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Recent Newspaper Series Brings Bad Publicity to North Carolina's Construction Industry: But, Construction Companies – Here's the Real Story

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On Thursday, September 4, 2014, the Raleigh *News and Observer* and the *Charlotte Observer* published their "Contract to Cheat" series online, with corresponding articles appearing in print each day from Sunday, September 7, through Thursday, September 11. This five-part series highlighted a year of investigative work by newspaper reporters across the country into how some construction workers are being paid improperly (and illegally) as independent contractors, rather than employees.

These articles focused on construction companies who completed work during the recession on government-funded projects such as affordable housing development projects. The articles purported to have uncovered the disturbing rate at which some construction companies are misclassifying their employees as independent contractors. Based on a review of construction companies' payroll records and interviews with construction workers, the articles estimated that approximately 35% of construction workers in North Carolina are being misclassified as independent contractors. From a tax perspective, the articles estimated that the employee-independent contractor misclassification problem cost North Carolina approximately $467 million in uncollected federal and state taxes each year.

The Difference between Employees and Independent Contractors

The distinction between an "employee" and an "independent contractor" is a critically important employment issue. Employees, but not independent contractors, are provided protections under Equal Employment Opportunity laws, wage and hour laws for minimum wage and overtime pay, workers' compensation laws, and unemployment compensation laws. Additionally, independent contractors are not entitled to, nor do they receive, the same employment benefits offered to employees such as health insurance, short- and long-term disability, and paid time off, to name a few. Additionally, unlike employees, independent contractors are not subject to payroll deductions or withholdings for taxes. Instead, independent contractors simply receive an IRS Form 1099 from the company or individual who hired them for a particular job, and it is incumbent upon the independent contractor to self-report the contractor's earnings to the IRS and the North Carolina Department of Revenue and pay all self-employment taxes.

In light of the potential savings, many employers become incentivized to misclassify employees as

independent contractors, mistakenly believing they have found a lawful method to avoid paying minimum wages and overtime pay, federal and state payroll taxes, social security taxes, workers' compensation insurance, and other employee-related expenses.

This misunderstanding of employment law, however, can be very costly for employers in the long run. A truth that is even more unsettling for employers is the fact that if an employee truly is an "employee," then it makes no difference that he or she agreed to or, for that matter, insisted on being treated and paid as an independent contractor. Frequently, we hear from employer clients that an employee "asked to be paid as an independent contractor," or "signed and agreed to an independent contractor agreement." While this may be some evidence that the individual truly is or was an independent contractor (and not an employee), it certainly is not dispositive on the issue and, oftentimes, is not persuasive when viewed in combination with other, more relevant, factors.

Properly Classifying Employees and Independent Contractors

So, how do you know whether a worker is an "employee" or an "independent contractor"? This question has been the subject of much discussion and debate, but let's separate fact from fiction. Simply stated, whether a worker is an employee or an independent contractor comes down to whether the employer reserves the right to control the means, manner, and details of how the work is performed. If the answer is "yes," the worker is probably an employee and not an independent contractor. Conversely, in an employer-independent contractor relationship, the independent contractor agrees to complete a particular job, but retains the right to perform the work according to the contractor's own judgment and methods, without being directed by the employer except as to the result of the work. The touchstones here are "control" and "independence."

The United States Department of Labor ("DOL") enforces the Fair Labor Standards Act, the Davis-Bacon Act, the McNamara-O'Hara Service Contract Act, and other federal laws which govern how employees are to be paid. The DOL has developed a multi-factor "economic reality test" which has been accepted by the federal courts to differentiate between employees and independent contractors. The "economic reality test" consists of six factors that are aimed at determining the overall economic dependency of the worker on the employer. The six factors are as follows:

- The degree of control that the employer has over the manner in which the work is performed and by whom;
- The worker's opportunities for profit or loss dependent on the worker's managerial skill;
- The employer's and worker's relative investment in equipment or material;
- The degree of skill and/or independent business judgment required for the work;
- The permanency of the working relationship; and,
- The degree to which the services rendered are an integral part of the employer's business.

There are multiple issues within each of these factors that must be analyzed. The "Contract to Cheat" articles attributed much more significance than is appropriate to the single factor of how the worker is paid. This over-reliance on one factor, by itself, can lead to misclassification. In fact, the United States Supreme Court has held that the classification of a worker as an employee or independent contractor is not determined by the manner or timing of pay (such as hourly). Rather, all factors must be given equal consideration and weight when determining whether a worker is an employee or an independent contractor.

Simply because a worker is paid by the hour does not indicate, without something more, that the worker is an employee and not an independent contractor. Likewise, the fact that a worker signs an "Independent Contractor Agreement" does not, by itself, mean the individual is an independent contractor. However, a worker and an employer can agree, in advance, that their relationship will be governed by specific rules and

requirements. For instance, an independent contractor relationship can still be formed where the parties agree that the payment will be based on the number of hours worked, that the contractor will report to a particular job site when requested by the employer, and that the work will be completed to the employer's specifications.

For example, have you ever hired a landscaping company to landscape or mow your backyard; has your company ever hired an IT professional to rewire your information systems; or have you retained a lawyer to defend you against a lawsuit? In each of these examples, the parties reach an agreement beforehand on how their working relationship will be governed (including, very often, fees based on hours worked, especially in the case of the attorney), but the relationship may well be that of independent contractor and contracting company/individual, not employee and employer, based upon the totality of the factors listed above.

IRS Guidelines for Employee-Independent Contractor Classification

The Internal Revenue Service ("IRS") also has developed guidelines to help both businesses and workers choose the correct status. The IRS analyzes the employee-independent contractor issue from a tax perspective. Under IRS rules, workers are presumed to be employees; the burden is on the employer to prove that a worker is an independent contractor and not an employee. Like the DOL's "economic reality test," the IRS guidelines are built with the touchstones of control and independence in mind. The IRS categorizes these two touchstones into three subgroups: behavioral control, financial control, and the type of relationship.

Both the DOL and the IRS address the same legal concerns—the DOL in the employment context and the IRS in the tax context. Despite this difference, both agencies are clear that their respective sets of factors are to be applied and judged in a manner that considers the totality of the circumstances. No one factor is dispositive on the issue; each factor must be analyzed in relation to all other factors.

Conclusion

The "Contract to Cheat" series certainly has created a stir in the construction industry and across North Carolina. In fact, the final article in the series, published on September 11, urged the Governor, the General Assembly, and state agency leaders to remedy the misclassification problem. Additionally, the articles, whether rightly or wrongly, specifically named employers and companies who, as the newspapers carefully phrased it, "may have violated" the law in how they classified and paid employees.

The growing perception of problems due to misclassification, the government's impending examination of these issues, and the threat of being the next named "possible" violator in a newspaper article all provide impetus for companies to review their employee-independent contractor classifications to ensure proper classification under the law.

As you can gather from the required balancing of factors, determining whether a worker is an employee or an independent contractor sometimes is not as easy as it should be. When in doubt, promptly seek competent legal advice on these issues. Do not let your company be the topic of discussion in the next "Contract to Cheat" article or, worse, the subject of a government investigation.

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article without obtaining the advice of an attorney.

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