WORKER CLASSIFICATION BEST PRACTICES AND REMEDIES FOR ERROR: OPTIONS FOR PROFESSIONAL PRACTICES

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This article on worker classification is a result of two ABA, Section of Taxation, Closely Held Businesses Committee panels on February 9 and May 11, 2018. While this article discusses IRS and DOL worker classification standards along with the VCSP and Section 530 relief, selected state standards are also discussed.

For professional practices, such as a dental practice, worker classification continues to be an ongoing problem for associates and retired dentists and specialists who continue to render professional services post-retirement (collectively "Associates") because the Internal Revenue Service ("IRS"), and now the Department of Labor ("DOL"), as well as the states believe they are incurring a huge loss in revenue and workers are being denied benefits from misclassification.[1] Three agencies are auditing and three different tests determine worker classification!

Often, a practice determines that it cannot afford to pay the Associate well and also pay direct business expenses, insurances (including health insurance) and benefits (including retirement plan benefits)

(collectively "Benefits"). Therefore, the practice prefers to classify the Associate as an independent contractor to eliminate payroll taxes and Benefits. The Associate prefers to be classified as an independent contractor because the Associate can fully offset Benefits against income and also receive a higher rate of compensation than as an employee because the practice has eliminated payroll taxes and Benefit costs. As a result, the practice owner and Associate think that so long as the Associate agrees to pay all applicable taxes, they can simply elect to treat the associate as an independent contractor.

Not so! I am often asked "if the Associate, as an independent contractor, and practice pay all applicable taxes, no harm no foul, right?" No. Note that the IRS has stated that where worker classification is found, the penalty is steep. The practice would be assessed all unpaid federal taxes, FICA, FUTA, fines and interest.[2] The Associate would lose nearly all deductions for Benefits, subject to the two percent of adjusted gross income limitation.[3]

Except for limited situations in which a specialist renders specialty services for a general practice, through a separate entity, all other Associates are employees. In fact, the IRS has stated when a retiring dentist was an employee of his or her own practice entity, it follows the retiring dentist is an employee of the purchasing dentist's or specialist's practice. The IRS further stated that it believes that it can win this argument.[4]

THE IRS CONTROL TEST

The well-known 20-point test[5] for determining worker classification has evolved into the control test as to whether the business or practice has a right (whether or not exercised) to direct or control the means and details of the work.[6] The control test is determined by an analysis of three categories: behavioral control, financial control and relationship of the parties.[7]

Behavioral Control

Behavioral control considers whether the Associate is subject to practice scheduling and patient assignment policies or is subject to a restrictive covenant.

Financial Control

Financial control in a practice considers whether the practice bills the patients, sets and collects the fees, compensates the dentist, or pays the operating expenses.

Relationship of the Parties

Relationship of the parties provides that an independent contractor agreement between the practice and the Associate is not sufficient evidence for determining a worker's status.[8] It is the substance of the relationship, not the label, that governs the worker's status.[9] However, the IRS acknowledged in one case[10] that where an athlete had worked for his corporation and the athlete's corporation entered into an agreement with the athlete's professional team and also entered into an employment agreement with his own corporation, the athlete was an independent contractor. Under this case, if the practice and the Associate are attempting to justify independent contractor status, consider the following. First, the Associate should practice through his or her S corporation as a separate entity that is formed prior to the dentist working for the practice.[11] A limited liability company is not a separate entity and treated as a sole proprietor. Second, corporate formalities must be followed[12], meaning minutes must be prepared in accordance with state law. Third, the practice and S corporation (through the Associate as the shareholder) should enter into a written independent contractor agreement. Finally, the Associate should enter into a written employment agreement with his or her S corporation. While not bulletproof, these steps are helpful.

The DOL Administrators Interpretation No. 2015-1 Withdrawn

On June 7, 2017, the Department of Labor's Wage and Hour Division ("WHD") withdrew Administrator's Interpretation No. 20151 ("AI").[13] When issued on July 15, 2015, AI provided guidance on the application of the Fair Labor Standards Act ("FLSA") in the identification of employees who are misclassified as independent contractors. At the time, WHD entered into a memorandum of understanding with many states, as well as the IRS, to assist in ultimately curtailing misclassification.

While AI has been withdrawn, WHD has not released any further guidance on worker classification. Thus, there is no basis to believe that WHD's application of its "economic realities test" has changed. The economic realities test includes a multifactor analysis and provides a much broader scope of employee classification than the control test used by the IRS.

The inquiry by the WHD under the FLSA is whether the worker is economically dependent upon the employer

or truly in business for him or herself. If the worker is economically dependent on the employer, then the worker is an employee. If the worker is in business for him or herself and economically independent from the employer, then the worker is an independent contractor.

Is the Work an Integral Part of the Employer's Business?

If the work performed is integral to or the primary work of the employer's business, the worker is an employee. In a dental practice, work would include the Associate performing professional dental services.

Does the Worker's Managerial Skill Affect the Opportunity for Profit or Loss?

The ability to work more hours does not separate employees from independent contractors. The focus is on managerial skill and a worker's decision to hire, purchase equipment, advertise, rent space and manage timetables reflect the worker's opportunity for profit or loss.

How Does the Worker's Relative Investment Compare to the Employer's Investment?

The worker's investment should be compared with the employer's investment to determine whether the worker is an independent business. The worker's investment should also not be relatively minor when compared to the employer.

Does the Work Performed Require Special Skills and Initiative?

Technical or special skills do not indicate that workers are in business for themselves. Only a worker's business skills, judgment, and initiative help to determine whether a worker is in business for him- or herself.

Is the Relationship Between the Worker and the Employer Permanent or Indefinite?

Permanency or indefiniteness suggests that the worker is an employee. A worker's lack of a permanent or indefinite relationship with an employer shows independent contractor status if it results from the worker's own business initiative. Independent contractors also typically do not continuously or repeatedly work for one employer.

What Is the Nature and Degree of the Employer's Control?

The worker must control meaningful aspects of the work performed so that it's possible to show that the worker is conducting his or her own business.

The economic realities test factors all relate to the worker owning his or her business or practice. At this point, we do not know whether the IRS or states will accept the economic realities test, but if they do, there will be few instances in dentistry where independent contractor status will pass scrutiny.

THE STATES

Notwithstanding the DOL's memorandum of understanding with states and the IRS, which have not been withdrawn, the IRS and 39 states have been sharing worker classification information for several years.[14] States each follow their own tests to determine worker classification. For example, New Jersey follows the ABC test,[15] which is similar to the DOL's economic realities test. Ohio, in contrast, follows the IRS control test[16] and relies upon the 20-factor test.

RESOLUTIONS TO MISCLASSIFICATION

Voluntary Classification Settlement Program ("VCSP")

The Service introduced the Voluntary Classification Settlement Program ("VCSP") to allow taxpayers who are not in compliance with the classification of workers to get into compliance without facing the potential of numerous costs for coming into compliance. A taxpayer can enter into the program by filing Form 8952, Application Form Voluntary Classification Settlement Program (VCSP).

In order to be eligible for VCSP a taxpayer must meet the following requirements:

- The employer must have treated workers that would be classified as employees as independent contractors;
- Be in compliance with the filing of all 1099s for all workers for the immediate past three years. A taxpayer can come into compliance immediately prior to submitting the application for VCSP, by submitting any missing 1099s;
- There cannot be a pending employment tax or employer classification audit by the IRS, DOL, or any state agency. If there was a previous audit, prior to

the immediate past years, the taxpayer can still be eligible for the VCSP, if the taxpayer is in compliance with determinations, if any, of the previous audit;

- Taxpayer must be a for-profit company or an exempt organization. The program is not available for state and local governments.

If a taxpayer is able to meet all of these requirements, then they can file to be part of the VSCP. After filing the application, if the taxpayer meets all of the requirements they will be granted relief under the program terms. The taxpayer will be required to pay 10 percent of the employment tax liability that would have been due for the misclassified employees for the most recent tax year, without having to pay penalties or interest on that amount. This will provide a substantial financial savings to the taxpayer. It will prevent the taxpayer from having to pay all of the taxes due during an audit period, typically three years, and prevents any penalties or interest from having to be paid. In addition, the taxpayer will not be subject to a worker classification audit for those workers that are reclassified. Since the program is not considered an audit and since an audit is not completed, the information that is filed with the Service in the VCSP program is not shared with the state taxing agencies. The information is only shared with state taxing agencies if a worker classification audit is conducted and changes are made. Upon completion of the VCSP the employer must agree to treat all workers that have been reclassified as employees for future tax periods.

While the VCSP can provide substantial savings to a taxpayer, issues may still arise with state agencies. Although the information is not shared with the states, numerous states do not have similar programs, so when the taxpayer does come into compliance in future years, a state employment tax audit for worker classification could be conducted.

Section 530 Relief

Section 530 relief is generally used in common law situations. It provides protection for employers who treat common law employees as independent contractors if the employer can demonstrate the following:

- The employer has a reasonable basis for treating the employee as an independent contractor;
- The employer did not treat the worker or any other worker in a similar position as an employee; and
- The employer has filed all required federal tax returns and documents in compliance with the worker being treated as an independent contractor.

In order to meet these three qualifications, the taxpayer should look at judicial precedent such as previous cases that are similar to the taxpayer's situation that have been determined favorably for the taxpayer. The taxpayer should also look to published rulings by the Service or other technical advice that has been offered by the Service.

If the taxpayer has been audited by the Service in the past for worker classification purposes, and no change was made in the past, then the taxpayer can use that as a defense. Arguing that the taxpayer has been consistent in its reporting and that the Service has accepted in the past should cause the Service to accept it again.

Finally, if the taxpayer can demonstrate that a significant portion of their industry treats the workers in a similar manner to the taxpayer then it meets the requirement of Section 530. In order to do this, the taxpayer has to show that other similar businesses of the same size and same industry treat workers that perform identical jobs in a similar manner. This can generally be accomplished with affidavits and statements from the other employers. If necessary, it can also be accomplished by providing witnesses. While some employers may not want to come forward to make these statements out of fear of being audited next, it is generally to their benefit to participate to help protect themselves if they are ever audited.

These types of defenses are more general and can be used in numerous situations. The Service will generally work with an employer who is making these defenses, but it will be up to the employer to persuade the Service with enough evidence.

UPDATES FOR CALIFORNIA, MARYLAND, AND NORTH CAROLINA

California Worker Classification

In California, there is no set definition of the term "independent contractor," so practitioners look to the courts and enforcement agencies to determine if a worker is an employee or independent contractor. California Labor Code Section 3357 sets forth the

rebuttable presumption that a worker is an employee; the determination depends upon a number of factors, all of which must be considered, and none of which alone is controlling.

Typically, the facts are applied to the "multi-factor" or the "economic realities" test adopted by the California Supreme Court in the case of S. G. Borello & Sons, Inc. v. Dept. of Industrial Relations, 769 P.2d 399 (Cal. 1989). Borello was a case in which cucumber sharefarmers were found to be employees and not independent contractors for the purposes of workers' compensation insurance. The Borello court found that while the company exercised minimal control, if any, the work was an integral part of the business, the workers were reliant on the company for their livelihood, and where there was a lack of actual control, the menial nature of work only required a pervasive control over the enterprise at large. The work was essentially deemed to be so unskilled that detailed supervision was not necessary.

The Borello test is a hybrid combination of the California common law "right to control" test and the federal "economic reality" test, which originally applied only to workers' compensation benefits cases. Prior to Borello, no California court had applied such a broad standard in a tax case, however it is now common for the California Employment Development Department ("EDD") to apply this case and determine employee status on a regular basis, even when there is a pretty decent case for legitimate contractor relationships.

Janitorial and transportation companies are example of industries in which the initial determination of worker status by the EDD is that of an employee. Although these industries may traditionally have lower-skilled workers, that is not always the case. See JKH Enterprises, Inc. v. Department of Industrial Relations, 142 Cal. App. 4th 1046 (Cal. Ct. App. 2006); Air Couriers International v. Employment Development Department, 150 Cal. App. 4th 923 (Cal. Ct. App. 2007); Yellow Cab Cooperative, Inc. v. Workers' Comp. Appeals Bd., 226 Cal. App. 3d 1288 (Cal. Ct. App. 1991).

More recently, California practitioners have observed a trend in determining the relationship status between franchisors and franchisees. The franchise industry includes businesses that take an established successful business model, duplicate it, and sell it to a franchisee under an agreement with certain rights and obligations. California courts have recognized that a franchisor's interest in the reputation of its entire marketing system may allow it to exercise certain controls over the enterprise without running the risk of transforming its independent contractor franchise into an agent. See Kaplan v. Coldwell Banker, 57 Cal. App. 4th 958, 961 (Cal. Ct. App. 1997), citing Cislaw v. Southland Corp., 4 Cal. App. 4th 1284, 1292 (Cal. Ct. App. 1992).

It is common in the franchise industry to require franchisees to adhere to certain aspects of the entity's business model, such as use of trademark colors and specific equipment related to the brand, to protect goodwill. In 2013, a significant change occurred following the California Unemployment Insurance Appeals Board ("CUIAB")'s decision in SuperShuttle International, Inc., et al. v. EDD, in which the CUIAB determined that the subject franchisee drivers were employees and not independent contractors.

The facts of SuperShuttle were common of an employer/employee relationship. For example, drivers could not drive for another business outside of their work for SuperShuttle; drivers were required to submit trip sheets to the franchisor; drivers were paid based on a formula established solely by the franchisor; drivers could not keep personal items in the vans they drove; and the drivers were previously treated as employees but then converted to independent contractors.

SuperShuttle argued it was merely exerting the level of control necessary to protect the brand standard of SuperShuttle, a control California courts have recognized as valid to protect a franchisor's interest in the reputation of its entire marketing system. In this case, the CUIAB found that the control surpassed that which was required to protect SuperShuttle's brand.

Almost immediately after the decision was issued, practitioners watched as the EDD embarked on what appeared to be an industry-wide program focusing on franchise companies, applying the SuperShuttle case liberally, even when the facts could be easily distinguished from SuperShuttle and the franchisor had little or no control over the franchisee.

Fortunately, relief came in August 2017, when Super Shuttle International filed a Claim for Refund in the Superior Court of California, County of Sacramento; the court applied the Borello factors and determined that the franchisees were in fact independent contractors and not employees. The court addressed the

challenges in interpreting both statutory and common law legal principles intended to differentiate between employee and independent contractor status. The court discussed the need to recognize "fluidity and the range of potential business relationships," some known, but others which might "develop in the future." Further, the court recognized that the franchise business model does not "fit squarely within the definition of a traditional employer/employee nor a principal/independent contractor business model."

Significantly, the court said that the very factors the defendants argue support a finding of control as in Borello, are the essence of the franchise business model. "Although it is convenient to parse out each factor as a litmus test of employment relationships, *Borello* teaches us that its application must be based upon the unique business context analyzed. To hold that a conventional franchise system such as the one present in Supper Shuttle falls within the definition of an employer/employee relationship would potentially be the demise of the franchise business model."

Most recently, the California Superior Court had the final say on worker classification determination concerning California Industrial Wage Commission ("IWC") wage orders. In Dynamex Operations West, Inc. v. Superior Court of Los Angeles County, the court considered the proper test to apply in determining whether delivery drivers were misclassified as independent contractors under IWC Wage Order No. 9-2001.

The Dynamex court held that both the "ABC" test used by other jurisdictions in a variety of contexts in determining worker status, and the Borello factors, are applicable in determining whether workers should be classified as employees or as independent contractors for purposes of California wage orders. As a result, all wage and hour litigation and administrative wage claims in California will now be subject to both tests.

Under the "ABC" test, the hiring entity must establish that: (A) the worker is free from the control and direction of the hirer in connection with the performance of the work, both under the contract for the performance of such work and in fact; (B) the worker performs work that is outside the usual course of the hiring entity's business; and (C) the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity.

The second requirement makes the "ABC" test more restrictive than the Borello factors, because to satisfy prong (B), for example, a janitorial business contracting janitors will not be able to treat the workers as independent contractors, since that is the usual work of the hiring entity's business.

Practitioners are reminded that Dynamex only applies to California IWC wage orders; it does not apply to worker classification determinations in payroll tax or workers' compensation cases.

Maryland Worker Classification

Maryland determines if a worker is an employee or independent contractor in a similar manner to that of the Service stating that it will depend upon the amount of control that is exercised over the worker by the employer. There is no statute in Maryland that determines the difference between an independent contractor and an employee, so it is all based upon common law. The law also varies depending upon the analysis and which Maryland agency is performing the audit. Employment matters are handled by the Maryland Comptroller's office and the department of labor and licensing with regards to unemployment taxes and also workers compensation matters.

A five part test was determined by the Court of Appeals of Maryland in Mackall v. Zayre Corp., 443 A.2d 98 (Md. Ct App. 1982), which was dealing with a workers compensation matter. The five factors that the Court listed were: (i) the power to choose and hire the worker; (ii) the power to discharge the worker; (iii) the power to direct and control the worker's actions; (iv) the payment of wages; and (v) the similarity of the work completed by the worker and the employer's overall business. The court identified the power over control of the worker's actions as the most important and determinative factor.

While this is one interpretation of the law there is another test that is used by Maryland based upon the Fair Labor Standard Act. It includes many of the same factors that were identified in Mackall, id., but also added in a few additional factors. It also factors in looking at the independent contractor to determine if they regularly work as an independent contractor for others was well; who provides the equipment used by the worker; and whether or not the worker is also an owner of the business.

These two tests are typically used by the Comptroller of Maryland in making an analysis to determine if the worker classification status. Whereas the Department of Labor and Licensing with regards to unemployment tax matters uses a different test which is simplified method. It has created a statutory test with three elements which must all be met in order for a worker to not be classified as an independent contractor. The worker must meet these qualifications to be an independent contractor: (i) free from control and direction for the performance of the work in reality and based upon the contract; (ii) the individual is usually involved in an independent business that involves the work being performed; and (iii) performs the work outside of the employer's location and is not the usual type of work performed by the employer.

For Maryland employers a first step is to try to ensure that they can meet the test for purposes of the unemployment matters. It is a simplified test but, since it is a statutory test, it is more easily defined. If an employer can meet that test then it is more than likely they will be able to meet the more burdensome test of six factors.

North Carolina Worker Classification

Statutory and Common Law

In North Carolina, independent contractor status is determined largely under common law. The term "independent contractor" is not defined statutorily for income tax withholding, workers' compensation, and the wage and hour laws. A statutory definition exists only in the unemployment insurance world where an "independent contractor" is defined as "an individual who contracts to do work for a person and is not subject to that person's control regarding the way the work is performed and what must be done as the work progresses." N.C. Gen. Stat. Ann. § 96-1(b)(19). This statutory definition follows the common law test, which North Carolina courts apply to analyze unemployment insurance claims. State ex rel. Emp't Sec. Comm'n v. Huckabee, 461 S.E.2d 787, 787 (N.C. Ct. App. 1995).

Under the common law, an "independent contractor" is a person "who exercises an independent employment and contracts to do certain work according to his own judgment and method, without being subject to his employer except as to the result of his work." Youngblood v. N. State Ford Truck Sales, 364 S.E.2d 433, 437 (N.C. 1988). An employer-employee relationship exists when "the party for whom the work is being done retains the right to control and direct the manner in which the details of the work are to be executed." Id. While the definition of "independent contractor" relies on the common law, North Carolina statutes amply define the term "employee" albeit by reference to other defined terms.[17] The terms "wages," "employer," and "employment" are some examples.

Nevertheless, courts rely on common law principles to determine whether an employment relationship exists. In Hayes, the North Carolina Supreme Court has articulated an eight-factor "right to control" test to determine which party retains the right to control and direct the details of the work. Courts use the test to assess whether the worker:

1. is engaged in an independent business, calling, or occupation;
2. is to have the independent use of his special skill, knowledge, or training in the execution of the work;
3. is doing a specified piece of work at a fixed price or for a lump sum or upon a quantitative basis;
4. is not subject to discharge because he adopts one method of doing the work rather than another;
5. is not in the regular employ of the other contracting party;
6. is free to use such assistants as he may think proper;
7. has full control over such assistants; and
8. selects his own time.

See McCown v. Hines, 549 S.E.2d 175, 177-78 (N.C. 2001); Hayes v. Board of Trustees of Elon College, 29 S.E.2d 137, 140 (N.C. 1944).

The North Carolina Supreme Court has established that: "presence of no particular one of these indicia is controlling. Nor is the presence of all required. They are considered along with all other circumstances to determine whether in fact there exists in the one employed that degree of independence necessary to require his classification as independent contractor rather than employee." McCown, supra, 549 S.E.2d at 177-78 (2001).

Recently, the Fourth Circuit applied the Hayes test to the wage and hour context.[18] See Church v. Home Fashions Int'l, LLC, 532 Fed. Appx. 345, 348 (4th Cir.

2013). In Church, the Fourth Circuit acknowledged that, "[a]lthough no single factor is controlling, nor must all factors be present or in agreement, there are 'four principal factors generally recognized as demonstrating the right to control the details of work: (1) method of payment; (2) the furnishing of equipment; (3) direct evidence of exercise of control; and (4) the right to fire.'" Id. at 347-48.

In Church, the Fourth Circuit determined that a salesperson in the furniture industry was an employee. He worked exclusively for one company on a regular basis for 18 months and did not hold himself out as a contractor or independent businessperson; was paid a guaranteed $11,000 per month, regardless of the work he completed, plus commission on his sales; was provided with an office and reimbursed for various business-related expenses, some of which had to be pre-approved; was not entitled to hire assistants without the company's approval, and never became responsible for compensating the sales representatives he hired.

The Fourth Circuit noted that the labels the parties used in the employment agreement and the manner in which the company regarded the worker for tax purposes were of little consequence. Particularly significant was that the employee performed a function that was integral to the primary objective of employer's business. The company assigned him an ever-evolving and diverse range of responsibilities and, at the direction of and in collaboration with the company's executives, he assisted in almost every aspect of the company's attempt to expand into furniture manufacturing.

Skilled Trades

Workers engaged in skilled trades have been found to be contractors. See McCown v. Hines, 549 S.E.2d 175, 177-78 (N.C. 2001) (roofer); Beddingfield v. WNC Pallet and Forest Products, No. COA02-997 (N.C. Ct. App. 2003) (logger). In two cases from the early 2000s, the estates of a roofer and a logger who suffered fatal injuries on the job sought to recover workers' compensation. The two workers were found to have developed and used special skills and knowledge in the independent callings of roofing and logging. Both used mostly their own equipment, were paid by the project or upon completion of the day's job, selected their own time to work, were not instructed, and were not subject to discharge. The roofer was not under the regular employ of the individuals who hired him because he was hired for the limited purpose of re-roofing a specific rental property and worked for others between projects with these individuals. The logger was found to be in a unique employment arrangement where he paid his own medical expenses resulting from a previous accident to recover workers' compensation.

Transportation Industry

Recently, the North Carolina Court of Appeals explored the worker classification of taxi drivers for workers' compensation. In Mills v. Triangle Yellow Transit, 751 S.E.2d 239 (N.C. Ct. App. 2013), a taxi driver was found to be an employee because the taxi company controlled his work to a degree sufficient to establish an employer-employee relationship. The taxi company owned, maintained, and insured that driver's and all other taxis. The company set the driver's work schedule and required him to start work at 6:00 p.m. for six days each week and required advance notice for approval of vacation. The driver did not have another job, could not set his own wages, and was required to give the taxi company 50 percent of all his earned fares. He was required to follow service routes and pick up customers based on the commands of the company's dispatcher. He was prohibited from using the taxi for his own personal purposes and picked it up from company's office each day and returned it to the same location at the end of his shift.

In Ademovic, where a taxi driver had contracted with a franchise, the North Carolina Court of Appeals was on the opposite end of the spectrum. Ademovic v. Taxi USA, LLC, 767 S.E.2d 571 (N.C. Ct. App. 2014). The driver's employment agreement contained express language indicating that he was not an employee, but an independent contractor. The driver kept all the fares and tips he earned even though he paid the franchise a weekly flat franchise fee of $195.00. The franchise did not determine the number of days or the number of hours he worked; rather, it allowed the driver to determine his own work schedule. The driver owned, insured, maintained, and paid the taxes for his own taxi. He was not required to use dispatch services to pick up fares and was free to accept hailed fares and go to taxi stands to pick up customers.

It is yet to be seen how North Carolina will address the rise of the gig economy in the transportation industry. Interestingly, the key factors in Ademovic align with

the requirements of the safe harbors for the treatment of drivers working for transportation networking companies as independent contractors in Florida and West Virginia. Fla. Stat. § 627.748 (2017); W. Va. Code §§ 17-29-1-19 (2016). Transportation networking companies are companies like Uber and Lyft that use a digital network to connect a rider to a driver to provide prearranged rides. For a driver to qualify as an independent contractor in Florida, the company must not unilaterally prescribe specific or prohibit the driver from using the digital networks of other companies or restrict the driver from engaging in any other occupation or business, and the driver must agree in writing that the driver is an independent contractor. See, e.g., Fla. Stat. § 627.748 (2017).

North Carolina Employee Fair Classification Act

North Carolina has been on the frontier of deploying new laws and procedures to tackle the growing use of independent contractors. As part of a coordinated statewide effort to address employee misclassification, the North Carolina General Assembly enacted the North Carolina Employee Fair Classification Act, N.C. Gen. Stat. § 143-761 et seq. (the "Act"). The Act became effective on December 31, 2017.

It permanently established the Employee Classification Section, a new division of the Industrial Commission, which serves as the primary point of contact for the public to report suspected instances of worker misclassification. It investigates reports and shares information with several state agencies—the North Carolina Department of Labor, the North Carolina Division of Employment Security, the North Carolina Department of Revenue, and the North Carolina Industrial Commission. It coordinates with these state agencies and district attorney's offices to assist in the prosecution of employers and with the recovery of back taxes, wages, benefits, penalties, and other assessments owed as a result of misclassification. In addition to reporting suspected instances of misclassification, the Employee Classification Section must submit to each state agency an annual report that reviews the number of misclassification reports received, the number and amount of various monies assessed and the amount collected, and the number of cases referred to each agency.

The Act is the result of several years of state government efforts. In August of 2012, Governor Bev Perdue issued Executive Order No. 125 establishing the Governor's Task Force on Employee Misclassification. The Governor's Act followed a media outcry that employee misclassification had deprived the state and federal governments of significant tax revenue and allowed businesses that misclassify to unfairly undercut their competitors. In December 2015, Governor Pat McCrory signed Executive Order No. 83, which established the Employee Classification Section and designated a liaison within each agency responsible for reporting allegations of misclassification to the director of the Employee Classification Section.

The Act codified provisions of Executive Order No. 83 and permanently established the Employee Classification Section. Before the Employee Classification Section was created, no formal mechanism existed for sharing information among the state agencies. This new law does not affect the "right to control" test for independent contractor status in North Carolina and does not provide a single definition of "employee." Rather, it defines an "employee" by incorporating by reference existing statutory definitions and excluding independent contractors. N.C. Gen. Stat. Ann. § 143-762(a)(3).

Although the Act levies no additional penalties and creates no additional cause of action against an employer that engaged in misclassification, it links employee misclassification with occupational licensing. For the first time, the Act requires employers to report their compliance in properly classifying employees with state occupational licensing boards and commissions.

The Act requires every occupational licensing board to include on its initial application for a license, permit, or certification and its application for renewal, the following: (1) a certification that the applicant has read and understands the public notice statement; and (2) disclosure by the applicant of any investigations for employee misclassification and the result of the investigations for a time period determined by the occupational licensing board. See N.C. Gen. Stat. Ann. § 143-765.

While the Act does not require boards to deny a license or otherwise penalize an employer that has engaged in employee misclassification, it does require the denial of a license to an applicant who fails to comply with the certification and disclosure requirements. Hence, North Carolina employers that are subject to

occupational licensing requirements should be particularly concerned with classifying properly the workers they hire.

SUMMARY AND THOUGHTS

Worker misclassification is costly. The IRS, DOL, and states all have different tests for determining worker classification and all three agencies share information. To eliminate a costly misclassification finding, consider utilizing VCSP. Better yet, classify properly.

Notes

1 American Bar Association, Section of Taxation Meeting, "Worker Classification – What›s New Is Old Again", January 29, 2016, Los Angeles, CA.

2 Office of Chief Counsel Meeting, IRS, "Worker Classification: Employee or Independent Contractor?" August 13, 2008, Atlanta, GA.

3 Internal Revenue Code («IRC») Section 3509.

4 American Bar Association, Section of Taxation, Meeting, September 24, 2010, Toronto, Canada.

5 Revenue Ruling 87-41.

6 Training Materials page 2-3; IRS Publication 1779 (Rev. 8-2008) ("Training Materials").

7 PLR 200323022; Prescott WP, Altieri MP, VanDenHaute KA, Tietz RI, Worker Classification Issues: Generally and in Professional Practices. The Practical Tax Lawyer, 2017; 31(2): 17-28.

8 Training Materials p. 2-22.

9 Treas. Reg. Section 31.3121(d)-1(a)(3).

10 Sergeant v. Commissioner, 93 T.C. 572 (1989), rev›d 929 F.2d 1252 (8th Cir. 1991) («Sergeant»); Training Materials Lesson 2, p. 2-23.

11 Dutch Square Medical Center Limited Partnership v. United States, 74 A.F.T.R. 2d 1994-6356, 94-2 USTC, 1994 WL 605850 (D.S.C. 1994).

12 Training materials p. 2-23.

13 DOL Withdraws Joint Employer and Independent Contractor Administrator›s Interpretations, U.S. Secretary of Labor Withdraws Joint Employment, Independent Contractor Informal Guidance, OPA News Release 6/7/2017, Release No. 17-0807-NAT, available at https://www.dol.gov/newsroom/releases/opa/opa20170607.

14 American Bar Association, Section of Taxation, Meeting: "Worker Classification Challenges – The Hinge on Which So Many Tax and Businesses Turn," May 8, 2010, Washington, D.C.

15 Sam Hargrove, et. al. v. Sleepy›s, LLC, 106 A.3d 449 (N.J. 2015).

16 Walid Jammal, et al, v. American Family Insurance Group, et al., 2015 WL 1810304 (N.D. Ohio 2015); Whitt v. Wolfinger, 39 N.E. 3d 809 (Ohio Ct. App. 2015); Gino Ferrari v. Top Flight Driver Leasing, LLC, et al., 2013 WL 6212044 (Ohio Ct. App. 2015); Soloman v. Dayton Window & Door Co., L.L.C., et al., 961 N.E.2d (Ohio Ct. App. 2011); Jakob v. Eckhart, 963 N.E.2d 851 (Ohio Ct. App. 2011).

17 For income tax withholding, an "employee" is "[a]n individual, whether a resident or a nonresident of this State, who performs services in this State for wages or an individual who is a resident of this State and performs services outside this State for wages." N.C. Gen. Stat. Ann. § 105-163.1(4). Under the wage and hour laws, an "employee" is "any individual employed by an employer." N.C. Gen. Stat. Ann. § 95-25.2(4)-(5). Instead of using a state specific definition, the North Carolina unemployment insurance statute incorporates by reference the definitions of "employee" and "employer" provided in section 3306 of the Internal Revenue Code. N.C. Gen. Stat. Ann. § 96-1(b)(10). For workers› compensation coverage, an "employee" is defined in great detail. N.C. Gen. Stat. Ann. § 97- 2(2) ("every person engaged in an employment under any appointment or contract of hire or apprenticeship, express or implied, oral or written, including aliens, and also minors, whether lawfully or unlawfully employed, but excluding persons whose employment is both casual and not in the course of the trade, business, profession, or occupation of his employer, and as relating to those so employed by the State…").

18 North Carolina courts, however, have examined wage and hour claims under the North Carolina Wage and Hour Act as they would under the Federal Labor Standards Act, which requires application of the "economic realities test." See, e.g., Rehberg et al v. Flowers Foods, Inc., et al., 2015 WL 1346125 at *5 (W.D.N.C. 2015); Sullivan v. Knight›s Med. Corp., No. 5:12-CV-592-FL, 2013 WL 4524897, at *5 (E.D.N.C. Aug. 27, 2013); Sinclair v. Mobile 360, Inc., 2009 WL 9073080, at *7, 9-10 (W.D.N.C. Jan. 16, 2009), vacated and remanded on other grounds, 417 F. Appx 235 (4th Cir. 2011).