

2015 Annual Conference

Concurrent Work Session
October 5, 2015

Uncle Sam Wants His "Fair" Share:

The Internal Revenue Service, The U.S. Department of Labor and Local Government Employment

Misclassification of Employment Status Under the Fair Labor Standards Act

Materials Prepared by
Attorney Daniel D. Crean

Crean Law Office
Pembroke, NH
creanlaw@comcast.net
www.creanlaw.com

N. H. Municipal Lawyers Association
Executive Director/General Counsel
nhmlaadmin@comcast.net
www.nhmla.org

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Misclassification of Employment Status Under the Fair Labor Standards Act

By Daniel D. Crean, Crean Law Office, Pembroke, NH

US Department of Labor Wage & Hour Division (WHD)
Misclassification of Employee and Independent Contractor Status

This paper and the accompanying presentation at IMLA's 2015 Annual Conference seek to discuss and provide guidance on avoiding errors in classifying employees and independent contractors for compliance with the Fair Labor Standards Act (FLSA). Though use of independent contractors may be more prevalent in the private sector than in municipal employment, issues associated with employment status are not limited to the private sector.

The determination of whether an individual is an employee, volunteer, or independent contractor has important ramifications in a number of areas depending on applicable laws and the jurisdiction in which the relationship exists. While definitions exist under common law in many jurisdictions, the expansive array of labor laws on both the federal and state levels means that the determination of employment status can be complex and may vary depending on the reason for determining that classification. The classification of an individual, for example, and without limitation due to listing of examples, may affect:

- Municipal liability in general;
- Municipal liability to others arising from the conduct of the individual;
- Workers' compensation or tort liability for injury to the individual;
- Employment practices liability;
- Equal employment opportunity issues;
- Other "civil rights "laws issues;
- Collective bargaining status;
- Wage and hour law issues (under both federal and state law).

Though all of those topics listed can involve substantial issues and liability exposure for local governments, it is the latter topic, particularly under federal law, which is the subject examined here.

The expansive scope of federal law and the reach of the federal government's tax collectors and regulators appear to be a continuing and expanding topic of interest to both the Internal Revenue Service[1] and other federal regulators, including the U.S.

[1] IRS interest in and approaches to taxation of municipal employment fringe benefits are addressed by Attorney Sheldon Blumling in part 1 of this concurrent work session.

Department of Labor. This portion of this work session explores recent commentary from the Wage and Hour Division (WHD) of the U.S. Department of Labor (DOL) regarding what it calls "misclassification" of employment status.

As a starting point, it is well to remember that this discussion and analysis focus solely on matters relating to employment status under the FLSA, and not under other federal employment laws or state laws.[2] Regardless of jurisdictional variation, it is important to recall that federalism principles dictate that protection afforded by federal law generally provides a "floor" or minimum level of protection for individuals. In essence, this means that state legislatures and local governments must provide at least the same level and type of protection for individuals covered by the laws as provided under those laws (and increasingly by administrative rules adopted by federal agencies).

The Federal DOL's interest in misclassifications arises from its concerns with: minimum wage, overtime compensation, unemployment insurance, and workers' compensation. It claims that misclassification also results in lower tax revenues for government and an uneven playing field for employers who properly classify their workers. DOL recognizes that independent contracting relationships can be advantageous for workers and businesses, but says that some employees may be intentionally misclassified as a means to cut costs and avoid compliance with labor laws.

A July 2015 WHD Administrator's interpretation starts with the FLSA's definition of employ as "to suffer or permit to work." It notes that the "later-developed 'economic realities' test . . . provided a broader scope of employment than the common law 'control test.'" According to the WHD, "although the common law control test was the prevalent test for determining whether an employment relationship existed at the time that the FLSA was enacted, Congress rejected the common law control test in drafting the FLSA. See *Walling v. Portland Terminal Co.*, 330 U.S. 148, 150-51 (1947). Instead, the FLSA defines 'employ' broadly as including 'to suffer or permit to work,' 29 U.S.C. 203(g), which clearly covers more workers as employees, see *U.S. v. Rosenwasser*, 323 U.S. 360, 362-63 (1945)."[3]

Thus, the common law control test[4] is not the correct and sole test used to make the determination whether a worker is an employee or an independent contractor under the FLSA. WHD notes that "courts use the multi-factorial 'economic realities' test, which focuses on whether the worker is economically dependent on the employer or in business for him or herself." That test might be a bit difficult to apply in the municipal employment world as many activities of local government are not conducted in the same manner as an individual who is "in business for him or herself."

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[2] Naturally, some state laws may defer to or incorporate federal definitions. Other states may use their own definitions which are not necessarily consistent with the FLSA.

[3] This quotation – and unless otherwise noted other quotations in this paper are from the WHD Administrator's Interpretation No. 2015-1, issued July 15, 2015, by Administrator David Weil. The interpretation is included in pdf format in the materials for this session and also is available at: http://www.dol.gov/whd/workers/Misclassification/AI-2015_1.htm.

[4] The Social Security Administration appears to continue to apply the control test which it describes as:

> Under the common-law test, the employer has the right to tell the employee what to do, how, when, and where to do the job.

See http://www.ssa.gov/section218training/advanced_course_10.htm#4, which continues with a complete list of factors and descriptive questions and comments.

WHD continues by noting that a "worker who is economically dependent on an employer is suffered or permitted to work by the employer. Thus, applying the economic realities test in view of the expansive definition of 'employ' under the Act, most workers are employees under the FLSA. The application of the economic realities factors must be consistent with the broad 'suffer or permit to work' standard of the FLSA."

This paper now seeks to highlight some provisions of the Interpretation that may apply more directly to municipal employment.

- ***Enforcement.*** DOL and the IRS entered a memorandum of understanding (included in materials for this session), essentially using information sharing. Additionally, DOL has entered agreements with numerous states to assist in enforcement. See: http://www.dol.gov/whd/workers/misclassification/, for interactive chart with state status.

- ***Scope of Employment.*** The interpretation asserts that the "suffer or permit to work" standard was developed to assign responsibility to businesses that did not directly supervise putative employees. Thus, the scope of employment under the FLSA is the "broadest definition that has ever been included in any one act." Citing *Rosenwasser, supra*, 323 U.S. at 363 n.3 (quoting from statement of Senator Black on Senate floor).

- ***Tests for FLSA Employment Status***. An "entity 'suffers or permits' an individual to work if, as a matter of economic reality, the individual is dependent on the entity." The Supreme Court and Circuit Courts of Appeals have developed a multi-factor "economic realities" test to determine whether a worker is an employee or an independent contractor under the FLSA. The factors typically include (with no one factor being given conclusive weight):

  (A) the extent to which the work performed is an integral part of the employer's business;
  (B) the worker's opportunity for profit or loss depending on his or her managerial skill;
  (C) the extent of the relative investments of the employer and the worker;
  (D) whether the work performed requires special skills and initiative;
  (E) the permanency of the relationship; and
  (F) the degree of control exercised or retained by the employer.

- ***Analysis of Factors.*** The interpretation next examines each factor. Highlights include:
  - *Is the Work an Integral Part of the Employer's Business?*
    - Workers are more likely to be "employees" under the FLSA if they perform the primary work of the alleged employer. A true independent contractor's work, on the other hand, is unlikely to be integral to the employer's business.
    - While picking pickles is obviously an integral part of a pickle business, especially considering developments such as telework and flexible work schedules, "work can be integral to an employer's business even if it is performed away from the

employer's premises, at the worker's home, or on the premises of the employer's customers."

- *Managerial Skill as Affecting the Individual's Opportunity for Profit/Loss.*
  - A worker's decisions to hire others, purchase materials and equipment, advertise, rent space, and manage time tables may reflect managerial skills that will affect his or her opportunity for profit or loss beyond a current job.
  - But, a worker's ability to work more hours and the amount of work available from the employer have nothing to do with the worker's managerial skill and do little to separate employees from independent contractors—both of whom are likely to earn more if they work more and if there is more work available.
  - An individual's ability to earn more by being more technically proficient is unrelated to an individual's ability to earn or lose profit via his managerial skill, and it does not indicate that he operates his own business. The interpretation contrasts a worker for a cleaning company who works a regimented schedule with one who produces advertising, negotiates contracts, decides which jobs to perform and when to perform them, decides to hire helpers to assist with the work, and recruits new clients.

- *Individual's Investment Compared to the Employer's Investment.*
  - Even if the individual has made an investment, it should not be considered in isolation; it is the relative investments that matter. Looking not just to the nature of the investment, but also comparing the individual's investment to the employer's investment helps determine whether the worker is an independent business.
  - Investing in tools and equipment is not necessarily a business investment or a capital expenditure that indicates that the person is an independent contractor. Instead, the tools and equipment may simply be necessary to perform the specific work for an employer. Even if the investment is possibly a business investment, the investment must be significant in nature and magnitude relative to the employer's investment in its overall business to indicate that the person is an independent businessperson.
  - Where workers provided their own gloves, and the employer provided farm equipment, land, seed, fertilizers, and living quarters, their work was not independent of the employer.
  - The interpretation, again using a cleaning activity, contrasts the investments by someone who may occasionally use their own cleaning supplies to one who owns a specialized vehicle and obtains his or her own customers.

- *Requirement for Special Skill and Initiative.*
  - Skills here refer to business skills, judgment, and initiative, not the individual's technical skills.
  - Skill and initiative may be indicative of an independent contractor if the individual markets his services, and, for

example, determines when to order materials and the quantity of materials to order, and determines which orders to fill.

- *Permanent or Indefinite Relationship.*
  - A person who is truly in business for him or herself will eschew a permanent or indefinite relationship with an employer and the dependence that comes with such permanence or indefiniteness. Most workers are engaged on a permanent or indefinite basis (for example, the typical at-will employee).
  - Even if a working relationship lasts weeks or months instead of years, there is likely some permanence or indefiniteness to it as compared to an independent contractor, who typically works one project for an employer and does not necessarily work continuously or repeatedly for an employer.
  - But a lack of permanence or indefiniteness does not automatically suggest an independent contractor relationship, and the reason for the lack of permanence or indefiniteness should carefully be reviewed to determine if the reason is indicative of the person running an independent business.
  - The interpretation contrasts the position of an editor whose work is determined by the publisher's standards and who edits only works provided to her by the publisher with one who: worked intermittently with several different publishing houses over the past several years; markets her services to numerous publishing houses; and negotiates rates for each editing job.

- *Nature and Degree of the Employer's Control.*
  - An individual's control, to be relevant, must be meaningful and more than theoretical – i.e., the individual must actually use it.
  - The control over working hours and lack of direct, on-site supervision by remote or distant workers (or telecommuters) might well be largely insignificant in determining status. An employer does not need to look over his workers' shoulders every day in order to exercise control.
  - Increasingly, flexibility in work schedules is becoming more common; thus flexibility is not significant in and of itself.
  - Technological advances and enhanced monitoring mechanisms may suggest that employers may engage workers not as employees, but still may maintain stringent control over aspects of the workers' jobs - from their schedules, to the way they dress, to the tasks that they carry out. Some employers assert that the control that they exercise over workers is due to the nature of their business, regulatory requirements, or the desire to ensure that their customers are satisfied. "However, control exercised over a worker, even for any or all of those reasons, still indicates that the worker is an employee."

Conclusion and Practice Pointers. As mentioned above, the public employment arena may be sufficiently different from the private sector as to render employment status questions less significant in most instances. Yet, the trend to seek to minimize costs associated with "employment status" seems to be growing in the public sector as well as

the private sector. Failure to observe the components of employment versus independent contractor status can have significant consequences.
To avoid, or at least lessen, issues associated with use of independent contractors, public employers, prior to instituting a practice, should:

- ✓ Review and understand the mult-factor tests applied in the federal wage and hour context.
- ✓ But, also review and understand the consequences of employment-independent contractor status in other contexts as well (e.g., collective bargaining, employee speech, workers' compensation and tort liability, and insurance and benefit eligibility).
- ✓ Determine if factors other than wage and hour compliance might indicate a need for greater control of the work than might exist under independent contractor status.

Though no one can accurately predict which municipal work situations might raise these types of issues and concerns, some of the positions and functions that may require analysis could include:

- Special details/duties for law enforcement.
- Assessing services.
- Code enforcement and building or health inspection services.
- Individuals recording minutes for boards and commissions.
- And, of course, legal services.