ABA MEETING

Employee/ Independent Contractor Worker Classification

November 10, 2015
Background - External

- Increased federal agency compliance requirements:
  - Department of Labor “Misclassification Initiative” – combat employee misclassification and restore rights denied to workers
  - Various agencies/divisions involved – DOL Wage and Hour Division, Employee Benefits Security Administration (EBSA), Occupational Safety and health Administration (OSHA), Office of the Solicitor
  - Labor commissioners from 14 states (so far) are participating through MOU’s with DOL
  - Employee entitlements – retirement and medical benefits, family and medical leave, overtime, minimum wage, unemployment insurance, workers compensation
  - Fair Labor Standards Act (FLSA) – defines requirements for minimum wage, overtime, employer time and pay record keeping; new guidance issued July 2015 aims to classify most workers as employees
  - Affordable Care Act – required essential health care coverage for eligible employees
Background - External, cont’d

- Increased IRS activity:
  - Recent court cases involving worker classification
  - Increased audits of colleges and universities
  - IRS Voluntary Compliance Program
  - Development of factors to assist in worker classification determination

- New DOL guidance:
  - Most workers would be employees under the FLSA’s broad definitions, per Administrator’s Interpretation issued July 15, 2015
  - DOL is responding to numerous complaints from workers alleging misclassification
Background - Penn

- Procurement and payment for independent contractor services:
  - “P2P” initiative to convert I/C’s from PDA forms to Purchase Orders
  - Development of “template” contract for I/C’s
  - Payment and tax reporting for travel and business expenses of I/C’s

- Existing University policies and procedures:
  - Policy 2319 – Payments to Individuals for Honoraria, Consulting Fees, Human Subject Fees and Other Services
  - Form C-12 – Independent Contractor Determination and Certification
  - H/R, Payroll and Tax policies related to employees
Challenges

- **Determination and classification as employee vs. independent contractor:**
  - Not a single criterion – numerous factors guide determination
  - Factors relevant in one situation may not be relevant in another
  - Requires input from service provider and Penn employer/purchaser
  - No hard and fast formula – requires judgement

- **Timing:**
  - Should be done *prior* to engaging/employing services
  - Current process allows determination to be done at time of payment

- **Current Policy and guidance**
  - No standard contract tailored to independent contractors
  - Various ways to engage and pay I/C’s
IRS Determination Factors

- IRS list of 20 “Common Law” factors

- Organized into 3 major categories of evidence:
  - **Behavioral Control**
    - Who controls how the work is done
  - **Financial Control**
    - Who controls the business aspects of the worker’s assignment
      - Payment for service
      - Reimbursement of expenses
      - Investment in tools, equipment
      - Worker’s service availability to the marketplace
      - Worker’s profit and loss
  - **Relationship of Parties**
    - Worker’s and employer’s/purchaser’s type of relationship
      - Type of contract
      - Entitlement to benefits
      - Permanency of the relationship and termination
      - Services part of employer’s/purchaser’s regular ongoing business activities
Behavioral Control Test

- Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired.

<table>
<thead>
<tr>
<th>BEHAVIORAL CONTROLS</th>
<th>EMPLOYEE</th>
<th>INDEPENDENT CONTRACTOR</th>
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<tbody>
<tr>
<td>Instructions</td>
<td>An employer has the right to give an employee instructions regarding how, when and where the work is performed</td>
<td>The client has a right to the parameters of the deliverables; not the details of how, when and where the work is performed</td>
</tr>
<tr>
<td>Training</td>
<td>Employees are often trained to do their jobs</td>
<td>Independent Contractors are hired for their expertise and should receive no internal training</td>
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Economic aspects of the relationship between the parties are frequently analyzed in determining worker status.

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<th>FINANCIAL CONTROLS</th>
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<tbody>
<tr>
<td>Significant Investment</td>
<td>Employers provide the tools and equipment necessary for their employees</td>
<td>Independent Contractors provide their own tools and equipment</td>
</tr>
<tr>
<td>Unreimbursed Expenses</td>
<td>Employees are reimbursed for any out-of-pocket business expenses they might incur</td>
<td>Independent Contractors pay their own business expenses</td>
</tr>
<tr>
<td>Marketing</td>
<td>Employees do not market their services to public</td>
<td>Independent Contractors market their services to the public</td>
</tr>
<tr>
<td>Method of Payment</td>
<td>Employees are paid based upon the passage of time – guaranteed return for his/her labor</td>
<td>Independent Contractors are generally to be paid upon the completion of specific deliverables</td>
</tr>
<tr>
<td>Opportunity for Profit/Loss</td>
<td>Employees generally have no opportunity for suffering a loss</td>
<td>Make business decisions which allow them to not only make a profit but also have the opportunity to suffer a loss</td>
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Relationship of Parties

- Facts that show the parties’ type of relationship reflecting both parties intent

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<td>Intent of Parties</td>
<td>Expressed via employment contract; extent of direction and control the employer requires over the employee</td>
<td>Expressed in a contract between the two parties; Independent Contractor expresses his/her intent by fulfilling local and state requirements for business (i.e. securing business license etc.)</td>
</tr>
<tr>
<td>Employee Benefits</td>
<td>Employees are entitled to benefits such as vacation or sick time, health care benefits and ability to attend company sponsored events</td>
<td>Independent Contractor provides their own benefits</td>
</tr>
<tr>
<td>Termination</td>
<td>Within the confines of legal or contractual requirements employees can be discharged at will by the employer</td>
<td>Contracts can only be terminated according to the specifications of the contract. Non-performance on the part of the contractor or client can lead to legal recourse</td>
</tr>
<tr>
<td>Permanency of Relationship</td>
<td>Employer engages for indefinite period of time</td>
<td>Specific services are for limited period of time</td>
</tr>
<tr>
<td>Regular Business Activity</td>
<td>Employees perform services which are key aspects of employer’s regular business activities</td>
<td>Independent Contractors perform services which do not affect client’s bottom line. (limited exceptions)</td>
</tr>
</tbody>
</table>
DOL Economic Realities Factors

- Goal is to determine whether a worker is economically dependent on the employer or is really in business for him/herself

- Six factors to consider
  - Whether the work is an integral part of the employer’s business
    - The DOL considers this factor “compelling”
  - Whether a worker’s managerial skill affects the opportunity for profit or loss
    - Examples of managerial skill:
      - The decision to hire others
      - Purchasing materials and equipment
      - Advertising
      - Renting space
      - Managing time tables
DOL Economic Realities Factors

- **Whether the work performed requires special skill and initiative**
  - The DOL looks only at workers exhibiting business skills, business judgment and business initiative as favorable to a determination of independent contractor status

- **Comparing the relative investment of a worker and employer**
  - The worker’s investment must be significant in nature and magnitude relative to the employer’s investment in its overall business to indicate that the worker is an independent businessperson
  - Investing in tools and equipment is not necessarily a business investment that indicates that a worker is an independent contractor

- **Whether a working relationship is permanent or indefinite**
  - Permanency or indefiniteness suggests the worker is an employee

- **The nature and degree of the employer’s control**
  - The worker must control meaningful aspects of the work performed – must conduct his or her own business
A full-time engineer worked as an adjunct faculty member for two universities:

- He was paid on a course-by-course basis over several years
- He taught on campus but otherwise worked from home communicating with students on email
- He maintained a website devoted to his teaching activities
- The universities treated him as an employee but he challenged his status in Tax Court
ANSWER

Example 1: Adjunct Faculty

The Tax Court concluded the faculty member was an employee of both universities:

• Services as an adjunct professor were part of the regular business of the universities
• He bore no risk of loss from under enrollment
• He had worked for both universities continuously for several years
• His contracts treated him as an employee

Beitel v. Commissioner, T.C. Summary Opinion (2001)
CASE STUDIES
Example 2: Physician

A university hired a physician to provide medical care to students:

• The physician had her own private practice
• She worked on-call for the university clinic
• The physician received an hourly wage but no benefits
• There was no written contract between the physician and the university, which treated her as an employee
ANSWER

Example 2: Physician

The IRS ruled the physician was an employee:

- The physician’s services were integral to the clinic’s functions
- The services were preformed on the university’s premises and subject to clinic protocols
- There was a continuing relationship even though the physician worked on-call
- The university had treated the physician as an employee

PLR 9326015
CASE STUDIES
Example 3: Law Student

A firm hired a law student to provide part-time legal research and litigation support:

- The student set his own hours and decided where to work – the firm, school, at home
- He was paid by the hour and received no benefits except for parking reimbursements
- The firm reviewed his work and signed all court filings he drafted
- The student did not have a contract with the firm
The IRS ruled that the student was an employee:

- His services were integral to the firm
- The student had no capital investment in an independent business or risk of loss
- The firm supplied the student with a computer and other office resources
- The firm had the right to direct and control the work
- There was no contract establishing the student’s status
- The firm reimbursed the student’s parking expenses
Where are we?

- Pilot program underway
  - Includes select organizations within PSOM, SAS and Wharton
- Incorporating ongoing feedback into policies, procedures, templates
  - New process for nonresident aliens (NRAs)
  - Created new job classification code (Professional Service Provider)
  - Created new forms and policies
  - Drafted new process flow and procedural guidelines
  - Presented best practices to pilot HR representatives

- Review of recommendations
  - Restructure Process Flow
  - Changes to Policies and Procedures
  - Develop and Communicate Best Practice Guidelines
  - Implement Tools and Templates
  - Develop and Deliver Training and Communication
Tools and Templates

- **Service Provider Questionnaire**
  - Completed by the individual providing services to provide relevant information be used in determining independent contractor status

- **Service Provider Evaluation Worksheet**
  - Completed by the individual needing a service provider in concert with the applicable HR director to determine proper classification PRIOR to engaging the individual

- **Template Contractor Agreements**
  - Provided by Purchasing for standard contractor categories

- **Limited Engagement Agreement for Guest Speakers/Guest Lecturers**
  - Simplified process and documentation for one-time, non-recurring events (seminars/workshops)
Risk of Non-Compliance

- There are approximately 45 agencies within the Federal government that can determine who is or who isn’t an independent contractor
  - MaryKay Cosmetics – FMLA $11 million dollar settlement
    - Not Independent Contractor
  - Time Warner
    - Misclassification of Workers – Department of Labor $5-6 Million
  - Coca Cola
    - 8 Year Independent Contractor
      - Qualified Plan written properly; protected
- Many recent tax law cases, revenue rulings, and PLRs dealing with teaching by independent contractors that ruled in favor of the IRS
  - Common themes:
    - Exercising degree of control
    - Service is regular and ongoing
    - Service is necessary and incident to the business conducted by the organization
- Increased random audits are being scheduled by the IRS in this area
Training and Communication

- Advisory Group will utilize Human Resources’ Communication Specialist to develop a communication plan to the University community.

- Training developed and will be administered by Independent Contractor Advisory Group.
  - List of mandatory trainees being developed.

- Training timeline will be targeted after pilot is completed; March 2016 forward.
Open Issues

- Advisory Group
  - Adjustments to forms and policy language
    - Ongoing through Pilot (Pilot extended to February 2016 and expanded to other orgs within Pilot schools)
    - Develop training for HR representatives/business administrators in departments, schools and centers

- Human Resources
  - Address co-employment concerns with Personnel Employment Organizations
  - “Headcount” concern - new employee type “Professional Service Provider”
    - BA’s being overruled by determination; who makes the final decision?
    - Unauthorized out-of-pocket payments by employees to service providers
  - Termination and re-hiring of temporary workers

- Purchasing
  - Determine alternative for processing NRA Independent Contractors through Purchasing when withholding is necessary

- IT/ISC
  - Development of electronic Work Flow (automation of forms, etc.)
  - Online repository for program related information
Risk of Non-Compliance

- IRS has an information sharing agreement with Federal, State and municipal agencies and over 30 state agencies in particular to facilitate exchange of taxpayer information.
- Some states known to be aggressive in this area
  - California
  - Connecticut
  - New Jersey
  - New Mexico
  - Oklahoma
- Audit triggers
  - Independent Contractors filing unemployment claims
  - Worker’s Compensation Claims
  - Individual receiving W-2 and 1099 from the same organization
  - Independent contractors with ongoing relationships with the same organization
Risk of Non-Compliance

- Non-compliance implications
  - Penalties and interest; going back 3 years minimum (IRS can go back further)
    - Federal, state and local
    - Multiple agencies
  - Impact on employee and fringe benefits
  - Potential claims for unemployment and worker’s compensation
  - Significant ACA fines
  - Reputational risk
  - Budgetary impact at the school/center level for payment of fines and fees
Next Steps

- Implementation timeline
  - Continue to incorporate feedback from Pilot findings
  - Communication sessions to schools, departments and centers as early as January
    - Share draft policies and procedures
  - Pilot to be completed by end of February 2016
  - Training timeline beginning March 2016
  - Implementation July 2016