The High Stakes of Misclassifying Employees and Independent Contractors

Robert W. Wood

Independent contractor or employee? That sounds like a simple distinction, It is anything but. Worker status issues involve multiple disciplines: tax, labor, employment law, and more. As these issues have become more complex, their multi-disciplinary character has become more pervasive. The stakes of misclassifying a worker are higher today than ever before.

One reason is the now unfettered information exchanges among state and federal agencies. As a result of the seamless flow of information among agencies, one agency's investigation or dispute often triggers an investigation or dispute at another. Cost-benefit considerations may militate against an employer contesting every determination. Yet because even a small worker status dispute may trigger a large one, there can be an insidious kind of estoppel at work in these situations. Awareness of the inter-agency nature of these disputes can alter the cost-benefit playing field.

It is clear that enforcement is ramping up, as an increasing number of employers are being charged with misclassifying workers. President Obama's 2012 budget proposals contemplate tougher IRS enforcement of what is now often characterized as the contractor v. employee "loophole." Legislative changes to increase penalties and administrative changes to apply more scrutiny of employers' characterizations are surely coming. The IRS has already begun a new audit program.

Robert W. Wood

Robert W. Wood is a tax lawyer with a nationwide practice (www.woodporter.com). The author of more than 30 books including Legal Guide to Independent Contractor Status (5th Ed. 2010) (www.taxinstitute.com). He can be reached at wood@woodporter.com. This discussion is not intended as legal advice and cannot be relied upon for any purpose without the services of a qualified professional.

Awkward Timing

Unfortunately, many employers and their advisors become knowledgeable about these issues only *after* disputes have arisen, years after the characterization decision was made. By that time, the amount of money at stake may be huge. Rather than waiting until it is too late, employers should re-evaluate their contractual arrangements *before* they have a problem.

Of course, there can be huge differences between what a contract says and how business is actually conducted. For that reason, employers also should re-evaluate their actual practices with workers. A contract that says an "independent" worker can work any hours of his choosing will be little defense if it turns out that, in actuality, the employer regularly prescribes the hours during the day the worker has to work.

Employers should evaluate business practices not only at the inception of a relationship but also periodically. This kind of periodic review is especially important as a business grows and changes. Yet as important as it is to consider these issues early and often in a relationship with a worker, most businesses do not seem to consider these issues until a direct legal challenge has been made. For many lawyers and business people, however, it is difficult to think about independent contractor and employee characterization questions *without* thinking about possible disputes.

Myriad Disputes

Disputes arise when the IRS or another agency attempts to collect employment taxes. The U.S. Department of Labor, state employment development departments, workers' compensation insurers and authorities, and other governmental bodies also have an interest in these disputes. The issue also may arise during civil litigation with third parties because an employer is vicariously liable for the acts of employees but not for the acts of independent contractors.

Furthermore, either individually or as a class, workers may sue their own "employers" to obtain benefits reserved for employees. Since *Vizcaino v. Microsoft*[1] was decided, these cases are common. Although *Vizcaino* was not the first such case, it was a watershed decision germinating many similar attacks on the characterization of workers. In *Vizcaino*, Microsoft had characterized many of its computer programmers as "independent contractors"; these workers sued Microsoft to obtain employee stock options that Microsoft employees of similar tenure were entitled to receive under Microsoft's employee benefit plans. The programmers won the case and ultimately received stock options worth millions of dollars. It is worth noting that each of these workers had previously entered into written agreements clearly stating that they were independent contractors and did *not* qualify for employee benefits.

Contracts and More

Written agreements between an employer and a worker provide a good starting point for any analysis of worker status—but they are not the end point. Despite labels, courts generally look to the reality of the relationship, putting yet another set of pressures on companies and their advisors. These questions are highly fact-dependent and at the same also quite subjective. Work in this area requires good communication, awareness of the law, and realism about what one expects of workers.

One must amass substantive knowledge of the law to be able to make a careful assessment of how far an employer can go in supervising and controlling independent contractors without stepping over the line. Difficult, subtle, and intensely factual determinations have to be made. Yet a high degree of formalism is often respected by the courts, making the lawyer's role especially important.

Legislative Responses to the Misclassification Problem

The IRS believes misclassification of workers is one of the areas of greatest noncompliance in the tax law. The IRS has ramped up worker status audits, targeting thousands of additional employers each year. The general consensus is that misclassification of worker status costs the federal government billions of dollars annually,[2] and something must be done about it.

The legislative effort to fix the misclassification problem has focused not merely on worker classification but on penalties. Increasingly, Congress has been considering the circumstances in which errant employers should be forgiven for misclassification of worker status. When many felt the IRS was being too harsh in imposing crippling tax liabilities and penalties on employers who misclassified workers, Congress responded by enacting section 530 of the Revenue Act of 1978.[3] Section 530 provides errant employers with a veritable get-out-of-jail-free card.

To qualify for section 530 relief, the employer must have had one of several specified good reasons to consider the worker as an independent contractor. Today, over 30 years after section 530 was enacted, several bills have attempted to gut its key provisions. It seems inevitable that section 530 relief will be curtailed in some manner.

There is also increased attention to the worker misclassification problem at the state level. In California, for example, legislators introduced a bill to prohibit the willful classification of employees as independent contractors.[4] The bill would authorize California's Labor and Work Force Development Agency to assess civil penalties and allow workers and labor organizations to bring suit to recover penalties. A number of states have even made misclassification a criminal offense.

Common Questions

Throughout all of this, businesses must grapple with tough and unforgiving rules. Apart from taxes, significant employee benefits and potential liability are at stake. Questions commonly asked by employers with respect to worker classification include the following:

Q: Will I, as an employer, be required to provide employee benefits (pension plans, stock option plans, etc.) if my workers are deemed to be employees rather than independent contractors?

A: Often, yes, although there can be classification decisions that apply only for some specific purposes and not for others. Employee benefit plans can be a terribly frightening and expensive subject, and even though an "employee" determination may not apply to benefit plans at the outset, that determination can trigger a chain reaction that eventually implicates such plans.

Q: What should I do if I am currently involved in an independent contractor/employee audit with the IRS or state taxing authorities?

A: Get experienced counsel and be very cautious in responding and providing information. You should also be careful how you handle the matter with your workers.

Q: If I encourage my workers to incorporate and then I hire their corporation, will I avoid the characterization issue?

A: Hiring only incorporated workers is common in certain fields (e.g., medicine). It provides an additional layer of insulation from liability, but it does not entirely eliminate the independent contractor/employee classification issue.

Q: Is it possible to treat some workers as employees and treat others who perform the same functions as independent contractors?

A: Generally, no. One of the prime areas of attack by the IRS and other agencies is where similarly situated workers are treated differently. For example, if there are some sales agents who are employees and some sales agents who are independent contractors, make sure their duties and responsibilities are significantly different.

Q: What are some of the contract and tort liability issues that can arise with independent contractors?

A: Contract issues arise less frequently than tort issues, and typically concern whether a particular person was authorized to contract on behalf of the company. Usually these issues present themselves after a dispute has arisen. Tort issues, however, seem to be ever-present and can be very expensive to resolve. For example, if a delivery driver who is an independent contractor causes an accident, the injured party will often attempt to attribute employee liability to the driver in order to add the employer as a defendant. If an employee relationship is found, the employer likely will be held liable through *respondeat superior*.

Q: What are the chances that a business that fails to treat workers as employees can subject its owners to personal liability for employment taxes, penalties and interest?

A: One must separate federal and state employment tax liabilities from most other types of liabilities. If a business is a corporation or limited liability company, its owners are presumptively not liable for the debts and obligations of the entity. However, in the case of federal and state withholding and employment taxes, all "responsible persons" have personal liability. Assume, for example, that a corporation hires workers and classifies them as independent contractors, but they are later determined to be employees for income and employment tax purposes. That determination means that income and employment taxes *should* have been withheld. The corporation will be held liable for that failure. So, too, will the "responsible persons" of the corporation. That generally means all officers, and possibly some directors, of the corporation. Non-officer signers paychecks are usually held liable, too. As an enforcement mechanism, the IRS can *simultaneously* seek 100% of the unpaid taxes (plus interest) from the corporation *plus* a 100% penalty from *each and every* responsible person. The IRS may legitimately seek collection from a dozen or more responsible persons at the same time.

Q: May I rely on a written contract in which the worker expressly says—under penalty of perjury—that he is an independent contractor?

A: Not at all. Virtually any time an employer is defending an independent contractor relationship as such, there will be a written agreement expressly characterizing the worker as an independent contractor. Conversely, if there is no written agreement, employee status will almost always be found. But a written independent contractor agreement by itself is unlikely to carry the day. In nearly every worker status dispute, there is a written agreement that says the person is an independent contractor.

Q: What factors will the IRS and other governmental agencies use to determine whether my workers are independent contractors or employees?

A: The IRS and other governmental agencies use different tests. The IRS uses either a 20-factor test formulated in 1987 or a more recent three-factor test that essentially regroups and restyles the same criteria contained in the 20-factor test. Most states use a three-part so-called "ABC test" to determine whether workers compensation coverage should exist. Federal labor and pension laws generally use an economic reality test that looks to key relationship criteria. State tort and contract law usually looks to the common law. All of these tests are more similar than they are different. In general, these tests find that an employee is someone whom the employer controls not merely as to the work being done, but as to the method, manner, and means of doing it. The common law "right to control" the worker is what most commonly imports employee status, whether or not the employer chooses to exercise that right of control.

Conclusion

Whether you are a business owner, manager, executive, adviser, or even a worker being expected to take on a putative independent contractor role, you should consider these issues. Navigating the minefield of legal, tax, and contractual issues can be tricky. You should not wait for an investigation, administrative controversy, or lawsuit before considering these issues. Review contracts, "employee" files, manuals, meetings, procedures and protocols, reports, invoicing, insurance policies, and even check stubs, early and often—and continue to review them periodically.

While not dispositive of an issue, terminology can matter, so be wary what you call something or someone. Even something as seemingly innocuous as referring to an independent contractor as an "employee" can be held against you. Consider not only what is written (e.g., in contracts, handbooks, and policies), but also what is *not* written. A good contract usually provides no defense if you fail to follow it.

If you are committed to classifying certain workers as independent contractors, revisit that classification often and improve upon the facts underlying it. There is rarely a contract, policy, manual, or procedure that cannot be improved. However, be realistic in your expectations. If there is little hope for an independent contractor classification holding up, do not continue attempting to fit a square peg into a round hole. ■

Endnotes

1 97 F.3d 1187 (9th Cir. 1996), 120 F.3d 1006 (9th Cir. 1997) (*en banc*), *cert denied sub nom. Vizcaino v. Microsoft*, 118 S. Ct. 899 (1998), *on remand* 98-1 U.S. Tax Cas. ¶ 50,240 (W.D. Wash. 1998).

2 U.S. Department of Treasury, Treasury Inspector General for Tax Administration, *While Actions Have Been Taken to Address Worker Misclassification, an Agency-Wide Employment Tax Program and Better Data Are Needed*, No. 2009-30-035 (Feb. 2009), *available at* http://www.treasury.gov/tigta/auditreports/2009reports/200930035fr.pdf.

3 Pub. L. No. 95-600, 92 Stat. 2763, 2885-86.

4 Employment: Misclassification of Employees as Independent Contractors (S.B. No. 622) introduced by California State Senator Alex Padilla, *available at* http://info.sen.ca.gov/pub/07-08/bill/sen/sb_0601-0650/sb_622_bill_20070222_introduced.pdf.