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Gotcha! Endings to Worker Status Questions

BY ROBERT W. WOOD

In O. Henry's "The Gift of the Magi," desperate to buy a platinum chain for the heirloom pocket watch that is her beloved husband Jim's most prized possession, Della cuts off and sells the flowing long hair that is her most distinctive feature to a wig maker. Desperate to please his young wife and showcase her locks, Jim sells his watch to buy combs for Della's hair. This simple but gut-wrenching surprise knocks the wind out of the reader in O. Henry's last paragraph. We are cunningly brought into this couple's cramped turn-of-the-20th-century cold-water flat in Greenwich Village, experiencing surprise and irony before we go.

In "Two Thanksgiving Gentlemen," we are transported to the same era's Thanksgiving Day, where a vagabond is feted each year to a grand dinner out with all the trimmings by his businessman benefactor. Knowing how important the grand meal is to the vagabond, the businessman,

himself down on his luck that year, starves for days not to let the vagabond down. Knowing how important the Thanksgiving ritual is to his kindly benefactor, the vagabond plays along, despite having already been treated to two holiday meals that day. So each endures it — the starving businessman hiding frayed cuffs and hunger, the vagabond hiding a stomach already full to bursting. The reader is sated with both irony and surprise, as O. Henry delivers the role-reversing sucker punch.

Former Commissioner of the Internal Revenue Service Lawrence B. Gibbs has described IRS rulings on independent contractor versus employee status as "O. Henry short stories, because the reader is left guessing whether the worker will be classified as an employee or an independent contractor, right up to the surprise ending."¹ Sadly, there is considerable truth in this metaphor. The traditional IRS 20 factors (set out at the end of this article), in use since the 1980s, give a seesaw-like list of criteria one must ride out with a kind of glass-half-full/half-empty balancing act. Yet there is no minimum or maximum number of factors that spells either employee or independent contractor status.

Similarly, although the IRS 20 factors remain good law, in recent years the IRS has taken to grouping its analyses into three topical areas, perhaps believing that we will be less hit with O. Henry-style endings using this three-pronged analytical tool.

The first is behavioral, asking whether the company controls — or has the *right* to control — what the worker does and how the worker does his or her job. The right to control is enough to spell employee classification, even if the company chooses not to exercise that right.

The second tranche is financial. The query here is whether the business aspects of the worker's job are controlled by the payer. These include such basics as how the worker is paid, whether the worker's expenses are reimbursed, who provides tools/supplies, and so on.

The final category is what the IRS refers to as relationship control. This includes questions such as whether there are written contracts or employee-type benefits, such as a pension plan, insurance, vacation pay, etc. The IRS wants to know whether the relationship will continue and whether the work performed by the worker is in a key aspect of the business.

The IRS exhorts that businesses must weigh all these factors when determining whether a worker is an employee or an independent contractor. Some factors may

indicate that the worker is an employee while others may indicate that he or she is an independent contractor. The IRS itself recognizes that there is no magic number of factors that earmark the worker an employee or an independent contractor.

Over and over again, the IRS cautions that no one factor stands alone in making this determination. Moreover, the IRS notes, factors which are relevant in one situation may not be relevant in another. This is a giant mish-mash, a mosh pit of give and take, a purée of ingredients that defies taste, texture, and odor.

The keys, says the IRS, are to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally, to document each of the factors used in coming up with the determination. Yet this amalgam of mush is of critical importance. Indeed, nothing seems more fundamental than the distinction between independent contractors and employees.

With employees, you must pay their wages, withhold taxes, and give them employee benefits. You can be held liable for their acts of negligence and can face the scrutiny of state and federal law concerning nondiscrimination, discipline, and termination.

These downsides give employers big incentives to deal with independent contractors.

Since you withhold and pay income and employment tax on employees and not on independent contractors, disputes with taxing agencies are the most obvious potential problem. But not all worker status disputes involve government agencies, and it's easy to see why. If a delivery driver is your employee when he causes an accident, the company is liable under agency law. If the driver is a true independent contractor, the liability is his alone, not the company's.

Sometimes independent contractors themselves sue seeking employee benefits, damages for discrimination, wage and hour protections, etc. Some companies ask how a worker can claim "employee" benefits after signing a contract expressly waiving benefits and agreeing to independent contractor status. Yet a written contract purporting to establish an independent contractor relationship may not be as bulletproof as you thought. Courts discount written contracts even more readily when signed by unsophisticated workers with no bargaining power.

Big Bucks

How big a problem is this, and how much

money is involved? Billions. In one famous case, a group of freelance programmers sued Microsoft, claiming they were entitled to stock options. The programmers signed contracts saying they would receive no benefits. They were paid through accounts receivable, not payroll, and got a higher rate than comparable Microsoft employees.

Microsoft's problems started with the IRS, which ruled the independent programmers were employees for tax purposes. However, learning of the IRS ruling, the programmers sued Microsoft for employee benefits and got them. Clearly, employers cannot rely solely on labels.

There is often interaction between tax controversies and other worker status inquiries. In fact, state taxing authorities may follow federal or vice versa. A state employment development audit may trigger an IRS or state tax audit, or a suit by workers. A major reclassification controversy can start with a simple workers' compensation claim, making the dollars involved hard to assess. A \$500 workers' compensation dispute may lead to much more.

Who is and is not an employee is getting heightened press, and worker classification disputes are occurring across a wide array of

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settings. Classically, an independent contractor works for himself or herself and provides a one-time service (think doctors or dentists). In contrast, employees classically work day-in and day-out for one company, subject to supervision and control.

Independent contractors exercise independent judgment to produce an end result (say, installing a pool in your backyard) or getting you from point A to point B (like a taxi driver). Exactly how they do it is no one's business but their own. Employees take orders about everything, or at least are subject to orders. The employer may choose to let them go about their work untutored, but could give them orders.

Whether a company has control over

workers — even though it may not exercise it — might seem obvious. Yet control issues can be terribly fact-intensive. Courts and administrative agencies look to a variety of factors to define the often-blurred lines.

As noted earlier, the IRS traditionally identifies 20 relevant factors, but there's no litmus test for how many factors prove a worker is an independent contractor or employee. You have to wade through them all:

1. Instructions — Instructions to workers suggests they are employees.

2. Training — Training of workers suggests they are employees.

3. Integration — Close integration of the work with the employer's overall business suggests the worker is an employee.

4. Services rendered personally — A requirement that a worker must personally do the work and cannot delegate it to someone else suggests employee status.

5. Hiring, supervising, and paying assistants — A person who hires, supervises, and pays their own assistants is more likely to be an independent contractor.

6. Continuing relationship — A long-term working relationship (e.g., 10 years versus three weeks) suggests the worker is an employee.

7. Set hours of work — Prescribed hours of work (e.g., 9 a.m. to 5 p.m.) is one sign of employee status.

8. Full-time required — Working full-time (rather than freelancing) tends to suggest employee status.

9. Performing work on employer's premises — Working on the employer's premises (rather than from home or from the worker's own place of business) weighs in favor of employee status.

10. Order or sequence set — Performing services in a prescribed order or sequence tends to weigh in favor of employee status.

11. Oral or written reports — Reports to an employer tend to suggest employee status.

12. Payment by hour, week, or month — Payment by the hour, week, or month is likely to suggest employee status; payment by the job, the reverse.

13. Payment of business and traveling expenses — Paying worker's business and traveling expenses tends to suggest employee status.

14. Furnishing of tools and materials — Furnishing significant tools, materials, and other equipment suggests employee status.

15. Significant investment — A worker's significant investment tends to indicate independent contractor status, while little or no worker investment tends to suggest employee status.

16. Realization of profit or loss — A worker's potential to realize a profit or suffer a loss suggests independent contractor status.

17. Working for more than one firm at

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a time — Working for more than one firm at the same time suggests independent contractor status.

18. Making services available to the general public — Making services available to the general public on a regular and consistent basis suggests independent contractor status.

19. Right to discharge — The right to discharge a worker tends to suggest employee status.

20. Right to terminate — A worker's right to terminate the relationship without incurring a liability suggests employee status.

Beware

A worker can be an independent contractor despite many factors that suggest he is an employee. The converse is also true, which makes the analysis quite nuanced.

It is also connected in ways you might not imagine, with agencies communicating among themselves much more seamlessly than ever before. Once one domino falls, other agencies and private parties can show up with their hands out. It may seem expedient in the short run to label workers as independent contractors even if they could have no reasonable chance of withstanding scrutiny. In the long run, it rarely saves money.

Companies should have realistic expectations and should harmonize contract language and actual practice as much as possible. There are still many circumstances where independent contractors are perfectly legitimate. Yet, often companies big and small don't try to address problem areas (in their contracts and otherwise) until it's too late. Employers who skirt the rules and don't have a good case should remember that sometimes when something looks too good to be true, it is. ☹

Robert W. Wood practices law with Wood & Porter in San Francisco (www.woodporter.com), and is the author of Taxation of Damage Awards and Settlement Payments (4th Ed. 2009), Qualified Settlement Funds and Section 468B (2009), and Legal Guide to Independent Contractor Status (5th Ed. 2010), all available at www.taxinstitute.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

NOTES

1. *Fifth Edition of Legal Guide to Independent Contractor Status*, reviewed by Lawrence B. Gibbs, *Tax Notes*, Vol. 129, No. 6 (November 8, 2010), p. 733.



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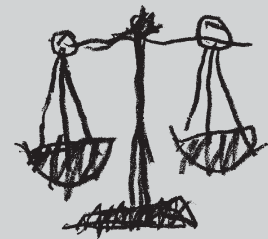
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