Defining Employees and Independent Contractors

Don't Try This at Home!

By Robert W. Wood

If you hire employees, you must pay their wages, withhold taxes, give them employee benefits, be liable for any acts of negligence they may commit during their employment, and face the scrutiny of state and federal law when it comes to nondiscrimination, discipline, and termination. Independent contractors, on the other hand, are classically one-time workers who do a job for a fixed price and who generally work for multiple companies. Axiomatically, you can't control independent contractors with detailed direction, and they bring no tort, contract, or tax liabilities to the employer's doorstep.

This may make the dichotomy between employee and independent contractor seem obvious; one that could cause no controversy. In fact, however, there are many instances where the line is blurred, making the spectrum of workers far more homogeneous than you might suspect. It is often difficult to determine into which category a particular worker or class of workers falls.

Incentives for treating workers as independent contractors instead of employees have led to an epidemic of mischaracterized independent contractors who do not necessarily function the way they are supposed to. This mischaracterization produces controversy about what role independent contractors can play. That can undermine real independent contractor relationships, for it is clear that everyone need not be an employee.

Sheep from Goats?

The classification of workers can be difficult and consequential. The laws are vague and serve different purposes. They are enforced by different agencies, including the IRS, state unemployment and workers' compensation agencies, insurance companies, and the courts. These parties use different criteria, have different reasons for making decisions, and reach different decisions regarding the same working relationship. The controlling standard for most purposes, however, is the common law right-to-control standard.

Yet, given the problems of defining control and the right to exercise it, different approaches have evolved. For example, in *United States v. Silk*, 331 U.S. 704 (1947), the Supreme Court ruled that coal unloaders were employees, even though they provided some of their own tools and did not work on a regular basis. The Court suggested criteria for determining if employees are integral to the employer's work, including investments the workers make in the business, and whether they stand to gain or lose from their efforts. These new criteria became part of what is known as the "economic reality" test.

Congress became concerned that this economic reality definition could bring all workers under the coverage of the Social Security Act. Even in those early years, there was fear such über-coverage would bankrupt Social Security. Therefore, in the 1948 Gearhart Resolution, Congress expressed a preference for the narrower common law definition.

The courts have long been divided on how to interpret these issues. Even today, there is no single test for determining whether a person is an employee or independent contractor. The IRS and a variety of state and federal agencies make determinations, and consistency is not always possible. A person may be classified as an employee for one purpose, and as a contractor for another.

For example, for purposes of state unemployment tax, less than half of the states use the common law criteria for evaluating whether a worker is an independent contractor or employee. The common law definition focuses on the

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employer's right to direct the means of production. The remaining states use the so-called ABC test, which is broad and includes most workers. The ABC test's three factors are (1) the worker is free from control or direction in the performance of the work; (2) the work is done outside the usual course of the firm's business and is done off the premises of the business; and (3) the worker is customarily engaged in an independent trade, occupation, profession, or business. Unless the worker meets one of the three factors, the worker is considered an employee.

Twenty-two states use the full ABC test, and 10 states use two of the three factors. Eighteen states and the District of Columbia use the common law criteria. Because the ABC test is more inclusive than the common law factors, workers can be considered employees for state unemployment purposes, but independent contractors for federal tax purposes.

The IRS has its own test for determining worker status. The IRS uses a 20-factor test. The factors include training and instructions given a worker, use of assistants, continuing relationship, set hours of work and on a full-time basis, where the work takes place, method of compensation for work performed and reimbursement of expenses, exclusivity of the working relationship, and the right to discharge and terminate the relationship. Other important factors are whether the worker is provided with tools and materials, makes a significant investment, and has a potential to realize a profit or suffer a loss.

Why It's Important

Worker status determinations are consequential decisions. They determine eligibility for federal unemployment, state workers' compensation, and some pension and fringe benefit plans. A worker must be classified as an employee to be eligible to sue under the Fair Labor Standards Act, Title VII of the Civil Rights Act, the Age Discrimination in Employment Act, the National Labor Relations Act, and others.

The true relationship and the true practice between the worker and the company will control the worker status question. Mere words in a contract are generally not determinative, as worker status determinations must generally take into account the totality of the situation. Many companies have written contracts purporting to establish independent contractor relationships, only to find that their actual practice involves many actions (and many controls over the worker) that fly in the face of the contract language. To characterize the relationship one must look beyond the language of the contract.

Moreover, some courts have discounted written contracts when the facts suggest they were "adhesion" contracts signed by unsophisticated workers with no bargaining power. Although the language of the contract is relevant, so is the pattern of practice between worker and employer. The courts will generally analyze all the facts and circumstances surrounding the relationship.

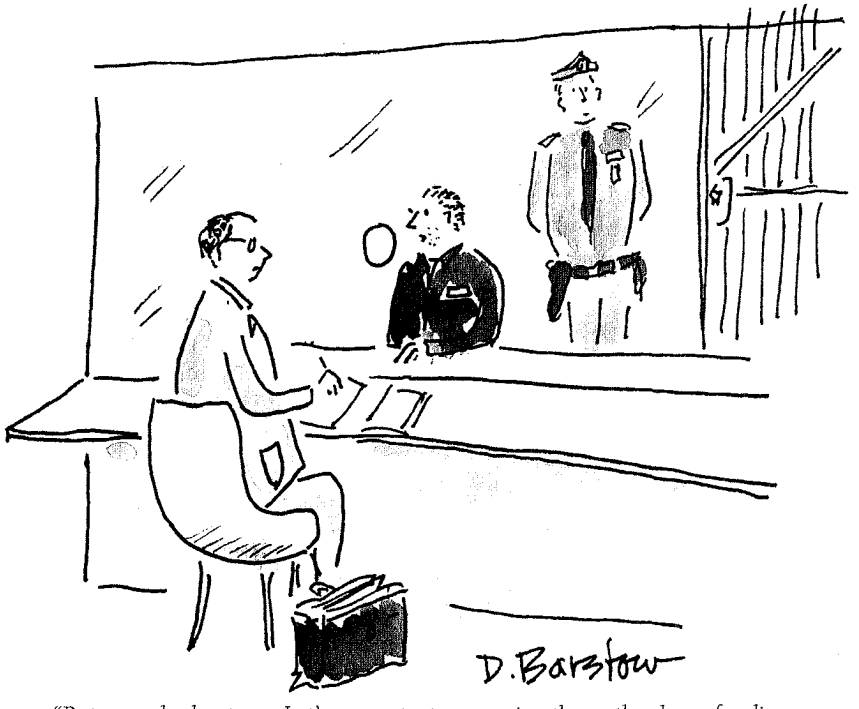
Controversy Venues

Many worker status controversies occur with government taxing and regulatory agencies. The taxes, administrative burdens, and federal and state employment law liabilities are much greater for employees. As a result, there is a natural tendency for businesses to want to treat workers as independent contractors.

With independent contractors, the employer pays gross pay with no withholding. With employees, the employer must withhold federal, state, and local taxes and must remit those taxes to the proper authorities. There are also workers' compensation implications, labor law issues, pension and employee benefit considerations, and a host of other issues that can be affected by this pivotal employee versus contractor divide.

As such, it is no wonder disputes arise. Such questions come up in very different contexts, including

- audits from federal or state taxing agencies;
- third-party lawsuits where the worker's actions (and liabilities) are sought to be attributed to the putative employer;
- actions from labor organizations seeking to enforce worker protection measures provided to employees but not to independent contractors; and
- audits from pension authorities seeking to determine compliance with



"But enough about me. Let's concentrate on saving the wetlands, or funding an alternate energy source.

nondiscrimination, coverage, and other rules governing pension and employee benefits.

Companies are more apt to understand audits and disputes from taxing agencies, and perhaps labor and employment agency audits, than they are other lawsuits. These disputes are about money, and about the government's interest in ensuring that workers are being protected. However, it is inappropriate to dismiss any of these as unimportant. All worker status disputes can be protracted and expensive, and they can involve bet-the-company stakes.

Legislative Changes

While the bulk of the law affecting worker characterization emanates from the common law and agency principles, state and federal laws are increasingly encouraging compliance. For example, former New York Governor Eliot Spitzer established a joint task force to address worker misclassification in New York. The Joint Enforcement Task Force allows state agencies charged with classification enforcement to coordinate their investigations and share information.

Led by the New York Department of Labor, the Task Force is comprised of representatives from the Workers' Compensation Board, the Workers' Compensation Inspector General, the Department of Taxation and Finance, the Attorney General's Office, and the New York City Comptroller's Office. Coordination among these agencies is meant to strengthen enforcement of independent contractor characterization in the state.

In November 2007, the IRS also announced a new state and federal information-sharing plan for employment tax audits. These new agreements between the IRS and state workforce agencies, part of the IRS' Questionable Employment Tax Practice initiative, provide a centralized and uniform means for the IRS and state employment officials to exchange data. Meant to encourage businesses to comply with federal and state employment tax requirements, the agreements call for collaborative outreach and education activities designed to help businesses understand their employment and unemployment tax responsibilities. So far, more than two dozen states have signed partnership agreements with the IRS.

In addition, Senators Barack Obama, Dick Durbin, Edward Kennedy, and Patty Murray have launched the Independent Contractor Proper Classification Act of 2007. The bill would revise procedures for worker classification, primarily focusing on section 530 of the Revenue Act of 1978. Section 530 relieves an employer of employment tax liabilities stemming from a failure to treat an individual as an employee if the employer meets three requirements: reasonable basis, substantive consistency, and reporting consistency.

The Independent Contractor Proper Classification Act of 2007 would no longer allow employers to use industry practice as a reasonable basis for not treating a worker as an employee, and would prohibit employers from receiving employment tax relief for any worker who the IRS has determined should have been classified as an employee. Workers would be allowed to petition for determination of status for employment tax purposes. In a kind of *Miranda* rights procedure, it would require employers pre-hiring to notify individuals classified as independent contractors of (1) their rights to seek a status determination from the IRS, (2) their federal tax obligations as an independent contractor, and (3) the labor and employment law protections that would not apply to them.

The new legislation would also impact the IRS and Department of Labor. The IRS would be allowed to issue regulations and revenue rulings on employment status. The bill would also allow the IRS to perform employment tax audits, inform the Department of Labor, notify the worker of the possibility of a self-employment tax refund, and instruct the worker to take affirmative action to abate the violation.

The Department of Labor would be required to identify and track complaints and enforcement actions involving misclassification of workers and to investigate industries where worker misclassification often occurs. The Department of Labor and the IRS would be required to exchange information on worker misclassification cases and to provide the information to relevant state agencies. So far, the bill has not passed.

Suits by and Involving Workers

Worker status controversies can arise in civil litigation between private parties. The status of a worker may be pivotal in assessing a company's liability for the worker's acts. If a delivery driver is your employee when he hits a pedestrian, the company is liable. If the driver is a true independent contractor, the tort liability is the driver's. These are third-party disputes in which the status of the worker is relevant to the plaintiff's case.

Worker status determinations must take into account the totality of the situation.

However, it is also possible to have direct disputes with one's own workers. The workers themselves may sue their employers, expressly seeking reclassification. The workers may be seeking employee benefits, protection under state or federal nondiscrimination or employment rights laws, wage and hour protections, etc.

The cornerstone of modern worker status litigation is *Vizcaino v. Microsoft*, 97 F.3d 1187 (9th Cir. 1996). In that case, a group of freelance programmers sued Microsoft claiming they were entitled to various benefits under Microsoft's

employee benefit plans. The programmers were hired with the understanding they would not be eligible for benefits given to Microsoft's regular employees. They were paid through Microsoft's accounts receivable department, not the payroll department. They were also paid at a higher hourly rate than comparable regular employees.

Microsoft may have assumed there was no risk of reclassification. Yet, the IRS examined Microsoft's employment records and determined the programmers were employees for withholding and employment tax purposes. The IRS concluded that Microsoft retained the right to exercise direction over the services they performed.

Learning of the IRS rulings, the programmers sued Microsoft for employee benefits. Microsoft argued they were independent contractors who were ineligible for employee benefits. After all, they had contractually waived all right to benefits, and they were not regular, full-time employees.

The district court agreed with Microsoft. The Ninth Circuit reversed and remanded, holding the programmers eligible to receive benefits.

Vizcaino demonstrates that employers cannot rely entirely on contractual language. An independent contractor label is not sufficient to establish an independent contractor relationship. The fundamental truth of the relationship will control.

Domino Effect

Perhaps more importantly, from a purely practical perspective, *Vizcaino* illustrates the nearly inevitable interaction between tax controversies and other worker status inquiries. *Vizcaino* was a civil suit brought by workers. Yet, the IRS really started *Vizcaino*. The programmers made their claims on the heels of an IRS reclassification.

Such chain reactions are common. In fact, a reclassification controversy frequently emanates from a simple worker's compensation claim. State taxing authorities may follow federal, or vice versa. A state employment development audit may be followed by an IRS or state tax audit, or by a direct suit by workers seeking recognition as employees. One dispute over worker status often snowballs.

Even public agencies are not immune from private litigation over worker classification. In *Metropolitan Water District of Southern California v. Superior Court of Los Angeles County*, 32 Cal. 4th 491 (Cal. 2004), the plaintiffs were workers hired through private labor suppliers to work on long-term projects for the water district. They sought to compel the water district to enroll the workers into the California Public Employees Retirement System (CalPERS).

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The workers were labeled as "consultants" or "agency temporary employees," and were ineligible for benefits. The California Supreme Court held the Public Employee's Retirement Law (PERL) required the water district to enroll all common-law employees into CalPERS, with only a few statutorily defined exceptions.

Blackwater, the huge defense contractor, currently faces scrutiny over its classification of security guards. The guards sign independent contractor agreements, but apparently are ordered around like soldiers. One former guard complained to the IRS, and soon there was a media firestorm, and even congressional scrutiny, over Blackwater's multimillion-dollar employment tax savings.

Class Actions

Many companies justifiably fear class actions, and with good reason. Class actions on worker status are becoming more common. In *Estrada v. FedEx Ground,* Superior Court of Los Angeles County, No. BC210130, the plaintiffs were parcel delivery drivers denominated as independent contractors in contracts they signed with FedEx. The plaintiffs sought to be classified as employees, and the court agreed, finding that FedEx had the right to control the drivers. The court admonished that "the label placed by the parties on their relationship is not dispositive, and subterfuges are not countenanced."

The truth of the relationship between worker and company is often more defined by actions than by words in a contract. Indeed, courts will not allow employers to call a worker an "independent contractor" while subjecting him or her to the control it exercises upon a normal employee.

The Road Less Traveled?

There is no question that worker status litigation will continue to evolve. If anything, the stakes seem likely to increase. Companies facing worker status issues should consider the larger ramifications, since one dispute is often the catalyst for another.

That, in turn, raises a fundamental precept. Undeniably, the independent contractor versus employee line is not often crystal clear. On the other hand, it is also not always unintelligibly murky. One can, and should, evaluate what workers are, and what they can reasonably be expected to be.

Some companies label workers as independent contractors who could have no reasonable chance of withstanding scrutiny. This can seem expedient in the short run, even savvy. Yet, it rarely saves money in the long run. Even companies that are in the infancy of drafting and implementing independent contractor relationships should have realistic expectations. They should make contract language and actual practice consistent wherever possible.

Moreover, they should bear in mind the adage that only very rarely can one have one's cake and eat it too. BLT