Independent Contractors

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Summary

Independent contractors allow employers to avoid the cost of payroll taxes and the burden of complying with certain employment laws in return for giving up some control over how, when and where work is performed. But not all workers can be independent contractors. *See* **Overview**.

There is no single test for determining whether a worker is an employee or an independent contractor. There are several factors that employers should consider when classifying workers. These criteria are not uniform, but they are generally consistent. *See* **Determining Whether a Worker Is an Employee or an Independent Contractor**.

There are several concerns involved in hiring and managing independent contractors, such as drafting sound independent contractor agreements and fulfilling tax-reporting requirements. *See* **Hiring and Managing Independent Contractors**.

Employers may sometimes have to reclassify independent contractors as employees, usually as the result of an IRS order, a court ruling or a settlement. Such reclassifications can result in significant liabilities. However, there are some options available to employers that can help limit these liabilities. *See* **Reclassifying Independent Contractors as Employees**.

Overview

Who is an independent contractor? An independent contractor is a worker who is not an employee. That sounds simple, does it not?

Of course, it also requires an employer to know who is an employee. That too would seem to be simple. After all, either an employer is paying someone regularly or it is not, and both the employer and the worker surely must know if the pay is a one-time thing or regular wages.

Still, just paying someone, even regularly, does not necessarily solve the question. An employer can pay someone as an employee or as an independent contractor. An employer can do so as part of its business or for personal reasons, like hiring a babysitter or plumber.

Say a homeowner hires a plumber to come fix his toilet one time for $100. Clearly, that person is not the homeowner's employee. However, suppose the homeowner hires the same plumber hundreds of times to fix plumbing at all of his commercial investment properties? That sounds

very different from the one-time fee. Is the plumber now the homeowner's employee? If so, what are the consequences of that determination?

One might on the surface think that if the homeowner and the plumber agree that he is *not* an employee, he could *never* be labeled as one. Despite their agreement, it turns out many different agencies can rule someone to be an employee even though the employer and the worker might both disagree. The homeowner and the plumber might both insist that independent contractor status is correct. In effect, though, employer-employee treatment can be thrust upon them.

Put another way, the relationship the homeowner has with the plumber can be *recast* as that of employer to employee. What is more, this recharacterization can occur retroactively. That can have grave financial and legal consequences.

The criteria that legal and taxing authorities use to make the employee-versus-independent contractor distinction are not uniform, but they are generally consistent. Several factors go into this important decision. *See* **Determining Whether a Worker Is an Employee or an Independent Contractor**. Yet no matter how much an employer may know, because all facts and circumstances are generally relevant, certainty can be elusive.

Overlap of Different Laws

Even though the status of a worker as an employee or independent contractor would seem to be quite fundamental - surely it seems, one could be definitive about this - it turns out to be quite complex and nuanced. Moreover, there is also the question of for which law or purpose an employer is making the employee-versus-independent contractor decision. Plainly, that status can exist for many different purposes. In fact, a worker could be an employee for some purposes but not for others. In addition to the federal tax code, there are nearly a dozen federal employment laws, not to mention state unemployment and workers' compensation laws, that address independent contractors. *See* **Under Other Laws**.

One might assume that a worker who has been ruled to be an independent contractor for federal income and employment tax purposes would have to be classified in the same way for state labor law purposes or unemployment insurance purposes. In fact, one might assume that an employee for one purpose is an employee for all, and vice versa. That is incorrect.

It is probably true that in a majority of cases, workers will be consistently categorized across a variety of different rules, statutes and purposes. However, an employer cannot count on this. Workers, employers and agencies will routinely rely upon one classification decision as a way of supporting another one. In fact, that is one reason it is important to consider every dispute over worker status carefully.

Pros and Cons

Having employees is a big responsibility. There are many financial and legal commitments and limitations that come with having employees. In fact, for many businesses, the direct and indirect cost of having employees is the number one cost of running the business.

Avoiding all these costs - the payroll taxes, the day-in and day-out commitments, the costs of fringe benefits, the legal cost of complying with industrial health laws, discrimination laws and so many others - can sound awfully tempting.

Indeed, the most obvious advantage of having a worker classified as an independent contractor is to avoid the financial obligations incurred by having employees. Currently, these expenses include:

- The employer's matching contribution to Social Security and Medicare, or 7.65% of wages up to the wage base ceiling;
- The employer's matching contribution of 1.45% beyond that wage base;
- Federal unemployment tax of 6.2% on the first $7,000 of wages; and
- The applicable contribution to the state workers' compensation system of an amount that is usually about 2% of payroll but can be much greater.

The Fair Labor Standards Act (FLSA) requires overtime to be paid to employees who work more than 40 hours a week. *See* **Employee Compensation > Overtime**. However, this law does not apply to independent contractors. The Civil Rights Act of 1964, as amended, and the Occupational Safety and Health Act (OSH Act) provide protection for employees but not for independent contractors. These include primarily workplace safety standards and are pervasive in their scope.

See

Employee Management > EEO - Discrimination;

Risk Management - Health, Safety, Security > HR and Workplace Safety (OSHA Compliance).

Labor unions and related issues can also be significant. *See* **Labor Relations > Labor Relations Overview**. Independent contractors need not be included in collective bargaining agreements. Independent contractors are not considered employees under the Employee Retirement Income Security Act of 1974 (ERISA) and are excluded from coverage under employer pension plans. *See* **Employee Benefits > Retirement Benefits**. Employers must not discriminate in such matters with employees, but can it seems with independent contractors.

Although it cannot be denied that employers may benefit from the cost savings that independent contractors bring, there can be advantages to having employees. Most workers prefer the fringe and pension plan benefits associated with being employees, and therefore may be easier to hire and retain. Also, an employer will avoid the costs involved in having a determination challenged or reversed by an auditing agency. Conversely, some workers prefer independent contractor classification because, by definition, there will be no tax withholding.

A major source of audits is unemployment insurance claims. Independent contractors are not eligible for unemployment insurance. After all, they are not "employed".

However, many workers file claims for unemployment benefits even though they have been classified as independent contractors. They may do so thoughtlessly or they may be itching for a fight over their status. If the unemployment insurance agency finds that a worker should have been classified as an employee, the employer is liable for past withholdings, interest, and penalties. Thus, an employer may have a financial incentive to classify workers as employees to avoid these liabilities.

There can be tax benefits associated with employees. Internal Revenue Code Section 162(a) allows employers to deduct certain ordinary and necessary expenses from their income taxes. Furthermore, some benefits can be tax deductible if provided for employees, but not if provided for independent contractors.

This is particularly relevant for pension funds because of the amount of money involved. ERISA requires that 70 percent of eligible employees participate for a plan to be qualified. The number of workers who are classified as independent contractors will affect the number of employees who are eligible to participate.

Employers are expected to have more control over employees than over independent contractors. Therefore, classifying a worker as an employee gives the employer the right to exert more immediate control. Absent an agreement or the intervention of state wrongful termination law, it gives the employer the common law right to employment at-will. *See* **Recruiting and Hiring > Employment At-Will**.

Determining Whether a Worker Is an Employee or an Independent Contractor

There is no single test in statutes or case law for determining whether a person is an employee or an independent contractor. The Internal Revenue Service (IRS) and a variety of state and federal agencies determine whether a person performing services is an employee or independent contractor. The controlling standard for most purposes refers to the *common law right to control*. *See* **Common Law Right to Control**.

However, consistency is not always possible because the agencies use overlapping and different criteria. A person may be classified as an employee for one purpose and as an independent contractor for another. Moreover, some of the classifications discussed in this article, such as that of statutory employee, apply only for some purposes and not for others.

This exacerbates the frequent confusion surrounding worker status. One ideally should not only refer to a worker's status, but should also for what purpose. Where an employer does not specify what purpose it intends, people may automatically assume taxes.

Indeed, it is perhaps a testament to the omnipotence of the IRS that the IRS method for classifying persons as employees or independent contractors is widely assumed to be an original creation of the agency. However, even though it may emanate from the IRS, it relies predominantly on the *common law* - that is, the law that is developed by judges through decisions of courts and other tribunals rather than by statutes.

This section is divided into three parts:

Common Law Right to Control, which discusses the legal foundation on which independent contractor classification schemes are built;

Under the Tax Code, which details independent contractor classification under the federal tax code; and

Under Other Laws, which details independent contractor classification under federal employment laws and state unemployment and workers' compensation laws.

Common Law Right to Control

Common law is a term used frequently in the context of independent contractors. It simply means the law that is developed by judges through decisions of courts and other tribunals rather than by statutes. A common law system is a legal system that gives great weight to judicial decisions.

In that way, similar facts and situations should ideally be treated similarly. The body of precedent is called *common law* and it binds future decisions. This concept is important to the treatment of workers as either employees or independent contractors even when there are particular statutes in place defining who is or is not an employee.

The United States derives much of its common law system from England. In that sense, the common law clearly predates the IRS and all other investigative agencies in the US. A common law definition of employment or employees remains terribly important even today.

The common law definition focuses on the right of the employer to direct the means of production, or the *right to control*. It is based on the assumption that employers are interested in the final goods or services produced, whether provided by an employee or independent contractor. However, the employer has more reason to be concerned with how the employee produces the product than how the independent contractor does so.

What is meant by control over the means of production? Various criteria have been accepted as suggesting, but not determining, the existence of control. For example, if the employer provides training, instructions, tools and the place to work, the IRS will probably assume that the employer has the right to control the means of production. The right to terminate at will is also taken as a sign of the right to control the means of production.

Note that it is the employer's *rights* that are significant. One can have a legal right to impose conditions and rules on another, even if one does not choose to exercise that right. In that

sense, mere legal rights can result in workers being classified as employees even when the employer maintains a strict "hands off" policy.

Traditionally, employees go to work at set hours, work on premises owned by someone else, follow company dress codes, perform tasks the boss requires, and get paid at a regular rate and on a regular basis. On the other hand, independent contractors are generally considered self-employed people or professionals. They may have large investments in the success of the business. They set their own hours and location, and wear what they want.

Moreover, independent contractors do not have immediate bosses or supervisors. They get paid when they finish their jobs. They work for many customers, and have no long-term special relationships. How much they earn is largely determined by how hard they work and by risk factors beyond their control.

Employees classically go to work at set hours while independent contractors usually determine their own hours. Employees do what their bosses want them to do; independent contractors are free to do the work in the manner in that they prefer. Employees receive regular paychecks while independent contractors get paid by the job. Employees work year-round; independent contractors are temporary.

Of course, these are archetypes and one often encounters far more blended fact patterns. Moreover, no one of these factors stands alone. One usually encounters a mix of factors, which one must analyze carefully in making the classification determination.

Employers have much more control over the actions of employees than they do over those of independent contractors. The independent contractor must agree to produce goods or services according to a contract. But once that contract is signed, the means of production are left to the independent contractor.

Practical Example

Harry is paid to construct a new patio wall. How and when he does so are not specified, and his only obligation is to produce a wall of a given size and quality. This end-result approach suggests independent contractor rather than employee status.

One aspect of the worker status determination seems to be based on the assumption that independent contractors can be trusted to work on their own while employees cannot. Although this assumption may be dubious, it is at least one underpinning for the common law definition of an employee.

Within the common law, there are two major approaches to definitions based on differing views of the essence of the employer-employee relationship. The first view focuses on the control the employer has over an employee but lacks over an independent contractor. This could be seen as a social definition because of its emphasis on the personal relationship

between the employer and the behavior of workers.

The second view is based on financial considerations, especially the investment and risk the worker has in the business. This definition could be seen as economic because of the emphasis on the economic relationship between the worker and the business. Both definitions rely on specific criteria as manifestations of the relationship. The factors used to assess these relationships are generally similar.

Given the problems of defining who is an employee, a different approach evolved from two cases argued before the Supreme Court and decided in a consolidated opinion on June 16, 1947. In *United States v. Silk*, +*331 U.S. 704* (U.S. 1947), the Court determined that coal unloaders were employees rather than independent contractors even though they provided some of their own tools and did not work on a regular basis. The Court focused on the fact that the unloaders were integral to the employer's work.

Since then, that focus on integration into the employer's business has been important. The Court suggested criteria for determining if employees are integral to the employer's work, including the investment the workers have in the business and whether they stand to lose or gain from their efforts. These new criteria became part of what is generally known as the *economic reality test*.

Congress had reason to be concerned with the economic reality definition suggested by the Court. A vague definition could include all workers, bringing them under the coverage of the Social Security Act and possibly causing it to become bankrupt. We have concerns today about the solvency of the Social Security system, but there was already concern in the 1940s.

Therefore, in the 1948 Gearhart Resolution, Congress expressed a preference for the common law definition because it appeared to be narrower than other prevailing definitions. However, Congress did not clearly reject the Court's reasoning that economic factors should be considered in making the determination. Consequently, the courts have been divided on how to interpret the resolution and congressional intent.

Under the Tax Code

Although many laws address the classification of workers as employees or independent contractors, perhaps nowhere are the stakes as high as with the federal tax code. Not coincidentally, the case law and agency guidance are the most robust in this area.

Tax Code Criteria

Take a closer look at the criteria that the IRS and many other agencies and courts use to determine who is an employee and who is not for purposes of the federal tax code.

Right to Control

In general, the "right to control" dictates whether someone providing services does so as an employee or as an independent contractor. Where the employer exhibits the requisite right of control over a worker, that worker should be characterized as an employee. This is true for

purposes of federal income tax withholding, Social Security and Medicare tax, and federal unemployment tax. The right to control is a common law concept that traditionally has been based on a variety of factors. *See* **Common Law Right to Control**.

Other Laws Generally Irrelevant

Although the determination that a person is an employee may be made under various laws, they are not binding on the IRS for federal income and employment tax purposes.

Practical Example

The IRS has held that a determination by the National Labor Relations Board that a person is an employee for labor relations purposes is not binding on the IRS. Whether a person is an employee is inherently factual, and there is a wealth of authority concerning factors relevant to this determination.

Type or Class of Employees Irrelevant

In making the employee/independent contractor distinction, it does not matter what class or level of employee is being considered. Supervisory personnel, managers and other high-level persons are subject to the same analysis and scrutiny. They can be ruled to be employees under the general right to control standard.

In fact, the federal tax code states flatly that an officer of a corporation is an employee. However, the Treasury Regulations indicate that an officer who receives minimal compensation and performs only minor services should not be classified as an employee. A director who holds no other capacity with the corporation is generally classified as an independent contractor. *See* **Directors, Officers and Partners**.

Professionals

Although the class or level of workers is generally not the final word in independent contractor classifications, the lower level the worker is, the more likely it might seem that the worker would be subject to the employer's direction and therefore be an employee. On the other end of the spectrum would be professionals. Persons engaged in professions (such as law, medicine or accounting) for which they maintain private practices are generally classified as independent contractors because such professionals are generally not subject to control and supervision of the services they perform for others.

In some situations, however, professionals have been held to be employees.

Practical Example

A physician maintained a private practice but also worked part-time for a corporation. When he worked for the corporation, he was subject to the corporation's control,

performed services on the corporation's property, and was required to submit written reports. He was also prohibited from responding to emergencies that arose in connection with his private practice during the hours of his corporate employment. Based on the facts and circumstances, the IRS ruled that the physician was an employee.

If the physician had been permitted more latitude to perform work on behalf of the corporation as he saw fit, the result might have been different. For example, if the physician had been free to leave the company's premises in response to private practice emergencies, the physician might have qualified for independent contractor status.

An Independent Contractor Questionnaire can be given to prospective workers with the goal of determining if they can be properly classified as independent contractors. A Worker Internal Evaluation Checklist can also be used to help a company determine if it can treat a worker as an independent contractor.

Contract Terms and Labels

The particular language used in a contract is not the decisive factor in establishing the worker's relationship with the employer. Although courts and commentators often list the language of the contract as one factor to consider, at the same time, they often dismiss the labels given by the parties. In that sense, the fact that a contract calls the hired party an "independent contractor" may be of little import.

Tax Withholding

The facts that an employer withholds taxes, makes deductions for Social Security or even pays state unemployment tax for a worker are circumstances to be considered but do not settle the issue. Nevertheless, the courts find it significant if an employer deducts taxes from wages, such withholding being considered strong evidence that the hired person in fact is an employee.

For example, in a case involving tort liability, *Toyota Motor Sales U.S.A. v. Superior Court*, +*220 Cal. App. 3d 864* (Cal. App. 2d Dist. 1990), the employer argued that the fact that a delivery driver paid his own payroll and income taxes supported a finding that the driver was an independent contractor. The court, however, was unimpressed with such bookkeeping. The court stated that an employer could not disguise an employer-employee relationship by making the employee assume burdens that the law imposes on the employer. Since the employer exercised detailed control over the driver, the employer's decision not to withhold taxes was unimportant.

Furnishing Materials

Whether the worker furnishes the tools, materials, workers, and/or equipment necessary to perform the job bears on whether he or she is an independent contractor. Many courts have expressed the viewpoint that when a worker furnishes such items it tends to indicate independent contractor status.

Measure and Timing of Compensation

The measure and timing of compensation provided to the worker is relevant in determining the worker's status as an employee or independent contractor. For example, the payment to a worker of a salary or hourly wage based upon the time the job takes to perform is evidence that the worker is an employee. Conversely, paying a trucker a specified price for each haul of dirt is consistent with being an independent contractor. Similarly, paying an aerobics instructor for each class helps support independent contractor status. On the other hand, paying the trucker or instructor by the hour or with a weekly or monthly check based on the time spent working suggests employee status.

Nature of Business or Occupation

Another factor is the nature of the work that is performed by the hired party. If the hired party has a special skill or does work beyond the expertise or usual line of work of the employer, courts are more likely to view the worker as an independent contractor.

As the American Law Institute pointed out in Restat 2d of Agency, § 220, among the matters of fact to be considered are:

> Whether or not the one employed 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 employer or by a specialist without supervision; and
>
> The skill required in the particular occupation.

Power to Discharge

Because the extent of an employer's control is relevant, it is important to examine the employer's ability to discharge the worker. A contract term that permits the employer to terminate the hired party for any reason can be a strong indicator that the hired party is an employee.

An independent contractor is hired to do a particular task, often calling for special skill or experience. The employer may only retain a general right to ensure that the work is proceeding according to the contract terms. The right to terminate at will is inconsistent with this limited right to control. The employer should only be able to terminate the hired party for inadequate performance.

The IRS 20-Factor Test

The IRS has developed a list of 20 factors that it uses to classify workers as employees or independent contractors. This list of factors dates all the way back to 1987 - from +*Rev. Rul. 87-41* (I.R.S. 1987). The IRS has talked about revising it over the years, but it remains in effect to this day.

Even so, it is not the exclusive list of factors that may be relevant in making the employee or independent contractor determination. All facts and circumstances are relevant. Yet these 20

criteria are the most important considerations in making the classification decision for federal tax purposes. Note that many of these factors overlap with the broader tax law criteria listed above.

1. Instructions

A worker required to comply with instructions about when, where and how work is performed is ordinarily an employee. This factor is present if the person for whom the services are performed has the right to require compliance with instructions.

2. Training

When the employer requires an experienced employee to help train a worker or requires the worker to attend meetings, it indicates that the person for whom the services are performed wants them performed in a particular method or manner. If the work to be performed requires special training and skill, the worker is more likely to be an independent contractor.

3. Integration

Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers must necessarily be subject to a certain amount of control. If the work constitutes an integral part of the employer's business, this tends to support employee classification. Conversely, if the work is only tangential to the employer's business, the workers are more likely to be classified as independent contractors.

4. Services Rendered Personally

If the services must be rendered personally, it suggests the employer is interested in the methods used to accomplish the work as well as in the results. This tends to support employee classification. If the person providing the services has the right to delegate all or a portion of the work to others, independent contractor status may be indicated. Conversely, the lack of a right to delegate duties may support employee classification.

5. Hiring, Supervising and Paying Assistants

If the entity for which the services are performed hires, supervises and pays assistants, that factor generally shows control over the workers. However, suppose that a worker can hire, supervise and pay assistants pursuant to a contract under which the worker agrees to provide materials and labor, and under which the worker is responsible only for attaining a result? Such an arrangement suggests independent contractor status. This situation often arises in the trucking industry. If truck drivers are employees and have the company's permission to hire assistants to unload the trucks, the unloaders are seen as employees, even though their work is irregular.

6. Continuing Relationship

A continuing relationship between a worker and an employer indicates an employer-employee

relationship. A continuing relationship may exist if work is performed at frequent although irregular intervals. The duration of the engagement will also be considered. A long-term engagement is more consistent with employee classification, while a short-term or one-time engagement is more consistent with independent contractor status. Workers who have been employees and then are terminated as employees (either by the employee or the company) only to be rehired as "independent contractors" bear special scrutiny. Nevertheless, it is common for a company executive to terminate employment (as in the context of the sale of a business) but to remain as a "consultant" for some period of time. As long as the consultant's duties change substantially, as they typically will in the context of a business sale, there is rarely a problem with the independent contractor classification. The usual factors would be relevant, including whether the executive can work for other companies, whether the employment is full time, whether the relationship is full time, whether the executive can work on his or her own schedule, where the work is performed and so forth. A primary danger zone, however, occurs when a company terminates workers who have been treated as employees and then rehires them as "independent contractors" without making significant changes in the relationship.

7. Set Hours of Work

The establishment of set hours of work tends to indicate control.

8. Full Time Required

If the worker must work substantially full time for the business of the employer, the employer obviously has control over the time the worker spends working. This also restricts the worker from doing other gainful work. An independent contractor, on the other hand, is free to set his or her hours and seek other work.

9. Performing Work on Employer's Premises

If the work is performed on the premises of the employer, this suggests control over the worker, especially if the work could be done elsewhere. Work done off the premises of the employer, such as at an independent office of the worker, indicates some freedom from control. Control over the place of work also is indicated when the person for whom the services are performed has the right to compel the worker to travel a designated route, to canvass a territory within a certain time or to work at specific places.

10. Order or Sequence Set

If a worker must perform services in an order or sequence set by the employer, the worker is not free to follow the worker's own pattern of work. Often, because of the nature of an occupation, employers do not set the order of the services, or they set the order infrequently. It is sufficient to show control, however, if the employer retains the right to do so.

11. Oral or Written Reports

A requirement that the worker submit regular oral or written reports to the employer indicates a degree of control.

12. Payment by Hour, Week or Month

Payment by the hour, week or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump-sum agreed upon as the cost of a job. Payment made by the job or on a straight commission basis generally indicates that the worker is an independent contractor.

13. Payment of Business or Travel Expenses

If the employer ordinarily pays the worker's business or travel expenses, the worker is ordinarily an employee. To control expenses, an employer generally retains the right to regulate and direct the business activities of employees but not of independent contractors.

14. Furnishing Tools and Materials

If the employer furnishes significant tools, materials and other equipment, it tends to show the existence of an employer-employee relationship. A worker who provides equipment is more likely to be characterized as an independent contractor. However, one must define equipment for this principle to be helpful and analyze how much equipment is required in the position. A person who is provided an office, a desk, a telephone and secretarial service, but who provides a calculator and other minimal equipment, will probably not be considered to be providing equipment for purposes of this rule.

15. Significant Investment

If the worker invests in facilities used in performing services that are not typically maintained by employees (such as an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, the worker's lack of investment in facilities indicates dependence on the employer for such facilities and, accordingly, suggests he or she is an employee.

16. Realization of Profit or Loss

A worker who can realize a profit or suffer a loss (beyond those ordinarily experienced by employees) is generally an independent contractor. The worker who cannot is an employee. For example, suppose that a worker risks economic loss due to significant investment in his or her tools or by bearing the costs of expenses. That would tend to suggest that the worker is an independent contractor. The risk that a worker will not be paid for services does not count here. After all, that risk is common to both independent contractors and employees. As such, that risk of non-payment is not a sufficient economic risk weighing in favor of classifying the worker as an independent contractor.

17. Working for More Than One Firm at a Time

If a worker performs more-than-inconsequential services for more than one person or business at the same time, that factor generally indicates that the worker is an independent contractor. After all, that is classically what independent contractors do, working for the general public and not only to one person or company. However, employers should not assume that merely having multiple companies means there can be no employee status

issue. In fact, a worker who performs services for several companies could be an employee of each of them. It all boils down to all of the facts and circumstances. Of course, if the worker is free to offer services to the general public and to accept as many assignments as possible from others, this tends to support independent contractor characterization.

18. Making Services Available to General Public

When workers make their services available to the general public on a regular and consistent basis, it suggests independent contractor status. *See* **Working for More Than One Firm at a Time**.

19. Right to Discharge

The unrestricted right to discharge - to fire - a worker suggests that the worker is an employee and the person possessing the right is an employer. Hiring and firing is fundamental. In a sense, an employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired as long as the independent contractor produces a result that meets the contract specifications. The lack of an ability to discharge the worker without cause is more consistent with independent contractor status. Consequently, some employers attempt to make their workers appear to be independent contractors by executing contracts that either limit the employer's right to discharge the worker except for specified reasons or provide for a notice period before discharge. The right to discharge is an important consideration with leased workers. If the leasing employer cannot terminate them, they are generally seen as employees of the lessor company. The leasing employer enters into contracts with the subscribers under which the subscribers specify the services to be provided, and a fee is paid to the leasing employer for each individual furnished. The leasing employer has the right to control and direct the worker's services for the subscriber, including the right to discharge or reassign the worker. The leasing employer hires the workers, controls the payment of their wages, provides them with unemployment insurance and other benefits, and is the employer for employment tax purposes. Nurses contracted on short notice by hospitals often fit this description.

20. Right to Terminate

If workers have the right to end their relationship with the employer at any time without incurring liability, that factor suggests an employer-employee relationship.

Additional Factors

Although not listed in the Revenue Ruling, some other factors noted in the case law deserve mention.

Understanding of the Parties

If the parties believe they have an employment or independent contractor relationship, this belief will generally be entitled to some weight in making the determination as long as other criteria are ambiguous.

Custom in the Industry

If the custom in the trade or industry is for the service to be provided by employees, employee status may be indicated. Conversely, if the custom is for the work to be performed by independent contractors, that status may be indicated.

Laws and Regulations

Many workers are subject to laws and regulations promulgated by federal, state and industry agencies. The impact of such laws and regulations on the classification of a worker is merely one factor the courts consider in assessing whether an employer wields control over a worker. Generally, courts rule that an employer's compliance with laws and regulations does not constitute control over a worker.

Practical Example

In *National Labor Relations Board v. Associated Diamond Cabs, Inc*., +*702 F.2d 912* (11th Cir. 1983), the court evaluated the impact of Miami City Code regulations on taxi drivers. The court concluded that the employer did not impose these rules. The City of Miami required taxi drivers to fill out "trip sheets" to record all trips made, their origin and destination, the fares charged and the time of each trip. At the end of each day, the drivers submitted the trip sheets to the company, and retained them for city inspection. The court found that the trip sheets, which the company maintained solely for the use of the city, were not evidence of control by the company. In fact, the court stated that government regulations constitute supervision not by the employer, but by the city. The law controlled the driver, not the employer.

Similarly, in *K & D Auto Body, Inc. v. Div. of Empl. Sec.*, +*171 S.W.3d 100* (Mo. Ct. App. 2005), the court found that compliance with federal drug testing law did not amount to evidence of control by the employer over its tow truck drivers. K&D Auto Body was an employer subject to the Missouri Employment Security Law. K&D owned tow trucks, and it required the tow truck drivers to sign an agreement which stated the driver was an independent contractor. In 2004, the Labor and Industrial Relations Commission of Missouri found that the drivers were employees. In making this determination, the Missouri Commission used the IRS 20-Factor Test. K&D appealed the Commission's decision. In the appeal, the Division of Employment Security claimed that K&D had the right to require the drivers' compliance with its instructions, since K&D could require the drivers to take a random drug test mandated by the federal government. However, the court stated that "reasonable efforts to insure compliance with government regulations do not evidence control 'unless pervasive control by the employer exceeds to a significant degree the scope of the government imposed control.'" While this particular factor indicated an independent contractor relationship with K&D, the remaining factors revealed an employee relationship. Thus, the court held that the truck drivers were employees.

However, when employers subject workers to requirements that exceed the prescribed

regulations, this may provide evidence that the employer wields control over the worker.

Practical Example

In *National Labor Relations Board v. Deaton, Inc.*, +*502 F.2d 1221* (5th Cir. 1974), the court ruled that interstate courier drivers were employees of Deaton based on the control exerted over the drivers. The court analyzed Interstate Commerce Commission (ICC) and the Department of Transportation (DOT) regulations, which closely regulate interstate truck lines. The agencies require each truck traveling interstate to be certified with the agencies in order to promote safe operation of trucks and ensure continuous financial responsibility so that truck-related losses would not go uncompensated. The court stated that the regulations are designed to protect both the highway-traveling public and the segment of the public directly using trucking services. The court further stated that the holder of the certificate possesses and exercises control over all trucks operating under the certificate. The court focused on the holder of the certificate, who did not necessarily own the truck. In fact, the court suggested that "control over trucks involves control over drivers." The court held that it was unnecessary to decide whether ICC-mandated controls alone would be sufficient to establish employee status. Instead the court analyzed the substantial nexus of control required by federal regulations, and found the facts established the existence of "additional control" reserved by the employer. The court evaluated the ICC-mandated requirements and additional controls. For example, Deaton "checked out" all drivers before permitting them to drive. The ICC regulations merely required Deaton to make certain inquiries, but the record showed that Deaton went beyond that requirement. Deaton reviewed the driver's references, any police record and driving record. Based on that inquiry, Deaton assessed whether the driver met the qualifications Deaton required. Moreover, the regulations forbade any disqualified persons from driving commercial motor vehicles. However, Deaton's practice of assessing whether a driver was a "good risk" involved a subjective, employer-like inquiry different in quality from merely making sure the driver was not barred by law from commercial driving. Based on the control exerted by the company over the drivers, the court found the drivers to be employees.

The Simplified IRS Three-Factor Test

It is also worth noting the IRS use of a simpler and more streamlined three factors. This three-factor test is intended to complement rather than replace the 20-Factor Test. In **IRS Publication 15-A** (link to external site), the IRS divides and regroups the 20 factors under three headings: *behavioral control*, *financial control* and *the type of relationship*.

Under *behavioral control* the IRS considers instructions and training that the business gives to the worker. The IRS examines whether the business gives instructions as to:

- When and where to do the work;

What tools or equipment to use;

What workers to hire or to assist with the work;

Where to purchase supplies and services;

Whether work must be performed by a specified individual; or

What order or sequence to follow.

The factors included under *financial control* are:

The extent to which the worker has unreimbursed business expenses;

The extent of the worker's investment;

The extent to which the worker makes his or her services available to the relevant market;

How the business pays the worker; and

The extent to which the worker can realize a profit or loss.

When considering *the type of relationship*, the IRS examines:

Written contracts describing the relationship the parties intended to create;

Whether or not the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay or sick pay;

The permanency of the relationship; and

The extent to which the services performed by the worker are a key aspect of the regular business of the company.

The right to work for competitors of the company is not explicitly included, though it is perhaps implicit between controlling hours and offering services to the public.

Statutory Employees, Nonemployees and Employers

Most employee-versus-independent contractor questions are resolved based upon the standards previously discussed. There are certain classes of workers, however, who are automatically classified as employees or nonemployees regardless of the common law criteria. Some workers are deemed to be employees or nonemployees by statute. Likewise, certain employers are deemed to be employers by statute rather than common law.

Statutory Employees

A *statutory employee*, like a common law employee, is subject to Social Security and Medicare coverage even though the common law right to control test may not be met. However, income tax withholding is optional. Wages and taxes withheld are reported on Form W-2, Wage and Tax Statement. The four categories of statutory employees are:

1. Agent-drivers or commission drivers engaged in distributing meat, vegetable or bakery products; beverages (other than milk); or laundry or dry cleaning;
2. Full-time life insurance salespersons;
3. Home workers performing work according to furnished specifications on materials provided, which products are required to be returned to the principal; and
4. Full-time traveling or city salespersons soliciting orders from wholesalers or retailers for merchandise for resale or for supplies used in their business operations.

In addition to belonging to one of the specific occupations listed above, a statutory employee must satisfy all the following requirements:

1. Any contract of service contemplates that the worker will personally perform substantially all the work;
2. The worker has no substantial investment in the facilities; and
3. There is a continuing work relationship with the business for which the work is performed.

A statutory employee does not have any authority to delegate substantial portions of the work to another person. In addition, the work relationship must be regular and recurring. Thus, a single job transaction will not meet the definition of a "statutory employee".

Practical Example #1

In *Tavella v. Comm'r*, T.C. Summary Opinion 2009-76 (T.C. 2009), the Tax Court considered whether a worker was a statutory employee and, therefore, not subject to self-employment taxes. The worker, who performed services as a consultant, argued that his work was similar to the statutory employee category of life insurance agents. The court ruled that a Treasury Department regulation, +*26 C.F.R. § 31.3121(d)-1*, defines the term "employee" and lists discrete and specific categories of service that are not ambiguous. The court found that the taxpayer did not fit the definition of "statutory employee" as prescribed by that section.

Practical Example #2

In an IRS Technical Advice Memorandum, 1993 PLR LEXIS 2529 (I.R.S. 1993), the IRS concluded that before a company can obtain relief under Section 530 of the Revenue Act of 1978, it must first determine the employment status of the workers in question. The Letter Ruling confirms that the provision requires a two-step analysis. First, it must be determined if the workers are employees or independent contractors. Then, if they are employees, a determination must be made as to whether the provisions of Section 530 have been met.

Statutory Nonemployees

Just as there are certain workers who are given automatic employee treatment, there are also rules governing *statutory nonemployees*.

These statutory nonemployees are in effect outside the category of employees, even though an application of the normal IRS criteria might suggest otherwise. As with the statutory employee rules, the statutory nonemployee rules are purely creatures of federal tax law.

Three categories of workers are classified as nonemployees by statute: direct sellers, qualified real estate agents and certain companion sitters. Direct sellers and qualified real estate agents are treated as self-employed for all federal income and employment tax purposes. However, to qualify, substantially all payments for the services of direct sellers and qualified real estate agents must be related to sales or other output. Furthermore, their services must be performed under a written contract providing that they will not be treated as employees for federal tax purposes.

Direct Sellers

Direct sellers include individuals who are engaged in the trade or business of:

1. Selling (or soliciting the sale of) consumer products to any buyer on a buy-sell basis, a deposit-commission basis or any similar basis, for resale (by the buyer or any other person) in the home or otherwise than in a permanent retail establishment;
2. Selling (or soliciting the sale of) consumer products in the home or otherwise than in a permanent retail establishment; or
3. The delivering or distribution of newspapers or shopping news (including any services directly related to such trade or business).

For purposes of the direct sellers definition, the term "consumer products" includes both tangible consumer goods and intangible consumer services. For example, in *Smoky Mt. Secrets v. United States*, +*910 F. Supp. 1316* (E.D. Tenn. 1995), the court found telephone marketers and delivery persons (of gourmet foods and condiments) to be direct sellers, where the delivery persons collected payment and often closed the sale.

Qualified Real Estate Agents

Qualified real estate agents are considered statutory nonemployees as long as they are properly licensed. However, the possession of a real estate license does not on its own mean an individual is performing services as a real estate agent. Federal law requires both the possession of a valid real estate license *and* the performance of services as a real estate agent. 26 U.S.C. § 3508.

Practical Example

A real estate loan officer is not considered a "qualified real estate agent" despite the fact that he may be licensed to sell real estate. Although loan officers may place loans for residential real estate sales made by a real estate agent or may refinance existing loans, the IRS has ruled they are not engaged in services as real estate agents, and therefore are not statutory nonemployees.

Companion Sitters

Companion sitters furnish personal attendance, companionship or household care services to children or individuals who are elderly or disabled. These workers are not treated as the employees of "companion-sitting placement services," or persons or entities engaged in the trade or business of putting sitters in touch with individuals who wish to employ them. Any individual who is deemed not to be the employee of a companion-sitting placement service is treated as self-employed for purposes of self-employment tax.

The statutory designation of nonemployee status only attaches to companion-sitting placement services that do not pay or receive the salary or wages of the sitters, and which are compensated by the sitters or the persons who employ them on a fee basis. If, under the traditional common law rules, a companion sitter is considered the employee of the individual for whom the sitting is performed (rather than the companion-sitting placement service), the special exception provided at 26 U.S.C. § 3506 has no effect upon that employer-employee relationship. In other words, in that event, the traditional 20-factor analysis would determine the status of the worker.

Statutory Employers

In general, federal law defines an "employer" in accordance with its common law definition, as a person for whom an individual performs any service as an employee. 26 U.S.C. § 3401(d). However, in addition to the statutory employee and nonstatutory employee categories, the Internal Revenue Code codifies the definition of "employer" under certain circumstances. If the person for whom the individual performs services does not have control of the payment of the wages, Section 3401(d)(1) provides that the "employer" is the person having control of that payment. In that case, the person with control over the payment of wages - a statutory employer - is responsible for withholding, paying and reporting the employees' federal income taxes.

In determining who is covered by this statutory employer definition, courts have held that control over the payment of wages means control over the bank account. The party with control of the account from which wages are paid is the employer. Only the party with control of the account from which wages are paid can control whether payment will occur and in what amount. Literally, one must follow the money to see who is responsible.

Of course, the person who distributes wage payments from the source is best able to account

for distributions to employees and to ensure that taxes are withheld. These persons (whether individuals or firms) are considered statutory employers and are normally liable for the wage withholding of their employees.

This treatment extends to federal income tax withholding responsibilities, as well as to employment taxes. In *Otte v. United States*, +*419 U.S. 43* (U.S. 1974), the Supreme Court determined that statutory employers under Section 3401(d)(1) are also employers for the purpose of Social Security and Medicare (FICA) taxes. Other courts have since required statutory employers to pay federal unemployment (FUTA) taxes, even though they may not be the common law employers of their employees.

Directors, Officers and Partners

Are the directors, officers and partners of a company employees or independent contractors?

Outside or independent directors are almost invariably treated as independent contractors.

Officers of a company, however, are generally treated as employees. In fact, officers of corporations are generally seen as statutory employees of the company, except those officers who provide minimal service and are not entitled to receive any pay. Some directors may seek to avoid employee status. However, if they perform substantial services for the corporation and receive remuneration for those services, they probably will be held to be an employee for federal employment tax purposes.

Practical Example

John Yeagle owned 99 percent of Yeagle Drywall Co.'s stock, and his wife owned the remaining one percent of the S corporation. Yeagle performed many services for the business, including soliciting business, ordering supplies, entering into oral and written agreements, overseeing finances, collecting money owed, and hiring and firing independent contractors. The business did not make regular payments to Yeagle, but he withdrew money and paid his personal expenses from the business' bank account at his discretion. The business did not treat Yeagle as an employee or file quarterly employment tax returns. The business treated individuals who performed services for it, other than Yeagle, as independent contractors and issued Forms 1099-MISC to them. The business did not issue Forms 1099-MISC or W-2 to Yeagle. The business reported the net income it paid to Yeagle as Yeagle's share of the business' income. The Yeagles reported John's share of the business' income as nonpassive income from an S corporation on their individual returns. On audit, the IRS determined that Yeagle was an employee for employment tax purposes, and that the business was not entitled to safe harbor relief under Section 530. The Tax Court agreed. Yeagle was an officer who performed substantial services and received remuneration for those services. The court rejected the characterization of the payments to Yeagle as a distribution of net income. The payments were wages subject to federal employment taxes. Plus, the business was not entitled to safe harbor relief because it had no reasonable basis for not treating Yeagle as an

employee. *Yeagle Drywall Co. v. Comm'r,* T.C. Memo 2001-284 (T.C. 2001).

May a partner also be an employee of the partnership to which he or she belongs? This would mean that the person could receive money in two capacities: as an employee for services and as a partner for a share of the profits. The IRS position is that *bona fide* partners of a partnership cannot also be employees of that partnership for purposes of the employment tax provisions of the Code. To qualify as an employee for purposes of Social Security, Medicare, federal unemployment and income tax withholding, the worker must be classified both as not a *bona fide* partner *and* as an employee under the common law control test. IRS CCA 200117003 (I.R.S. 2001).

Requesting IRS Rulings on Worker Status

Any worker and any employer can ask the IRS to rule on a worker's status as either an independent contractor or an employee for federal employment tax purposes using **IRS Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding** (link to external site). The SS-8 Unit of the IRS reviews all the submitted information and, where appropriate, issues a determination letter. If the worker has requested the determination, the determination letter is issued to both the worker and the employer. If the employer has requested the determination, the determination letter is issued only to the employer. Unlike most IRS Letter Rulings, there is no fee for requesting a determination through Form SS-8.

No Rulings for Expired Tax Years or Hypothetical Situations

No determination letter will be issued for tax years in which the statute of limitations has expired, meaning more than three years from the due date or filing date of a return, whichever is later. Additionally, the IRS will not issue a determination on hypothetical situations, although a more informal "information letter" may be issued in some cases.

Use in Audits and Legal Effect of an SS-8 Ruling

Form SS-8 may also be used in an audit or examination. However, a request for a determination of worker status via Form SS-8 is a pre-examination matter that does not resolve a tax controversy or result in an employment tax adjustment or assessment of employment tax liability. Therefore, if the IRS determines that the worker is an employee, the IRS sends no tax bill or balance due.

The IRS determination resulting from a Form SS-8 is advisory in nature and does not trigger a tax bill. If the IRS determines that a worker is an employee, the employer is responsible for satisfying the resulting employment tax payment obligations, as well as filing requirements. However, there are generally four options available to the employer in such a case.

1. The employer may simply accept the IRS's determination that the worker in question is an employee. The employer is generally liable for employment taxes and filing requirements, including **Form 941, Employer's Quarterly Federal Tax Return** or **Form**

941-X, Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund, and **Form W-2, Wage and Tax Statement**.

2. The employer may choose to file another Form SS-8. If, for example, the employer has engaged workers under a new contract after an adverse SS-8 ruling, the employer may wish to reapply for a worker status determination under the facts and circumstances prevailing under that new contract.

3. The employer may dispute the SS-8 determination by exercising certain appeal rights. The appeals process for an SS-8 determination is designed to resolve tax controversies without litigation in a manner that is fair and impartial to both the government and the taxpayer. Either the worker or the employer involved in an SS-8 determination can request a reconsideration of that determination.

4. If the IRS finds that a worker is an employee through an SS-8 determination, the employer may simply do nothing and wait for an audit. Only about 20% of employers that are sent SS-8 determination letters, but who are not selected for examination, voluntarily comply with the IRS's classification determination; and an average of only 2-3% of employers who have misclassified employees as revealed in SS-8 determinations are referred to an audit examination, and even fewer are actually audited, according to IRS officials. GAO-09-717.

Even if the IRS elects to audit the employer after an SS-8 determination finding employee status, the employer has recourse to safe harbor under Section 530 of the Revenue Act of 1978. *See* **Safe Harbor**.

Under Other Laws

Of course, the classification of workers as independent contractors or employees has ramifications beyond just the tax code. Federal employment laws, state unemployment laws and state workers' compensation laws also come into play.

Federal Employment Laws

The term "employee" appears in federal labor, civil rights and pension laws. The employer-employee relationship is regulated by a host of federal laws, including:

The Fair Labor Standards Act;

Title VII of the Civil Rights Act of 1964;

The Age Discrimination in Employment Act;

The Rehabilitation Act of 1973;

The National Labor Relations Act;

The Longshore and Harbor Workers' Compensation Act;

The Immigration Reform and Control Act of 1986;

The Federal Employers' Liability Act;

The Employee Retirement Income Security Act of 1974;

The Family and Medical Leave Act of 1993; and

The Older Workers Benefit Protection Act.

Independent contractor status for purposes of federal labor laws generally removes a worker from protection. These labor laws are not uniform, and an analysis of the facts and circumstances of each case is needed to make the employee/independent contractor determination. Some state labor and employment laws protect independent contractors as well as employees. For example, California has a statute protecting independent contractors from discrimination, although it is certainly not as strong a protection as that afforded to employees.

The Fair Labor Standards Act

The Fair Labor Standards Act (FLSA), +*29 U.S.C. § 201* - +*29 U.S.C. § 219*, applies minimum wage, overtime, equal pay and child labor protections to most employees.

The express wording of the FLSA indicates that the wage and hour provisions apply only to "employees". +*29 U.S.C. § 203*; +*29 U.S.C. § 206*; +*29 U.S.C. § 207*. The FLSA defines employee as "any individual employed by an employer". +*29 U.S.C. § 203(e)(1)*. To employ means "to suffer or permit to work". +*29 U.S.C. § 203(g)*.

Federal courts traditionally define "employee" expansively for purposes of FLSA coverage. *See Rutherford Food Corp. v. McComb*, +*331 U.S. 722, 728* (1947); *see also Real v. Driscoll Strawberry Assocs.*, +*603 F.2d 748, 754* (9th Cir. 1979); *Usery v. Pilgrim Equip. Co.*, +*527 F.2d 1308, 1311* (5th Cir. 1975). Independent contractors are not covered or protected by the FLSA, but because courts define "employee" liberally, the majority of reported decisions that have grappled with the issue of employee versus independent contractor status have found particular workers to be employees.

Neither the statute nor the implementing regulations define the term "independent contractor". The federal courts have developed a relatively uniform set of factors to determine independent contractor status, however. Application of these factors has been termed the *economic realities test*.

The courts generally consider the following factors when determining employee or independent contractor status under the FLSA:

1. The hiring firm's right to control the means and manner of the individual's work;
2. The worker's investment in equipment, tools and facilities;

3. The worker's opportunity for profit or loss;
4. The permanency of the relationship between the worker and the employer;
5. The skill of the worker required in performing the work (for example, managerial skills suggest the individual is an independent contractor, but skill and diligence in the performance of labor alone are not sufficient to create an independent contractor relationship); and
6. Whether the service rendered is an integral part of the employer's business.

See

Brock v. Superior Care, Inc., +*840 F.2d 1054, 1058 - 59* (2d Cir. 1988) (nurses dispatched by home health care service were employees);

Sec'y of Labor v. Lauritzen, +*835 F.2d 1529, 1534 - 35* (7th Cir. 1987) (migrant farm workers were employees);

Patel v. Wargo, +*803 F.2d 632, 635* (11th Cir. 1986);

Donovan v. DialAmerica Mktg., Inc., +*757 F.2d 1376, 1382* (3d Cir. 1985) (home researchers of telephone marketing firm were employees);

Donovan v. Brandel, +*736 F.2d 1114, 1117 - 20* (6th Cir. 1984) (migrant farm workers were independent contractors);

Doty v. Elias, +*733 F.2d 720, 723* (10th Cir. 1984) (waiters and waitresses were employees);

Donovan v. Sureway Cleaners, +*656 F.2d 1368, 1370* (9th Cir. 1981) (operators of dry cleaning outlets were employees);

Real v. Driscoll Strawberry Assocs., +*603 F.2d 748, 754* (9th Cir. 1979) (strawberry growers may be employees);

Usery v. Pilgrim Equip. Co., +*527 F.2d 1308, 1311 - 15* (5th Cir. 1975) (laundry workers were employees).

As with independent contractor determinations in other contexts, no one factor is determinative. Instead, courts examine the "circumstances of the whole activity" or relationship. *Rutherford Food Corp. v. McComb*, +*331 U.S. 722, 730* (1947).

Some courts have articulated a few additional factors as part of their economic realities analysis, such as whether the alleged employer:

1. Had the power to discharge the worker;
2. Supervised and controlled work schedules or working conditions;

3. Determined the rate and method of payment; and

4. Maintained employment records.

See Watson v. Graves, +*909 F.2d 1549, 1553* (5th Cir. 1990); *Carter v. Dutchess Cmty. Coll.*, +*735 F.2d 8, 12* (2d Cir. 1984); *Doty v. Elias*, +*733 F.2d 720, 723* (10th Cir. 1984).

Moreover, the courts have uniformly held that labels designating an individual as an employee or independent contractor in a contract, for example, will not determine independent contractor status.

Title VII of the Civil Rights Act of 1964

Title VII of the Civil Rights Act of 1964 makes it illegal to discriminate against someone on the basis of race, color, religion, national origin, or sex. The law also makes it illegal to retaliate against a person because the person complained about discrimination, filed a charge of discrimination, or participated in an employment discrimination investigation or lawsuit. The law also requires that employers reasonably accommodate applicants' and employees' sincerely held religious practices, unless doing so would impose an undue hardship on the operation of the employer's business. *See* **Employee Management > EEO - Discrimination**.

The Title VII statute and regulations offer little guidance on who is an employee and who is an independent contractor. As a result, the federal courts have been left to interpret this question. Most courts have applied either an *agency test*, an *economic realities test*, or a *hybrid test* blending the two. *Frankel v. Bally, Inc.*, +*987 F.2d 86* (2d Cir. N.Y. 1993).

The agency test arises out of the common law (*see* **Common Law Right to Control**) and considers the following factors:

The skill required;

The source of the instrumentalities and tools;

The location of the work;

The duration of the relationship between the parties;

Whether the hiring party has the right to assign additional projects to the hired party;

The extent of the hired party's discretion over when and how long to work;

The method of payment;

The hired party's role in hiring and paying assistants;

Whether the work is part of the regular business of the hiring party;

Whether the hiring party is in business; the provision of employee benefits; and

The tax treatment of the hired party.

Cmty. for Creative Non-Violence v. Reid, +*490 U.S. 730* (U.S. 1989).

Other courts, finding the agency test too narrow and thus "inconsistent with the broad remedial scope" of Title VII (*Frankel*) have applied an *economic realities test.* Courts have applied several variations of this test, but one common denominator among them is that they all focus on whether the worker is *economically dependent* on his or her employer.

A good example of an economic realities test comes from the 5th Circuit Court of Appeals, which considers the following factors:

> The degree of control exercised by the alleged employer;
>
> The extent of the relative investments of the putative employee and employer;
>
> The degree to which the "employee's" opportunity for profit and loss is determined by the "employer;"
>
> The skill and initiative required in performing the job; and
>
> The permanency of the relationship.

Brock v. Mr. W Fireworks, Inc., +*814 F.2d 1042, 1043* (5th Cir. Tex. 1987), citing *United States v. Silk*, +*331 U.S. 704* (U.S. 1947).

The Age Discrimination in Employment Act

The Age Discrimination in Employment Act (ADEA), +*29 U.S.C. § 621* - +*29 U.S.C. § 634*, is similar to Title VII in the scope and nature of its coverage. The ADEA provides that it shall be unlawful for an employer "to fail or refuse to hire or to discharge any individual or otherwise discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's age." The ADEA limits its prohibition against age discrimination to those individuals who are 40 years of age or older. +*29 U.S.C. § 631(a)*; *Gen. Dynamics Land Sys. v. Cline*, +*540 U.S. 581* (2004). *See* **Employee Management > EEO - Discrimination**.

The ADEA also prohibits retaliation against employees who participate in investigations or litigation against employers for alleged unlawful age discrimination practices. +*29 U.S.C. § 623(d)*. The ADEA defines employer as "a person engaged in an industry affecting commerce who has twenty or more employees." +*29 U.S.C. § 630(b)*. Person is defined as "one or more individuals, partnerships, associations, labor organizations, corporations, business trusts, legal representatives, or any organized groups of persons." +*29 U.S.C. § 630(a)*.

As in Title VII, the ADEA defines employee as "an individual employed by any employer," and extends its protection to United States citizens employed abroad. +*29 U.S.C. § 630(f)*. The ADEA, like Title VII, is remedial in nature and has consistently been interpreted liberally to effectuate its purposes. *See Zimmerman v. N. Am. Signal Co.*, +*704 F.2d 347, 353* (7th Cir.

1983); *EEOC v. Karuk Tribal Hous.*, +*2000 U.S. Dist. LEXIS 14292*, at *7 - *9 (N.D. Cal. 2000), *rev'd on other grounds*, +*260 F.3d 1071* (9th Cir. 2001). Thus, as with Title VII, courts examine the circumstances of a work relationship to determine if an employer-employee relationship exists; the parties' description of their relationship is not controlling. *EEOC v. First Catholic Slovak Ladies Ass'n*, +*694 F.2d 1068, 1070* (6th Cir. 1982).

However, courts interpreting the ADEA generally have been unwilling to extend the ADEA's coverage to relationships other than the direct employment relationship. *Hyland v. New Haven Radiology Assocs., P.C.*, +*794 F.2d 793, 796* (2d Cir. 1986); *Garrett v. Phillips Mills, Inc.*, +*721 F.2d 979, 980 - 981* (4th Cir. 1983). *But see Mattice v. Mem'l Hosp. of S. Bend*, +*203 F.R.D. 381, 384* (N.D. Ind. 2001)*;Saxon v. Thompson Orthodontics*, +*71 F. Supp. 2d 1085, 1088* (D. Kan. 1999) (discussing *Hyland* and looking to actual control of business in determining whether shareholders in a professional corporation were employees).

The Rehabilitation Act of 1973

The Rehabilitation Act of 1973, +*29 U.S.C. § 701* - +*29 U.S.C. § 796*, established a federal program to assist handicapped individuals in assuming a full role in society. *Consol. Rail Corp. v. Darrone*, +*465 U.S. 624* (1984). Section 503 regulates the practices of employers that have supply, service, or construction contracts with the federal government. Section 503 expressly applies to the employment relationship: Any contract in excess of $10,000 entered into by any federal department or agency for the procurement of personal property and non-personal services (including construction) for the United States shall contain a provision requiring that, in employing persons to carry out such contract, the party contracting with the United States shall take affirmative action to employ and advance in employment qualified individuals with handicaps. +*29 U.S.C. § 793*.

Section 504 of the Act applies to those entities that receive federal financial assistance. Its coverage is broader than that of Section 503 in that it prohibits discrimination beyond the employment setting:

> *No otherwise qualified individual with handicaps in the United States ... shall, solely by reason of his or her handicap, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving federal financial assistance.* +*29 U.S.C. § 794*.

An individual claiming discrimination in employment under Section 504 must establish: (1) that the employer is a recipient of federal financial assistance; (2) that he is an otherwise-qualified handicapped individual; and (3) that adverse employment action was taken against him or her solely by reason of his or her handicap. *Lucero v. Hart*, +*915 F.2d 1367, 1371* (9th Cir. 1990). An individual claiming employment discrimination under Section 503 does not have a private right of action. Rather, a charge of discrimination must be filed with the Department of Labor. *D'Amato v. Wis. Gas Co.*, +*760 F.2d 1474, 1478* (7th Cir. 1985).

Few cases have been brought under either Section 503 or Section 504 in which the issue of a claimant's status as an employee has been litigated. It appears, however, that courts may analyze the work relationship based upon common law principles of agency.

A few courts held that the doctrine of *respondeat superior*, or vicarious liability, was applicable to claims brought under Section 504. This doctrine holds that a master or employer is liable in certain situations for the wrongful acts of a servant or employee as a principal is liable for the acts of an agent. Thus, in *Bonner v. Lewis*, +*857 F.2d 559, 567* (9th Cir. 1988), the 9th Circuit Court of Appeals concluded that the doctrine of *respondeat superior* was applicable to claims brought under Section 504 when a prison inmate named prison officials in his lawsuit and claimed they were responsible for the discriminatory acts of lower-level guards.

In *Glanz v. Vernick*, +*756 F. Supp. 632* (D. Mass. 1991), an HIV-infected patient filed a Section 504 suit against a physician for refusing to perform surgery because of the patient's HIV-positive status. The patient also named as a defendant the hospital where the physician was a staff member. The hospital claimed it should not be considered liable because it never treated the patient and it had no control over the physician's medical decisions. In rejecting the hospital's argument, the court opined that vicarious liability was appropriate in a Section 504 action.

It appears that the court applied a hybrid test, one in which either an individual's employment status was considered, or one in which the employer's "power and control" over a nonemployee was evaluated. In either case, liability could attach. While some courts have followed *Glanz,* a few have also rejected its approach. *See Doe v. City of Chicago*, +*883 F. Supp. 1126* (N.D. Ill. 1994) (holding that plaintiffs may assert claims against under Section 504 of the Rehabilitation Act after their applications to be police officers were rejected after they tested HIV-positive); *Guckenberger v. Boston Univ.*, +*957 F. Supp. 306* (Mass. 1997) (plaintiffs may assert Rehabilitation Act claims against responsible individuals). In *Fitzpatrick v. Pennsylvania*, +*40 F. Supp. 2d 631* (E.D. Penn. 1999), the court explicitly rejected *Glanz*, finding its reading of Section 504 to be "questionable".

The National Labor Relations Act

The National Labor Relations Act (NLRA) regulates private sector labor relations in industries engaged in interstate commerce. +*29 U.S.C. § 151* - +*29 U.S.C. § 168*; *see* **Labor Relations > Labor Relations Overview**. The NLRA is designed to prevent obstructions to commerce "by encouraging the practice and procedure of collective bargaining and by protecting the exercise by workers of full freedom of association, self-organization, and designation of representatives of their own choosing for the purpose of negotiating the terms and conditions of their employment or other mutual aid or protection."

The NLRA protects the rights of employees to organize, choose their own collective bargaining representatives, and engage in concerted activities for the purpose of collective bargaining, mutual aid or protection, or to refrain from such activities. +*29 U.S.C. § 157*. The NLRA's definition of "employee" specifically excludes "any individual having the status of an

independent contractor." +29 U.S.C. § 152(3). The legislative history of this exclusion reflects congressional intent that the National Labor Relations Board (NLRB) and the courts apply the common law principles of agency in distinguishing between employees and independent contractors:

> *"Employees" work for wages or salaries under direct supervision; "independent contractors" undertake to do a job for a price, decide how the work will be done, usually hire others to do the work, and depend for their income not upon wages, but upon the difference between what they pay for goods, materials and labor and what they receive for the end result, that is, upon profits.*

H.R. Rep. No. 245, 80th Cong., 1st Sess. 18 (1947); *see also NLRB v. United Ins. Co. of Am.*, +390 U.S. 254, 256 (1968).

In *NLRB v. Hearst Publications, Inc.*, +322 U.S. 111 (1944), the Supreme Court held that the common law distinctions between employees and independent contractors were not controlling under the NLRA and that the "employee" should be interpreted broadly to effect the purposes of the NLRA. A 1947 amendment that specifically excluded independent contractors from the NLRA's protection overturned the Supreme Court's holding

Congress established the NLRB to administer the NLRA and effectuate the public policies articulated in it. The NLRB may be called upon to determine whether a worker is a protected employee or an excluded independent contractor either in proceedings to determine the identity or composition of an appropriate unit of employees for purposes of collective bargaining or in proceedings to prevent labor practices that violate employee rights guaranteed by the NLRA. *See NLRB v. United Ins. Co. of Am.* +390 U.S. 254, 255 (1968).

The NLRB and the reviewing courts historically apply common law agency principles to the facts presented by the dispute to determine whether the worker is an employee or independent contractor under the NLRB. *Chaiken v. VV Publ'g Co.*, +119 F.3d 1018 (2d Cir. 1997) (citing with approval to common law right to control test, although case decided on other grounds). In *News Syndicate Co.*, 164 NLRB 422 (1967), the NLRB summarized these principles as the right of control test:

> *In determining the status of persons alleged to be independent contractors, the Board has consistently held that the Act requires application of the right-of-control test. Where the one for whom services are performed retains the right to control the manner and the means by which the result is to be accomplished, the relationship is employment, while, on the other hand, where control is reserved only as to the result sought, the result is that of an independent contractor. The resolution of this question depends on the facts of each case, and no one factor is determinative.*

164 NLRB 422, 423 (1967).

The NLRB also refers to this as the right to control test. *Standard Oil Co.*, 230 NLRB 967, 968 (1977). In *Air Transit, Inc.,* 277 NLRB 1108 (1984), the NLRB explained the test further as follows:

> *The extent of the actual supervision exercised by a putative employer over the "means and manner" of the worker's performance is the most important element to be considered in determining whether or not one is dealing with independent contractors or employees.*

277 NLRB at 1110 (quoting *Seafarers Local 777 v. NLRB*, +*603 F.2d 862, 872-873* (D.C. Cir. 1978)).

The NLRB weighs a number of factors in making determinations. Among these are the factors found in Restat 2d of Agency, § 220, specifically:

- The extent of control which, by the agreement, the master may exercise over the details of the work;
- Whether or not the one employed 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 employer or by a specialist without supervision;
- The skill required in the particular occupation;
- Whether the employer or the work[er] supplies the instrumentalities, tools and the place of work for the person doing the work;
- The length of time for which the person is employed;
- 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 employer;
- Whether or not the parties believe they are creating the relation of master and servant; and
- Whether the principal is or is not in business.

The NLRB and reviewing courts determine independent contractor status by assessing the "total factual context" presented by the dispute. *NLRB v. United Ins. Co. of Am.*, +*390 U.S. 254, 258* (1968).

The Longshore and Harbor Workers' Compensation Act

The Longshore and Harbor Workers' Compensation Act (LHWCA), +*33 U.S.C. § 901* - +*33 U.S.C. § 950* (1984), provides compensation for the disability or death of a maritime employee

that occurs upon appropriate statutory sites, which include the navigable waters of the United States. The LHWCA does not cover injuries to independent contractors. +*33 U.S.C. § 905(a)*.

U.S. Department of Labor regulations provide administrative and procedural rules for submitting compensation claims under the LHWCA. 20 C.F.R. § 701; +*20 C.F.R. § 702*; +*20 C.F.R. § 703*; 20 C.F.R. § 704. The DOL's Office of Workers Compensation Programs undertakes informal resolution of disputes over compensation claims. If a claim is not resolved informally, it may be litigated. Litigated claims are initially resolved by an administrative law judge. +*33 U.S.C. § 919(d)* (1984); +*20 C.F.R. § 702, 331* (1991). If appealed, administrative law judge decisions are reviewed by DOL's Benefits Review Board (BRB). +*33 U.S.C. § 921(b)(3)* (1984); +*20 C.F.R. § 702, 391* (1991). The decisions of the BRB may be appealed to the United States Court of Appeals for the circuit in which the injury occurred. +*33 U.S.C. § 921(c)* (1984).

Although this section deals with federal workers compensation issues, there may be concurrent state workers compensation claims not addressed here. In *Sun Ship v. Pennsylvania*, +*447 U.S. 715* (1980), the Supreme Court held that employees who have sustained land-based injuries that fall within LHWCA may file concurrent claims under a state's worker compensation program. Where concurrent jurisdiction exists, state-specific independent contractor classification tests under workers compensation laws become relevant and important considerations.

Historically, three tests have been used to determine whether a claimant is a maritime employee or an independent contractor under the LHWCA:

1. The test set forth in Restat 2d of Agency, § 220 (*see* **The National Labor Relations Act**);
2. The relative nature of the work test; and
3. The right to control the details of work test.

At the administrative level, any one of these three tests may be used. *Tanis v. Rainbow Skylights*, 19 Ben. Rev. Bd. Serv. (MB) 153, 155 (1986); *Carle v. Georgetown Builders, Inc.*, 14 Ben. Rev. Bd. Serv. (MB) 45, 47 - 48 (1980); *Burbank v. K.G.S., Inc.*, 12 Ben. Rev. Bd. Serv. (MB) 776 - 778 (1980). One federal circuit court of appeals has ruled, however, that only the "relative nature of the work" test is appropriate. *Oilfield Safety & Mach. Specialities, Inc. v. Harman Unlimited, Inc.*, +*625 F.2d 1248*; +*625 F.2d 1254* (5th Cir. 1980).

The relative nature of the work test is used by both the BRB and the 5th Circuit Court of Appeals to determine whether a claimant is an employee or an independent contractor under the LHWCA. This test involves an examination of the nature of the claimant's work, and the relationship of that work to the regular business of the employer. *Haynie v. Tideland Welding Serv.*, +*631 F.2d 1242, 1243* (5th Cir. 1980); *Oilfield Safety & Mach. Specialties, Inc. v. Harman Unlimited, Inc.*, +*625 F.2d 1248, 1253* (5th Cir. 1980); *Brian v. Precision*

Valve/Hayley Marine, 23 Ben. Rev. Bd. Serv. (MB) 207, 210 (1990); *Carle v. Georgetown Builders, Inc.*, 14 Ben. Rev. Bd. Serv. (MB) 45, 47 n.2 (1980) (citing Arthur Larson, *Workmen's Compensation Law*, § 43 (1980)).

The BRB has also held that the "right to control the details of work" test may be used to determine whether a worker is a covered maritime employee or an independent contractor. There are four elements of this test: (1) the right to control the details of the work; (2) the method of payment; (3) the furnishing of equipment; and (4) the right to discharge. *Carle v. Georgetown Builders, Inc.*, 14 Ben. Rev. Bd. Serv. (MB) 45, 47 n.1 (1980); *Burbank v. K.G.S. Inc.*, 12 Ben. Rev. Bd. Serv. (MB) 776, 778 (1980).

The Immigration Reform and Control Act of 1986

The Immigration Reform and Control Act of 1986 (IRCA), +*8 U.S.C. § 1324*, requires employers to verify the eligibility of those being hired, recruited or referred for employment by checking certain documents and completing a **Form 1-9, Employment Eligibility Verification** (link to external site), under penalty of perjury. It also establishes that it is unlawful to hire an unauthorized alien for employment. +*8 U.S.C. § 1324a(a)(1)(A)*.

Employers are not responsible for verifying whether independent contractors are unauthorized aliens for IRCA purposes because employment is defined as "service or labor performed by an employee". 8 C.F.R. § 274a.1(g). To determine whether an individual is truly an independent contractor, the Immigration and Customs Enforcement Bureau (ICE) examines whether the following factors characterize the relationship between the worker and the employer requesting services:

1. Whether the worker or business supplies the tools or materials;
2. Whether the worker makes services available to the general public;
3. Whether the worker works for a number of clients at the same time;
4. Whether the worker has an opportunity for profit or loss as a result of labor or services provided;
5. Whether the worker invests in the facilities for work; and
6. Whether the worker directs the order or sequence in which the work is to be done and determines the hours during which the work is to be done.

8 C.F.R. § 274a.1(j).

Immigration regulations state that the factors to be evaluated are not limited to those listed above and that independent contractor status is to be determined case by case. The regulations further state that these factors are to be examined when worker classification is in dispute and that such disputes should not be resolved by focusing on what the individual or entity calls itself.

As of this writing, the issue of employee versus independent contractor status under the IRCA has not been tested in the courts. The factors listed in the regulations for determination of employee or independent contractor status suggest, however, that the approach will likely be a common law factor analysis similar to the right to control test applied by the NLRB.

Although work authorization inspection and completion of Form I-9, Employment Eligibility Verification, is required only of employers, it is also important to note that the IRCA specifically prohibits any employer or other person from obtaining or using the labor of an alien worker known to be unauthorized for work purposes, by use of contract, subcontract or exchange. +*8 U.S.C. § 1324a(a)(5)*. This means that an employer can be fined when a contractor or subcontractor employs unauthorized workers and the employer "knows" of the status. "Knowing" use of labor under this statute includes "constructive knowledge" where facts and circumstances would lead a person, through the exercise of reasonable care, to know about the unauthorized status. 8 C.F.R. § 274a.1(l)(1).

The Employee Retirement Income Security Act of 1974

The classification of an individual as an employee or an independent contractor has great significance under the Employee Retirement Income Security Act of 1974, as amended (ERISA), +*29 U.S.C. § 1001* (1988 & Supps.). ERISA provides remedies for participants of plans covered by ERISA, including the right to file civil actions for benefits under Section 502(a)(1)(B) of ERISA. However, only participants or their beneficiaries may take advantage of the remedy provided in Section 502(a)(1)(B) of ERISA. The term "participant" is defined in Section 3(7) of ERISA and is limited to *employees* or *former employees* of the employer maintaining the plan. Thus, independent contractors are not eligible to take advantage of the remedies provided in ERISA.

Section 3(6) of ERISA defines an employee as an individual employed by an employer. There is no regulatory interpretation or other statutory guidance with respect to the definition of an employee under ERISA.

However, in *Holt v. Winpisinger,* +*811 F.2d 1532* (D.C. Cir. 1987), the District of Columbia Court of Appeals set forth a standard to determine an individual's status as an employee or an independent contractor. The court noted that the statutory definition of employee found in ERISA provides little or no guidance on whether a party performing services pursuant to a particular work arrangement is an employee. Thus, the court looked to common law rules of agency to determine employee status. The court looked to the intent of the parties - that is, the manner in which the individual was classified by the company - as one factor in determining whether the individual was an independent contractor, but recognized that intent is not the only factor involved.

Additionally, the court in *Holt* cited the Restatement (Second) of Agency, which lists 10 factors that are helpful in differentiating between an employee and an independent contractor. *See* **The National Labor Relations Act**.

The Family and Medical Leave Act

The Family and Medical Leave Act (FMLA) requires most employers with 50 or more employees to provide a total of 12 workweeks of leave during any 12-month period for any of the following reasons:

1. Because of the birth of an employee's child or the adoption or placement in the employee's foster care of a child, in order to care for the child;
2. In order to care for the employee's spouse or child or parent who suffers from a serious health condition; or
3. Because the employee himself or herself suffers from a serious health condition that prevents performance of the functions of the job.

+*29 U.S.C. § 2612*(a)(1); *see* **Managing Leaves > FMLA**.

The FMLA covers employers that employ 50 or more employees for each working day during each of 20 or more calendar workweeks in the current or preceding calendar year. +*29 U.S.C. § 2611*(4)(A)(1). Employees who have been employed by the employer for at least 12 months and who have worked at least 1,250 hours during the previous 12 months are eligible for leave. +*29 U.S.C. § 2611*(2)(A). Employees of an employer that employs 50 or more employees may still not be eligible for leave if they work at a site that has fewer than 50 employees and is not within 75 miles of another of the employer's work sites that has at least 50 employees. +*29 U.S.C. § 2611*(2)(B).

The FMLA provides that the term "employee" under the FMLA will have the same meaning given such term for purposes of the FLSA. +*29 U.S.C. § 203*(e). The economic realities test is used to determine employee status under the FLSA. *Rutherford Food Corp. v. McComb*, +*331 U.S. 722, 730* (1947). The economic realities test for employee status uses a list of common law factors that focus on the worker's economic dependence on the alleged employer. *See* **The Fair Labor Standards Act**.

Determination of employee status under the FMLA will not only determine whether the FMLA covers an employer but also whether an individual worker is eligible for leave under the act. For the purposes of determining who shall be included as employees, federal regulations suggest that any employee is employed by the employer if he or she is regularly maintained on the employer's payroll. +*29 C.F.R. § 825.110*(b). Thus, whether an employee is part-time or on-call is of no importance. As long as the worker is an employee and not an independent contractor, and is regularly on the employer's payroll, the worker will be considered to be employed by the employer for the purposes of determining whether the employer is subject to the provisions of the FMLA.

Cases involving an employee's status for the purposes of the FLSA should be persuasive in making such a determination in the FMLA context as well. *See Figueira v. Black Entertainment Television*, +*944 F. Supp. 299* (S.D.N.Y. 1996).

State Unemployment Law ABC Test

Worker status is important under state unemployment insurance law. By definition, employees are covered while independent contractors are not. For purposes of state unemployment tax, less than 50 percent of the states use the common law criteria for evaluating whether a worker is an employee or an independent contractor. The common law definition focuses on the right of the employer to direct the means of production.

The remaining states use something other than the common law criteria. This test is referred to as the "ABC Test" because it has three factors. The ABC Test is very broad and shows a bias for treating virtually all workers as employees. Unless the worker meets one of the three factors, the worker is considered an employee. The three factors are:

The worker is free from control or direction in the performance of the work.

The work is done outside the usual course of the firm's business and is not done on the premises of the business.

The worker is customarily engaged in an independent trade, occupation, profession, or business.

Eighteen states and the District of Columbia use the common law criteria. Twenty-two states use the full ABC Test, and 10 states use two of the three factors, either A and B or A and C. These latter states are known as AB states and AC states for unemployment tax purposes. A list of states using each test is found below. Because the ABC Test is more inclusive than the common law factors, workers can be considered employees for state unemployment purposes but still be independent contractors for federal tax purposes. It is an understatement to say this creates confusion.

State Unemployment Law Tests		
ABC Test	***Common Law***	***Other***
Alaska	Alabama	Colorado (AC)
Arkansas	Arizona	Idaho (AB)
Connecticut	California	Kansas (AB)
Georgia	District of Columbia	Michigan

Hawaii	Delaware	Montana (AC)
Illinois	Florida	Oklahoma (AB or AC)
Indiana	Iowa	Pennsylvania (AC)
Louisiana	Kentucky	South Dakota (AC)
Maryland	Massachusetts	Virginia (AB)
Maine	Minnesota	Wisconsin (AC)
North Dakota	Missouri	
Nebraska	Mississippi	
New Hampshire	North Carolina	
New Jersey	New York	
New Mexico	Oregon	
Nevada	Rhode Island	
Ohio	South Carolina	
Tennessee	Texas	
Vermont	Utah	

Washington		
West Virginia		
Wyoming		

Workers' Compensation Test

Workers' compensation law is governed by statute in every state. Although the laws vary, there are key features that are remarkably consistent from state to state. The idea is simple. An employee is automatically entitled to receive certain benefits when he suffers an occupational disease or accidental personal injury arising out of and in the course of employment.

The benefits that are available may include cash or wage-loss benefits, medical benefits and career rehabilitation benefits. Where there is an accidental death of an employee, there would also be benefits to dependents. Significantly, the negligence and fault of either the employer or the employee are usually immaterial. But axiomatically, these laws apply to employees and not to independent contractors. In some states domestic workers and agricultural workers are also excluded or are only partially covered.

Notably, a worker whose injury is covered by a workers' compensation statute loses the common law right to sue the employer for that injury. However, the injured worker may still sue third parties whose negligence contributed to the work injury. For example, a courier injured in a rear-end collision by an unemployed third party would be entitled to collect workers' compensation and also to sue the third party for negligence.

In such cases, a plaintiff who recovers money from a third-party lawsuit must first repay the employer or insurer that paid workers' compensation benefits. The plaintiff may keep any remaining money. Many jurisdictions permit the employer or its insurer to sue negligent third parties on the employee's behalf to recover funds paid as workers' compensation benefits.

Most workers' compensation statutes require employers to purchase private or state-funded insurance, or to self-insure, to make certain that injured workers receive proper benefits. Workers' compensation insurance is a cost of doing business, part of the company's overhead associated with having employees. Usually, the cost of insurance is reflected in the cost of goods or services produced by the employer. In that way, the cost of workers' compensation liability is passed on to consumers.

Workers' compensation law is often administrative rather than judicial in nature. In most states, parties to workers' compensation disputes resolve them in administrative proceedings.

Many such proceedings can involve the fundamental question of whether the worker is or is not covered by the workers' compensation system. In short, the status of the worker as an employee or an independent contractor is critical.

Hiring and Managing Independent Contractors

There are several considerations that employers should keep in mind when hiring and managing independent contractors, including:

- **Drafting independent contractor agreements** that can help ensure the independent contractor is properly classified and protect the employer in the event of a lawsuit or a DOL audit;
- **Avoiding practices that might support recharacterization as an employee**;
- **Considering incorporated contractors**, which may shore up independent contractor classification; and
- **Fulfilling reporting requirements** for any payments made to independent contractors.

Drafting Independent Contractor Agreements

When hiring independent contractors, it is almost always a mistake not to have a written contract. It is extremely hard for an employer to defend against an assertion that one of its "independent contractors" is actually an employee if it does not have a written contract.

A written contract is usually the first point of reference to govern the relationship. So if an employer does not have a written contract, the worker is far more likely to later be labeled as an employee. Potential recharacterization from independent contractor to employee is always a one-way street.

While written contracts with independent contractors are important, drafting them is a virtual minefield. The drafter must consider specifics, but must always keep in mind the fundamental question: whether the company has the right to control the manner in which services are performed. This can require considerable creativity compared to normal contract drafting.

Employers may be tempted to rely on titles, affixing the "independent contractor" label but saying little more. They should go further. For example, employers should consider obligating the employer to pay for a finished product rather than allowing the company to direct each step leading to that finished product. Integration of the worker's services into the company's business can also show control, but integration is generally not something the drafter can address.

Although contract drafting is challenging, a good agreement goes a long way toward securing independent contractor relationships. The more thoughtfully an employer approaches contract drafting the more likely it is that it will enjoy long-term success in the independent contractor

relationship. Yet no matter how thoroughly an employer drafts, no independent contractor agreement is entirely safe from recharacterization.

Drafting independent contractor agreements presents daunting challenges. Many lawyers and businesspeople rely too heavily on forms and templates with no bearing on the facts. Forms can get an employer started, but should be read carefully and adapted to the employer's situation.

Business persons, human resource professionals and others without legal experience in this area should consider getting experienced legal help. This type of contract is different from many.

Of course, an employer will want to cover duration, exclusivity, location, hours, assistants, expenses and more. But unlike most other contracts, with an independent contractor agreement an employer must always be watching out for the danger of recharacterization. Even sophisticated parties may need help with the nuances of contractor-versus-employee analysis.

An employer should consider each provision and how it impacts the worker's status. If an employer uses a lawyer to help draft, it should make sure the process will be interactive and specifically focused on the extent to which the independent contractor status of the worker is likely to stand up to scrutiny. More than with most contract drafting, there should be give-and-take between lawyer and client.

These discussions are not easy and involve many factors. Third-parties often seek to recharacterize workers. Moreover, some independent contractors - who seemed happy to be treated as independent contractors - may end up later contesting their status and claiming they were always employees despite the independent contractor agreement they signed.

The law is clear that who is an employee is a legal and tax question not controlled by a contact between private parties. That fact will rub many business people the wrong way. While most contracts are private matters, an independent contractor agreement is not entirely private.

Any government agency can come along and want to examine it on the theory that perhaps the employer should have been paying taxes (or unemployment or workers' compensation) by treating the worker as an employee. Even private parties can scrutinize a contract, for example if they are suing a worker and claiming that they can sue the employer too because the worker was really an employee and not and independent contractor.

Here are some drafting suggestions to keep in mind:

Names and Titles

How an employer uses labels is a fundamental indicator of intent. An agreement for an independent contractor should state unequivocally that the person is performing services as an independent contractor, *not* an employee. Similarly, the agreement should be labeled an

Independent Contractor Agreement or Consulting Agreement.

More generally, throughout the agreement, employers should avoid employee-sounding nomenclature. Drafters should try to evaluate how the agreement would be interpreted by someone who was trying to attack the independent contractor relationship, and try to make sure that the agreement uses neutral terms or terms that only support independent contractor treatment.

Instructions and Training

The difference between contract specifications and ongoing instructions is important and is often overlooked in contract drafting. A worker required to comply with the employer's instructions about when, where and how to work is ordinarily an employee. Yet if one hires a contractor to install a swimming pool in his backyard, one can specify where one wants the pool!

Similarly, training workers (by requiring an experienced employee to work with them, requiring them to attend meetings, or other methods) may indicate the employer wants services performed in a particular manner. Ideally, an employer should make clear that the worker need not undergo training. Contracts should distinguish between existing skills and skills taught by the employer, either in the recitals or in the description of work to be performed by the independent contractor.

This also ties into the qualifications the worker may have. If an employer is contracting with a qualified electrician to come do wiring and light fixture installation, it is not likely it will need to do any training. It is also likely the electrician is certified in a particular field or skill level. These things help, so employers should do as much as they can in the contract to emphasize those things.

Right to Delegate, Hire Assistants, Etc.

Employers are often uncomfortable allowing workers to delegate duties. However, it can be important to address these issues in the contract. Allowing a worker to delegate some or all of the work to his or her subordinates tends to support independent contractor status.

Optimally, an independent contractor agreement should specify that any helpers or assistants must be hired, supervised and paid by the independent contractor. Optimally, the contract will give the independent contractor the right to do as much of this as he or she likes as long as the work is done according to the contract specifications.

Duration and Hours

There is no limit on contract duration for an independent contractor. In terms of the likelihood that the independent contractor relationship will withstand scrutiny, however, a shorter term is clearly preferable to a longer one.

Renewals may avoid an extended duration. However, an employer should not assume that just because it has had a one-year contract that is renewed or signed anew each year it is

safe from recharacterization. After all, a continuous and exclusive 20-year relationship punctuated by 20 annual renewals may not be very persuasive.

Hours are another important matter. Hours set by the employer - say, 9:00 a.m. to 5:00 p.m. every weekday - also suggest employee status. This is sensitive, since even under an independent contractor arrangement, an employer may reasonably believe that it should be able to tell a worker - any worker - when to work.

Yet the essence of independent contractor work is that the employer is paying for a finished product or the results of a finished service, not worrying over the details of exactly how the worker gets the job done. Of course, a homeowner might prohibit a home remodeler from noisy work past 7:00 p.m. That by itself does not make the contractor an employee.

However, from a contract drafting point of view, putting scheduling in the independent contractor's hands can help to support independent contractor characterization. While drafting, employers should consider how the contract will be read by someone who is trying to claim that they ordered the independent contractor around so much that he or she is really an employee.

Full-Time and Exclusivity

Classically, independent contractors are free to seek other work at the same time they are working for their employer. If a worker must work full time for one company, that restricts other work. The agreement should make clear whether full-time work is required. An alternative to full time might be to set a deadline for a final product.

Similarly, an exclusivity requirement hurts independent contractor status. Conversely, the lack of an exclusivity requirement should help to show that the worker is truly an independent contractor. This is so even if the worker does not choose to work for anyone else.

One possibility for getting some of the benefits of exclusivity without actually providing for it in the contract relates to noncompetition provisions. Employers can consider prohibiting the independent contractor from competing with them in their businesses. They also can consider including nondisclosure and confidentiality provisions. In some cases such provisions can help employers get what they want without expressly requiring that the contractor work exclusively for them.

If an employer must have exclusivity, exclusivity by itself is not fatal to a claim of independent contractor status. For example, following a business sale, departing executives who consult usually cannot engage in competition. That is usually made clear in the consulting contract. However, it does not necessarily mean they are employees. No one factor controls.

Work Site

Work performed on the employer's premises suggests control over the worker. Therefore, such a requirement may suggest that he or she is an employee, especially if the work could be done elsewhere. Where possible, the agreement should allow the independent contractor to determine where to perform the work.

In some cases, even if an employer makes it possible for the worker to do the work at any location, the employer may be able to make it more convenient for the worker to do the work on its premises. The key should be whether the contract genuinely gives the independent contractor freedom to do the work at any location (and at any time), which is more consistent with independent contractor treatment.

Progress Reports

Requiring that the worker provide periodic or regular progress or status reports can also be telling. Employers should avoid requiring periodic oral or written reports, since they tend to suggest that they are interested in the method, manner and means by which the worker will do the work, rather than the end product. Often, oral or written reports are not mentioned one way or the other in a contract.

Yet they commonly feature in disputes over worker status. The employer may be accused of requiring progress reports (indicating control over the worker) even if the contract says nothing about them. For that reason, employers may want to consider expressly stating in the independent contractor agreement that no progress or status reports are required.

Throughout the independent contractor agreement, the end result or the finished product should be most important. The contract can be quite specific as to what that finished product might be, and the employer can require compliance with the contract specifications. However, the employer should not have the right to control the independent contractor with respect to the method, manner and means of doing the work.

Manner of Payments

It is usually possible to pay someone for goods or services in a variety of different ways. However, employers may need to think creatively about this. Payment by the hour, week or month generally suggests an employer-employee relationship.

On the other hand, the mere fact that someone is paid by the hour does not make the person an employee. Consider that lawyers who are independent contractors frequently charge their clients by the hour. In terms of helping to indicate an independent contractor relationship, a lump-sum or progress payments for work completed is normally better than hourly, weekly or monthly payments.

Piecework payments are another common way of paying independent contractors. It is appropriate to run some examples and to try several approaches in achieving your compensation goals.

Who Bears Expenses?

Independent contractors are in business for themselves and therefore should generally bear their own expenses. Employers should avoid reimbursements, since reimbursement of business or travel expenses may suggest an employer-employee relationship. Of course, travel expenses are routinely charged by attorneys, accountants and other independent

professionals. Such provisions must be very clear in the written contract.

Equipment and Investment

A person providing his or her own equipment, tools and supplies is more likely to be an independent contractor. Conversely, if the employer supplies the needed tools and equipment, that fact tends to be a strike against the worker being treated as an independent contractor. Of course, before one can include contract provisions about this, one must consider what tools and equipment he or she means.

For example, suppose an architect is furnished office and desk space, secretarial and telephone service, but provides his own drafting instruments and reference guides. The office, phone and secretary, will probably hurt the case for independent contractor treatment. Having an independent contractor bear his or her own costs tends to support his independence. To avoid line-drawing, employers should consider increasing the total contract price by the expected costs and stating that the independent contractor-consultant must bear them.

As this example shows, it is often possible through creative contract drafting to change the nature of the obligations between the company and the worker. Often, this can occur in a way that yields a similar economic result that is better from a legal perspective.

Risk of Profit or Loss

If a worker risks economic loss due to significant investment or liability for expenses, it suggests independence and therefore tends to support independent contractor treatment. In drafting an independent contractor agreement, employers should avoid financial safety nets that preclude workers from experiencing losses.

Available to the Public

Workers who make their services available to the general public seem independent and therefore are less likely to later be recharacterized as employees. Sometimes the possibility of other work is as important as actually doing it, so employers should consider allowing the worker to advertise, etc. Such contract provisions also tie in to the discussion of exclusivity above. If an employer requires an independent contractor to work exclusively for it, he or she is certainly not available to perform work for the general public.

Discharge and Termination

Classically, the right to discharge a worker for any reason suggests the worker is an employee. The idea is that the threat of dismissal causes the worker to obey instructions. An independent contractor, on the other hand, generally cannot be terminated as long as he or she meets contract specifications. Employers should consider this model in drafting, even though reciprocal worker-company termination provisions (e.g., either party can terminate the contract for any reason on 30 days' notice) are often ignored.

The converse of the employer's right to discharge a worker is the worker's right to terminate the work relationship. An independent contractor agreement may include detailed termination

provisions that do not allow the contractor to terminate the arrangement at any time without liability. One model involves payment for a finished product, with termination geared to a percentage of completion. In practice, though, a reciprocal 30-day termination may make sense and may obviate most of such issues.

Indemnification?

Is it a good idea to acknowledge the possibility in the contract that someone may try to recharacterize the relationship as that of employment? There is no definitive answer. Independent contractor agreements often require workers to indemnify employers for taxes, penalties and interest if workers are recharacterized as employees.

Some employers believe this shows that the employer did everything possible to ensure that the person was treated appropriately. Others believe that such a provision makes it clear that the employer was thinking about this issue and that it manifests doubt about the person's classification.

The IRS and other agencies are accustomed to indemnity provisions in many different types of contracts, and it does not mean that in each case the indemnity will be called into effect.

Avoiding Practices That Might Support Recharacterization as an Employee

Once an employer has hired an independent contractor, it should take pains to avoid practices that could result in the independent contractor later being recharacterized as an employee in the event of a lawsuit or a DOL audit.

This means avoiding actions that could fulfill any of the aforementioned factors that courts consider when determining whether a worker is an employee or an independent contractor. *See* **Determining Whether a Worker Is an Employee or an Independent Contractor**. In other words, employers should avoid:

- Giving instructions about when and where to do the work, what tools or equipment to use, what workers to hire or to assist with the work, where to purchase supplies and services, whether work must be performed by a specified individual, and what order or sequence to follow;
- Reimbursing the independent contractor's business expenses;
- Forbidding the independent contractor from making his or her services available to the relevant market;
- Paying the independent contractor a regular wage for a set period of time;
- Providing the worker with employee-type benefits, such as insurance, a pension plan, vacation pay or sick pay;
- Allowing the services performed by the independent contractor to be a key aspect of the regular business of the company; and

Allowing the relationship to continue indefinitely, rather than for a specific project or period of time.

Considering Incorporated Contractors

Some advisers suggest that a way to prevent having independent contractors recharacterized as employees is to insist that the independent contractors form a separate business entity (such as a corporation or limited liability company). Thus, the theory goes, if Hospital A contracts with Doctor B to perform certain functions, there is always at least some risk that for some purpose, Doctor B may be treated as an employee. In contrast, if Hospital A requires Doctor B to form Medical Corporation B, Hospital A can pay the contracted for amounts without fear of recharacterization.

How could a corporation, after all, be an employee of the hospital? It appears that this theory is not always correct. However, there is no question that it muddies the waters and makes it more difficult for a government agency or private party in litigation to recast the worker's status to that of employee.

Practical Example

In *Veterinary Surgical Consultants, P.C. v. Comm'r*, 117 T.C. 141 (T.C. 2001), the company argued that the worker received distributions of corporate net income, not wages. The worker performed substantial services for the company, and was paid. The court found that regardless of how the employer chose to characterize the payments, the payments represented remuneration for services rendered.

Fulfilling Reporting Requirements

Employers must report to the IRS most payments to an independent contractor.

Correctly Identifying the Contractor

Once an employer has determined that the worker it is paying is an independent contractor, it should have the contractor complete **Form W-9, Request for Taxpayer Identification Number and Certification**. This form can be used to request the correct name and Taxpayer Identification Number of the worker. The employer should keep the W-9 for four years in case of any questions from the worker or the IRS.

Reporting Payments

Any payment made to an independent contractor totaling $600 or more for the year must be reported on an information reporting form, typically an IRS Form 1099. The payment must be reported to the contractor by January 31 of the year following the payment, and to the IRS by February 28 of the year following the payment (or March 31 if the employer files the 1099 electronically using the **Filing Information Returns Electronically (FIRE) system** (link to external site)).

In general, the IRS imposes a penalty on an employer for: (1) any failure to file an information return by the required filing date; or (2) any failure to include all the information required to be shown on the return or the inclusion of incorrect information. The penalty is $50 for each information return with respect to which a failure occurs, but the maximum penalty cannot exceed $250,000 during the calendar year. However, the $50 penalty for failure relating to an information reporting requirement is waived if the failure is due to reasonable cause and not to willful neglect. If a payor intentionally disregards its requirement to furnish a timely information return, the penalty is 10 percent of the aggregate amount of the items required to be reported correctly.

Substantiating Expense Reimbursements

An employer is not required to report expense reimbursements for travel, entertainment, or gifts reimbursed to an independent contractor in connection with services performed for a client or customer if the independent contractor follows an established reimbursement arrangement (or an accountable plan) with the employer.

However, independent contractors are required to substantiate each element of an expenditure that is reimbursed. Any expenses that are not substantiated by an independent contractor must be included in income. In addition, an independent contractor must substantiate a reimbursement for entertainment regardless of whether he or she accounts for such entertainment. An independent contractor substantiates such expenses when the independent contractor submits to the employer adequate records or other sufficient evidence that describe the expense.

Reclassifying Independent Contractors as Employees

An employer may sometimes have to reclassify an independent contractor as an employee, usually as the result of an IRS order, a court ruling or a settlement.

> Such reclassifications can result in significant liabilities for employers. *See* **Consequences of Reclassification**.
>
> However, some employers can avoid paying back employment taxes if they meet certain requirements. *See* **Safe Harbor**.
>
> Also, employers that voluntarily come forward to the IRS can potentially avoid liability for back taxes if they give up independent contractor status going forward. *See* **IRS Voluntary Settlement Program**.

Consequences of Reclassification

There are several potential consequences for employers that reclassify independent contractors as employees, including:

Income tax and interest;

Social Security and Medicare (FICA) taxes and interest;

Federal unemployment (FUTA) tax and interest;

State unemployment tax, including interest and penalties, which vary by state;

Liability for state workers' compensation premiums, and potential interest and penalties, which vary by state;

Health and welfare benefits, such as paid leave, supplemental pay, insurance;

Retroactive participation in pension plans or, in some cases, disqualification of the employer's pension plan;

Reimbursement for past business expenses;

IRS penalties:

for employers that did not deliberately misclassify workers and properly reported payments (*see* **Fulfilling Reporting Requirements**), 20% of Social Security taxes and 1.5% of wages;

for employers that did not deliberately misclassify workers but did not properly report payments, 40% of Social Security taxes and 3% of wages; or

for employers that deliberately misclassify workers, all employment taxes that should have been paid, including the employee's share of Social Security and federal unemployment taxes, and a 100% penalty personally assessed against any responsible business owners or officers; and

Potential liability under other federal laws, such as unpaid overtime under the Fair Labor Standards Act. *See* **Under Other Laws**.

Safe Harbor

Section 530 of the Revenue Act of 1978 provides protection when an employer has classified a worker as an independent contractor and the worker is reclassified as an employee during an audit. The employer may be sheltered from paying employment taxes, as well as penalties and interest, if the appropriate tax returns, including information returns, show that all similar workers were consistently treated as nonemployees, and show a reasonable basis for the classification as an independent contractor. 95 P.L. 600. (Unlike most tax law, Section 530 has never been incorporated into the Internal Revenue Code.)

In general, for an employer to qualify for Section 530 relief, it must have:

1. Consistently treated the workers (and similarly situated workers) as independent contractors;

2. Complied with the Form 1099 reporting requirements with respect to the compensation paid the workers for the tax years at issue; and

3. Had a reasonable basis for treating the workers as independent contractors.

All three requirements must be met.

Certain types of workers are excluded from the safe harbor provisions: engineers, designers, drafters, computer programmers, systems analysts and other similarly skilled workers engaged in similar work if these workers are part of a three-party transaction for services after 1986. These individuals are classified as employees or independent contractors under common law standards.

Section 530 relief may be the best opportunity that an employer will have to minimize the tax disaster that often befalls an employer upon a reclassification of workers from independent contractors to employees. Although Section 530 was never codified into the Code, it is well-known to most tax practitioners. Indeed, under provisions of the Taxpayer Bill of Rights, the IRS is now required to disclose the existence of Section 530 relief whenever it proposes additional employment taxes based on a worker reclassification.

Although Section 530 relief may not be a panacea, it can in many cases save an employer from significant liabilities. Section 530 relief has grown in importance over the years so that now it should be discussed in virtually any IRS audit situation. Although it may seem that the above-stated requirements would be difficult to meet, small businesses and their advisors often find that Section 530 relief is available. In general, the IRS has become more liberal in granting Section 530 relief. It can be an expeditious and efficient means of avoiding what might otherwise be significant employment tax liabilities.

1. Consistent Treatment Requirement

A taxpayer satisfies the consistent treatment requirement of Section 530 if the taxpayer did not treat the individual at issue (or any individual in a substantially similar position) as an employee. This prong of Section 530 relief examines how the taxpayer treated the individual and individuals in substantially similar positions. Whether an individual holds a position substantially similar to a position held by another individual includes consideration of the relationship between the taxpayer and such individuals.

Section 530(a)(1)(A) requires that the employer not have treated the individual as an employee for any period after December 31, 1977. This involves an examination of what employment tax returns, if any, should be filed during the course of the audit. That can lead to disputes.

Practical Example

In *JJR, Inc. v. United States*, +*950 F. Supp. 1037* (W.D. Wash. 1997), *aff'd*, +*156 F.3d*

1237 (9th Cir. 1998), a district court denied summary judgment on the issue of whether a nightclub's nude dancers were employees for employment tax purposes. Despite this dispute, the court held the club was entitled to relief under Section 530. The case involved exotic facts including the written contract between the club and its nude performers, which the court found established a landlord-tenant relationship. The court concluded that the club qualified for Section 530 relief because, among other factors, it had consistently treated these performers as nonemployees.

During an examination involving reclassification, the IRS may recommend that the employer file current employment tax returns treating the worker as an employee to prevent a delinquent filing, which would result in additional penalties and interest. Such a hasty filing may be an easy trap in which to become ensnared. This is especially true if the employer has not fully prepared the argument against reclassification or is unaware of the safe harbor provisions of Section 530.

Filing a current employment tax return while the audit is pending may prove fatal for subsequent reliance on Section 530 because the employer will thereby have treated the individual as an employee. The result would be the same if the audit were ultimately to result in no reclassification - that is, the individual retains independent contractor status. Indeed, if the taxpayer withholds employment taxes or files employment tax returns with respect to those workers for the periods following the period under audit, this action is "treatment" of the workers as employees for those later periods.

However, filing an amended or delinquent employment tax return as a result of IRS compliance procedures is not considered treatment as an employee for that period, and therefore does not defeat the Section 530 consistency requirement. Compliance procedures include examination and collection procedures. Therefore, if the IRS determines, as the result of an audit, that a worker is an employee, the employer is not deemed to have treated the worker as an employee for the period under audit.

Preparation of a return by the IRS under *+26 U.S.C. § 6020(b)*, or the signing of an audit form agreeing to the assessment and collection of the tax, or IRS notices advising a taxpayer that no return has been filed do not constitute the employer's "treatment" of an individual as an employee.

If an employer changes a worker's status from independent contractor to employee, relief is still available to the employer under Section 530 for any periods prior to the period in which the individual was treated as an employee.

Individuals Holding Substantially Similar Positions

The safe harbor requires that employers consistently treat not just the worker in question, but also *any individual holding a substantially similar position*, as a nonemployee. This consistency requirement was included to prevent taxpayers from changing the way in which they treat workers for employment tax purposes solely to take advantage of the relief

provisions. In general, if all substantially similar workers are treated as independent contractors, then all the workers are covered under the safe-harbor protection. If, however, some of the workers holding substantially similar positions are treated as employees, then none of the workers are covered under the safe-harbor provisions.

Practical Example

In *VTA Mgmt. Servs. v. United States*, +*2004 U.S. Dist. LEXIS 26772* (E.D.N.Y. 2004), a management consulting company named VTA sought relief under Section 530 with respect to the classification of therapists who provided services for VTA to various hospitals. VTA treated all of these therapists as independent contractors. However, VTA treated a separate class of workers, clinical fellows who were completing requirements to become therapists, as employees. The IRS audited VTA for employment taxes and ruled that certain therapists were employees. VTA sought relief under Section 530. In district court, the government moved for partial summary judgment against VTA based on the substantive consistency requirement. The court ruled that it was proper to look not merely to the fact that both the therapists and clinical fellows provided therapy, but also to other factors relating to their relationship with VTA. These other factors included the level of supervision exercised by VTA over the clinical fellows as compared with VTA's supervision of the therapists. The court denied summary judgment. It was clear from the record that the clinical fellows received substantial supervision from VTA, while many of the therapists testified to receiving no supervision from VTA. The key, according to *VTA Mgmt. Servs.*, is that factors other than basic job function should be analyzed to determine whether two disparately treated groups occupied substantially similar positions under the substantive consistency requirement.

2. Return Filing Requirement

A second condition for safe harbor protection is the filing of all required information returns. For an employer to rely on the safe-harbor provisions, the taxpayer must have filed all required federal tax returns and the returns must have been filed on a basis consistent with nonemployee status.

Therefore, the employer must have filed Form 1099-MISC, Miscellaneous Income, to report fees, commissions, or other compensation to persons who are nonemployees. The Form 1099-MISC reporting requirements apply to amounts totaling $600 or more and paid in a calendar year to independent contractors who are either sole proprietors or partnerships. *See* **Fulfilling Reporting Requirements**.

Of course, the filing of a Form W-2, for any individual holding a substantially similar position would be inconsistent with treatment as a nonemployee. An employer having filed a Form W-2 for such a worker would therefore not be able to rely on the safe harbor.

Practical Example

In *Howard's Yellow Cabs v. United States*, +*987 F. Supp. 469* (W.D.N.C. 1997), a district court held that a corporation operating a cab service was entitled to relief under Section 530 with respect to its drivers. The court noted that the cab company used drivers who signed independent contractor agreements establishing a 50/50 fare arrangement. Drivers did not receive fringe benefits and were liable for employment taxes. However, the company provided the cabs, radios, dispatcher service, maintenance and one-half of fuel costs. Drivers were not required to work any set hours and could use the cabs for personal use during the day. Various other facts were also pertinent, but the only question before the court was whether the company was entitled to Section 530 relief. Interestingly, the cab company did not file any Forms 1099. Nevertheless, the court found that it was not required to do so because the cab company had not made any "payments" to its drivers. Thus, the court was able to find that the cab company had consistently treated its drivers as independent contractors (and had fulfilled the return filing requirements because there simply were no forms to file).

3. Reasonable Basis

The third requirement for safe harbor protection is that the employer had a reasonable basis for classifying the worker as an independent contractor. The legislative history specifies that "reasonable basis" is to be construed.

There are four ways in which an employer can meet the reasonable basis requirement: (1) federal judicial precedents and administrative rulings; (2) a prior audit of the taxpayer; (3) industry custom; and (4) a catchall of "other" reasonable bases. In each case, the taxpayer's treatment of the worker must have been "in reasonable reliance" on one of these four items.

Federal Judicial Precedents and Administrative Rulings

An employer is deemed to have a reasonable basis for nonemployee treatment if its classification decision is based on judicial precedent, published rulings, technical advice, or a Letter Ruling or determination letter to the taxpayer. The judicial precedent or published ruling upon which a taxpayer reasonably relied does not have to relate to the particular industry or business in which the taxpayer is engaged. However, a taxpayer may only reasonably rely upon technical advice or Letter Rulings specifically relating to the taxpayer.

Practical Example

The 6th Circuit Court of Appeals considered reliance on judicial precedent in *Peno Trucking, Inc. v. Comm'r*, +*296 Fed. Appx. 449* (6th Cir. 2008). The issue was whether the employer, Peno Trucking, Inc., had a reasonable basis for treating its truck drivers as independent contractors. The Tax Court had found the company did not have a reasonable basis, despite the fact that there were state workers' compensation rulings

that certain of the company's drivers were independent contractors for purposes of workers' compensation. Overturning the Tax Court, the 6th Circuit noted that the state agencies employed a 20-factor common law test virtually identical to the test used by the IRS. Therefore, the Court of Appeals found the company could reasonably rely on those determinations. The judicial precedent relied upon an evaluation of the employment relationship through a federal common law analysis.

The standard for technical advice is less clear. In *United States v. Arndt (In re Arndt)*, +*201 B.R. 853* (M.D. Fla. 1996), the court addressed whether an accountant's advice about classifying workers as independent contractors was "technical advice" within the meaning of Section 530. *In re Arndt* concludes that an accountant's advice is not the type of "technical advice" that can serve as a basis upon which a taxpayer can reasonably rely.

But *Arndt* seemed to rely on two decisions that are not wholly clear. Indeed, there is some evidence that reliance on an accountant's advice in classifying workers might satisfy the "reasonable basis" requirement of Section 530. Courts have interpreted an accountant's advice to fit within Section 530 either as "technical advice" under Section 530 (a)(2)(A) or as an "other reasonable basis" catchall.

Practical Example

In *Smoky Mt. Secrets v. United States,* +*910 F. Supp. 1316* (E.D. Tenn. 1995), the court found that reliance on the advice of two certified public accountants was a reasonable basis for treating telemarketers and delivery persons as independent contractors, apparently as an "other reasonable basis" within the meaning of Section 530. Similarly, *J & J Cab Serv. v. United States,* +*1995 U.S. Dist. LEXIS 482* (W.D.N.C. 1995), involved a taxpayer in the livery business who contracted with cab drivers to operate the taxpayer's cabs for a daily or weekly payment. The court granted Section 530 relief, without full analysis of whether an accountant's advice constituted the kind of technical advice that the statute seems to require.

Prior Audit

If a past audit entailed no assessment attributable to the taxpayer's employment tax treatment of individuals holding substantially similar positions to that of the individual whose status is at issue, the employer is considered to have a reasonable basis for treatment of the worker as an independent contractor. However, a taxpayer may not rely on an audit commenced after 1996 for purposes of the prior audit safe harbor, unless the audit included an examination for employment tax purposes of whether the individual involved (or any individual holding a substantially similar position) should be treated as an employee.

A prior audit must involve the examination of a taxpayer's books and records. Mere inquiries

from an IRS Service Center or a compliance check to determine if a taxpayer filed returns are not considered audits. The idea is that the taxpayer is entitled to protection, but only if the prior audit examined but did not successfully challenge the classification practices of that business.

The prior audit safe harbor extends to substantially similar workers in different industries of a corporation, enabling a taxpayer to rely on a single audit to qualify both industries for protection.

Practical Example

In *Lambert's Nursery & Landscaping v. United States*, +*894 F.2d 154* (5th Cir. 1990), the taxpayer's landscaping business was audited in 1976 with no assessment made with respect to landscape workers being treated as independent contractors. In 1980, the taxpayer began providing janitorial services. The IRS audited the taxpayer's 1981, 1982, and 1983 tax returns and determined that the janitorial workers were employees. Although there were dissimilarities in the working agreements, the district court found that both groups of workers were treated similarly in terms of control, supervision, pay and demands. The IRS contended that it was contrary to Congress' intent in enacting Section 530 to use an audit conducted within one industry to provide a safe harbor for employees in another. Nevertheless, the 5th Circuit held that the taxpayer could reasonably rely on a prior audit regarding landscape workers in treating the janitorial workers it hired in later years as independent contractors. The 5th Circuit discussed the requirements a taxpayer must satisfy to meet the prior audit safe harbor:

1. The IRS conducted a prior audit of the taxpayer for a particular tax year;
2. The IRS determined in the prior audit that the taxpayer's workers were independent contractors;
3. The workers who were the subject of the prior audit are "substantially similar" to the workers at issue; and
4. The taxpayer treated the two groups of workers in a "substantially similar" fashion.

Industry Practice

If the employer follows a longstanding, recognized practice of how a significant segment of the taxpayer's industry classifies a worker, the employer is considered to have a reasonable basis for treating a worker in the same manner. It is not necessary for the practice to be uniform throughout an entire industry.

The practice need not apply to more than 25 percent of the industry (determined by not taking into account the taxpayer). A showing of less than 25 percent may constitute a significant

segment of the taxpayer's industry based on the particular facts and circumstances.

An industry practice need not have continued for more than 10 years to be considered longstanding. An industry practice in existence for a shorter period may be considered longstanding based on the particular facts and circumstances. Finally, an industry practice will not fail to be treated as longstanding merely because the practice began after 1978. This provision is intended to allow new industries to take advantage of safe harbor relief.

Practical Example

In the colorful case of *303 West 42nd Street Enters. v. IRS*, +181 F.3d 272 (2d Cir. 1999), *rev'g* +916 F. Supp. 349 (S.D.N.Y. 1996), the 2nd Circuit Court of Appeals reversed a district court's ruling that certain "fantasy performers" of a New York City adult entertainment facility were employees. 303 West 42nd Street Enterprises, Inc. (West) operated an adult entertainment facility under the name "Show World" in Times Square. At Show World, customers in "fantasy booths" communicated with fantasy performers through a glass partition via telephone. When the customer deposited a coin, the telephone was activated, and the fantasy performer became visible. At the end of each shift, the fantasy performers retained all of their tips, but transferred the coins deposited by customers to the company. Fantasy performers signed a lease agreement authorizing the company to withhold 40 percent of the coins as a security deposit to reserve a booth for each fantasy performer. Show World treated the fantasy performers as tenants and not as employees. The IRS assessed West additional employment taxes, asserting that the Show World fantasy performers were employees rather than tenants. West paid a nominal portion of this additional tax assessment and thereafter instituted a refund suit in district court. The district court granted the government's motion for summary judgment and ordered West to pay the balance of the deficiency assessed by the IRS. West appealed to the 2nd Circuit where it asserted, among other things, that it was absolved from the payment of previously unpaid taxes under the safe harbor provision of Section 530. In granting the IRS's motion for summary judgment, the district court had ruled that Section 530 safe harbor relief applied only where the industry uniformly classified its workers as a single type of worker and where the taxpayer relied in good faith on that classification. Because the district court found the adult entertainment industry was ambivalent about worker classification, it found there was no longstanding industry practice, which is one of the requisite bases for Section 530 relief. The appellate court disagreed and reversed, reasoning that a taxpayer seeking Section 530 safe harbor relief can rely on the classification practice of a "significant segment" of the industry - it is not necessary to show "uniformity of practice". The Second Circuit cited *Springfield v. United States*, +88 F.3d 750 (9th Cir. 1996), expressly noting that:

> *[T]he plain language of Section 530 makes clear that to demonstrate reasonable basis for the tax treatment, a taxpayer must prove that a significant segment of the industry follows a particular practice - not that every segment of the industry follows that*

practice.

The 2nd Circuit also noted that the IRS had previously taken the position that a uniform industry practice was not a prerequisite to protection under the Section 530 safe harbor.

Other Reasonable Basis

An employer that fails to meet one of the safe harbor provisions may still be entitled to relief under Section 530 if it can demonstrate, in some other manner, a reasonable basis for not treating the individual as an employee. Fortunately, the term "reasonable basis" is to be construed liberally in favor of the taxpayer. Expert advice from accountants and attorneys may constitute reasonable basis under this fourth catchall category.

Courts may expect advisors to have demonstrated experience in employment tax issues before ruling their advice reasonable basis. The burden shifting typically provided for a taxpayer who has demonstrated that it was reasonable not to treat a worker as an employee does not apply to the catchall "other reasonable basis" category of the reasonable basis requirement.

IRS Classification Settlement Program

The IRS offers a classification settlement program (CSP) to allow businesses and tax examiners to resolve worker classification issues as early in the administrative process as possible. This program is optional, but IRS examiners may offer a worker classification settlement using a standard closing agreement. When an IRS examiner selects a business for an employment tax examination because of the treatment of certain workers as independent contractors, the examiner must first determine whether the business is entitled to relief from retroactive and prospective liability for employment taxes under Section 530 of the Revenue Act of 1978.

As noted above, to qualify for relief, the business must meet three requirements:

1. ***Substantive consistency requirement***. The business must have consistently treated similarly situated workers as independent contractors.
2. ***Reporting consistently***. All federal tax returns and information returns required to be filed must have been filed by the business on a basis consistent with the business's treatment of the worker as not being an employee.
3. ***Reasonable basis requirement***. The business must have had some reasonable basis for not treating the worker as an employee. A reasonable basis may consist of reasonable reliance on: judicial precedent, a published ruling, a Letter Ruling, or a technical advice memorandum issued to the taxpayer; the results of a past audit of the taxpayer; or a longstanding, recognized practice of a significant segment of the industry. Any other reasonable basis may also suffice.

Under the classification settlement program, a series of graduated settlement offers may be available. For example, if the business can meet the reporting consistency requirement, but either does not meet the substantive consistency requirement or clearly cannot meet the reasonable basis requirement, then the CSP offer will be a full employment tax assessment for the years under examination.

However, this would involve the favorable tax rates under Internal Revenue Code Section 3509. If the business meets the reporting consistency requirements and has a colorable argument that it meets the substantive consistency requirement and the reasonable basis requirement, then the CSP offer will be an assessment of 25 percent of the employment tax liability for the year using the favorable tax rates of Internal Revenue Code Section 3509. In each case, the business will be required to classify its workers as employees prospectively, thus ensuring future compliance.

The IRS expects this future compliance to result in substantial litigation and enforcement cost savings for the government. The CSP is available exclusively for worker classification issues. If a business treated a corporate officer as an independent contractor and timely filed a Form 1099, the business is eligible for CSP. However, the CSP cannot be used to resolve other issues, including the nature of compensation paid to corporate officers.

The following chart summarizes the possible outcomes of an examination and the CSP offer applicable to each outcome.

Classification Settlement Program Analysis Chart

Are the Workers Employees?	***Were Forms 1099 Timely Filed?***	***Is Taxpayer Entitled to Section 530 Relief?***	***Type of CSP Offer***
Yes	Yes	Yes	TP's Option
No	Yes/No	N/A	None
Yes	No	No	None
Yes	Yes	No	1 Yr. Tax + CSP

Yes	Yes	Maybe	25% Tax +

IRS Voluntary Settlement Program

In 2011, the IRS **announced** (link to external site) a new voluntary relief program for worker status. The program appears to have no deadline and no announced date of termination. Fundamentally, it involves voluntarily giving up on independent contractor status prospectively in exchange for immunity for the past.

The prospective voluntary reclassification need not be for all workers, but would need to cover a class or type of workers. Within the confines of the program, one cannot have similarly situated workers working as employees while others continue as independent contractors.

There are two attractive features to the IRS program. First, there are no penalties, no interest, and only a nominal tax payment involved - 10 percent of the payroll taxes that would have been payable for the covered workers for the prior year. That payment can be nominal indeed when one considers the stakes. Second, the IRS signs a closing agreement committing that there will be no audit for past worker status practices.

In that way, although participants in the program will be giving up on their independent contractor classifications prospectively, they do so in a way that cannot implicate the past.

Employer Eligibility

To be eligible, the taxpayer must:

1. Have consistently treated the workers in question as independent contractors;
2. Have filed all required **Forms 1099** (link to external site) for the workers for the previous three years;
3. Not currently be under audit by the IRS;
4. Not currently be under audit by the Department of Labor or a state government agency concerning worker classification; and
5. If the taxpayer was previously audited by the IRS or the Department of Labor concerning the classification of the workers, it will only be eligible if it complied with the results of that audit.

The IRS has discretion to accept applicants into the program.

Payments

Once a taxpayer is accepted, the taxpayer's payment is 10 percent of the employment tax liability that would have been due on what the taxpayer paid the affected workers for the most

recent year, but determined under the reduced rates of **section 3509(a)** (link to external site). The IRS estimates that this 10 percent payment will equal slightly more than one percent of the pay paid to the reclassified workers for the prior year.

To see how this payment is computed, see **VCSP FAQ 16** (link to external site) and **Instructions to Form 8952 (Sept. 2011)** (link to external site).

There are no interest charges or penalties. Moreover, the IRS agrees (in a binding closing agreement) not to audit the taxpayer with respect to payroll taxes related to these workers for prior years. The taxpayer must consent to a special six-year statute of limitations rather than the three years usually applicable to payroll taxes.

How to Apply

An application to the program commences with filing **Form 8952** (link to external site). The IRS asks prospective participants to file it at least 60 days before the taxpayer wishes to begin treating the affected workers as employees. The taxpayer is also to submit contact details for the taxpayer's representative on a **Form 2848 Power of Attorney** (link to external site).

Evaluating Exposure

The nominal tax payment that is the entry fee for the program is unlikely to matter much to most companies. It is in some respects like a teaser rate for a mortgage loan that later escalates to higher rates. The minor tax payment here is a relatively nominal payment. This finite tax payment is a cost, of course, but it is not the major cost of the IRS program.

The major cost will be in the future. Prospective participants should compare the projected costs of operating with employees rather than with independent contractors. Some companies may fail to seriously consider the IRS program, viewing it as involving a fundamental shift of policy from how they now do business. It may be, but there ought to be a way of analyzing the economics and factoring in the risks.

If one does not consider recharacterization risk (*see* **Consequences of Reclassification**), using independent contractors in the future will almost certainly be more cost efficient than using employees in the future. In that sense, even without paying the 10 percent tax payment that the program requires, volunteering for the program would not seem to make sense. However, companies should consider the extent to which they may face scrutiny over their use of independent contractors, the anticipated cost of defending themselves, and the likelihood that they will prevail.

This will often be a complex analysis. It may even vary from one group of workers to another within the same company. Companies monitoring their independent contractor usage and aware of the risks and costs of recharacterization battles may already have some idea how much their costs will increase with employees.

However, most if not all companies will probably need to do some fine-tuning of such projections. Such estimates should help to fully inform the question of whether participating in the IRS program would be prudent and, if so, for precisely which group or class of workers

currently treated as independent contractors. Evaluating one's exposure is rarely easy or dispassionate.

It is likely to be especially difficult here given the uncertainties pervading the entire worker status regimen. Murky legal and factual distinctions must be made when evaluating whether workers are employees or independent contractors. In spite of (or perhaps because of) this, companies should use the IRS program as a chance to truly consider their exposure and to identify the areas in which they need to improve if they are to keep using independent contractors on a large scale. That means companies will also need to see how their own fact patterns, documentation and actual use of independent contractors stack up to the law.

Deciding Whether to Participate

Independent contractor controversies are expensive and frustrating. The IRS has long seemed to focus primarily on the future. The IRS often seems willing to abate most or all of an assessment in exchange for the taxpayer's agreement to convert workers to employee status for the future. The new IRS program does this in an explicit and non-audit-centric way.

Of all the variables to consider, employers believing that they have a virtual lock on Section 530 relief may be least likely to sign up. After all, Section 530 relief allows them to avoid liability for their past misclassification and to continue it.

Another significant issue can be the effects of state law. Although the IRS issues a closing agreement for the past, some states may not conform.

Another concern is how workers themselves may react. Employers may want to make sure they have no objection to being reclassified from independent contractors to employees. But with their new employee status, some workers might consider whether they have a claim against their employer (for benefits, etc.) for the past.

There also could be tort and agency liabilities to consider. Most employers will reclassify their workers for all purposes not merely with the IRS. They will begin paying unemployment insurance, workers' compensation premiums and more. Liability issues could muddy the analysis.

The IRS program can still be a very good deal for some, but employers should examine the whole picture before deciding.