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Independent Contractor or Employee?

Getting It Wrong Can Be Costly

By Debbie Whittle Durban

Imagine you are the owner of a small business and you have decided that the most cost efficient way to run your business is to treat your workers as independent contractors, not employees. Because your business will not have to pay payroll taxes or provide employee benefits to these workers, it will save thousands of dollars a year. The decision appears to be a no-brainer. Everything goes great for the first few years until you happen to terminate a contract worker who then files a claim for unemployment benefits. Or a contract worker gets injured on the job and files a claim for workers' compensation benefits. Suddenly, the classification of your workers as independent contractors is being questioned, and the burden will fall on you to prove that the workers are truly independent contractors and not employees. How will you do this and what are your chances of succeeding? What happens if you fail? What will happen if the IRS gets involved? What should you do if other workers, realizing their status as independent contractors is being questioned, begin demanding benefits and rights that are normally given only to employees? This article will attempt to answer these and other questions while describing the costs businesses face if they are found to have wrongly classified their workers, the different tests used to determine whether workers are employees or independent contractors, IRS enforcement policies regarding worker misclassification, and the current state of the law in South Carolina pertaining to worker classification issues.

Advantages and disadvantages of using independent contractors

Businesses that opt to treat workers as independent contractors rather than employees enjoy significant benefits. Most importantly, there is a significant financial motivation for using independent contractors in place of employees. Even if companies end up paying independent contractors more per hour than they pay employees, they can save untold dollars in payroll taxes, workers' compensation premiums and employee benefit programs. Second, businesses can limit their exposure to lawsuits and resulting liability under state and federal employment laws because such laws are interpreted, in most cases, to apply only to employees. Examples of potential claims that could be avoided by treating workers as independent contractors include:

- claims brought for overtime compensation under the Fair Labor Standards Act and comparable state wage and hours law;
- claims for discrimination, harassment and retaliation under Title VII, the Age Discrimination in Employment Act, the Americans With Disabilities Act and others;
- claims under the National Labor Relations Act, ERISA and the Family and Medical Leave Act; and
- claims for wrongful termination under state laws.

Companies that may have vicarious liability for acts of employees done within the scope of employment may be able, in some instances, to escape vicarious liability for acts done by independent contractors. Companies may also enjoy greater staffing flexibility with independent contractors and may have greater leeway in hiring and firing. Finally, independent contractors, if they are highly skilled, may bring greater efficiency to the company.

On the other hand, there are also disadvantages to having a workforce made up of independent contractors, not the least of which is the very significant risk associated with misclassifying workers. Independent contractors often have much greater autonomy and freedom to come and go as they wish, thus possibly disrupting work schedules. Independent contractors may have less loyalty to the company than an employee, and a company's right to terminate an independent contractor may be limited by contract. Notably, even though the company may not have to provide workers' compensation insurance to independent contractors, the company will not have the protection of the workers' compensation laws that can limit potential damages for workers' injuries. Lastly, companies may discover that they do not own copyrights on materials created by independent contractors.

Costs associated with misclassification

Wrongfully classifying workers as independent contractors when the workers should have been considered employees can cost businesses big money. Just ask FedEx Ground. In December 2008, FedEx Ground agreed to pay $27 million in damages and attorneys' fees to 203 FedEx Ground drivers in California. *See Estrada v. FedEx Ground Packaging Sys., Inc.*, 154 Cal. App. 4th 1 (2nd Dist. 2007). Dozens of other suits against FedEx Ground are pending in state and federal courts throughout the country, and a federal multi-district class action lawsuit is pending in Indiana on behalf of 27,000 FedEx Ground drivers. The decision as to whether workers are independent contractors or employees, however, is never cut and dry. For example, just this year, a Washington jury, in contrast to *Estrada,* and based on similar facts, found 320 FedEx Ground drivers to be independent contractors. *See Anfinson et al. v. FedEx Ground,* Civil Action No. 04-2-39981 (Wash. Sup. Apr. 2009)

No industry is immune from misclassification lawsuits. In 2002, Microsoft settled a lawsuit for $97 million after the Ninth Circuit Court of Appeals held that Microsoft's freelance programmers were common law employees and not independent contractors. *See Vizcaino v. Microsoft,* 290 F.3d 1043 (9th Cir. 2002). In the past several years, misclassification lawsuits have been filed by brokers, security guards, home care workers, insurance agents, strippers and professional wrestlers, just to name a few. Blackwater USA, the huge defense contractor, is currently under congressional scrutiny for misclassifying its security guards as independent contractors, thus denying the U.S. government millions of dollars in tax revenues.

If an administrative agency or court has determined that a company has misclassified its workers as independent contractors, that company can be liable for years of back taxes, including interest and penalties, for federal and state payroll taxes. In addition, the company could be subject to penalties for not providing workers' compensation insurance and, in some cases, liable for an injured worker's medical bills and lost wages. Workers, who will now be deemed to be employees, can assert claims against the company for unpaid overtime compensation, employee benefits that had been wrongfully withheld on the assumption the employee was an independent contractor, as well as a multitude of other laws that give rights and benefits to employees. Further complicating the issues, and leading to greater costs, is the fact that a reclassification controversy, which often arises from a simple workers' compensation claim or unemployment claim, can have a chain reaction leading to IRS or state tax audits or to direct suits by workers seeking benefits and rights normally granted only to employees. For example, *Vizcaino v. Microsoft* started as an IRS audit but ended only after a lawsuit, filed by workers, was settled for $97 million.

Worker classification determinations

The determination of whether a worker is an independent contractor or an employee is very fact intensive and subjective. Because the definitions of "employer" and "employee" found in the federal employment statutes are usually circular and therefore not very useful, federal courts have devised different

tests to determine when the parties have established an employment relationship. These tests, however, do not really simplify the determination because certain tests apply to some laws and other tests to other laws and the courts do not always apply the same test to the same law. The similarity among the three tests, however, somewhat diminishes the differences in legal results. For example, if the company exerts control over the employee's work, in at least some manner, the company will most likely be considered an employer regardless of the test used.

The three main tests that have been traditionally used by federal courts and federal agencies include (1) the common law test, (2) the economics reality test and (3) the hybrid test, although often the distinctions between these tests are murky. State courts and state administrative agencies may use variations of the federal tests or, in some instances, states may use a much more stringent test known as the ABC test, which requires that an independent contractor's work for a business be outside the company's usual course of business and away from the company's premises. Because of the various tests and differing applications, it is entirely possible for a worker to be classified as an independent contractor under one law or in one state and as an employee under another law or in another state.

The common law test

The traditional common law test, which originated with the IRS, contains 20 different factors, but the primary emphasis is how much control the employer has over the employee. The factors used in this test include (1) whether instructions are provided, (2) whether training is provided, (3) degree of integration between employer's business and contractor's services, (4) whether services are rendered personally, (5) whether the contractor hires, supervises and pays assistants, (6) whether the relationship is continuing, (7) whether there are set hours of work, (8) whether the contractor is required to work full time, (9) whether the contractor works on employer's premises, (10) whether there is an order or sequence of work, (11) whether oral or written reports are required, (12) payment methods, (13) who furnishes the tools and materials, (14) does contractor make a significant investment, (15) does employer pay business and or traveling expenses, (16) does contractor realize a profit or loss, (17) can the contractor work for more than one firm at a time, (18) does the contractor make services available to the general public, (19) does the employer have the right to discharge the contractor and (20) does the contractor have the right to terminate the relationship.

No one factor is considered decisive and not all 20 factors are used all of the time. This test, or variations of it, is primarily used by state courts and agencies and to decide cases brought under ERISA and the National Labor Relations Act.

The economic reality test

Under this test a worker is deemed to be an employee if the worker is economically dependent upon the employer for continued employment and examines the nature of the relationship between the employer and worker in light of the fact that an independent contractor would typically not rely on a sole employer for continued employment at any one time, but would work for and be compensated by many different employers. Courts in applying this test generally look at (1) the degree of control exerted by the alleged employer over the worker; (2) the worker's opportunity for profit or loss; (3) the worker's investment in the business; (4) the permanence of the working relationship; (5) the degree of skill required to perform the work; and (6) the extent to which the work is an integral part of the alleged employer's business. This test generally is applied to laws whose purposes are to protect or benefit workers and is used by the Department of Labor and courts in cases brought under the Fair Labor Standards Act, the Age Discrimination in Employment Act and the Family and Medical Leave Act. Because of its broader scope, this test has a greater likelihood of finding workers to be employees than does the common law test.

The hybrid test

The hybrid test is a combination of the common law and economic reality test and is often used by courts in cases brought under Title VII of the Civil Rights Act of 1964 and the Americans With Disabilities Act. This test considers the economic realities of the work relationship as a critical factor in determination but focuses on the employer's right to control the work process as the determinative factor. When examining the control component, courts have focused on whether the alleged employer has the right to hire and fire the employee, the right to supervise the employee and the right to set the employee's work schedule.

IRS enforcement of worker classification

The IRS is probably the federal agency with the most interest in worker misclassification. The IRS has estimated that the federal government loses approximately $3.3 billion a year because of the misclassification of workers and has announced that worker classification cases will be a "major area of emphasis" in the future. To implement this initiative, the IRS has entered into data sharing agreements with workforce agencies in numerous states, including South Carolina, to share results of employment tax examinations.

Over the years, the IRS had traditionally used the 20-factor common law test to determine whether a worker was classified correctly. In 2008, however, the IRS revised this test into a three-category test. *See* Internal Revenue Serv., *Independent Contractor or Employee, available at* www.irs.gov/pub/irs-pdf/p1779.pdf. Under this revised test, the IRS has divided the factors into three main categories:

(I) behavioral control, which includes facts that show whether a business has a right to direct and control how a worker does the task for which the worker was hired, including the type or degree of instructions and training the business provides;

(II) financial control, which includes facts that show whether the business has the right to control the business aspects of a worker's job, including (1) the reimbursement of expenses, (2) the extent of worker's investment, (3) the extent to which workers make services available to the relevant market, (4) how the business pays the worker and (5) the extent to which the worker can realize a profit or loss;

(III) the type of relationship between the worker and the business, including (1) whether there is a written contract describing the parties' intent to create an independent contractor relationship, (2) whether the business provides the worker with employee-type benefits, such as insurance, pension plan, vacation or sick pay, (3) the expectation of permanency in the relationship and (4) the extent to which services performed by the worker are considered a key aspect of the company's regular business.

Although companies found to have misclassified workers can be subject to back taxes, interest and penalties, there is a safe harbor provision found in Section 530 of the Revenue Act of 1978. This provision may permit some companies to entirely avoid not only liability for past federal employment taxes but also for future employment taxes.

Under Section 530, if a company has been selected for an employment tax examination to determine whether the company correctly treated workers as independent contractors, the company will not be liable for employment taxes or penalties if the company meets all three of the following requirements:

1. Reasonable belief—The company must have had a reasonable belief for not treating the worker as an employee. A company can demonstrate reasonable belief by showing that (i) the company reasonably relied on a court case or IRS ruling, (ii) the company was audited by the IRS at a time when the company treated similar workers as independent contractors and the IRS did not reclassify those workers as employees, (iii) the company knew that a significant segment of the business's industry treated similar workers as independent contractors or (iv) the company relied on some other reasonable basis, such as advice of a lawyer or accountant.
2. Substantive consistency—The company and any predecessor must have consistently treated the worker and any similar workers as independent contractors. If the business treated similar workers as employees, relief under Section 530 is not available.
3. Reporting consistency—The company must have filed all required federal tax returns consistent

with treatment of the worker as an employee, *i.e.*, if company has paid a worker $600 or more, the company must have filed a Form 1099-MISC for that worker.

Not only does Section 530 relieve a company from back employment taxes and penalties, the employer is also entitled to continue to treat the worker as an independent contractor provided the business continues to meet the requirement of reporting consistency and substantive consistency. Section 530 only provides relief for federal, not state, employment taxes.

On July 30, 2009, H.R. 3408 was introduced, which would create The Tax Payer Responsibility, Accountability and Consistency Act of 2009. If passed, this Act would repeal Section 530 and replace it with a new safe harbor provision that would make it more difficult to meet the requirement that the employer reasonably believed the individual was an independent contractor and not an employee. This bill is currently pending in the House Ways and Means Committee.

Misclassification issues under South Carolina law

Liability under state law often arises under the Department of Revenue, the Employment Security Law or the Workers' Compensation Act and becomes an issue usually only after a worker has made a complaint or filed a claim for unemployment or workers' compensation benefits; however, the Employment Security Commission and the Department of Revenue have the right to randomly audit companies for compliance.

The Department of Revenue, the Employment Security Commission, the Workers' Compensation Commission and South Carolina courts have usually used a variant of the common law test, known as the right-to-control test, to make decisions regarding the status of workers as employees or independent contractors. This test uses the following four factors with the first factor being the most important: (1) direct evidence of the right or exercise of control, (2) method of payment, (3) furnishing of equipment and (4) right to fire.

Until just recently, the courts' interpretation and application of this test has made it virtually impossible, except in rare circumstances, for a business to show that workers are independent contractors and not employees. As explained by the S.C. Supreme Court in *Dawkins v. Jordan,* 341 S.C. 434, 534 S.E.2d 700 (2000), courts view evidence of an employee relationship in any one of the four factors as indicative, if not practical proof, of an employer-employee relationship, whereas contrary evidence as to any of the factors has been seen by courts as merely persuasive evidence of independent contractor status and in some cases may not be of any import at all.

The S.C. Supreme Court recently significantly altered the application of the right-to-control case, and this change could have far reaching impact on how worker misclassification cases in South Carolina are decided in the future. In *Wilkinson v. Palmetto State Transp. Co.,* 382 S.C. 295, 676 S.E. 2d 700 (2009), the Court overruled the Workers' Compensation Commission, the circuit court and the court of appeals to find that a worker was appropriately classified as an independent contractor and not an employee for workers' compensation purposes. More importantly, the Court held that all four factors in the right-to-control test are to be evaluated "with equal force in both directions," overruling its interpretation in *Dawkins.*

After making this pronouncement, the Court proceeded in its analysis of the four factors and found that the worker had been properly classified as an independent contractor. Evidence the Court found noteworthy includes the facts that (1) the parties had a formal independent contractor agreement that the parties' conduct mirrored, (2) the worker purchased his own tractor to drive, (3) the worker had the right to hire others to help him, (4) the parties negotiated a higher rate per mile once the worker, who had previously been an employee, became an independent contractor, (5) the company reported the worker's payments on a 1099 form and the worker filed his tax returns as a sole proprietor and paid self-employment taxes and (6) the agreement dictated how the relationship could be terminated.

Whereas in the past court precedent leaned heavily in finding workers to be employees, it appears from the *Wilkinson* decision that the playing field has been leveled somewhat. As the Court stated in acknowledging the general principle that the workers' compensation laws are to be construed liberally in favor of coverage, "that principle does not go so far as to justify an analytical framework that preordains the result." Although the Court took pains to limit the decision for only workers' compensation purposes, it is axiomatic that South Carolina courts and administrative agencies will defer to this opinion in making employee classification decisions in other areas.

Steps to minimize liability

In conclusion, the determination of whether a worker can be properly classified as an independent contractor is difficult to make and will vary not only by agencies and states, but also according to which laws are being enforced. At the same time, however, the consequences of making a wrong decision can be devastating to companies who use lots of independent contractors.

Companies who use independent contractors in which the classification is questionable have two options to help them avoid or minimize liability. First the company could consider reclassifying questionable workers as employees. This would entail withholding and paying federal and state income taxes, paying Social Security and Medicare contributions, setting up unemployment accounts and paying unemployment taxes, providing and paying for workers' compensation insurance, and providing the reclassified workers all employee benefits the company normally provides employees. In addition, companies

will need to be sure they are in compliance with all other laws impacting employment, such as immigration and safety laws, have posted all workplace posters, and have informed the employees of their rights as employees.

As an alternative to reclassifying, companies with questionable worker classifications could restructure their relationships to ensure that those workers classified as independent contractors truly have the right to perform their work with little or no control by the company. To do this the company should have a formal independent contractor agreement that expressly includes the parties' intention that their relationship will be that of an independent contractor and further specifies the duties and responsibilities that the worker will be responsible for, which costs the worker will have to pay, who will provide the necessary equipment and materials, the method and time of payment, the duration of the relationship, all other terms of the relationship, and the method of terminating the relationship. Then the company needs to ensure that the relationship conforms to the terms of the agreement. In order to receive the protections of Section 530, the company should make sure that all similar situated workers are also treated as independent contractors and that the company furnishes forms 1099 for all independent contractors. The company also should not provide independent contractors benefits that are normally reserved for employees. Other helpful steps, although not necessarily as easy to do, would be to encourage independent contractors to acquire their own business licenses and have them set up limited liability companies or corporations. Steps such as these should help companies avoid or minimize future liability for worker misclassifications but will probably do little to help companies avoid liability for past mistakes.

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