

# Is it Time for a Wage and Hour Audit? The Answer is Yes!

*Prepared for the Illinois Chamber of Commerce*

May 5, 2020

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# FLSA Enforcement

- **Department of Labor** has the authority to conduct audits recover:
  - Back wages and an equal amount in liquidated damages, going back 3 years.
  - Front pay, where reinstatement not practical
  - Attorney's fees
  - Injunctive relief
    - To restrain violations of law including the unlawful withholding of proper minimum wage and overtime pay
- **Employees** have the authority to recover:
  - Back wages and an equal amount in liquidated damages
  - Front pay where reinstatement not practical
  - Attorney's fees

# FLSA Statute of Limitations

- **Inadvertent violations**
  - 2 years
- **Willful violations**
  - Where the employer **knew or had reckless disregard** for whether its conduct was prohibited by the FLSA
  - 3 years
- Remedies may be recovered through administrative procedures, litigation, and/or criminal prosecution (Department of Justice)

# Illinois Minimum Wage Law Penalties

- Previously, employees who sued to recover wages and overtime pay under the Minimum Wage Law were entitled to recover the amount of any underpayment, **plus a statutory penalty of 2%** of the amount of the underpayment per month that amount goes unpaid.
- The new law more than **doubles the statutory penalty to 5%** per month.
- Even more significantly, the law creates a new provision allowing employees to recover not just the amount of wages owed, **but triple that amount of wages owed**, in addition to the 5% statutory penalty.

# Illinois Minimum Wage Law Penalties

- The amendments also have given authority to the Illinois Department of Labor to conduct **random audits** of employers to ensure compliance with the law.
- The Minimum Wage Law already provided that if an underpayment is found to be **willful, repeated, or reckless**, the employer is liable to the Department of Labor for a **penalty of 20%** of the amount of the underpayment.
- The amendments add an additional penalty of **\$1,500**, payable to the Department of Labor's "Wage Theft Enforcement Fund."

# Potential Areas of Concern

- “Employee” or Independent Contractor
- Exempt or Non-Exempt Under the Fair Labor Standard Act

# Auditing Independent Contractors

- All workers classified as independent contractors should be reviewed carefully as a part of any internal audit.
- Auditors should review any agreements between you and the worker, as well as your working relationship.
- Specific attention should be given to how much control you have over the worker's activities

# If Business and Independent Contractor Agree on the Relationship, Why Is It an Issue?

- Government is watching!!
- When a business uses independent contractors there is a commensurate loss of revenue to a host of government bodies, state and federal or in some instances local. These agencies that depend on a steady source of withholding from employees' salaries to fund programs and enforce laws are stretched thin and are instituting compliance programs to recover lost revenue due to misclassification.
- The Internal Revenue Service launched its National Research Program, which will randomly select and audit 6,000 employers. The IRS is looking at employers' compliance regarding worker classifications and various other "grey" areas.



# If Business and IC Agree on the Relationship, Why Is it an Issue?

- The United States Department of Labor (DOL) says it intends to continue its focus on employee misclassification as part of enforcement and outreach efforts under the federal Fair Labor Standards Act (FLSA). To that end, DOL has stepped up its FLSA enforcement efforts considerably, having hired approximately 250 new investigators.
- In this era of continued unemployment, the Illinois Department of Employment Security (IDES) is reacting harshly to employers who protest unemployment claims on the grounds that terminated workers were "independent contractors." These protests are being rejected, and employers are being subjected to seemingly random audits to assess whether employees have been misclassified as independent contractors.

# Tax and Wage Implications

- Worker classifications may have tax and/or wage implications.
- For employees, a business generally must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages.
- On the other hand, a business generally does not need to withhold or pay any taxes on payments to independent contractors.
- Likewise, employees generally must be paid at least minimum wage, and non-exempt employees must be paid overtime compensation. Minimum wage and overtime requirements, however, do not apply to independent contractors.
- Before determining how to treat payments you make to workers for their services, you must first know the business relationship that exists between you and the individual performing the services.

# How Does a Business Decide Who Is an Employee or an IC?

- There is no single answer to this question. There are no “magic words” or documents to sign that will ensure that someone you classify as an independent contractor will be found to be one by the investigating agency or in a civil court.
- A government body investigating whether your independent contractors should be classified as employees will look at the “totality of circumstances” and will impose various tests in making its decision.
- Courts take the lead from how various government agencies determine proper classification. What applies in a government investigation will help you in a civil case as well.

# IRS View

- The IRS has the power to impose penalties, fines and bring criminal charges and also require full payment for failure to withhold taxes even if the independent contractor has already paid his or her share.
- Should the IRS determine that your contractors are employees, the business can be liable for unpaid taxes, penalties and interest for three years even if the independent contractor paid his or her own taxes in full.
- In determining whether a worker is an employee or an independent contractor, the IRS has developed a “twenty factor” test that takes into account all information that provides evidence of the degree of control or independence.
- There is no magic number of factors that tips the scales regarding whether a worker is an employee or an independent contractor, and no one factor is determinative.
- The key is to look at the relationship as a whole and consider the degree to which you have the right to direct and control the worker.

# IRS View

The facts that provide evidence of control fall into three categories:

- **Behavioral Control:** Does the business control or have the right to control not only what the worker does, but also how the worker does his or her job?
  - Does the employer require the worker to arrive at a certain time and sign in using the company time management system?
  - Does the company require the worker to wear clothing identifying himself/herself as affiliated with the company?
  - Does the company impose any restrictions on outside work?
    - Example: For years, FedEx employed delivery personnel who wore company uniforms, drove FedEx trucks and looked to the public like employees of the company. Despite these indicia of employment, FedEx classified these workers as independent contractors. Ultimately, the Department of Labor overturned this status and FedEx was stuck with back pay and benefits going back two years.

# IRS View

- **Financial control** - Are the business aspects of the worker's job controlled by the company?
  - Is the worker paid by the hour or on a "per job" basis?
  - Does the company reimburse the worker for expenses related to the job?
  - Does the worker provide his own tools or does the company require use of its own?
- **Type of relationship** - Is the worker separately incorporated, insured and holding himself out to the public as a business entity?
  - Evidence can include business cards, yellow pages listings and computer web pages.
  - Does the company include the worker under any of its employee benefits? If so, this is almost conclusive evidence of an employment relationship.

# DOL View

- Since 2011, the US Department of Labor has established the “Misclassification Initiative” to address the issue of improper use of independent contractors and has entered into “Memoranda of Understanding” with related agencies, both state and federal, in order to share enforcement efforts.
- A business audited over its use of independent contractors by DOL may find the results of that investigation forwarded to the IRS or the state unemployment office which will then seek their own remedies against the company.
- In addition to government enforcement, employees may bring civil claims for unpaid overtime, minimum wage and employee benefits.

# DOL View

- To determine whether an individual is an employee, DOL looks to the “Totality of the Circumstances” of the parties’ business relationship as a whole.
- The government will ignore any written agreements between both business and independent contractor that describe the relationship.
- Titles, job descriptions and organization charts are meaningless.
- A written contract in which the independent contractor explicitly waives the right to be treated as an employee and to give up any claim for employee benefits is worthless if the economic circumstances don’t demonstrate independent contractor status.
- An investigating body will generally look to how the employer “controls” the day to day activities of the independent contractor or whether the nature of the service the independent contractor provides is similar to that of the employer.



# DOL View

- The focus is on the following six factors:
  - **The extent to which the worker's services are an integral part of the employer's business;**
  - **The permanency of the relationship;**
  - **The amount of the worker's investment in facilities and equipment**
    - Don't provide equipment, email address, business cards, uniform, etc.
  - **The nature and degree of control by the business**
    - Cannot control schedules or manage work IC's perform
    - Cannot give training or instruction
    - Cannot prohibit IC from working with other companies
    - Don't charge an hourly rate – have fee schedule
    - Don't track hours worked;
  - **The worker's opportunities for profit and loss; and**
  - **The level of skill required in performing the job and the amount of initiative, judgment or foresight in open-market competition with others required for the success of the worker.**

# IDES View

- Under the Illinois Unemployment Insurance Act, an individual who performs work for a business is generally presumed to be an employee. The Act, however, carves out an exemption for services performed by independent contractors. In order to meet the exemption, the worker must satisfy all three prongs of the so-called “ABC Test”:
  - The worker must be free from control or direction over the performance of the services;
  - The services must be either outside the company's usual course of business or performed outside its place of business; and
  - The worker must be engaged in an independently established trade, occupation, profession or business.

# IDES View

- A strict burden of proof is placed upon any business seeking exemption from unemployment contributions under the Act, and all three conditions must be established before an exemption is allowed.
- When interpreting the term “independent contractor” under the Act, the actual relationship of the parties must be considered. Designations and terminology used in any agreements are not controlling, nor are the mechanics of compensation.
- The third prong of the ABC Test is the most difficult to satisfy.
- “Engaged in an independently established trade, occupation or business” is interpreted by IDES to mean that the individual has a proprietary interest in the business that he or she can sell, give away or operate without hindrance from any other party. In other words, the individual truly must be operating his or her own business.

# NLRB View

- NLRB tests is qualitative vs. quantitative.
- The Board does not merely count up the common-law factors that favor independent contractor status to see if they outnumber the factors that favor employee status, but instead it must make a qualitative evaluation of those factors based on the particular factual circumstances of each case. Factors are the following:
  - The extent of control, which by agreement, the master may exercise over the details of the work.
  - Whether or not the one employed is engaged in a distinct occupation or business.
  - The kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision.
  - The skill required in the particular occupation.

# NLRB View

- Whether the employer or the workman supplies the instrumentalities, tools and the place of work for the person doing the work.
- The length of time for which the person is employed.
- The method of payment, whether by the time or by the job.
- Whether or not the work is part of the regular business of the employer.
- Whether or not the parties believe they are creating the relation of master and servant.
- Whether the principal is or is not in business.

# Examples of Independent Contractors and Employees

- A worker who is hired to paint the exterior of a software business office will assuredly be an independent contractor, absent other factors. He provides a service and is engaged in an activity which is different from the core business of the company;
- A worker who writes software code for this same business as a temporary for a week will likely still be considered an independent contractor if the engagement ends after a week. This is particularly true if the person was referred by a temporary staffing agency and was paid as an employee of that agency or the worker has an independent business which is separately insured and incorporated.
- Another code writer who has worked at this software company as a “temporary” for two years, arriving at a scheduled time to receive his assignments will be classified as an employee. The worker’s skill, knowledge and experience are used by the company to further its business purpose and the company controls the person’s activities on a daily basis. This is what happened in *Vizcaino v. Microsoft* and cost MS close to a billion dollars in unpaid salary, withholding and benefits.

# Voluntary Classification Settlement Program (IRS)

- Available for employers that want to voluntarily change the prospective classification of workers from independent contractors or other non-employees to “employees.”
- Eligibility requirements
  - Must have consistently treated the workers as independent contractors or non-employees;
  - Cannot currently be under an employment audit by the IRS or the DOL; and
  - If the employer was previously audited by the IRS or the DOL, the employer must have complied with the prior order

# Voluntary Classification Settlement Program (IRS)

- A taxpayer participating in the VCSP will agree to prospectively treat the class or classes of workers as employees for future tax periods. In exchange, the taxpayer will
  - Pay 10 percent of the employment tax liability that would have been due on compensation paid to the workers for the most recent tax year,
  - Not be liable for any interest and penalties on the amount; and
  - Not be subject to an employment tax audit with respect to the worker classification of the workers being reclassified under the VCSP for prior years.



# Now What?

- **Evaluate the exemption and classification status** of your employees
  - Time and motion observation – **actively observe employees** engaging in their job duties to determine their significance
  - Review self report data
    - Administer **job analysis questionnaires** that ask detailed questions about issues that are hard to observe such as **decision-making authority** and the **purpose of tasks** performed
    - Hold **structured interviews**, which allow for open-ended questions/dialogue
- **Train supervisors to be aware** of common pitfalls and mistakes that lead to violations of the FLSA
- Ensure **sufficient documentation** of employee job duties is maintained

# Auditing Exempt Employee Classifications

- An internal audit of exempt employee classifications should include a careful examination of all exempt employees and their job duties.
- Specifically, the audit should look beyond a job description and analyze what primary tasks and responsibilities exempt employees are actually performing on a day-to-day basis.
  - Time and motion observation – **actively observe employees** engaging in their job duties to determine their significance.
- Each exempt employee should be reviewed carefully to ensure compliance with the FLSA

# Exemptions Overview

- FLSA exempts certain **white-collar** employees from its overtime provisions
  - White-Collar Executive, Administrative, and Professional Employees (EAP Exemptions),
  - Highly Compensated Employees (HCE Exemption)
  - There is a different “duties test” for each of the three types of exempt employees (Executive, Administrative, and Professional)
  - An employee must meet all of the requirements identified in the relevant test to be exempt from the FLSA’s overtime and minimum wage requirements

# White-Collar “EAP” Exemptions – Salary Threshold

- **Exempt salary threshold: \$35,568 (\$684 per week)**
- Employees who **earn equal to or more than the salary threshold** are subject to a “**duties test**” to determine if they are exempt from FLSA requirements
- To be paid on a **salary basis** means that the employee “regularly receives each pay period on a weekly or less frequent basis, a predetermined amount ... which is not subject to reduction because of variations in the quality or quantity of the work performed.”

# White-Collar Exemptions - Executive Employees

- To qualify for the **Executive** Employee Exemption, all of the following requirements must be met:
  - Employee must be compensated on a salary basis at a rate not less than the salary threshold;
  - Employee's primary duty must be **managing** the enterprise, or managing a customarily recognized department or subdivision of the enterprise;
  - Employee must **customarily and regularly direct** the work of at least two or more other **full-time employees** or their equivalent; and
  - 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**

# White-Collar Exemptions

## – Administrative Employees

- To qualify for the **Administrative** Employee Exemption, **all** of the following requirements must be met:
  - Employee must be compensated on a salary basis at a rate not less than the salary threshold;
  - 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
  - This category includes teachers and academic administrative personnel in elementary and secondary schools

# White-Collar Exemptions – Administrative Employees

- **“Directly Related to Management or General Business Operations”**
  - Employee must perform work related to running or servicing of the business, as distinguished, for example from working on a manufacturing production line or selling a product in a retail or service establishment.
  - Work “directly related to management or general business operations” includes but is not limited to, work in functional areas such as tax; finance; accounting; auditing; budgeting; insurance; quality control; purchasing; procurement; advertising; marketing; research; safety and health; personnel management; human resources; employee benefits; labor relations; public relations; government relations; computer network; internet and database administration; legal and regulatory compliance; and similar activities.
  - Employees acting as advisors or consultants to their employer’s clients or customers – as tax experts or financial consultants.

# White-Collar Exemptions – Administrative Employees

- “Discretion and Independent Judgment”
  - Involves the comparison and evaluation of possible courses of conduct and acting or making decision after the various possibilities have been considered.
  - Implies that the employee has the authority to make an independent choice, free from immediate direction or supervision (e.g. implement management policies or operating practices; carries out major assignment in conducting the operation of the business; performs work that affects the business operations to a substantial degree; has authority to commit the employer in matters that have significant financial impact; has the authority to waive or deviate from established policies and procedures without prior approval.
  - The fact that an employee’s decision are revised or reversed after review does not mean that the employee is not exercising discretion or independent judgment.
  - Exercise of discretion and judgment must be more than the use of skill in applying well established techniques, procedures, or specific standards in manuals or other sources.



# White-Collar Exemptions – Administrative Employees

- “Matters of Significance”
  - Refers to the level of importance or consequence of the work performed.
  - An employee does not exercise discretion and independent judgment just because the employer will experience financial losses if the employee fails to perform the job properly.
  - Also does not apply just because the employee operates very expensive equipment.

# White-Collar Exemptions – Professional Employees

- Two Types of **Professional** Employee Exemptions
  - Learned
  - Creative
- To qualify for both types of professional exemptions, the employee must be compensated on a salary basis at a rate not less than the salary threshold.

# White-Collar Exemptions – Professional Employees

- To qualify for the **Learned Professional** Employee Exemption, **all** of the following additional requirements must be met:
  - 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
    - e.g. law, medicine, accounting, engineering, architecture; but not skilled trades.
  - The advanced knowledge must be customarily acquired by a prolonged course of specialized intellectual instruction (e.g. academic degree)
    - Common examples include doctors, lawyers, and accountants

# White-Collar Exemptions – Professional Employees

- To qualify for the **Creative Professional** Employee Exemption, the following additional requirement must be met:
  - 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.
  - E.g. Actors, musicians, composers, journalists may also fall into this category.

# White-Collar Exemptions – Hypothetical

- The **Payroll Specialist** reports to the Human Resources Director. She is in charge of payroll for all employees. She makes decisions about payroll issues, but she does follow written procedures in processing payroll. She can make deviations, but any major deviation must be approved. She is paid a salary (\$50,000/year) because she often works more than 40 hours per week. She performs a vital function for the company, but she wants to be paid overtime.
- Can she be treated as a salary exempt employee?

# White-Collar Exemptions - Answer

- She **likely** can be treated as an **exempt administrative** employee, but the Employer must consider whether she meets **all** the requirements of the duties test
  - ✓ She exceeds the new \$35,568 salary threshold
  - ✓ Her primary duty is to process payroll, which would be considered the performance of office work **directly related to the general business operations** of the District
  - **Key issue:** Does she **exercise discretion and independent judgment** with respect to matters of significance?
    - She makes decisions about payroll issues and can make deviations, but any *major* deviations must be approved – are the decisions within her discretion regarding **matters of significance**?
    - Consider employee's job duties and their importance: Calculating wages, processing taxes and employee benefits, preparing and executing pay orders, responding to questions from employees

# HCE Exemption – New Salary Threshold

- **Salary threshold: \$107,432 per year**
  - Approximately the 90<sup>th</sup> percentile of the earnings distribution of full-time, non-hourly workers in the entire United States
  - Employees who **earn equal to or more than the salary threshold** are subject to a “**minimal duties**” test to determine if they are exempt from FLSA requirements
    - An employee who customarily and regularly performs just one of the duties of an exempt executive, administrative, or professional employee is considered exempt
      - Fairly easy to meet the “minimal duties” test once an employee meets the HCE salary threshold

# Questions?



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# THANK YOU

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