Is That Worker Really an Independent Contractor?

Photographer: John Boykin

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There are many reasons why companies engage individuals to perform work as independent contractors. Some companies engage workers as independent contractors to perform work on a temporary basis or in connection with discrete projects. Others engage workers as independent contractors to reduce payroll or benefit costs. Others engage workers as contractors for perceived liability reasons, or to comply with customer requirements. Regardless of the reasons, companies should engage individual workers as contractors with caution.

When can a worker properly be classified as an independent contractor rather than an employee? The answer depends on the nature and length of the relationship, the type of work performed, where the work is performed, and other factors.

On the federal level, the U.S. Department of Labor (DOL) and the Internal Revenue Service (IRS) both have "misclassification" task forces dedicated to investigating use of independent contractors.

Litigation and enforcement on the rise

The consequences of misclassifying workers as independent contractors can be significant. The most well-known example involved Microsoft Corporation, which paid $97 million to settle claims brought by temporary employees who claimed they should have been allowed to participate in the company's benefit plans. More recently, a Massachusetts company paid $10 million to settle claims by cleaning personnel who were classified as independent contractors. In another case, California insurance agents filed a class action lawsuit challenging their status as independent contractors.

With use of independent contractors on the rise, state and federal agencies have stepped up their efforts to prevent and remedy misclassification of workers as independent contractors. When workers are classified as independent contractors, money is not reported and remitted to state and federal government agencies which would otherwise be collected, including payroll taxes, unemployment insurance withholdings, federal and state income taxes, etc. Faced with these revenue shortfalls, federal and state agencies have taken steps to work

together and step up enforcement.

On the federal level, the U.S. Department of Labor (DOL) and the Internal Revenue Service (IRS) both have "misclassification" task forces dedicated to investigating use of independent contractors, including conducting random and focused audits of employers. In addition, the DOL has entered into partnerships with various state labor agencies to coordinate collection of information and enforcement. On November 18, 2013, DOL announced that New York is the 15th state to sign a partnership agreement with the DOL pursuant to which they have agreed to jointly investigate and enforce applicable laws, share information about worker complaints and possible violations, and exchange confidential unemployment compensation information, among other steps. States that had already signed such agreements include California, Colorado, Illinois, Iowa, Louisiana, Minnesota, Missouri, Montana, Utah and Washington. In addition, state agencies may share data to aid in their investigation and enforcement efforts.

Why is misclassification such a big deal?

Here are some of the major issues:

• ***Federal taxes & withholding:*** Companies that misclassify workers as independent contractors may face considerable tax liability. Normally, companies are not required to withhold federal income taxes from or pay Medicare, and Social Security taxes on compensation paid to true independent contractors. If a worker is misclassified, the company may be held liable for all of the taxes and withholdings it failed to make, and may also be liable for the portion of those taxes and withholdings normally paid by an employee through payroll taxes. If an improperly classified worker failed to pay income taxes, the IRS could also seek to collect them from the company. A company's failure to properly classify its workers and pay the requisite taxes can result in hefty consequences such as monetary fines, interest, and even imprisonment, among other penalties, depending on the circumstances.

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• ***Compliance with I-9 requirements:*** Under federal law, when companies hire employees, they must verify each worker's eligibility to work in the United States within their first three days of employment. Employer's must keep a copy of the completed "Form I-9" on file and make it available for inspection if requested by the government. Failure to comply with these requirements can result in civil and criminal penalties for the company and its management. It is a crime to employ an individual who is not authorized to work. Some companies have tried to circumvent the I-9 requirement by classifying workers as independent contractors. However, if an individual is deemed an employee, the company (and its executives) could face criminal penalties.

• ***Liability under state and federal employment and benefit laws:*** Most state and federal employment laws only apply to employees, not true independent contractors. This means that a misclassified worker would likely have rights under those laws and could assert a discrimination claim for failure to hire or for terminating the employee based on a protected status. Likewise, a misclassified worker would likely have the right to assert a hostile workplace claim if subjected to harassment based on a protected factor. Employers that take steps to prevent discrimination and harassment—like conducting manager training, publishing good anti-discrimination and anti-harassment policies, and investigating and remedying employee complaints—may have special defenses against certain claims and avoid liability. Making independent contractors subject to these policies can make them look like employees; not doing so can create liability or deprive the company of some defenses.

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Misclassified workers could potentially assert rights to statutory benefits, such as: job-protected leave under the Family and Medical Leave Act (FMLA), an accommodation of a medical issue under the Americans with Disabilities Act (ADA), overtime pay under the Fair Labor Standards Act (FLSA), or medical, retirement or other benefits provided to employees covered by the Employee Retirement Income Security Act of 1974 (ERISA). Similarly, complaints about working conditions by misclassified workers could be protected under the National Labor Relations Act (NLRA).

There is no one single standard for employee status. Federal courts typically apply variations on a common law test known as the "economic realities test" in order to determine whether an individual is an employee or an independent contractor for purposes of coverage under Title VII, the ADA, and the Age Discrimination in Employment Act (ADEA). Federal courts and the Department of Labor use the same test to determine whether an individual is an "employee" subject to the FLSA's minimum wage and overtime requirements. The focus of the economic realities test is generally on whether the alleged employer paid the employee's salary, withheld taxes, provided benefits, set the terms and conditions of employment, and had the right to control the "means and manner" of the worker's performance, among other factors.

Federal courts and the Department of Labor typically use the "economic realities test" to determine whether an individual is an "employee" subject to the FLSA's minimum wage and overtime requirements.

The National Labor Relations Board uses a different test, known as the "common-law agency" test, to determine an individual's employee status under the NLRA. This test looks at additional unique factors such as the belief of the parties, the length of time the individual is employed, the type of occupation involved, and the individual's risk of loss and opportunity for gain, among other important factors.

Who will qualify as an employee under the equal opportunity and benefits laws will vary based on the facts and the applicable law. Merely calling a worker an independent contractor is not enough to avoid coverage, even if the worker agrees to the arrangement and signs an "independent contractor agreement." Companies should carefully evaluate a worker's status before classifying him or her as an independent contractor.

• ***Liability for injuries suffered by independent contractors:*** Companies which maintain workers' compensation insurance coverage for their employees generally do not have direct liability for on-the-job injuries suffered by employees which do not result in death. Workers' compensation coverage typically pays medical and income replacement benefits to employees who are injured at work or have work-related diseases or illnesses. Claims are resolved through the insurance program and administrative process rather than through a personal injury lawsuit filed against the employer. Punitive damages are generally unavailable for employee injuries covered by workers' compensation insurance.

In most states, individuals who are properly classified as independent contractors are typically excluded from workers compensation insurance coverage. This means that a true independent contractor who is injured while working for the company could assert a claim against the company in court for injuries suffered in connection with the performance of their services. This is why companies often require true contractors to carry general liability insurance and to indemnify and hold the company harmless from such liabilities. Employers may not be able to escape liability for injuries or accidents suffered by workers just because they are classified as independent contractors.

• ***Liability for injuries to third parties:*** What happens if a worker classified as an independent contractor damages a third party's property or causes bodily injury to a non-employee or another contractor? The answer depends on the circumstances, including whether the "contracting" company was negligent in selecting the independent contractor, whether the company exercised control over the individual or his/her work, whether the worker was held out as acting on behalf of the company, or allowed to hold himself out, and other factors. While a company is generally not liable for the negligence of an independent contractor, the company can be held liable for an independent contractor's negligent and tortious acts in some circumstances, such as under legal theories like negligent hiring,

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negligent control, non-delegable duty, and the borrowed servant doctrine. Classifying the worker as an independent contractor may not insulate the company from liability for the worker's unexpected or unwanted conduct.

• ***Unemployment insurance coverage:*** Employees are generally eligible for unemployment benefits if their employment involuntarily ends or their hours are substantially reduced. True independent contractors generally are not eligible for such benefits. In Texas, there is a legal presumption of employment, and the burden is on the employing company to prove that an individual is not an employee as contemplated under the statute. The Texas Workforce Commission (TWC) applies a twenty-factor test previously used by the IRS to determine independent contractor status. If the TWC determines that the individual is, in fact, an employee, he or she may be entitled to unemployment compensation benefits at termination, which would be charged to the employer's account.

Which individuals are properly classified as contractors?

Independent contractor status is not determined based on the parties' written agreement. It is determined based on the factual realities of the parties' relationship. Boiled down to their essence, the various tests used to determine independent status look at the following:

• ***Is the individual voluntarily in business for him/herself?***

Agencies and courts will look to see if the worker uses his own equipment, sets his own work hours, determines what rates to charge for services, has opportunities for profits and losses, etc.

• ***Does the company supervise the manner in which the individual performs the work?***

Agencies and courts look for signs the company controls the manner and method for doing the work, not just the outcome of the work. They also look at whether the work is really of a type central to the company's business which could be or is ordinarily done by employees.

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• ***Is the relationship between the individual and the company temporary in nature or long-term, and exclusive or open?***

A relationship between an individual and a company which is long-term and exclusive will more likely be found to be an employment relationship than a short-term engagement during which the worker is free to work for other companies.

• ***Does the company treat the worker like an employee?***

When companies issue workers business cards like the ones given to employees, assign workers company-sponsored email addresses, assign workers company phone numbers or list them on employee directories, invite them to company events for employees, and/or hold them out to third parties as employees, etc., agencies and courts are more likely to find them to be employees.

Whether a worker can properly be classified as an independent contractor will depend on the unique facts of the work arrangement and the relationship between the parties.

Summing it up

Given all of the potential pitfalls and considerations associated with the use and classification of independent contractors, it is essential that companies understand the risks associated with hiring and using individuals to perform work as independent contractors and take steps to ensure that workers are properly classified. Employers should audit contractor status with the assistance of counsel, so that communications and analysis of the facts may be shielded from future discovery under the attorney-client privilege, and to ensure that evaluation of workers' status is based on the correct legal standards, relevant facts and current interpretations of the law.

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