

# Contractor Traction: The Use and Abuse of Independent Contractor Status

By Mark Terman, Esq.

**It's easy to see why California employers are frustrated with the endless tangle of employment laws that appear to change every 10 minutes. But some employers mistakenly attempt to avoid regulation and save the cost of employment taxes by classifying workers as independent contractors when the substance of the relationships is one of employee-employer. This article will explore why independent contractor status often is attacked; risks of misclassification; and factors to consider in determining whether workers are truly independent contractors.**

## **If It Looks Too Good to be True**

Companies that hire independent contractors generally avoid employer obligations under many state and federal laws. For example:

- Reasonable accommodation and return to work obligations under disability laws do not apply.
- Anti-discrimination obligations to protected employee classes (e.g., age, race, sex, national origin, ancestry, disability, medical condition, sexual preference, religion, etc.) are not a concern (though independent contractors are protected under sexual harassment laws).
- No collective bargaining or union issues.
- No employee benefits to give, such as medical insurance, pension, stock option and other equity plans.
- No disability insurance, life insurance, sick pay and vacation pay.
- The worker is not part of the work force for workers' compensation insurance purposes.
- Leaves of absence, such as California Family Rights Act, Family and Medical Leave Act and pregnancy disability leave, are not required.
- Tax and trust fund obligations (e.g., income tax, unemployment insurance, state disability insurance, paid family leave, employment training tax, Social Security and Medicare) are of little concern.

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- Unemployment insurance benefits are not owed.
- Wage and hour laws (e.g., minimum wage, overtime, rest periods, vacation pay on termination, etc.) do not apply.
- Plant closure and mass layoff notice laws are not a worry.
- Wrongful employment termination and related causes of action do not exist.

Does this look too good to be true? Many regulatory agencies think so. Each body views the classification with its own tests and varying degrees of skepticism.

California jurisdictions include Cal-OSHA; the Department of Fair Employment and Housing; Department of Labor and Workforce Development (Division of Labor Standards Enforcement a.k.a. Labor Commissioner); Employment Development Department—Benefits/Tax; Franchise Tax Board; Unemployment Insurance Appeals Board; and Workers' Compensation Appeals Board.

Federal agencies include the Department of Labor (e.g., wages, EEOC); Immigration and Naturalization Service; IRS; and OSHA.

Of course, there are also court actions brought by individuals or the government to assert rights and regulation triggered by an employment relationship.

### Domino Theory

The attack on classification sometimes comes first from a tax authority.

In addition to tax withholding and trust fund problems, pension plans can be exposed. A widely publicized 1997 case, *Vizcaino v. Microsoft*, dealt with hundreds of freelance programmers who argued they should have been participants in, and received employer contributions to, a pension plan.

Among the huge fallout risks in pension cases are unpaid employee contributions; IRS disqualification of the plan; disallowance of deductions taken; and participants' vested account balances becoming immediately taxable.

More often, the attack comes from a worker who alleges a loss of some kind. A typical first classification attack – the first domino to fall – comes when the working relationship ends and the independent contractor files for Unemployment Insurance benefits.

The EDD, seldom convinced that the independent contractor classification is correct, often will reclassify the worker as an employee, award UI benefits, then look for other workers who might be reclassified and assess the employer for actual or estimated unpaid

withholding of employment and income taxes.

Administrative and civil appeals and settlement officer negotiations to undo all this are costly for the employer.

If the determination is not challenged, workers and other government agencies can be emboldened to assert many of the rights reserved for employees that the company hoped to avoid.

Another domino falls if a worker is injured on the job and the company's workers' comp carrier denies the claim. Then the company will be exposed to a civil lawsuit with the presumption of employer negligence and face potential penalties, including up to \$100,000 for failure to insure.

When the issue of independent contractor classification comes up in one jurisdiction, employees or the government are motivated to figure out a way for the issue to be raised in other jurisdictions. It is not unusual for the issue to start with a UI claim, followed by state tax, state Labor Board, federal tax scrutiny and civil litigation dominoes.

### Key Classification Factors

Notwithstanding this hostile environment, real independent contractors do exist. Care should be taken with experienced professionals to identify and document the relationship with these workers.

Companies should review the standards of the various jurisdictions to determine whether their workers are independent contractors or employees to avoid any possible penalties.

For example, the EDD's Employment Determination



“SO YOU WERE IN THE COURIER BIZ IN CALIFORNIA TOO?”



Guide, [www.edd.ca.gov/taxrep/de38.pdf](http://www.edd.ca.gov/taxrep/de38.pdf), is a useful planning tool. It identifies tough tests that EDD investigators use to gather evidence and make determinations.

Similarly, June 2003 IRS Form SS-8, [www.irs.gov/pub/irs-pdf/fss8.pdf](http://www.irs.gov/pub/irs-pdf/fss8.pdf), summarizes IRS thinking on proper classification beyond the 1987 "20 Factor" test tax practitioners learn.

Note that employers seldom send completed SS-8 forms to the IRS since that may invite the agency's scrutiny.

Below is a summary, though not exhaustive, of the classification factors used by most courts and agencies. It identifies commonalities among the various tests for classifying California workers.

Evaluate all the facts and circumstances of the relationship, give appropriate weight to the factors and use some common sense in each context. The more factors that fit, the better the chances that "independent contractor" is the right classification.

1. The company has no right to control the manner and means of how the contractor accomplishes the results desired, regardless of whether that right is actually exercised. Give this factor the greatest weight.
2. The contractor's work is not the company's primary work.
3. The contractor is in a distinct occupation or separate business.
4. The contractor's relationship is short-term.
5. The contractor decides where the work is to be done (usually the contractor's facility) and sets his or her own hours.
6. The contractor is paid by the job.
7. The contractor uses personal tools.
8. The contractor cannot be terminated at-will.
9. The contractor is highly skilled, works without supervision of the company and uses initiative, judgment and foresight for success of the independent operation.

10. The contractor has the right to hire and terminate others.
11. The contractor does not have a company title or business card.
12. The contractor acts like a separate business (e.g., entity, contracts, invoices, leases, insurances, employees, etc.).
13. The parties believe they are creating an employer-employee or principal-independent contractor relationship.
14. The contractor has financial control of the business (i.e., significant investment in the business, opportunity for profit or loss, and pays own expenses).

For example, consider accountants who are engaged by an accounting firm during busy season. They receive substantially all of their work from the firm; are provided offices, phones, computers and secretarial services by the firm; are supervised by someone at the firm; have business cards showing an affiliation with the firm; and are reimbursed by the firm for business expenses. These accountants are most likely employees, even if engaged for just a few months.

By contrast, consider accountants who do business through a corporation or LLC; have a city business license; lease space from an accounting firm; receive some work from the firm, but do work for, and are paid by, multiple clients generated independently of the firm; invoice the firm for the work done for the firm's clients; employ a staff; dictate the manner and means of the work; and pay their own business expenses.

These workers are most likely independent contractors.

### Get It Right Now and Avoid Attack

Disputes over independent contractor classifications can take time and cost money. Businesses that evaluate classification and the risks of attack can modify these relationships to make them more defensible or determine that employee classification is more realistic and reduce the risks of improper classification.

**MCW**

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