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Employee vs. Independent Contractor

By Larry J. Brant

In 2005, the Bureau of Labor Statistics reported approximately 10.3 million workers, or 7.4 percent of the U.S. workforce, were classified as independent contractors.[1] Today, that number is likely dramatically larger. According to government studies, many workers classified as independent contractors are actually employees. Consequently, worker classification has become a hot topic for the IRS, state departments of revenue, and other federal, state and local government agencies. In addition, the plaintiff's bar has taken note of this issue and the opportunities for individual and class action lawsuits against businesses. This article highlights some of the worker classification rules, the risks of misclassification, and general guidelines for businesses and advisers.

New Scrutiny on Worker Classification

Although worker classification has been an area of focus for many years, current economic and political pressures have pushed it to the forefront of governmental attention. Congress' Joint Committee on Taxation has concluded there is a significant loss of tax revenue associated with worker misclassification. Consequently, the IRS is dramatically increasing audit activity, targeting worker misclassification as a means of reducing budget deficits. State and local governments have followed suit and are aggressively scrutinizing businesses and industries that commonly utilize independent contractors.

State and local governments have the same motivation to prevent worker misclassification as the federal government – to generate revenue, increase compliance, and ensure workers are properly treated under their employment laws. State and local governments are particularly concerned about payment of income taxes and ensuring their unemployment insurance and workers' compensation systems remain healthy. Federal and state legislatures and local administrative agencies are reviewing a wide range of proposals and recommendations related to reducing worker misclassification.

Misclassification

Many businesses have legitimate business reasons for classifying workers as independent contractors, such as when the workers perform temporary, specialized services for the business and perform the same services for others through independently established businesses. In some industries, the use of independent contractors is a common practice (e.g., construction and transportation). Workers in these industries often prefer to be independent contractors because they like the freedom to be their own boss, and to own and operate their own businesses.

It is not uncommon for businesses to pay independent contractors more than the wages they pay employees because the contractors are responsible for their own costs of doing business, including payroll taxes, benefits, tools, equipment and liability insurance. So, classification of workers as independent contractors does not automatically result in cost savings. Nevertheless, some government regulators perceive businesses as solely motivated to classify workers as independent contractors to avoid payroll and other "employee-related" expenses, circumvent minimum wage, overtime, antidiscrimination and other employment laws, or avoid union organization. As a result of this widespread perception, along with the significant need for governments to cure budget deficits, the focus on worker classification has recently intensified throughout the United States. Businesses and their legal advisors need to pay careful attention to this important issue.

Risks of Misclassification

The risks of misclassifying workers, whether or not intentional, are significant. If the IRS determines an independent contractor is really an employee, it may assess amounts that should have been withheld from payroll for federal payroll taxes (i.e., Social Security and Medicare) and income taxes, as well as penalties and interest. Other federal agencies, such as the Department of Labor or the National Labor Relations Board, may also assess penalties, fines and interest, in addition to disqualifying retirement plans. State and local agencies are also quick to assess taxes that are based in whole or part on employee payroll, including unemployment taxes, withholding taxes, workers' ▶

compensation insurance taxes and public transit taxes, as well as assessing penalties, fines and interest.

Federal, state and local taxes are not the only areas of concern. The workers themselves may initiate private lawsuits seeking damages for breach of contract and compensation for failure to pay for tools and equipment, workers' compensation insurance, pension contributions and benefits, sick pay, vacation pay, business expenses, and other employee benefits. When many workers are involved, class action lawsuits may evolve.

The costs of defending worker lawsuits or battling government audits can be staggering. Likewise, the publicity from worker lawsuits can hurt business goodwill. Moreover, the distraction to management resulting from worker lawsuits or government audits usually has a negative impact on business operations.

General Classification Rules

Worker classification is not an exact science. While some types of workers should clearly be classified as employees, there is a significant gray area with respect to other types of workers. Moreover, although workers are often classified in groups based upon occupation, classification should technically be done on an individual-by-individual basis. Additionally, state and local rules may differ from federal rules, such that a worker may potentially be classified as an employee under state law and an independent contractor under federal law.

Making matters more complex, state and local rules may differ within a single jurisdiction, depending upon the application within the jurisdiction. For example, it is not uncommon for some of the classification rules applicable to workers within a state to differ for purposes of unemployment taxes, workers' compensation insurance taxes and withholding taxes. These differences are often less than obvious and make compliance difficult for most businesses.

Federal Law

Under federal law, certain workers are classified by statute as employees (i.e., corporate officers and commission drivers, home workers and salespersons), but most others are classified under common law rules. Under the federal common law rules, an employment relationship exists when the person for whom the services are performed has the right to control and direct the individual performing the services, not only as to the result to be accomplished, but also as to the details and means by which that result is accomplished. It is not necessary that the employer actually direct or control the manner of performance; it is sufficient if the employer has the right to do so. If an employment relationship exists, any other designation of the relationship by the parties (including designation of independent contractor status) is immaterial.

The IRS and other agencies look to a variety of factors in determining whether a right to control a worker's performance exists. Twenty common law factors[2] are discussed in Revenue Ruling 87-41, which for years was the standard by which worker classification determinations were made. Nearly all tax practitioners and employers have some familiarity with the "20-factor test."

In the two decades since issuing Revenue Ruling 87-41, the IRS has modified and updated its approach to worker classification. In an attempt to ensure the focus is on the "right to control," the IRS now encourages its auditors to

look beyond the 20 factors contained in Revenue Ruling 87-41 and to focus on three categories of factors: (1) Behavioral Control Factors; (2) Economic Control Factors; and (3) Factors Evidencing How the Parties Perceive their Relationship. This evolutionary approach essentially groups many of the factors from Revenue Ruling 87-41 into these three general categories and gives some factors more weight than others. Regardless, application of the test remains quite subjective.

State Law

Federal law does not control worker classification for state and local law purposes. States use a variety of different tests to classify workers. The majority of states use some variation of a three-prong common law test, often called the "ABC Test," which analyzes whether:

- The worker is free from direction and control over the performance of services;
- The services are either outside the employer's usual course of business or performed outside of the employer's business premises; and
- The worker is engaged in an independently established trade, occupation, profession or business.
- If the ABC Test is met, the worker is an independent contractor. If one of the three prongs is not met, the worker is an employee.

Although the ABC Test is based in common law, many states have codified variations of it. One common variation uses only the first and last prongs, and is often called the "AC Test." Some states allow workers to be classified under alternative tests. For example, Washington's unemployment tax statutes utilize two similar, but alternative, tests to determine whether a worker is an employee.

The variety of state law tests and differences from federal law creates significant confusion and hazards. A worker may be classified differently for federal and state purposes, differently from state to state, and even differently within in the same state. For example, Oregon has codified a variation of the AC Test for purposes of its workers' compensation, unemployment, and withholding tax laws. Oregon's test differs from the federal test, so workers in certain industries are frequently found to be independent contractors by the IRS, but employees for Oregon tax purposes. This statutory test does not apply to other employment-related determinations in Oregon, such as when an independent contractor sues for employment related benefits or for determining an employer's liability for acts of its employees. A different common law test is used in such cases. These differences can be hazardous to unsuspecting businesses.

Conclusion

Businesses and their advisors must be prepared for increased federal, state and local government scrutiny of worker classification. Businesses and their advisors should regularly discuss the risks of misclassification and review worker classification decisions as this area of law is in a state of flux. Business owners should not assume a worker who is an independent contractor for one purpose is automatically an independent contractor for all purposes. They are well-advised to enlist their attorneys to periodically review their worker classification decisions and determine if possible problem areas exist. Assistance of qualified legal counsel should also be obtained when appropriate, including when:

- Drafting and reviewing independent contractor agreements;
- Analyzing differences between relevant state, local and federal laws, and the application of those laws to a group of workers; and
- Undergoing state, local or federal worker classification audits or exams.

Proper worker classification has always been a concern for federal, state and local agencies. Due to recent economic and political pressures, however, worker classification is currently and will likely continue to be at the forefront of government regulation. The risks associated with worker lawsuits or government audits are significant. Businesses need to be well advised in this area. Consequently, periodic reviews and adjustments, if necessary, to prior worker classification decisions are warranted.[3]

1 The contents of this article are for educational purposes only and should not be construed as legal or tax advice or a legal or tax opinion relative to any specific situation. Persons faced with worker classification issues should seek the counsel of an attorney experienced in this specific area of law.

2 The factors are: (1) worker instructions; (2) worker training; (3) hiring, supervising, and paying assistants; (4) setting work hours; (5) requiring full-time work; (6) work on employer premises; (7) setting work order or sequence; (8) requiring reports; (9) provision of tools and materials; (10) significant investment by worker; (11) payment of expenses; (12) payment by the hour, week, or month; (13) economic risk of profit or loss; (14) making services available to the public; (15) working for multiple persons; (16) degree of integration into employer business; (17) personal rendering of services; (18) continuing relationship; (19) right to discharge; and (20) right to terminate.

3 This author has published a much more detailed white paper, ***Employee vs. Independent Contractor: Another Look at Worker Classification,*** on this topic. To request a copy, please email him at: lbrant@gsblaw.com.

Author's profile appears on Page 4.