

Tackling Worker Classifications

By Jonathan R. Flora

A perennial problem for employers (and their advisors) is classifying workers. Every worker must be slotted into one of two fixed categories: employee or independent contractor. And let's face it — there's a lot of incentive for an employer to prefer the fruits of independent contractor status: no income tax withholding, no payroll or employment tax obligations, no workers compensation — the list goes on and on. The trouble is, the stakes

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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.

Given the stakes and the frequency with which this issue arises, one might expect there would be a clear set of guideposts used to classifying a worker. Yet sadly, the opposite is the case. For example, a traditional and longstanding method used to classify a worker is the Internal Revenue Services' so-called 20 factor test. This test is perhaps one of the least helpful the IRS has provided — not one of the 20 factors is determinative, and to make planning more difficult, each factor is given different weight depending on the facts and circumstances.

It is against this backdrop that the *"Legal Guide to Independent Contractor Status"* by Robert W. Wood (5th Edition 2010) sits as an essential treatise for practitioners facing worker classification issues. Guidance is crucial in this area. Wood recently issued the fifth edition of the *"Legal Guide"* (the first edition was published in 1992). The timing could not be better. Classification of workers continues to be a front burner item for the IRS — in fact, it has conducted a series of worker classification audits over the last several months.

The *"Legal Guide's"* comprehensive scope and exhaustive detail make it a resource practitioners will turn to again and again. The treatise is logically organized in a manner that a tax professional would use approaching the subject (Wood is, in fact, a prominent tax attorney who practices in San Francisco). First, it addresses the tax treatment of independent contractors and employees. Next, it analyzes how to determine classification. Finally, it lays out the stakes of misclassification. The *"Legal*

Guide" also includes a chapter on how to draft independent contractor agreements and an appendix of multiple sample documents and checklists.

Worker status turns on the right of control the employer has over the worker, regardless of whether the right is exercised.

The right to control is measured through numerous factors. The IRS has used the 20 factor test, which looks to training, instructions, hours of work and similar components of the relationship to determine whether there is a sufficient right to control to give rise to employee status. In recent years, the IRS has moved away from the 20 factor test to a three factor test (that resembles the 20 factors).

At the crux of the treatise is a chapter devoted to the issue of how to classify a worker. The *"Legal Guide"* analyzes the control tests in detail, providing examples and references to applicable rulings. It parses the components of the tests, provides discussions of relevant decisions that have applied them, and posits useful practice tips. In addition, it focuses on specific types of workers to analyze the appropriate classification of each and to discuss applicable rulings and authority. The treatise, for example, examines workers labeled consultants, corporate directors and officers, employment agencies, construction workers and attorneys.

There is general consensus that the agreement between the company and worker will be a very significant factor in the event the relationship is scrutinized. The intention of the parties is a factor

for determining classification, and nowhere is the intent better expressed than in the agreement between the parties. While not by itself determinative, it is nevertheless essential that the agreement consistently represent the desired worker relationship.

It is one thing to understand how to apply the relevant factors to an existing relationship. It is quite another thing to prospectively structure a relationship to successfully cope with the factors to achieve the desired classification. The *"Legal Guide"* correctly notes that practitioners rarely spend enough time on the front end structuring the relationship, which makes resolving disputes more difficult on the back end. Recognizing the importance of the agreement, the *"Legal Guide"* supplements the chapter on how to classify a worker with a separate chapter dedicated to how to draft independent contractor agreements and 17 sample agreements (ranging from consulting to work for hire).

Proper classification of a worker may be challenged in various ways. For example, in a well-known decision, workers sued Microsoft in the

1990s claiming that they were really employees even though Microsoft treated them as independent contractors. See *Vizcaino v. Microsoft*, 97 F.3d 1187 (9th Cir. 1996), modified en banc, 120 F.3d 1006 (9th Cir. 1997). In that case, the IRS in a routine review initially reclassified certain workers as employees, and it required Microsoft to pay withholding taxes and the employer's portion of Social Security and Medicare taxes. Following the reclassification,

the workers then sued claiming they should have participated in Microsoft's employee benefit plans.

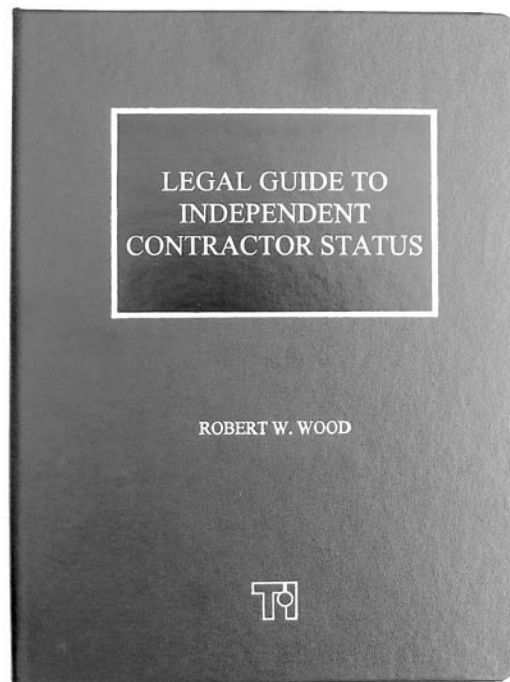
As noted in the *"Legal Guide"*, the decision demonstrates the interaction between tax controversies and other worker status inquiries. It is not uncommon for state taxing authorities also to follow a federal dispute. The stakes are high because employees typically have a much greater arsenal of substantive rights than independent contractors. There are federal labor and employment laws that apply to and protect employees. Employees also have certain rights with respect to participation in employer sponsored retirement and employee benefit plans. Also relevant to classification is the fact that employees are generally much more likely to bind the employer with respect to tort and contract claims than an independent contractor. The "[Legal Guide]" deftly covers all of these areas in separate chapters.

If the IRS were to challenge a classification, the employer may be able to rely on a safe harbor introduced as Section 530 of the Revenue Act of 1978. When it applies, Section 530 may relieve an employer of liability for unpaid taxes, as well as penalties and interest. The safe harbor is different from the traditional 20 factor test — it does not turn on control. Instead, it applies when an employer can show that it consistently treated the workers as independent contractors, complied with Form 1099 reporting for the tax years at issue, and had a reasonable basis for treating the workers as independent contractors. The third requirement — reasonable basis — can be met through judicial precedents or administrative rulings, a prior audit, industry custom, or a catch all "other" reasonable basis. The *"Legal Guide"* navigates the elements of the Section 530 safe harbor, and it illustrates the application of the safe harbor in various cases.

Throughout the years, the IRS has focused on worker status and, given the stakes and the often ambiguous nature of worker status, it will surely continue to do so in the future. The *"Legal Guide"* will prove a useful tool when confronting the thorny classification issue and its consequences.

Robert W. Wood's book, *"Legal Guide to Independent Contractor Status"* (5th Ed. 2010), is available at <http://www.taxinstitute.com>. Compression bound, including CD, 1,034 pages, \$399.

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