

State, Federal Worker-Misclassification Audits on the Rise

By Christina Pazzanese and Kimberly Atkins

Employers that improperly treat workers as independent contractors are the target of stepped-up audit and enforcement efforts by the federal government and the Attorney General's Office.

With misclassification claims on the rise nationally, scrutiny is only likely to increase as the Internal

Revenue Service and U.S. Department of Labor push ahead with plans to audit thousands of companies, including small businesses, for possible misclassification violations.

In Massachusetts, the forthcoming audits underscore the struggle employers here continue to face trying to comply not only with federal law, but with a state wage statute that is among the most stringent and punitive in the nation, lawyers say.

Broad enforcement of the Wage Act by the attorney general's Fair Labor Division is rigorous.

Last July, AG Martha Coakley reached a \$3 million settlement with FedEx Ground over the alleged misclassification of delivery drivers as independent contractors. Coakley claimed the company's actions denied the state payroll taxes, workers' compensation and unemployment assistance contributions.

"This is a priority for us," said Harry Pierre, a spokesman for the AG's Office.

Nearly three years after major revisions went into effect in 2008, the complexity and ambiguity of G.L.c. 149, §148B makes even good-faith efforts at compliance a distinct challenge.

"It has been, and remains, a huge problem," said Kenneth M. Bello, an employment defense attorney at Bello, Black & Welsh in Boston.

The Massachusetts Wage Act takes a "one-



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Lawyer: compliance still 'huge problem'

size-fits-all" approach that puts the legitimate use of independent contractors "at risk," he said, which ultimately limits productivity and competitiveness in a variety of blue- and white-collar industries.

"It's throwing the baby out with the bath water," Bello added.

Richard L. Alfred, who chairs Seyfarth Shaw's wage and hour litigation practice group and labor and employment group in Boston, said employers must meet the three-prongs of the state statute, as well as the separate standards of the IRS and DOL. That is an especially tall task since each has its own multi-part test to assess compliance, and complying with one does not necessarily ensure compliance with the others.

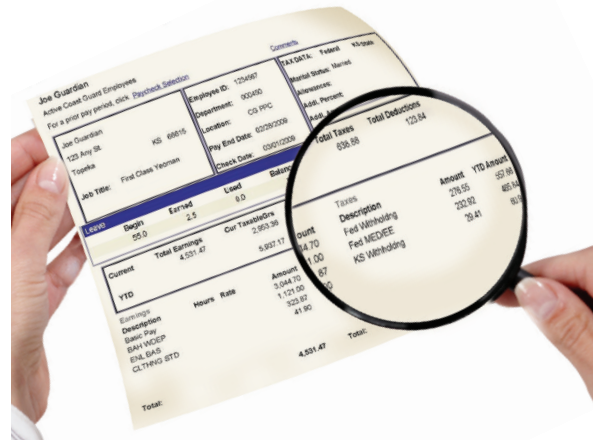
"My experience is employers try very hard to comply with wage and hour laws, but they are very difficult to apply and [it is] very difficult to have any certainty if a decision is correct," Alfred said. "There are three different layers of law and three different standards that may produce three different results."

In addition, he said, there has been no definitive review by the Supreme Judicial Court to clarify the gray areas of the statute.

Thousands of audits, new law proposed

The IRS has begun what will be a three-year auditing initiative targeting misclassification, including investigations of as many as 6,000 companies, large and small. The DOL, too, has stepped up efforts to pursue employers that misclassify employees.

Most expect the audits will focus on em-



ployers long known for their use of independent contractors, such as restaurants and hotels, the construction and health care industries, and package delivery businesses.

The Obama administration estimates the audits could net \$7 billion in unpaid taxes to the U.S. Treasury over the next decade.

Since the 2008 revisions to the Massachusetts statute, which provides mandatory treble damages for violations, many employers have already taken strides to tighten hiring practices to ensure they comply with state law, so the threat of IRS and DOL audits is not likely to create the flood of activity expected in other states.

Much of the remaining misclassification is the result of ill-informed employers that continue with long-standing hiring practices that are no longer allowed and the statute's narrow definition of independent contractors.

"A lot of employers make mistakes with that even out of good faith," said Sharen Litwin, a plaintiffs' attorney at Kotin, Crabtree & Strong in Boston. "The current law is difficult, and sometimes you need a lawyer to figure it out. A lot of companies rely on human

resources, and that's not sufficient."

But some companies break out the independent contractor form because it can be a huge cost-saver.

Alfred said the savings for employers by classifying and treating workers as independent contractors is about 20 to 30 percent of what it would cost to add them to the payroll as full-time employees.

By classifying a worker as an independent contractor, employers can avoid paying minimum wage, overtime pay, payroll taxes, Social Security, unemployment and workers' compensation insurance. The company also is not required to provide health insurance or retirement benefits, or to offer paid or unpaid leave under the Family and Medical Leave Act.

In some industries, the savings produced by routinely classifying workers as independent contractors can provide a competitive advantage in bidding for projects or when labor costs are high and profit margins are razor thin or seasonal.

In other cases, companies are not always aware that outsourcing or hiring high-paid consultants to come in and work on short-term projects could invite government scrutiny.

Whether intentional or accidental, the penalties for companies that misclassify workers can be severe, with IRS fines ranging from \$1,000 to \$5,000 per misclassified worker, plus state law penalties. Companies also face liability if the misclassified workers seek reimbursement for unpaid wages and benefits or bring retaliation claims under federal and state labor laws.

Under Massachusetts law, employers bear the burden of showing that a worker is prop-

erly defined as an independent contractor under the three-part test. Failure of a single test results in a presumption by the AG's Office that the worker is an employee, which can trigger the treble damages provision.

Legislation filed in Congress last month would boost penalties and impose new requirements on employers. The Payroll Fraud Prevention Act would amend the Fair Labor Standards Act to make misclassifying employees a separate federal labor law violation punishable by an additional \$5,000 in fines per employee. The measure also would require employers to give employees notice of federal employee classification laws.

A similar bill introduced last year, the Employee Misclassification Prevention Act, never advanced out of committee.



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Although the bill provides for the first time the potential to bring a direct claim of misclassification, Seyfarth Shaw's Alfred said he does not believe it is necessary since such claims can already be brought indirectly through allegations of failure to pay overtime.

Economic woes boost investigations

Like many other hot litigation areas, the increase in misclassification claims and the federal government's heightened interest in en-

forcement are driven in large part by the bad economy, both locally and nationally.

"The stated motivation is always [worker] exploitation, but the unstated motivation, I think, is revenue enhancement," Bello said.

It is not just government officials who are more interested in misclassification cases. Private attorneys are also seeking clients for private civil claims of misclassification as independent contractors or exempt workers.

Litwin said the ramped up federal and state enforcement is a boon for the plaintiffs' bar, which typically has to do all the heavy lifting to show violations occurred. Though flawed, the statute provides "a significant deterrent" to employers who resist or ignore the law.

"It's a very good thing because both problems are prevalent, and most times it's not because the employer doesn't want to do the right thing," she said.

For those worried about an audit, lawyers say the best course of action for employers and their attorneys is to take a hard look at their workplaces and evaluate what role employees are playing.

Though cases are often very fact specific, triggers for investigations include independent contractors who have been working for a particular company for a long period of time, contractors whose work is within the usual scope of an employer's business, those who do not take other jobs or who have full-time workloads for a particular company — much like the company's full-time employees.

Even when contractors are hired for a temporary project, how long the project lasts and what they are doing is worth examining.

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