The Fair Labor Standards Act's One-Two Punch

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The Fair Labor Standards Act (FLSA) has dominated legal updates and business alerts recently and likely has been the primary focus of many businesses. In spite of the recently issued nationwide injunction halting the regulatory changes related to overtime exemptions, it is the FLSA's one-two punch that is and always has been the most harmful to an employer if not properly addressed. What is the one-two punch? It is the "independent contractor vs. employee classification conundrum" and the "exempt vs. non-exempt classification challenge."

The one-two punch involves an extremely fact-intensive analysis that employers must conduct on a case-by-case basis for each individual or job position and as such, employers always should conduct that analysis with the assistance of legal counsel. That said, CPAs can and often do play an important role in the process. As employers' auditors, accountants and bookkeepers, CPAs often are the first people able to identify a likely problem and alert the employers about the need to address it. It is important, therefore, that CPAs have a basic understanding of the one-two punch so they can serve this important front-line role.

Independent Contractor vs. Employee

Any business with workers must classify those workers either as employees or independent contractors. The "employee" classification includes numerous responsibilities and requirements that the business must meet. These include the employer portion of federal employment taxes, Texas unemployment insurance taxes, the quarterly Form 941 (the Employer's Quarterly Federal Tax Return), the annual Form 940 (Employer's Annual Federal Unemployment Tax Return), the Texas Workforce Commission's (TWC) Unemployment Tax Services Employer's Quarterly Report, the USCIS Form I-9 (Employment Eligibility Verification), the Form W-4 (Employee's Withholding Allowance Certificate), the Texas Employer New Hire Reporting Form and the annual Form W-2 issuance. In addition and depending on the number of employees, various state and federal employment laws apply that govern minimum wage and overtime, medical leave, anti-discrimination and anti-harassment, insurance coverage under the Affordable Care Act, workers' compensation and workplace safety.

On the other hand, there are minimal responsibilities and requirements in place when a business classifies a worker as an independent contractor. The employer must complete a Form W-9 (Request for Taxpayer Identification Number and Certification) and annually issue a Form 1099 for payments made to the independent contractor. It is for this reason that many businesses seek to classify workers as independent contractors. In turn, this increased desire for the independent contractor classification has resulted in increased state and federal audits regarding worker classification.[1]

With that in mind, it is important to know how the state of Texas (TWC) and the U.S. Internal Revenue Service (IRS) determine a worker's classification. The TWC and the IRS utilize the same test but somewhat different factors, so it is critical to know and understand both approaches.

According to the IRS, a worker is an independent contractor if the payer (i.e., the business in most cases) has the right to control or direct only the result of the work, and not what will be done and how it will be done.[2] To make this determination, the IRS uses the common law control test to examine the relationship between the worker and the business. In doing so, the IRS examines the facts using three broad categories – behavioral control, financial control and relationship of the parties.[3] It is important to note that no single factor within the categories is determinative and the factors are meant to assist in determining the overall question of control and direction. That said, the more factors that favor an employee classification, the more likely it is the worker in question is an employee. The more factors that favor an independent contractor classification, the more likely it is the worker in question is an independent contractor.

1. Behavioral Control – Within the behavioral control category, the fact finder examines the business' right to direct and control what work is accomplished and how the work is accomplished, whether that is through instructions, training or other means.[4] The greater the business' right to direct and control what work is accomplished and how it is accomplished, the more likely this category favors an employee classification.

2. Financial Control – In this category, the fact finder examines the facts related to a business' right to direct or control the financial and business aspects of a worker's job. The areas of inquiry include: (a) the extent to which the worker has unreimbursed business expenses, (b) the extent of the worker's investment in the facilities or tools used in performing the work, (c) the extent to which the worker makes his/her services available to the relevant market, (d) how the business pays the worker and (e) the extent to which the worker can realize a profit or incur a loss.[5]

If the business reimburses the majority of the worker's business expenses and/or regularly reimburses the worker's business expenses, the fact finder should categorize that factor in favor of an employee classification. If a worker invests minimally in the facilities or tools used to perform his/her work, the fact finder should categorize that factor in favor of an employee classification. The third factor within this category favors an employee classification if the worker does not make his/her services available to the relevant market or at least highly minimalizes that availability. A common inverse example is a bookkeeper hired by a business to review and close the business' financial documents at year-end. If that bookkeeper makes such services available to other businesses as well, that factor favors an independent contractor classification.

With respect to how a business pays the worker, an hourly, weekly or monthly rate favors an employee classification, while a "per job" or flat rate favors an independent contractor classification. Finally, if a worker generally does not realize a profit or incur a loss in the business, the fact finder should categorize that factor in favor of an employee classification. Only independent contractors can realize a profit or incur a loss through the management of expenses and revenues (i.e., transportation costs, marketing expenses, payments to subcontractors, etc.). Employees simply are paid for services rendered.

3. Relationship of the Parties – Within this category, the fact finder examines the type of relationship the parties had. This includes examining (a) written contracts describing the relationship the parties intended to create, (b) whether the business provides the worker with benefits an employee typically receives, such as insurance, a pension and vacation and/or sick pay, (c) the permanency of the relationship, and (d) the extent to which the services the worker performs are a key aspect of the business' regular business.[6]

If the business and worker entered into a written contract in which it states the worker is an independent contractor, this factor favors an independent contractor classification. It is important to note, however, that a contract is not determinative and is merely one of many factors to examine. Furthermore, the parties' intent does not determine the worker's classification. With respect to the second factor, if a business provides a worker with benefits an employee typically receives, the fact finder should categorize that factor in favor of an employee classification. The factor addressing the permanency of the relationship sometimes can be confusing.

While Texas is an at-will employment state, meaning either the employee or the employer may terminate the employment relationship at any time and for any reason, this inquiry presumes that an employer-employee relationship is ongoing absent some reason to terminate. On the other hand, an independent contractor relationship typically is for a single job or project with no expectation of continuing work. As such, the more permanent the relationship, the more likely this factor favors an employee classification. The final factor in this category favors an employee classification when the services the worker performs are a key aspect of the business' operations and/or the business' success depends on the worker's services.

As this article mentioned previously, the TWC also utilizes the common law control test, which means a worker is an independent contractor if the payer (i.e., the business in most cases) has the right to control or direct only the result of the work, and not what will be done and how it will be done. To determine control, however, the TWC utilizes a 20-factor approach. As with the IRS approach, no single factor is determinative and the weight assigned any given factor can vary depending upon the specific facts. The factors can be found here: http://www.twc.state.tx.us/files/businesses/form-c-8-employment-status-comparative-approach-twc.pdf. While the factors vary slightly, most are found within the IRS approach and should be examined the same way.

Despite the extensive IRS and TWC tests, another government agency recently created more potential concern for businesses. In July 2015, the Department of Labor (DOL) administrator issued an interpretation memo regarding worker classification. The interpretation narrowed the DOL's definition of independent contractor so much that businesses should be extremely wary about classifying workers as independent contractors. Pursuant to the interpretation, the DOL moved away from the traditional control test and toward an economic realities test. That test examines each worker to determine if he/she is economically dependent on the business/employer or in business for himself/herself.

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> **IT IS EXTREMELY IMPORTANT TO NOTE THAT SIMPLY PAYING AN EMPLOYEE A SALARY DOES NOT MAKE THAT EMPLOYEE EXEMPT FROM THE FLSA'S OVERTIME COMPENSATION REQUIREMENTS.**

In conducting this test, the DOL utilizes the following six factors: (1) the extent to which the worker's work is an integral part of the employer's business; (2) the extent to which the worker's managerial skill affects his/her opportunity for profit or loss; (3) the worker's relative investment compared to the employer's investment; (4) whether the worker's work requires special skill and initiative; (5) the permanency of the relationship between the worker and employer; and (6) the nature and degree of the employer's control over the worker.[7] As with the IRS and TWC tests, no single factor is determinative.

While it can be more expensive and a larger administrative burden, classifying a worker as an employee rather than an independent contractor eliminates the misclassification risk. That said, if a business classifies a worker as an independent contractor, it should bear in mind that the analysis can change over time and a business regularly should monitor and evaluate the chosen classification.

Exempt vs. Non-Exempt

Once a business has determined that it has at least one employee, it most likely faces the "exempt vs. non-exempt classification challenge." If a business has annual gross volume of sales made or business done of $500,000 or more, that business' employees are covered by the FLSA.[8] Hospitals, businesses providing medical or nursing care for residents, schools and public agencies are subject to the FLSA no matter their annual gross volume of sales made or business done.[9] Furthermore, even if a business is not subject to the FLSA, individual employees may be covered if their work involves them in interstate commerce.[10] For example, making telephone calls and responding to email crosses interstate lines and implicates interstate commerce. As a practical matter, therefore, it is rare that a business has employees and those employees are not subject to the FLSA in some way. The focus of this article is the FLSA because the state of Texas has no added protection or requirements beyond those the FLSA imposes.

The FLSA delineates two broad categories of employees – those exempt from the law's minimum wage and/or overtime requirements and those who are not exempt. An employee who is exempt from the overtime requirements need not be paid time and one-half the employee's regular rate of pay for every hour worked in excess of 40 in a workweek. While the FLSA identifies 48 exemptions from the law's overtime requirements, 43 are industry-specific or job-specific exemptions that do not apply to most employers.[11] Five of the exemptions, however, are general exemptions, three of which are known as the "white collar" exemptions and are available to the vast majority of employers.

These exemptions are the executive, administrative, professional, computer and outside sales exemptions. With the exception of the computer exemption and the outside sales exemption, these exemptions require that the employer compensate the employee on a salary basis at a rate not less than $455 per week ($23,660 annually).[12] With respect to the computer exemption, employers also have the option to compensate the exempt employee on an hourly basis equal to $27.63 per hour.[13] There is no salary or hourly pay requirement for the outside sales exemption.

After a court-issued injunction in November 2016, this salary requirement remained unchanged and pending further court order, will remain unchanged. The term "salary basis" is a term of art within the DOL regulations. Pursuant to the regulations related to these exemptions and subject to some exceptions, an exempt employee must receive the full salary for any week in which the employee performs work, regardless of the number of days or hours worked.[14] The exemption is lost for any week in which the employer makes improper deductions.

There is one final note regarding the salary requirement. The DOL regulations permit employers to satisfy 10 percent of the required salary using nondiscretionary bonuses and incentive payments as long as employers pay those bonuses and incentive payments on at least a quarterly basis.[16]

It is extremely important to note that simply paying an employee a salary does not make that employee exempt from the FLSA's overtime compensation requirements. The exemptions discussed above also have required duties tests. In order to be exempt, therefore, an employee must earn the previously discussed required compensation and perform the required duties. These duties are as follows.

Executive Exemption – The employee's primary duty must be managing the enterprise or managing a customarily recognized department or subdivision of the enterprise; the employee must customarily and regularly direct the work of at least two or more other full-time employees or their equivalent and the employee must have the authority to hire or fire other employees, or the employee's suggestions and recommendations as to the hiring, firing, advancement, promotion or any other change of status of other employees must be given particular weight.[17]

Administrative Exemption – The employee's primary duty must be the performance of office or non-manual work directly related to the management or general business operations of the employer or the employer's customers; and the employee's primary duty includes the exercise of discretion and independent judgment with respect to matters of significance.[18]

Learned Professional Exemption – The employee's primary duty must be the performance of work requiring advanced knowledge, defined as work which is predominantly intellectual in character and

which includes work requiring the consistent exercise of discretion and judgment; the advanced knowledge must be in a field of science or learning; and the advanced knowledge must be customarily acquired by a prolonged course of specialized intellectual instruction.[19]

Creative Professional Exemption – The employee's primary duty must be the performance of work requiring invention, imagination, originality or talent in a recognized field of artistic or creative endeavor.[20]

Outside Sales Exemption – The employee's primary duty must be making sales, or obtaining orders or contracts for services or for the use of facilities for which a consideration will be paid by the client or customer; and the employee must be customarily and regularly engaged away from the employer's place or places of business.[21]

Computer Exemption – The employee must be employed as a computer systems analyst, computer programmer, software engineer or other similarly skilled worker in the computer field performing the duties described in the subsection. And the employee's primary duty must consist of the application of systems analysis techniques and procedures, including consulting with users, to determine hardware, software or system functional specifications, the design, development, documentation, analysis, creation, testing or modification of computer systems or programs, including prototypes, based on and related to user or system design specifications, the design, documentation, testing, creation or modification of computer programs related to machine operating systems; or a combination of the aforementioned duties, the performance of which requires the same level of skills.[22]

The DOL regulations further define specific phrases and terms within these duties tests, including primary duty, management, customarily and regularly, discretion and independent judgment, matters of significance and others. These explanations could themselves be the subject of an entire article but for purposes of this article, they can be found in Title 29 of the Code of Federal Regulations, Subtitle B, Chapter V, Subchapter A, Part 541, Subpart H, Sections 541.700 through 541.710.[23]

It is important to note that job titles do not determine exempt or non-exempt status and job descriptions in and of themselves do not determine exempt or non-exempt status. Rather, exempt or non-exempt status is determined by the actual duties the employee at issue performs. That said, a written job description can and should assist in determining an employee's exempt or non-exempt status.

One other exemption merits discussion here. The highly compensated employee exemption provides an exemption for any employee who performs office or non-manual work and earns at least $100,000 per year (which must include at least $455 per week paid on a salary basis) if that employee customarily and regularly performs at least one of the duties of an exempt executive, administrative or professional employee.

The purpose of this information is vital to any business or employer to avoid liability, but what is at risk? Since these areas of inquiry are related, a business or employer can face liability for one or both depending on how they classified the worker (i.e., whether the worker was classified as an independent contractor or employee and if classified as an employee, whether the worker was classified as exempt or non-exempt).

As an example, suppose a business wrongly classifies a worker as an independent contractor and following an audit by the DOL and the IRS, the worker is classified as a non-exempt employee. The business could be liable for back taxes to the state and federal government, as well as penalties related to the I-9, the Texas Employer New Hire Reporting Form and the Affordable Care Act. In addition, the business could be liable for two to three years of unpaid overtime compensation, penalties and interest. The dollar amount could be staggering. While an audit is dangerous enough, the situation is worse if the worker at issue decides to file a lawsuit as a collective action (i.e., a term of art for a class action lawsuit under the FLSA) and seeks unpaid overtime compensation, penalties (which includes a doubling of unpaid overtime wages), interest and attorney's fees for himself/herself and several other workers.

It is for all these reasons that businesses and their advisors must recognize potential issues involving the "independent contractor vs. employee classification conundrum" and the "exempt vs. non-exempt classification challenge." Once recognized and ideally with the assistance of legal counsel in some manner, businesses should carefully and thoughtfully ensure their workers are properly classified. In doing so, they can minimize risk and liability.

Footnotes

1. Wood, Robert W. "IRS Inspector Urges Crackdown on Mislabeling 'Independent Contractors'" *Forbes.com. Forbes*, 30 July 2013. Web. 22 Aug. 2016.
2. https://www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-defined
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