,300 instances of worker misclassification and discovered $157 million in unreported wages.[5] According to the 2010 Annual Report of the Massachusetts Joint Enforcement Task Force on the Underground Economy and Employee Misclassification, that task force recouped $6,489,549 in unpaid taxes due to misclassification from April 1, 2009 thru March 31, 2010.[6]

**The IRS Rolls Out Its Classification Settlement Program**

The IRS announced, on September 21, 2011, a new program designed to permit businesses to voluntarily reclassify workers as employees for federal employment tax purposes. Under this new program, instead of paying back taxes, penalties, and interest for three years of misclassification, businesses will be able to pay approximately ten percent of the taxes for the most recent of three years. This Voluntary Classification Settlement Program ("VCSP") also will relieve employers from paying interest or penalties on those workers whom they are reclassifying. To participate in the program, the employer must meet the following eligibility requirements:

- not currently under investigation or audit by IRS, DOL, or a state agency concerning the classification of its workers;
- consistently treated the workers as non-employees; and
- must have filed all required Forms 1099 for the workers for the previous three years.

Participation in the VCSP has no effect on possible state law audits and resulting violations will likely not preclude a DOL audit in connection with wage-hour issues, and will not preclude private actions, such as for overtime under federal or state laws.

**Steps to Consider Now**

The determination of whether a worker is an independent contractor or an employee can at times be very difficult and may even vary from law to law. In some circumstances the line between the classifications can be blurred, leaving employers open for inadvertent classification mistakes. In this environment, employers would be wise to consider the following practice pointers concerning the classification of workers:

1. Evaluate the classification status of workers carefully at the outset of the work relationship to determine whether a worker is an independent contractor or an employee. Concomitantly, if you inherit a large number of independent contractors on your company's 1099 payroll (such as following an acquisition or a merger), be suspicious, and inquire when was the last time the business conducted a classification audit;
2. Become familiar with factors used by the IRS, the DOL, and state enforcement agencies for determining independent contractor status. Also, case law applicable to relevant laws, occupations and/or industries may provide helpful guidance (as certain occupations and/or industries have been the subject of repeated litigation);
3. Conduct a self-audit of your independent contractors to determine whether any might more properly be classified as employees. Be mindful of the factors used by the IRS (or other federal agencies) and state enforcement agencies when making this determination and understand that it is often not an easy assessment. Understanding the legal "fine points" is often a critical factor in classifying workers properly, although in some cases the "call" is not easy.
4. Check your provider agreements with health insurers and/or third-party FMLA administrators to ensure that your business retains exclusive control over determinations regarding "covered employees" under the FMLA.

Proskauer's Employment Law Counseling Practice Group has extensive experience assisting employers with employee classification and compliance audits as well as training Human Resources Professionals in this area of the law. In addition, we can apply our experience representing employers in the defense of actions alleging misclassification to help ensure that problems which surface during a classification and/or payroll practices audit are resolved in a timely and discreet manner, with as little "fall-out" as possible.

If you have any questions about this client alert, please contact your Proskauer relationship attorney or any of the members of Proskauer's Employment Law Counseling and Training Practice Group.

[1] *Testimony before the Subcommittee on Income Security and Family Support and Subcommittee on Select Revenue Measures, Committee on Ways and Means, House of Representatives* (May 8, 2007).

[2] Office of Mgmt. & Budget, Exec. Office of the President, Budget of the United States Government, Fiscal Year 2011, at 100 (2010).

[3] Ryan J. Donmoyer, *IRS to Audit 6,000 Companies To Test Employment Tax Compliance*, (Sept. 18, 2009).

[4] FY 2011 DEPARTMENT OF LABOR BUDGET IN BRIEF, *available at http://www.dol.gov/dol/budget/2011/PDF/bib.pdf* (last visited Sept. 27, 2011).

[5] *Annual Report of the Joint Enforcement Task Force on Employee Misclassification, Feb. 1, 2011 Annual Report*, *available at www.labor.state.ny.us/.../Misclassification_TaskForce_AnnualRpt_2008_pdf.* (last accessed Sept. 26, 2011).

[6] Joint Enforcement Task Force on the Underground Economy and Employee Misclassification, at 2 http://www.mass.gov (last accessed Sept. 22, 2011).

*Special thanks to Associate, Carolyn Dellatore, for her contributions to this client alert.*

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