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T H E M & A Tax Report

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Pervasive Contractor vs. Employee Issues and How to Address Them

By Jon Flora • Schnader Harrison • Philadelphia

Classifying workers is a perennial problem for companies, and no less so for their advisors. After all, every worker must be slotted into one of only two categories: employee or independent contractor. In general, worker status turns on the right of control over the worker, regardless of whether the right is exercised. This important but amorphous right to control is measured through numerous factors, but there's no litmus test to make it easy to assess a worker's status.

Getting a fix on such liabilities has become harder and harder, which means corporate deals can be affected. Plainly, companies have considerable incentives to prefer the fruits of independent contractor status: no income tax withholding, no payroll or employment tax obligations, no workers compensation, no unemployment liabilities, no pension or employee benefit liabilities, no health care coverage obligations—the list goes on and on. Yet the stakes of misclassification are significant.

They run the gamut from liability for failure to withhold income taxes and pay employment taxes to potential exposure on pension and employee benefit plans and employment claims. If you're trying to do a corporate deal, these liabilities can loom large. Representation and warranty liability can be significant.

Employees qualify for an arsenal of substantive rights. They include federal labor and employment laws, coverage in employer sponsored retirement and employee benefit plans, and more. Even tort and contract claims manifest themselves differently, with an unbroken chain of liability from employee to company.

Age-Old Tests

Given the frequency with which this issue arises, one might expect there to be clear guideposts for classifying workers. The IRS has long used a 20-factor test looking to training, instructions, hours of work

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and similar components to assess whether there is a sufficient right to control to trigger employee status. In recent years, the IRS has moved away from the 20-factor test to a three-factor grouping of the 20 factors.

Unfortunately, not one of the 20 (or three) factors is determinative, and each factor is given different weight depending on the facts and circumstances. Fortunately, the new edition to the LEGAL GUIDE TO INDEPENDENT CONTRACTOR STATUS by Robert W. Wood (5th ed. 2010) (“the Legal Guide”) should be a big help to practitioners facing worker classification issues. Classification of workers continues to be a front-burner item for the IRS and the Obama administration, so the timing for this amped-up edition could not be better. The Legal Guide has comprehensive scope and exhaustive detail, addressing the tax treatment of independent contractors and employees; how to categorize them; and the tax and other stakes if you go awry.


The Legal Guide includes chapters on pension and employee benefit plan considerations, and on labor and employment law concerns. There is a chapter on how to draft independent contractor agreements and an appendix with multiple sample documents and checklists. The Legal Guide deftly covers all of these areas and more. On the all-critical classification question, the Legal Guide analyzes the control tests in detail, providing examples and references to applicable rulings.

Classification is the ultimate question, a nearly existentialist inquiry with big bucks attached. This book parses the components, provides discussions of relevant decisions which have applied them, and posits useful practice tips. In addition, the treatise enumerates specific types of workers and the appropriate classification of each tied to applicable rulings and authority. Recognizing the importance of the agreement, the Legal Guide includes a separate “how-to” chapter on drafting independent contractor agreements, and there are nearly 20 samples.

Misclassification

One of the strengths of this book is its unrelenting focus on the cross-fertilization that seems currently to run rampant. The domino analogy—let one fall and they’ll all start to tumble—comes frequently to mind. Worker classification can be challenged in myriad ways, from IRS audits, to worker’s compensation hearings, NLRB proceedings, unemployment insurance disputes, third-party civil litigation and direct class actions by workers against putative employers.

Perhaps most famously, independent programmers sued Microsoft in the 1990s claiming they were really employees, but it was a tax dispute that started it all. See *Vizcaino v. Microsoft*, CA-9, 96-2 USTC ¶150,533, 97 F3d 1187 (1996), *modified en banc*, CA-9, 97-2 USTC ¶150,572, 120 F3d 1006 (1997). The IRS reclassified them as employees, and Microsoft had no problem paying the withholding taxes and the employer’s portion of Social Security and Medicare taxes. Although the contract excluded participation in benefit plans like stock options, the workers sued—and won—claiming they should participate as employees no matter what the contract said.



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The Legal Guide is filled to the brim with authorities and planning ideas. Yet its biggest lesson may be the pervasive interaction between tax controversies and other worker status inquiries. It is not uncommon for state taxing authorities to follow federal, or *vice versa*. Labor or industrial relations authorities may follow worker's compensation or unemployment insurance disputes. That means a dispute over a few hundred dollars that isn't worth fighting might actually be the first domino.

As we look forward to 2011, further focus on this area, including legislation, is likely. With the proposed bill, Taxpayer Responsibility,

Accountability and Consistency Act of 2009 (H.R. 3408), Internal Revenue Code Section 530 relief is once again on the chopping block. That by itself should make companies sit up and take notice. Although the IRS focus on worker status in the past has been a pendulum swing, it is going to get far more expensive and pervasive before it gets cheaper and more diffuse. The Legal Guide will prove a useful tool when confronting thorny classification issues and their consequences.

LEGAL GUIDE TO INDEPENDENT CONTRACTOR STATUS (5th ed. 2010) is available at <http://www.taxinstitute.com>. Compression bound, including CD, 1,034 pages, \$399.