The Proliferation of Misclassification of Employees as Independent Contractors

Some employers attempt to avoid paying overtime at a rate of time-and-a-half and other costs by misclassifying employees as independent contractors. As a result employees do not receive overtime pay at a rate of time and a half, and they can be precluded from receiving health insurance, workers’ compensation benefits, unemployment benefits, and a host of other benefits deriving from direct employment. Federal and state governments also do not receive payroll taxes and other income deriving from direct employment relationships. As such, courts look upon employers misclassifying employees as independent contractors with disfavor, and the costs of an adverse judicial action can dramatically outweigh the short term benefits of misclassification.

Why Would Employers Misclassify Employees as Independent Contractors?

Employers misclassify employees as independent contractors for a host of reasons. An employer who misclassifies an employee as an independent contractor does so attempting to avoid, *inter alia*, the following costs associated with employment:

a. paying minimum wages;
b. paying overtime;
c. paying the payroll tax (11% in D.C.);
d. paying worker’s compensation;
e. paying unemployment;
f. paying social security;
g. offering or subsidizing employee health benefits;
h. offering paid leave;
i. offering Federal Family and Medical Leave Act (FMLA) unpaid leave; and
j. offering D.C. Family and Medical Leave Act unpaid leave.
By misclassifying employees as independent contractors, employers can reduce FICA costs, unemployment contributions, workers’ compensation costs insurance costs, and benefits contributions. It’s more expensive to employ employees rather than to hire independent contractors, and misclassification eliminates a lot of filings and expenses that employers would prefer to avoid if possible.

**What’s the Downside?**

Under the Fair Labor Standards Act of June 25, 1938, Chapter 676, 52 Stat. 1069, 29 U.S.C. § 201, *et seq.* (FLSA), and the D.C. Minimum Wage Act, D.C. Code § 32-1001, *et seq.*, employees may file a private action against employers who fail to pay them properly. While both statutory causes of action address the issue of employers failing to pay overtime at a rate of time-and-a-half, the D.C. Minimum Wage Act defines “wage” as the “compensation due to an employee by reason of the employee’s employment… including allowances as may be permitted by any regulation issued under §§ 32-1003 and 32-1006.” § 32-1002(8). This means that the D.C. Minimum Wage Act also provides a remedy when an employer fails to pay a regular wage that is in excess of the minimum wage (a protection not afforded by the FLSA).

Moreover, both acts provide for liquidated damages, which an employee is entitled to receive if he or she brings a successful claim. The liquidated damages are defined by the FLSA as being double the unpaid wages due to the employee. Thus, if an employee is awarded $10,000 in unpaid wages, he or she may be entitled to get an additional $10,000 as liquidated damages, bringing the total recover to $20,000. These damages are essentially awarded instead of lost interest. An employer can avoid paying liquidated damages only if it shows that it acted in good faith and that it had a reasonable basis to believe its practices complied with the law. “Good faith” has a special meaning under the FLSA, and it requires that employers have made specific investigation into the application of the FLSA to the particular situation.

Finally, both statutory remedies provide for an award of reasonable attorney’s fees and costs for a prevailing employee, and this award can often far exceed the unpaid wage award to the employee. Moreover, the IRS may assess penalties for employee misclassification stemming from an employer’s nonpayment of federal employment taxes and failure to withhold income taxes. *See, e.g.*, [http://www.irs.gov/businesses/small/article/0,,id=99921,00.html](http://www.irs.gov/businesses/small/article/0,,id=99921,00.html).

**Who Is an Employer and Who Is an Employee?**

2. Definition of “Employer,” “Employee,” and “Employ.”

...
(d) “Employer” includes any person acting directly or indirectly in the interest of an employer in relation to an employee and includes a public agency, but does not include any labor organization (other than when acting as an employer) or anyone acting in the capacity of officer or agent of such labor organization.

(e)
(1) Except as provided in paragraphs (2), (3), and (4), the term “employee” means any individual employed by an employer.

(g) “Employ” includes to suffer or permit to work.

(s)
(1) “Enterprise engaged in commerce or in the production of goods for commerce” means an enterprise that—

(A)
(i) has employees engaged in commerce or in the production of goods for commerce, or that has employees handling, selling, or otherwise working on goods or materials that have been moved in or produced for commerce by any person; and
(ii) is an enterprise whose annual gross volume of sales made or business done is not less than $500,000 (exclusive of excise taxes at the retail level that are separately stated);
interest of an employer in relation to an employee, but shall not include the United States or the District of Columbia.

(emphasis added)

c. **IRS Guidance for Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding**

i. Firms and workers file IRS Form SS-8 to request a determination of the status of a worker for purposes of federal employment taxes and income tax withholding.

ii. A Form SS-8 determination may be requested only in order to resolve federal tax matters. If Form SS-8 is submitted for a tax year for which the statute of limitations on the tax return has expired, a determination letter will not be issued. The statute of limitations expires 3 years from the due date of the tax return or the date filed, whichever is later.

iii. The IRS will acknowledge the receipt of a Form SS-8. Because there are usually two (or more) parties who could be affected by a determination of employment status, the IRS attempts to get information from all parties involved by sending those parties blank Forms SS-8 for completion. Some or all of the information provided on this Form SS-8 may be shared with the other parties. The case will be assigned to a technician who will review the facts, apply the law, and render a decision.

iv. The IRS will generally issue a formal determination to the firm or payer (if that is a different entity), and it will send a copy to the worker. A determination letter applies only to a worker (or a class of workers) requesting it, and the decision is binding on the IRS. In certain cases, a formal determination will not be issued. Instead, an information letter may be issued. Although an information letter is advisory only and is not binding on the IRS, it may be used to assist the worker to fulfill his or her federal tax obligations.

What Happens When the Employer Gets Caught?

1. **Option 1: Government Action.**
   a. Under §216(c) of the FLSA, the U.S. Department of Labor (DOL) Wage and Hour Division can require the employer to pay employees unpaid wages, including time and a half for hours worked in excess of 40 per a week.
      i. The DOL can either supervise the payment of wages or compel the payment of wages by bringing an action in court on behalf of the employee.
   b. Under §216(a) of the FLSA, a person who is convicted of willfully violating 29 U.S.C. §215 – includes unpaid wages violations – can be fined up to $10,000, imprisoned up to six months, or both.
   c. Under §216(e)(2) of the FLSA, a person who repeatedly or willfully violates 29 U.S.C. §§206 or 207 – includes unpaid wages violations – can be fined by the DOL or the court up to $1,100 for each violation.
   d. Under §32-1012(f) of the D.C. Code, the Mayor can supervise the payment of unpaid wages.
   e. Under §914 of Title 7 of the D.C. Municipal Regulations, the D.C. Department of Employment Services Office of Wage-Hour can require the employer to pay unpaid wages.
   f. Under §32-1011(a) of the D.C. Code, a person who is convicted of willfully violating any provision of §32-1010 of the D.C. Code – includes unpaid wages violations – can be fined up to $10,000, imprisoned up to six months, or both.
   g. Under §32-1011(d) of the D.C. Code, the Mayor can collect administrative penalties up to $300 for the first violation and up to $500 for each subsequent violation in addition to any other penalties or remedies under §§32-1011 and 32-1012.

2. **Option 2: Private Action.**
   a. Under §216(b) of the FLSA, an employee whose private action succeeds in court can recover:
      i. Unpaid wages plus an equal amount of “liquidated damages” – a total award equivalent to double the amount of unpaid wages; and
      ii. Reasonable attorney fees and costs.
   b. Under §32-1012(a) of the D.C. Code, an employee whose private action succeeds in court can recover:
      i. Unpaid wages plus unspecified “liquidated damages;” and
      ii. Reasonable attorney fees and costs.
Examples of Misclassification Legislation

1. **Maryland Workplace Fraud Act of 2009.** On May 7, 2009, Governor Martin O’Malley signed this statute into law, providing the Maryland Commissioner of Labor and Industry and misclassified employees in construction and landscaping with additional tools for combating misclassification by employers. The law took effect on October 1, 2009, and it was intended “to protect and empower Maryland workers and level the playing field for employers who play by the rules.” Significantly, the Maryland intended to address:

   workplace fraud, which involves employers who wrongly classify their employees as independent contractors or do not classify them at all. This practice allows employers to cut payroll costs significantly, leaving workers unprotected by critical workplace protection laws and creating a competitive disadvantage for those employers who play by the rules. Workers who are misclassified as independent contractors are denied access to unemployment insurance, workers’ compensation and other protections, and the taxpayers are deprived of millions of dollars to the Unemployment Insurance Trust fund and the State General Fund.

   The Maryland Workplace Fraud Act of 2009 provides the following remedies, which provide additional protections for employees (and penalties for employers) in cases of misclassifying employees as independent contractors.

   a. **Option 1: Government Action, § 3-907.**
      i. A final order under this action exempts the employer from civil liability under Option 2: Private Action.
      ii. The Commissioner can investigate misclassification of employees as independent contractors by:
         1. entering the employer’s place of business or worksite;
         2. requiring the employer to produce records; and
         3. issuing subpoenas for testimony or records;
      iii. Following an investigation, the Commissioner can issue a citation against employers that have misclassified employees.
         1. If the Commissioner finds that the employer knowingly misclassified employees, the employer:
            a. Must pay restitution to misclassified employees;
            b. May have to pay an additional amount to misclassified employees up to three times the amount of restitution, § 3-909(C);
            c. Must become compliant with all labor laws by making all owed payments.
2. If the Commissioner finds that the employer unknowingly misclassified employees, the employer:
   a. Must pay restitution to misclassified employees; and
   b. Must become compliant with all labor laws by making owed payments for up to the previous 12 months.

   i. Unless a final order has been issued by a court or an administrative unit, an misclassified employee may bring a civil action.
   ii. The Statute of Limitations is 3 years.
   iii. Remedies available:
       1. “Economic Damages”
       2. **If the employer knowingly misclassified the employee, an additional amount up to three times the “economic damages” is available.**
       3. Reasonable counsel fees and costs
       4. “any other appropriate relief”

c. **Anti-retaliation Provision**, § 3-912.
   i. The employer cannot discriminate or take an adverse action against any employee who:
       1. files a complaint with the employer or with the Commissioner alleging violations of this statute;
       2. brings an action in court under this subtitle; or
       3. testifies in an authorized action
   ii. The employee must file a complaint with the Commissioner within 180 days of the retaliation.
   iii. The Commissioner may investigate and file a complaint in court to reinstate the employee with back pay and “other appropriate damages or relief”

d. **Government Penalties**, § 3-909.
   i. Once an employer is found to have misclassified employees by “a final order by a court or administrative unit,” the employer can be assessed a penalty.
       1. If the employer is found to have unknowingly misclassified employees, the employer will not be assessed a penalty if the employer comes into compliance in a timely manner. Otherwise, the employer will be assessed a penalty up to $1,000 for each misclassified employee.
2. If the employer is found to have knowingly misclassified employees, the employer will be assessed a penalty up to $5,000 for each misclassified employee. On the employer’s second offence, the employer will be assessed a penalty up to $10,000 for each misclassified employee and on further offenses the employer will be assessed a penalty up to $20,000 for each misclassified employee.

ii. The IRS may also assess fines, penalties and interest on unpaid taxes.
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Misclassification

• Some employers attempt to avoid paying overtime rates and other costs by misclassifying employees as independent contractors.

• However, the costs from an adverse judicial action can dramatically outweigh any short-term benefits from misclassification.
Why Employers Misclassify

• To avoid, *inter alia*, the following costs:
  – Paying minimum wages
  – Paying overtime
  – Paying payroll tax (11% in D.C.)
  – Paying workers’ compensation
  – Paying unemployment
  – Paying social security
  – Offering or subsidizing employee health benefits
  – Offering paid leave
  – Offering FMLA (or D.C. FMLA) unpaid leave
Downside of Misclassification

• FLSA and D.C. Minimum Wage Act
  – Private action
    • Regular wage v. minimum wage
    • Unpaid wages plus liquidated damages
    • Attorney’s fees and costs
  – Government action

• IRS may assess penalties for:
  – Nonpayment of employment taxes
  – Failure to withhold income taxes
Employer and Employee Defined

- FLSA, 29 U.S.C. § 203
- D.C. Code – Wage and Hour Laws, § 32-1002
- IRS Form SS-8
Employer Caught Misclassifying

• Option 1: Government Action
  – Under FLSA
    • DOL can supervise payment of wages.
    • DOL can bring action in court on behalf of employees.
    • Employer fined up to $10,000, imprisoned up to six months, or both for willful violation.
    • Employer fined up to $1,100 per violation for willful and repeated violations.
Employer Caught Misclassifying

- Option 1: Government Action
  - Under D.C. Code
    - Mayor can supervise payment of wages.
    - D.C. Dept. of Employment Services can require payment of wages.
    - Employer fined up to $10,000, imprisoned up to six months, or both for willful violation.
    - Mayor can assess administrative penalty up to $300 for first violation plus up to $500 for subsequent violations.
Employer Caught Misclassifying

• Option 2: Private Action
  – Under FLSA and D.C. Code
    • Regular wage v. minimum wage
    • Unpaid wages
    • Liquidated damages
    • Attorney’s fees and costs
MD Workplace Fraud Act of 2009

• Option 1: Government Action
  – Exempts employer from private action
  – MD Commissioner has subpoena power.
  – If employer knowingly misclassified
    • Employees entitled to restitution plus treble damages.
    • Employer must make owed payments to comply with labor laws.
  – If employer unknowingly misclassified
    • Employees entitled to restitution.
    • Employer must make owed payments to comply with labor laws for past 12 months only.
MD Workplace Fraud Act of 2009

- Option 2: Private Action
  - 3 year SOL
  - Remedies:
    - “Economic damages”
    - If employer knowingly misclassified, additional treble “economic damages”
    - Reasonable attorney’s fees and costs
    - “Any other appropriate relief”
MD Workplace Fraud Act of 2009

• Anti-retaliation Provision
  – 180 day SOL
  – Employer cannot discriminate against an employee who:
    • Files a complaint with the employer or government alleging violations of this law
    • Brings an action in court under this law
    • Testifies in an authorized action under this law
  – Remedies:
    • Reinstatement
    • Backpay
    • “Other appropriate damages or relief”
MD Workplace Fraud Act of 2009

• MD Government Penalties
  – If employer unknowingly misclassifies and does not come into compliance in a timely manner
    • Fined up to $1,000 / misclassified employee
  – If employer knowingly misclassifies
    • 1st offense: up to $5,000 / misclassified employee
    • 2nd offense: up to $10,000 / misclassified employee
    • 3 or more: up to $20,000 / misclassified employee

• IRS penalties