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North Carolina Confronts Misclassification: What Your Organization Needs to Know About the Employee Fair Classification Act

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Starting December 31, 2017, the North Carolina Industrial Commission will have a permanent Employee Classification Section responsible for taking complaints about and facilitating the sharing of information among state and federal agencies regarding the misclassification of employees as independent contractors. The recently enacted Employee Fair Classification Act (EFCA) codifies provisions of an executive order signed in 2015 and, for the first time, requires employers to report their compliance in properly classifying employees with state occupational licensing boards and commissions.

Background

In 2015, following a series of newspaper articles focusing on the misuse of independent contractors in certain industries, efforts to curb the practice began within North Carolina's state government. Because entities do not pay state or federal payroll taxes or unemployment taxes or provide worker's compensation insurance for independent contractors as they are required to do for employees, the articles reported that the misclassification of employees as independent contractors had deprived the state and federal governments of significant tax revenue and allowed individuals and entities engaged in employee misclassification to unfairly undercut their competitors. This prompted both legislative and executive-level reform efforts.

Although legislation to address this issue ultimately did not pass at the time, in December 2015, North Carolina Governor Pat McCrory signed Executive Order No. 83, which established the Employee Classification Section in the Industrial Commission which continues to operate. The Section is responsible for sharing instances of employee misclassification among the North Carolina Industrial Commission, the North Carolina Department of Revenue, the North Carolina Department of Labor, and the Division of Employment Security in the North Carolina Department of Commerce. All of these agencies are charged with overseeing employee classification with respect to the state laws they enforce, can penalize employers for misclassifying employees as independent contractors, and have independent investigatory and penalty powers.

Before the Employee Classification Section was created, there was no formal mechanism for sharing information among these agencies and a complaint to or finding of misclassification by one agency was unlikely to result in an investigation or penalty by another agency. Executive Order No. 83 created a designated liaison within each agency responsible for reporting allegations of employee misclassification to the director of the Employee Classification Section. These agencies have shared information regarding alleged employee misclassifications pursuant to Executive Order No. 83 since it was signed, increasing the likelihood that employers found to have misclassified employees as independent contractors will face liability on multiple fronts.

Requirements of the Employee Fair Classification Act

Enacted by the North Carolina General Assembly in August of 2017, the EFCA permanently establishes the Employee Classification Section within the Industrial Commission and the information-sharing practices created in Executive Order No. 83. In addition to continuing to take complaints regarding employee misclassification from the public, as of December 31, 2017, the Section will be required by statute to "provide all relevant information pertaining to each instance of reported employee misclassification" to the following agencies: the North Carolina Department of Labor, the Division of Employment Security within the Department of Commerce, the North Carolina Department of Revenue, and the North Carolina Industrial Commission. The Section also shares information with the U.S. Department of Labor pursuant to an agreement which will be permitted to continue under the EFCA. The Section may also "share information with other State and federal agencies as permitted or required by law."

The Section is also required to create a "publicly available notice that includes the definition of employee misclassification" which is defined by the EFCA as "avoiding tax liabilities and other obligations imposed by Chapter 95, 96, 97, 105, or 143 of the General Statutes by misclassifying an employee as an independent contractor." The provisions of the General Statutes incorporated into the definition of "employee misclassification" relate to the following subjects: state wage and hour laws (Chapter 95); unemployment benefits (Chapter 96); workers' compensation benefits (Chapter 97); revenue and taxes (Chapter 105); and occupational licensing (Chapter 143).

The EFCA defines the key term "employee" by incorporating definitions from the above-listed provisions of the General Statutes. As a result, unlike previous versions of this legislation that were considered by the legislature in 2015 and 2016, the EFCA provides no single definition or test for who is an "employee" and who is not. This means that an individual or entity that has been found to have misclassified an employee as an independent contractor under any of the above provisions of North Carolina law has engaged in "employee misclassification" under the EFCA if the individual or entity avoided "tax liabilities and other obligations" as a result of the misclassification.

Although the EFCA levies no additional penalties and creates no cause of action against an individual or entity that engaged in employee misclassification not already found in North Carolina, the EFCA nevertheless links employee misclassification with occupational licensing. Starting December 31, 2017, the EFCA will require every state occupational licensing board or commission to include "on every application for licensure, permit, or certification, or application for renewal of the same" (1) a certification that the applicant for the license "has read and understands the public notice statement" defining "employee misclassification" and (2) a "[d]isclosure 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 or commission."

While the EFCA does not require an occupational licensing board to deny a license or otherwise

penalize an employer that is found to have engaged in employee misclassification, it does require the denial of a license to “any applicant who fails to comply with the certification and disclosure requirements” in the EFCA. It also contains no restrictions on the ability of occupational licensing boards and commissions to deny licenses because of incidents of misclassification.

Finally, starting December 31, 2017, the EFCA will require all employers to display an additional poster in “every establishment” they operate stating the following in “plain language”: (1) that workers defined as “employees” under the EFCA be treated as employees; (2) that any employee who believes that he or she has been misclassified as an independent contractor may report the suspected misclassification to the Employee Classification Section; and (3) the contact information for the Employee Classification Section where suspected misclassification may be reported.

Action Steps for Employers

As a result of the EFCA, employers can expect a continued focus on employee misclassification issues by the North Carolina Department of Labor, the North Carolina Department of Commerce’s Division of Employment Security, the North Carolina Department of Revenue, the North Carolina Industrial Commission, and the U.S. Department of Labor since the Employee Classification Section and its information-sharing efforts among these agencies are now codified in state law.

Each agency investigation may result in cumulative fines, interest, and penalties for unpaid taxes, wages, and the failure to carry workers’ compensation insurance. Some state agencies, such as the North Carolina Department of Revenue and the Division of Employment Security, may seek to recover back taxes for each misclassified worker for up to five years before the date a misclassification determination is made. In other instances, state and federal wage and hour laws allow misclassified employees to file private lawsuits to recover up to double the amount of any unpaid overtime or lost wages that result from misclassification along with their attorneys’ fees.

After the poster requirement takes effect on December 31, 2017, employees will have readily accessible information about what employee misclassification is and where to report potential misclassification issues. As a result, employers should now consider reviewing any individual in their organization who is classified as an independent contractor to determine whether the person is properly classified. This is particularly true for employers that are subject to occupational licensing requirements.

One of the easiest ways to identify these individuals is to obtain a list of people who are issued IRS Form 1099 to reflect the compensation they receive from the organization. Many of the state agencies that fall under the EFCA’s information-sharing requirements initially identify potentially misclassified employees by reviewing the names of individuals whose compensation is reflected on an IRS Form 1099.

Although each state and federal agency responsible for investigating potential employee misclassification will apply its own unique test to determine whether an individual is an employee or independent contractor, the following factors are generally considered across all agencies:

- What is the nature of the work or activities being performed by the worker? Is it more consistent with work that would be performed by an employee (e.g., assembling products sold by the organization during the workday) or and independent contractor (e.g., providing a cleaning service after hours)?

- Does the organization provide direction on how to complete specific work tasks or is the individual free to choose his or her own method of performing these tasks? The less autonomy an individual has in adopting one method of doing the work over another and selecting the time when the work can be performed, the more likely the individual is an employee rather than an independent contractor.

- Is the individual free to use assistants or others to perform assigned tasks and does he or she have full control over such assistants? Can he or she hire and fire them without approval? If yes, this factor points to an independent contractor relationship.

- Whether the organization provides equipment for workers to use when completing assignments and tasks is another factor. Independent contractors should generally supply all their own tools and equipment for use when performing their work, while employees almost always use tools and equipment provided by their employer.

- What kind of documentation is there between the individual and the organization pertaining to the tasks or services the individual is performing? If there is an employment contract in place containing non-compete provisions or other restrictive covenants, this points to an employment relationship. On the other hand, an independent contractor agreement that permits the individual to perform the same work for other organizations points to an independent contractor relationship.

When making a determination about whether an employee has been misclassified, most state and federal agencies consider no individual factor to be controlling and instead look at the entirety of the relationship. Ultimately, if there is a close question about which side of the line an individual falls on, classifying the individual as an employee rather than as an independent contractor will result in no penalties, back taxes, back pay, or interest. Erring in the other direction, however, may expose the organization, and sometimes individual decision-makers within it, to significant liability.

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