

MCLE

Determining the True Status of Independent Contractors

Determining the true status of someone labeled as "independent contractor" is a complex inquiry, and a lot of money often rides on the result.

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Sharing is good, something we teach our kids. The sharing economy (also known in the common parlance as the "gig economy") has changed or invented industries—think Uber, Lyft, etc.—but the legal and tax issues surrounding worker status have not caught up. For that matter, long before the sharing economy, there were increasing controversies over worker status, and we can't blame that on sharing. Much of the law about worker status is decades and even centuries old, and present day controversies over these issues continue to arise. See, e.g., *O'Connor v. Uber Techs., Inc.*, 82 F.Supp.3d 1133 (N.D.Cal. 2015); *Cotter v. Lyft, Inc.*, 193 F.Supp.3d 1030 (N.D. Cal. 2016).

So, sharing economy or not, how does one go about analyzing the status of a worker or group of workers? Who does it, and what are the standards? Can it be covered entirely by a private contract? And does inserting the label "independent contractor" into a written agreement (and/or on a person's name badge) resolve the question, or can government agencies, third parties, and judges say differently?

HIGH STAKES

These questions are not inconsequential. They can involve great potential liability. The stakes can be high, and they can impact nearly all types of work settings.

You might need a refresher on the rules and stakes if you or your clients are: a company with contracted delivery workers, medical professionals, spa, hotel, or retail workers; companies with salespeople under contract who work strictly on commission; remote tech workers who do everything online; or even a law firm with independent contractor of counsel or associate lawyers.

In fact, the list is virtually endless, and these days one can add vast numbers of sharing economy apps or platforms, too. There are differences in settings, and vast differences between the forms of agreement that are typically used in these myriad contexts. But the basic approach the government and the courts use to analyzing them is similar.

Will independent contractor treatment stick, and who can attack it? Most importantly, what can and should parties do to put themselves in the best positions they can? We all know that employees receive paychecks, with tax withholding sent to the Internal Revenue Service, the state, even Social Security.

WHY IT MATTERS

In contrast to employees, self-employed workers get gross pay with no withholding. They take care of their own taxes, and they bear their own risk of profit and loss.

And know this: the decision whether to hire employees or independent contractors is not only a tax decision. It involves labor and employment law, ERISA and employee benefit laws, worker's compensation and unemployment insurance law. The list goes on.

In fact, it is hard to think of a more consequential business decision. Yet the question whether to hire someone in one capacity or the other may get virtually no attention. That can be a huge problem causing staggering tax and other liabilities down the road. It is not a one-time problem either.

Businesses can avoid major landmines by considering these topics from time to time. A worker's role may morph into something quite different from what it was at the inception of the relationship. That can impact the status of the worker as an independent contractor or employee. So

where do you start?

BRIGHT LINE RULE?

Independent contractors are classically one-time workers, doing a job for a fixed price, generally for multiple companies. You cannot control them with detailed direction, and they bring no tort, contract, or tax liabilities to the employer. That may make the dichotomy between employee and contractor seem obvious, causing no controversy.

Yet, it is often difficult to say in which category a worker or class of workers belongs, or how much you can shape the facts and the documents. Plainly, companies have incentives to deal with independent contractors rather than employees. The taxes, administrative burdens, and federal and state employment law liabilities for employees are much greater than for independent contractors.

As a result, there is a natural tendency for businesses to treat workers as independent contractors. Much of the lawyer or regulator's task, therefore, is in assessing what is legitimate and what is not. Taxes are the best-known consequence of the employee-contractor distinction, but hardly the only one.

There are wage and hour, non-discrimination laws, workers' compensation implications, labor law, pension and employee benefit considerations, and a host of other issues that can hinge on this pivotal employee versus contractor divide. It is no wonder that there are disputes over these fundamental characterization questions. Such matters come up in multiple contexts, including:

- Audits from federal or state taxing agencies;
- Third party lawsuits (in tort or contract) where the worker's actions (and liabilities) are sought to be attributed to the 'employer';
- Actions from labor and employment organizations seeking to enforce worker protection measures provided to employees but not to independent contractors;
- Audits from pension authorities seeking to determine compliance with nondiscrimination, coverage, and other rules governing pension and employee benefits; and
- Lawsuits from the 'independent contractors' themselves, claiming that despite their contracts, they are employees.

DOMINO EFFECT

Worker status controversies often arise in civil litigation between private parties. For example, if a delivery driver is your employee when he hits a pedestrian, the employee is the company's agent, so the company must pay. If the driver is a true independent contractor, the tort liability may be his, not the company's, depending on a variety of factors. See generally, *Vargas v. FMI*, 233 Cal.App.4th 638 (2015); *Privette v. Superior Court*, 5 Cal.4th 689 (1993); *SeaBright Ins. Co. v. US Airways, Inc.*, 52 Cal.4th 590 (2011).

Sometimes, the workers *themselves* sue for reclassification, seeking employee benefits, nondiscrimination, wage and hour protections, etc. A written contract may not be respected by the courts, even if the worker signed it. Besides, even if the contract itself is good, the courts (and government agencies) inquire into many facts and circumstances beyond the contract.

Moreover, one dispute often leads to another. For example, take *Vizcaino v. Microsoft*, 97 F.3d 1187 (9th Cir. 1996), *reh'g en banc granted*, 105 F.3d 1334 (9th Cir. 1997), *cert. denied*, 522 U.S. 1098 (1998). There, freelance programmers sued Microsoft claiming they were employees entitled to stock-options. Their contracts were clear that they were not eligible.

However, the IRS had ruled that some programmers were actually employees. The programmers found out about that audit, and approached Microsoft for a deal. When the company said no, they went to court. The district court agreed with Microsoft that the contracts were clear, and the programmers lost.

The Ninth Circuit reversed, holding that the programmers were eligible to receive benefits. The case shows that contracts can be ignored, and that one reclassification may have a domino effect. Worker status disputes can be protracted and expensive, and none of them is unimportant. In considering whether to contest a small worker status issue (perhaps a simple unemployment or workers' compensation claim), companies should consider whether there may be a domino effect.

THREE MAIN TESTS—CONTROL IS KEY

Which legal test to apply for contractor vs. employee status depends on the kind of legal dispute involved. The IRS uses one test, federal labor, employment, and ERISA law uses another, and California agencies and courts use another still. Although they are not identical, they often seem to come out with the same result.

Their most common underpinning evaluates the company's right to control the worker. If the employer has the right to control and direct the individual's work, not only as to the desired result, but also as to the method, manner and means by which that result is achieved, the worker is probably an employee. If the legal *right* exists, it may not matter that the company never *exercises* it.

Although control is important, legal requirements that apply to a particular industry are usually not attributed to the employer. For example, suppose that a company requires its truck drivers to rest at prescribed intervals. If this is required by law, such controls do not count against the employer.

CALIFORNIA RULE

In California, there are eight factors as enunciated by the State Supreme Court in *S.G. Borello & Sons, Inc. v. Department of Industrial Relations*, 48 Cal. 3d 341 (1989):

- Whether the one performing services 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 principal or by a specialist without supervision;
- The skill required in the particular occupation;
- Whether the principal or the worker supplies the instrumentalities, tools, and the place of work for the person doing the work;
- The length of time for which the services are to be performed;
- The method of payment, whether by the time or by the job;
- whether or not the work is a part of the regular business of the principal; and
- Whether or not the parties believe they are creating the relationship of employer-employee.

See *Borello*, supra, 48 Cal. 3d at p. 351.

In *Borello*, the court also discounted the contract as a kind of adhesion contract with unsophisticated farmworkers.

FEDERAL TEST

Federal labor and employment law uses a multi-factorial “economic realities” test (see *Spirides v. Reinhardt*, 613 F.2d 826, 831 (D.C. Cir. 1979)). The factors include:

- (a) Is the work performed an integral part of the employer’s business? If integral, then indicative of employee status.
- (b) Does the worker’s managerial skill affect the worker’s opportunity for profit or loss? If a worker exercises managerial skill that affects his profit and loss, then indicative of an independent contractor.
- (c) How does the worker’s relative investment compare to the employer’s investment? If the worker’s investment is relatively minor (e.g., supplies), that suggests that the worker and the employer are not on similar footings and that the worker may be economically dependent on the employer and thus an employee.
- (d) Does the work performed require special skill and initiative? A worker’s business skills, judgment, and initiative, not her technical skills, will aid in determining whether the worker is economically independent.
- (e) Is the relationship permanent or indefinite? Permanence or indefiniteness are indicative of an employee as compared to an independent contractor, who typically works one project for an employer and does not necessarily work continuously or repeatedly for an employer.
- (f) What is the nature and degree of the employer’s control? An independent contractor must control meaningful aspects of the work performed such that it is possible to view the worker as a person conducting her own business.

IRS ANALYSIS

In many ways, the test used by the Internal Revenue Service may well be the most helpful, since it seems to look at just about everything. It uses 20 separate factors, though the IRS does not describe how to weigh them, or if any particular number will spell safety or trouble. Here are the components of the IRS standard:

1. **Instructions.** The more instructions that are given, the more likely is employee status.
2. **Training.** The more training, the more likely is employee status.
3. **Integration.** The more closely integrated the work is with the employer’s business, the more likely is employee status.
4. **Services rendered personally.** If the worker must personally do the work, employee status is likely.
5. **Hiring, supervising, and paying assistants.** A person who does these things will often be an independent contractor.
6. **Continuing relationship.** The longer the arrangement’s term, the more likely is employment status.
7. **Set hours of work.** Set hours indicate employment status.
8. **Full-time required.** Working full-time indicates employment status.
9. **Doing work on employer’s premises.** Working on the employer’s premise may suggest employment status.
0. **Order or sequence set.** Performing services in a particular order or sequence set suggests employment status.
1. **Oral or written reports.** Reports to an employer tend to suggest employment status.
2. **Payment by hour, week, or month.** Payment by the hour, week, or month suggests employment status.
3. **Payment of business and traveling expenses.** Payment of business and traveling expenses suggests employment status.
4. **Furnishing of tools and materials.** Furnishing significant tools, materials, and other equipment suggests employment status.
5. **Significant investment.** A worker’s significant investment tends to indicate independent contractor status.
6. **Realization of profit or loss.** A worker’s potential to realize a profit or suffer a loss suggests independent contractor status.
7. **Working for more than one firm at a time.** Working for more than one firm at the same time suggests independent contractor status.

8. **Making service available to the general public.** Making services available to the general public on a regular and consistent basis suggests independent contractor status.

9. **Right to discharge.** The right to discharge a worker suggests employment status.

10. **Right to terminate.** A worker's right to terminate the relationship without incurring a liability suggests employment status.

If you find these lists and the various tests overwhelming, here are some practical suggestions to get you started.

HAVE A WRITTEN CONTRACT

You might be surprised at how many businesses have regular and long-term workers, paid year after year as independent contractors, without a written contract. Failing to have a written agreement is a recipe for disaster. The taxing, labor and employment and insurance authorities *expect* you to have a written contract, stating that the worker is an independent contractor and will be paid as such with no tax withholding or other benefits provided.

Plainly, a contract alone does not mean the worker is *really* an independent contractor. But if you don't have a written contract, you are likely to lose, and have misunderstandings with the workers themselves. Beware of other documents too. A good contract may be unconvincing if the company manual contradicts it!

TREAT SIMILAR WORKERS SIMILARLY

It is okay for a business to have some employees and some independent contractors. But it is not okay to have one worker selling on an independent contractor basis and another similarly situated worker doing the same thing as an employee. The risk of treating people differently is that the people you are *trying* to treat as independent contractors may be reclassified as employees.

In effect, you set yourself up for that by having the two differently classified workers for ready comparison by the IRS, state tax authorities, labor or employment agency, or other authority. Or by plaintiffs' lawyers. You need to make significant distinctions between them.

TOOLS AND SUPPLIES

One of the hallmarks of independent contractors is that they supply their own tools, equipment and supplies. As with just about everything else in the independent contractor vs. true employee characterization realm, this is not dispositive. However,

independent contractors are classically independent business people or professionals. They bring their own tools to the workplace and bear the prospect of gain, and the risk of loss, from their efforts as a independent business.

It makes sense that a true independent contractor would bring his/her own ladder, shovel or paint brush. But in this age of technology, it is not easy to determine exactly what will be regarded as tools, supplies and equipment. Does an independent contractor supply his/her own computer? Internet connection? Software?. The safest bet may be not to provide anything, although that can be impractical.

REIMBURSED EXPENSES

Another red flag is reimbursing workers for business expenses. If they work late, do you pay for their dinner or a taxi? If they need special materials, do you provide it or reimburse them? There is no bright line saying you can't cover the expenses of an independent contractor, but doing so can suggest the worker is an employee.

Classically, all such items are supposed to be factored into the price you are paying the independent contractor for a finished product. As a result, reimbursements and reimbursement policies are likely to be reviewed if you get into a worker classification dispute.

HOW IS THE PERSON PAID?

How you pay someone is about as fundamental a work variable as you can get. Classically, you pay a contractor for a *job*, like putting a pool in your backyard, repairing your computer system, or putting in a break room at your office. In contrast, you classically pay employees by the hour or by the week.

Yet there is no rule saying that you can't pay an independent contractor by the hour. That is how most lawyers, plumbers, and many others bill. But when you have alternatives, paying by the hour can be unwise. Some payment arrangements can be independent contractor-like in scope, but still address any tools and expense reimbursements as part of the payment formula.

SEPARATE TREATMENT MAY HELP

The fact that you *call* someone an independent contractor does not make it so. Is there an "employee file," "employee manual," or "employee lounge?" The fact that you pay a worker based on a time card and then issue a check and paystub does not make him an employee.

But all these things add up. Consider if independent contractors should turn in an "invoice" not a time card. Consider whether independent contractor discipline should be handled in exactly the same way as employee discipline.

SUPERVISION

With an independent contractor, you are paying for a product or result. With an employee, you are paying a person to do what you ask. With employees, you control not only the nature of the work, but the method, manner, and means by which they do it. This control factor is an overarching point.

It is also the most over-arching way in which you can end up in trouble with workers you *believe* are independent contractors, but who might be ruled otherwise. How much do you check in with workers, monitor what they are doing, or make ‘suggestions’? How frequently must they check in with you and report how and what they are doing?

The mere fact that an independent contractor must provide a weekly progress report on how the installation of the new laundry room in your house is going does not mean the builder is an employee. But if the report involves constant tweaking and redirecting of the effort in a more long-term work setting, it might be otherwise.

Note that the important inquiry is not merely whether you are *exercising* control over the method, manner and means by which the worker is doing the job. It can even be fatal if you have the *legal right* to do this even if you don’t *exercise* it. For that reason, be careful what your contract and other documents say about reports, supervision and the like.

HOURS

One of the classic signs of employee status is a time clock or 9 to 5 office hours. In contrast, with independent contractors, you should normally pay for the result, not exactly when or how they do it. That does not mean you can’t have some control over the hours an independent contractor works.

For example, the fact that you tell your building contractor he can’t work on your kitchen remodel past 7 pm does not make him an employee. Nevertheless, it is surprising how many businesses don’t even consider which workers need to be on a set schedule, and which workers do not. Consider whether you can allow workers to complete work on their own schedules as long as they meet applicable deadlines. That can help show they are independent contractors. Conversely, it can be telling if you dictate a 9 to 5 and full-time schedule.

COMPETITION

Many businesses using independent contractors require full-time work, prohibit competition, or do both. Neither point is likely by itself to be dispositive of an independent contractor versus employee characterization battle. However, both of these points are inconsistent with independent contractor treatment.

For that reason, it pays to consider whether you need such rules, and why. Optimally, if you are paying for a particular result—such as selling a minimum dollar volume of goods each month—you should stick to that target. Don’t focus on how long the worker may take to do it or where else they may work during the same period.

Those details are arguably irrelevant. Since requiring full-time work and/or no competition will be viewed as more employee-like in nature, consider whether it is a good idea to dictate these terms. Always bear in mind the paradigm case: an independent contractor—like a lawyer or plumber—ideally serves many clients or customers.

If you are worried about the worker giving away your business methods or intellectual property to a competitor, make those concerns explicit. Focus on prohibiting the worker from disclosing your property. That may accomplish your major goal, and may be cosmetically much more pleasing.

THE IMPORTANCE OF ONGOING EVALUATION

Sometimes, cutting corners ends up costing you way more money in the long run than if you had done it right in the first place. So, evaluating worker status can save you money. There are often multiple ways to get to a desirable result. And you can also consider employee status.

For example, you can try independent contractor status for short-term workers and those you are trying to evaluate. That can help streamline your health plans, payroll processing, employment tax returns, even worker’s compensation and unemployment insurance rolls.

Above all, evaluate what you are trying to do, what is realistic to expect, and whether you or your clients are being reasonable. It should not be a static or one-time process. Evaluate workers, their status, duties, and treatment periodically. The more frequently you do it, the less likely you are to have major problems to address.

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