

LEGAL ADVISOR



A PilieroMazza Update for Federal Contractors and Commercial Businesses

How Many People Do We Employ? Critical Employment Law Considerations for Small Businesses

By Cy Alba and Nichole Atallah



You might be surprised to learn that it is not always easy to determine who a company employs, exposing any business, and particularly small businesses, to great

risk. Not only do businesses have to be aware of the risk of classifying a worker incorrectly as an employee or independent contractor for tax and labor law purposes, but contractors need to pay special attention to these definitions to ensure compliance with limitations on subcontracting, to stay within NAICS code limitations, and to avoid joint employer liability.

In the past year, our practice has seen a significant rise in the number of federal investigations that center on these questions, highlighting how confusing this topic can be for both businesses and government agencies. In this article we explain how different agencies define employment and why carefully structuring your workforce is critical in the event of a federal investigation.

Employee Defined

The definition of “employee” changes depending on the law, regulation, or court holding. Additionally, agencies like the Internal Revenue Service (IRS) and the Department of Labor (DOL) have moved away from tests that give employers specific direction and toward balancing tests centered on several different factors. The SBA takes a totality of the circumstances approach

to determining whether a worker is employed by the small business, taking IRS and DOL factors into account.

	IRS	DOL	SBA
Test	Behavioral and Financial Control plus Relationship	Economic Control	Totality of the Circumstances

Should a business be subject to a federal investigation, each of these agencies may even look at the rule imposed in a slightly different way or not fully comprehend the issues. And this makes sense because we are asking SBA or the Department of Justice (DOJ) to interpret complex rules imposed by largely by the IRS and DOL. In fact, IRS and DOL audits often reveal disagreement internally and between agencies. All of the confusion surrounding who a business employs is unsettling when so much is at stake.

Impact on Small Businesses

The decision to use independent contractors or employees depends on a variety of factors. Sometimes workers demand to be classified as independent contractors or employers seek to reduce cost or risk to the company. Small business federal contractors additionally need to consider the impact the number of employees may have on their size or performance of work requirements. Regardless of the reasons, it is important to understand that the law favors employees over independent contractors. Thus, when a business decides to use independent contractors or to lease employees from another entity, the business needs to have sufficient justification for its actions.

Continued on page 2



To make matters worse, SBA generally starts from whatever position is least advantageous to the contractor. If a business hires an independent contractor to reduce the firm's number of employees to stay under an employee-based NAICS code, SBA may presume the contractor is avoiding the rules and will count that person as your employee (thus making you a large business). If the firm is trying to classify the worker as an employee that counts toward performance of work requirements, SBA takes the opposite approach and tries to exclude the employee from your employee count. Likewise, some contractors lease employees from one business to another to meet performance of work requirements. In our experience, DOJ and SBA often presume that the leasing arrangement is a way to get around the rules. While there is generally no nefarious purpose behind the arrangement, it can lead to serious compliance issues, or, at least, lengthy and costly investigations. This is precisely what small business government contractors find so confusing and frustrating.

Unfortunately, sometimes a contractor gets it wrong. All types of businesses are using independent contractors, which makes the choice tempting. Moreover, there is a prevalent misunderstanding in the small business community that independent contractors do not automatically count as employees for performance of work purposes. But SBA will treat the worker as a subcontractor, not as an employee, leading to a violation of the performance of work rules. Therefore, it is important to evaluate whether classifying such workers as independent contractors or entering into a leasing arrangement will actually help you achieve your goals.

Strategic Considerations

In the event of an investigation, your business must be prepared to demonstrate confidence in your classification decisions and employee count by vetting these decisions carefully in advance of placement. Here are some tips to help guide this process:

1 You cannot contract your way out of these legal obligations. In the event of a compliance audit, an employee leasing agreement or independent contractor agreement alone is not

sufficient to demonstrate compliance. Each agency will look at the working relationship alongside the contractual arrangement.

2 Carefully review the SBA's 11 factor test to determine who should be considered an employee of the small business. Critical among these factors is whether the small business engages and selects the employees, has the power to dismiss the employee and to control and supervise employee performance. Again, keep in mind that the company undergoing scrutiny will bear the burden of showing the personnel should be treated as employees.

3 For performance of work requirements, a leased worker needs to work and function much like an employee. However, the more the worker functions like an employee, the more likely it is that DOL and IRS will also treat them as employees subjecting you to potential liability. This delicate balancing act is extremely difficult to achieve and should be carefully vetted with counsel.

4 Use the SBA's new "similarly situated rule" to meet performance of work requirements. Since 2013, small businesses can rely upon "similarly situated" subcontractors to meet performance of work rules. If the independent contractor is a small business, you may be able to count that independent contractor's work toward meeting your performance of work requirements on the prime contract. However, when you are performing as an 8(a), HUBZone, SDVOSB, or WOSB, the independent contractor will also have to be in the same certified classification for it to be considered "similarly situated."

5 Do not forget about IRS and DOL regulations governing the use of independent contractors. Businesses cannot lose sight of the impact that violations of these laws could have, even if having independent contractors will help them on other fronts. However, you can overcome these challenges if you have the flexibility to change the amount of control your business has over work product, direction, and financial success of the worker.

Continued on page 3

The Legal Advisor is a periodic newsletter designed to inform clients and other interested persons about recent developments and issues relevant to federal contractors and commercial businesses. Nothing in the Legal Advisor constitutes legal advice, which can only be obtained as a result of personal consultation with an attorney. The information published here is believed to be accurate at the time of publication but is subject to change and does not purport to be a complete statement of all relevant issues.

6 When leasing employees from another contractor, you may be considered a joint employer who is liable for wage and hour violations and even discrimination claims. While the leasing agreement may not protect you from the investigating agency, consult with counsel to ensure that the agreement protects you if the other company is negligent or violates the law.

7 Keep good records of your rationale in making these critical decisions to demonstrate a good faith effort to comply with all applicable regulations.

Thinking ahead about these issues will put you in an advantageous position should you be subject to an audit. Should investigators show up, regardless from which agency, demonstrating your knowledge of the issues and your efforts to comply will go a long way to resolving the issue as expeditiously as possible.

About the Authors: Cy Alba is a partner with PilieroMazza and is a member of the government contracts and small business programs groups. He may be reached at ialba@pilieromazza.com. Nichole Atallah is a partner and heads the labor & employment law group. She may be reached at natallah@pilieromazza.com.