



Preventing Employee Misclassification

Best Practices to Assure Regulatory Compliance

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Introduction

In today's difficult economic climate, employment classification has emerged as a leading topic of concern for every organization. Why? Federal and state governments are experiencing hefty budget deficits.

Consequently, the Department of Labor (DOL) is significantly increasing employment audits and employment-related penalties, as well as the associated reputational damages to any organization that fails to comply with the stringent regulatory requirements of the Fair Labor Standards Act (FLSA) and counterpart state laws.

This HR Access white paper — from a series focusing on FLSA compliance¹ — offers HR professionals important information and best practices to enhance their ability to accurately classify their workforce and assure compliance.

Employment Misclassification is Costly to All

If you were to look at a group of people working in your organization, could you identify which ones are employees, which are contractors, which are salaried or hourly, which work part-time or full-time?

Probably not with complete confidence. Yet the need to accurately classify every worker is essential to your organization's well-being. Today the DOL is more diligent than ever in its targeted enforcement of FLSA regulations, especially for non-compliance of wage and hour regulations.

Misclassification of workers is costly for federal and state governments. Lost tax collections amount to billions of dollars a year. This issue is now in the audit spotlight as government agencies look for ways to increase revenue. In 2011, the DOL budget increased by more than \$15 million, and the Wage and Hour Division hired more than 100 additional auditing personnel.² These increases resulted in an estimated 4,700 more investigations and the focus of the expanded scrutiny was worker misclassification.

Litigation resulting from enforcement of these regulations can be expensive. Some of the numbers associated with court decisions are staggering, while damages to an organization's reputation are incalculable. Human resources leaders face a tall order to be extremely vigilant in compliance management.

Degree of Control Guides Classification

Employment classification is the first and most basic determination a company must make when hiring a worker: is the individual an employee or an independent contractor, or "consultant?"

The FLSA rules and regulations are very clear, but many times employers do not have full awareness of them. Are you confident you have the proper tools and resources to accurately classify independent contractors?

The treatment of independent contractors, with regard to their wages, benefits and tax withholdings, is much different than employees. The Internal Revenue Service (IRS) has developed common law rules that speak to the degree of control or independence in the relationship between a contractor and the organization.³

Facts that provide evidence of the degree of control and independence fall into three categories, or themes:

1. The first is **behavioral**. What independence does a worker have over the job itself and the basic activities they perform each day? Does the company control what the worker does and how the worker performs the job? Who designs how to approach the job and how it will be completed?

Is the worker or company in complete control of all the day-to-day activities? Who provides the necessary skills, training and knowledge for the work? Those are all the questions you have to think about when looking at the behavioral aspect under the common law rule.

Organizations that fail to accurately classify their workers are risking penalties and litigation.

Evidence of the degree of control and independence of workers falls into three categories: behavioral, financial and type of relationship.

- The second common law theme is **financial**. Is there any financial risk to the worker if the job is not performed? What if the deliverables are not met on time? Is there a penalty or loss of contract if the employer is not satisfied?

Does the contract speak to when and how the worker is paid? Are expenses reimbursed, or does the worker cover all the expenses? Who provides the tools, supplies and workspace to perform the job?
- The third common law theme is **nature of work relationship**. Are there written contracts that speak to the deliverables of the job? Are employee-type benefits provided to the worker, such as pension, 401(k), health insurance, vacation and sickness? Will the relationship continue for an unspecified period of time, or is it for a set period?

If the worker is self-employed, there is a true contract governing the relationship: how it will begin and how it will end.

An independent contractor is a worker or business entity that provides goods and/or a service to another individual or business entity under the terms of a specified contract.

Common Law Test Examples

Employee	Independent Contractor
Hired by the Employer	Self-employed
Subject to dismissal; can quit without liability	Contract governs how relationship will end
Works exclusively for the Employer	Can work for multiple Employers
Paid a salary	Paid by the job
Employer provides training	Brings skills and knowledge necessary for the job
Required to comply with Employer's working rules and conditions	Sets own hours

Source: American Payroll Association

These are the criteria employers can use to identify the worker as an independent contractor. The Social Security Administration (SSA) offers a guide that walks employers through each of these questions with examples to support the determination.⁴

In addition, the IRS offers the easy-to-use Form SS-8 (go to: www.irs.gov/pub/irs-pdf/fss8.pdf), offering additional guidance on determining the differences between contract workers and employees.

SS-8 <small>(December 2009)</small> <small>Department of the Treasury Internal Revenue Service</small>		Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding	
Name of firm (or person) for whom the worker performed services		Worker's name	
Firm's address (include street address, apt. or suite no., city, state, and ZIP code)		Worker's address (include street address and ZIP code)	
Firm's name		Daytime telephone number () -	
Firm's telephone number (include area code)	Firm's employer identification number	Worker's employer identification number	
b. If the worker is paid by a firm other than the one listed on this form for these services, enter the name, address, and telephone number of the payer. ▶			
Disclosure of Information			

Classifying Exempt and Non-Exempt Workers

Within the DOL and the FLSA, there are two different types of workers: exempt and non-exempt.

The FLSA was passed into law in 1938. Although the guidance is clear, many employers mistakenly use title to identify employee classification when classification is actually determined by the work performed or the job duties.

The classification drives the application of overtime pay and minimum wage, which is why it is so critical to ensure individuals are classified appropriately into exempt and non-exempt right from the start.

Employers must be extremely careful their employees truly match the requirements of being exempt and meet all applicable exemption tests. Yes, there are tests for exemptions as well, similar to those for independent contractor and employee.

Exempt Criteria

To be classified as exempt, the employee must be paid at least \$455.00 per week and be paid on a salary basis. Exempt employees must also perform exempt job duties as defined by the DOL.

There are a few exceptions, especially in the technology industry. For example, employees in this sector can be paid hourly. Caution should be taken when working with this population to validate they accurately match the exempt employee criteria.

The salary is set and must not be subject to reductions – or increases – because of the number of hours worked, or for any variations in the quality or quantity of work performed. To be classified as exempt, professional employees must be paid at least \$100k annually, which may consist of commissions, nondiscretionary bonuses and other nondiscretionary compensation earned during a 52-week period.

Having a set salary also means the salary may not be reduced for absences of less than a full day, a rule not commonly practiced or known within many organizations. Absences can be substituted with paid-time-off (PTO) programs, such as vacation or sick leave.

Why is this fact important? When deductions have been made due to lack of work, it is an indication the employer really had no intention of paying on a salary basis

The employer actually can lose the exempt status for a professional employee or employees upon an audit.

The intention of this regulation is to pay for work performed. The duties are not based on a predetermined number of hours per week.

When looking at exempt employees, there is an expected level of independence for making business decisions.

Title does not automatically drive exempt/non-exempt classification.

Misclassification Costs \$\$

A court case involving a large technology company illustrates the significant costs of litigation.

Thousands of workers at the company were doing comparable work. Some of the workers were employees and some were “perma-temp” contractors employed through temporary work agencies and did not receive the same benefits of employees.

The contractors complained to the IRS, which in turn sued the company. The court ruled the independent contractors were misclassified, since they were performing the same job duties as the employees. Moreover, they were entitled to retroactive benefits, including participation in the company's stock option plan.

In addition to the overtime and other elements owed the workers, the retroactive stock option benefits alone cost the company in excess of \$97 million.⁵

Exempt Employee Salary Regulations

Paid \$455.00 * per Week

- **Administrative**
- **Professional**
- **Executive**

Paid \$27.63 * an Hour

- **Technology-Related Occupations**

Paid \$100,000.00 * Total Compensation Annually

* Minimum set amounts

Source: U.S. Department of Labor

Because of this independence, the duties may take 38 hours one week and perhaps 45 hours the following week. Due to the set salary, the employee is not paid less during a 38-hour week.

On the other hand, they are not paid more for a 45-hour week. There is a set amount required to be paid for each pay period.

As defined by the DOL, the exempt worker's primary duty must include the exercise of discretion and independent judgment on "matters of significance."⁶

Their work must be non-manual and should be related directly to the oversight of general business operations or perhaps servicing the employer's customers. Again, it cannot be manual in nature.

The IRS provides guidance on certain groups of employees commonly exempt from FLSA. The criteria just provided must be applied regarding salary and job duties. There are, however, common classifications that have already been reviewed as exempt, often referred to as "White Collar" exemptions.

Examples of "White Collar" Exemptions

- **Executive**
- **Supervisory/Managerial**
- **Administrative – Independent workers**
- **Professional employees**
- **Outside sales employees**
- **Certain technology-related occupations**

Source: U.S. Department of Labor

On this list of exempt workers, employers should pay particular attention to administrative – they commonly are misclassified.

Administrative workers must meet the criteria of working independently without supervision and they must meet the salary requirements. Again, it is the job duties that need to be evaluated; the title of the position alone does not demonstrate the exemption.

Exempt = Exempt from Hourly Wage and Overtime Regulations.

Calling workers 'professional' employees is not sufficient proof they qualify as exempt employees.

The DOL website is a helpful resource and provides guidance on common exemptions. The site also offers a list of some less-common exemptions, such as people who work at home making wreaths. No joke – check it out at <http://www.dol.gov/elaws/esa/flsa/screen75.asp>.

Non-Exempt Criteria

A non-exempt employee typically performs clerical, administrative or even professional services. Examples of non-exempt jobs include customer service, skilled trades, technical, clerical, maintenance, inside sales, production workers, and many others. Employees in these positions usually do not manage people.

Non-Exempt Employee Requirements

- **Track time worked**
- **Pay frequency**
- **Minimum Wage**
- **Hours**
 - » **Overtime**
 - » **Minimum and Maximum**
 - » **Breaks**

Source: U.S. Department of Labor

Employers are required to follow all federal, state and local wage and hour regulations, which include minimum wage and overtime for this classification of workers.

For audit purposes, employers must track time of all non-exempt workers each and every day. It is important to demonstrate when lunch breaks were taken, along with when the start and finish times of the day occurred.

In many industries, employers also have to track various breaks and provide time to actually get ready for work. If time is required for any type of special preparation or to get into uniform, this time is included as work time.

Pay frequency is actually a common misnomer, implying that employers can design the pay frequencies. In reality, every state has a regulation as to how and when employees need to be paid. Employers must get permission from the state for any frequency that deviates from the typical schedule.

Employers also must ensure compliance with minimum wage rates for the work performed and provide breaks and lunchtime, with appropriate pay for the time the employee is not working.

There is plenty of information to help analyze and determine workers classification. The bottom line: job duties are the critical components of any analysis.

Non-Exempt = Not Exempt from Hourly Wage and Overtime Regulations.

Employers need to be aware of and comply with the special work rules for non-exempt minor employees, which vary by state. In Colorado, for example, youth labor laws restrict minors from working more than 40 hours in a week and 8 hours in a day.⁷

Top 3 Employment Misclassifications

Be on the alert for the three employment misclassifications most likely to attract a government audit.

#1 Misclassification: The Retiree

You have a valued worker in your company with lots of experience, but the person decides to retire. You put together an agreement for the retiree to come back to work with a seat in the same exact cubicle and the same exact job duties.

The former employee is now called a consultant, classified in your system as an independent contractor and paid as such. Unfortunately, while this may seem like a great arrangement for your organization, it is highly likely this person is a misclassified worker.

This type of misclassification is becoming so prevalent the IRS, DOL and some state agencies have created software programs to identify recently retired individuals who return to the same company as independent contractors.

#2 Misclassification: The Manager

A “manager” is getting a salary but is still doing the same work as others and has no supervisory authority.

This is a red-flag reason to investigate the employee’s classification. Just calling someone by a certain title and paying them a salary is not sufficient to make them exempt from FLSA. It is the job duties that matter most.

#3 Misclassification: The Professional

There are professionals who believe they are entitled to the same overtime and other benefits due to non-exempt employees.

Professional status alone is not enough to determine if an employee is exempt. It comes down to a case-by-case evaluation of the job duties. The California case cited here is a perfect example.

Five Best Practices to Assure Compliance

Experience, as the saying goes, is the best teacher. If you think your company may have misclassification issues, or even if you just want peace of mind, performing these best practices can help assure compliance with federal and state labor regulations.

1. Review FLSA requirements with your management team. Keep them informed of regulatory changes and legal rulings.
2. Conduct periodic reviews of the classifications of your organization’s workers.
3. If you identify errors in worker classifications, correct them immediately.
4. Maintain and preserve worker records as appropriate. Audits and litigation often occur years after the arrangement with an independent contractor has ended. Do not rely on your memory.

Job Duties Rule

A California court case involved a large international accounting firm and a class action lawsuit by its unlicensed accountants or CPAs, whom the firm had classified as exempt.

In California, the professional exemption required the person be licensed by the state for their profession, and be primarily engaged in an occupation recognized as a learned profession.

The plaintiffs argued the firm could not consider them exempt from FLSA, since they weren’t licensed CPAs. Their cause for wanting exempt status — lots of overtime.

The court decided the unlicensed accountants could not be categorically ineligible simply because they did not yet have their CPA license. There needed to be an evaluation of their job duties to determine if they classified as exempt.⁸

It’s always better to take the initiative to discover problems and resolve them yourself than it is to have somebody else find them for you.

5. Automate compliance through timekeeping. In addition to using this for your non-exempt employees, timekeeping is a great way to keep track of the hours and days worked by your independent contractors.

Compliance is the foundation of all best practices for mitigating the risk of employment misclassification. So, take the initiative, develop a plan for FLSA compliance, and meet the challenge to classify every worker in your organization accurately.

Useful Links for Employment Classification Information:

Department of Labor

<http://www.dol.gov/elaws/esa/flsa/screen75.asp>

Social Security Administration

http://www.socialsecurity.gov/OP_Home/handbook/handbook.08/handbook-0803.html

Internal Revenue Service

www.irs.gov/pub/irs-pdf/fss8.pdf

American Payroll Association

<http://www.americanpayroll.org/>

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