Independent Contractor Versus Employee Issues: Bad, Ugly, and Uglier

By Robert W. Wood

Independent contractor or employee? That sounds like a simple dichotomy but is anything but: Worker status issues involve multiple disciplines—tax, labor and employment law, employee benefits, workers’ compensation, unemployment, and more.

As these issues have become more complex, their multidisciplinary character has become more pervasive. The stakes are higher today than ever before.

One reason is the now unfettered information exchanges among state and federal agencies. The seamless flow of information means that one investigation or dispute often triggers another. Cost benefit considerations may militate in favor of not contesting every determination. Yet because even a small worker status dispute may trigger a large one, there can be an insidious kind of estoppel in such situations.

Awareness of the domino nature of these disputes can alter the cost-benefit playing field.

President Obama’s 2012 budget proposals include tougher Internal Revenue Service enforcement of what is now often characterized as the contractor-versus-employee “loophole.” Legislative changes (to increase penalties) and administrative changes (to apply more scrutiny) are surely coming. IRS has already begun a new audit program.

Awkward Timing

Unfortunately, many businesses and advisers become knowledgeable about these issues only after disputes have arisen. That may occur years after the characterization decision was made. By that time, the dollars at stake may be huge. Rather than waiting until it is too late, employers should evaluate their contractual arrangements before they have a problem.

Of course, there can be huge differences between what a contract says and how business is actually conducted. For that reason employers should evaluate their actual practices with workers in addition to their contract. A contract that says an “independent” worker can work any hours of his or her choosing will be of little defense if it turns out that the employer regularly dictates hours of work.

Employers should evaluate such matters not only at the inception of a relationship but also periodically. This kind of periodic review is especially important as a business grows and changes.

Yet as much as I recommend considering these issues early and often, most businesses do not seem to get around to these issues unless there is a direct legal challenge. For many lawyers and business people it is difficult to think about independent contractor and employee characterization questions without thinking about disputes.

Myriad Disputes

Disputes arise when IRS or other agencies attempt to collect employment taxes. The U.S. Department of Labor, state employment development departments, workers’ compensation insurers and authorities, and other governmental bodies also have an interest. In civil litigation the issue may arise in third-party suits. An em-
employer is vicariously liable for the acts of employees but not the acts of independent contractors.

Furthermore, individually or as a class, workers may sue their own “employers” seeking benefits only employees receive. Since Vizcaino v. Microsoft,1 such cases are common.

Although Vizcaino was not the first such case, it was a watershed decision germinating many similar attacks. Vizcaino involved Microsoft and “independent contractor” programmers who sought lucrative employee stock options. They eventually got them—millions of dollars worth—despite a clear written agreement they were independent contractors and did not qualify for benefits.

Contracts and More

A starting point—but clearly not an ending point—is a written agreement. Despite labels, the courts generally look to the truth of the relationship, putting yet another set of pressures on companies and their advisers. These questions are highly fact-dependent but they are also quite subjective. Work in this area requires good communication, awareness of the law, and realism about what one expects of workers.

One must amass substantive knowledge of the law to be able to make a careful assessment. How far can one go in supervising and controlling independent contractors without stepping over the line? These are difficult, subtle, and intensely factual determinations. Yet a high degree of formalism is often respected, making the lawyer’s role especially important.

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The legislative effort has focused not merely on worker classification but on penalties. Increasingly, IRS believes one of the areas of greatest noncompliance in the tax law is misclassification of workers. IRS and other agencies is the presence of similarly situated workers who are treated differently. If there will be some sales agents who are employees and some sales agents who are independent contractors, make sure their duties and responsibilities are significantly different.

Common Questions

Throughout all of this, businesses must grapple with tough and unforgiving rules. Apart from taxes, significant employee benefit issues and liability questions are at stake. Some common questions include:

Q: Will I face liability for employee benefits (pension plans, stock option plans, etc.) if my workers are deemed to be employees rather than independent contractors?

A: Often yes, although there can be classification decisions that apply only for some purposes and not for others. Employee benefit plans can be a terribly frightening and expensive subject. Even though an “employee” determination may not apply to benefit plans, it can start a chain reaction that implicates them too.

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

A: Get experienced counsel and be very cautious in how you respond and how you handle the information provided. Also be careful how you handle the matter with your workers.

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

A: Hiring only incorporated workers is common in certain fields (for example, medicine). It provides an additional layer of insulation but does not entirely obviate the independent contractor versus employee characterization question.

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

A: Generally no. One of the prime areas of attack for IRS and other agencies is the presence of similarly situated workers who are treated differently. If there will be some sales agents who are employees and some sales agents who are independent contractors, make sure their duties and responsibilities are significantly different.

1 97 F.3d 1187 (9th Cir. 1996), 120 F.3d 1006 (9th Cir. 1997) (en banc), cert denied sub nom. Vizcaino v. Microsoft, 118 Sup. Ct. 899 (1998), on remand 98-1 U.S. Tax Cas. ¶ 50,240 (W.D. Wash. 1998).
Q: What contract and tort liability issues can arise with independent contractors?
A: Contract issues arise less frequently, and typically concern whether a particular person is authorized to contract on behalf of the company. Usually such issues are problems only when they are raised after the fact and there is a dispute.

Tort issues seem to be ever-present and can be very expensive. For example, if an independent contractor delivery driver causes an accident, an attempt will often be made by the injured party to attribute employee liability to the driver in order to add the company paying the delivery driver as a defendant. If there is an employee relationship, there is liability.

Q: If a business fails to treat workers as employees, can this subject its owners to personal liability for employment taxes, penalties, and interest?
A: Yes. One must separate federal and state employment tax liabilities from most other types of liabilities. If a business is a corporation or limited liability company, its owners are presumptively not liable for the debts and obligations of the entity. However, in the case of federal and state withholding and employment taxes, all “responsible persons” do have personal liability.

Suppose a corporation uses independent contractors who are later determined to be employees for income and employment tax purposes. That determination means income taxes and employment taxes should have been withheld. The business will be liable for that failure.

So too will the “responsible persons.” That generally means all officers, and possibly some directors of the company. Non-officer check signers are usually responsible too. As an enforcement mechanism, IRS can simultaneously seek 100 percent of the tax from the company, plus a 100 percent penalty from each and every responsible person. IRS may legitimately seek collection from a dozen or more responsible persons at the same time.

Q: How safe is a written contract in which the worker expressly says—under penalty of perjury—that he is an independent contractor?
A: Not safe. Virtually any time one is defending an independent contractor relationship as such, there will be a written agreement expressly characterizing the worker as an independent contractor.

Conversely, if there is no written agreement, employee status will almost always be found. But a written independent contractor agreement by itself is unlikely to carry the day. In virtually every independent contractor versus employee dispute there is a written agreement that says the person is an independent contractor.

Q: What factors will IRS (and the various states) use to determine whether my workers are independent contractors or employees?
A: IRS uses either a 20-factor test released in 1987 or a more recent three-factor test that simply regroups and restyles essentially the same criteria. Most states use a three-part so-called ABC test for purposes of workers’ compensation coverage. Federal labor and pension laws generally use an economic reality test that looks to key relationship criteria. State tort and contract law generally looks to the common law.

All of these tests are more similar than they are different. In general, an employee is someone whom the employer controls not merely as to the work to be done, but as to the method, manner, and means of doing it. The common law “right to control” the worker is what most commonly imports employee status, whether or not the employer chooses to exercise that right of control.

Conclusion

Whether you are an adviser, business owner, manager, executive, or even a worker being expected to take on a putative independent contractor role, you should consider these issues. Navigating this legal, tax, and contractual minefield is tricky. You should not wait for an investigation, administrative controversy, or lawsuit. Review contracts, “employee” files, manuals, meetings, procedures and protocols, reports, invoicing, insurance policies, and even check stubs.

Terminology matters, so be wary what you call something or someone. Even something as seemingly innocuous as an “employee” slip of the tongue can be fatal. Consider not only what is written (in contracts, handbooks, policies, etc.) but also what is not. A good contract is usually no defense if you fail to follow it.

If you are committed to independent contractor status for certain workers, revisit it, strengthen and improve it. There is rarely a contract, policy, manual, or procedure that cannot be improved. However, be realistic in your expectations. If there is little hope for independent contractor treatment holding up, do not continue attempting to fit a square peg into a round hole.