



# Employee or Independent Contractor?

## Not Knowing the Difference Is Expensive

By Kathryn Vanden Berk

**SCENARIO:** Economic hard times have driven you to the point where you must find new ways to accomplish agency goals with a smaller payroll. A colleague tells you that she's been using a great new technique that has allowed her to decrease her full-time staff by 20 percent yet maintain the same number of workers on the books, and still cut an easy 4 percent out of her budget!

You're definitely intrigued. Your board has been on you to reduce staffing costs as your revenue streams are shriveling up. You bite, and ask, "So, how do you do it?" She says, "It's easy. I only wish I had discovered it earlier. I've just turned all of our kitchen and maintenance staff into independent contractors. I let everyone go and hired back only those who were willing to sign an agreement stating that they were independent contractors and not employees. I filled in with new workers over the next few months. They're happy to have a job, I can tell you." She sighed, "It was a hard decision, and I didn't like letting them all go. But the results have definitely been worth it."

It seems like the perfect set-up. You've been thinking about outsourcing your food services anyway. You know there are hundreds of people in the area who would be glad to pick up hourly work, even if they had to work without benefits. You remember that your friend Sam has been doing this at his agency since the mid-1990s and you've been meaning to call him about it. It's time to get in touch. Sam's not available when you call. He and his board chair are in Washington meeting with the IRS.

**A**s state and federal governments seek to uncover all legitimate sources of tax revenue, they will no doubt be looking at organizations that engage large numbers of "independent contractors." I use the quotation marks around the term to indicate that the "independent contractor" classification is viewed with suspicion by a number of government agencies that are charged with collecting taxes or overseeing employee welfare. For purposes of this paper, I will discontinue using quotes, but remember that anyone you hire as an "independent contractor" is not *bona fide* (i.e. genuine) unless you can prove it.

What is your exposure? When you do not classify an employee correctly, you are responsible to make good on any benefits to which the employee would have been entitled, and any taxes that the government did not receive. Thus, the IRS must be paid the employer's share of FICA, and your re-classified employees must receive retroactive contributions to pension plans. In certain instances, an employer may be required to pay retroactively for health care costs that would have been covered by insurance and accumulated unpaid overtime. This can be serious enough if there is a single mis-classified employee, but if you have a number of them for several years, you can imagine the impact this can have on your organization.

### The Microsoft Cases

The government's interest in mis-classified independent contractors was

## IRS Test for Employee Classification

The classic test of whether an employer-employee relationship exists is whether the putative (assumed) employer has the right to control not just the end result to be accomplished, but also “the manner and means” by which the result is accomplished. The IRS examines 20 different facets or factors pertaining to the parties’ relationship. No single factor or facet is determinative—the test being of the “totality of circumstance” type—but some factors, blue key symbols, are more important than others.

**To define a worker as an employee, it must be determined if you can, or actually do, some or all of the following:**

### **Instructions.**

You tell the worker what tools or equipment to use, when to work and how physically or procedurally to do the job.

### **Training.**

You require the worker to work alongside an experienced employee for a period of time in order to learn your system.

### **Integration into Business Operations.**

The worker must work alongside your regular staff at the same jobs or very similar jobs.

### **Services Rendered Personally.**

You require this particular worker to do the work, not his/her assistants or delegates. (Key element)

### **Hiring, Supervising, and Paying Assistants.**

The worker can engage his/her own assistants only by or with your approval.

### **Continuing Relationship.**

The worker was “converted” to an “independent contractor” to work at the same job he/she previously did as an employee. (Key element)

### **Set Hours of Work.**

You can demand that he/she work specific shifts and hours.

### **Full Time Required.**

The worker must work full time.

 **Work Performed on Employer's Premises.**  
The worker must come to your place of business. (Key element)

### **Order or Sequence of Work Set.**

You can, or you do, set the order or sequencing of the work.

### **Oral or Written Reports.**

You require written or oral reports.

### **Payment by Hour, Week, and Month.**

You pay the worker based on time increments worked rather than jobs completed. (Key element)

### **Payment of Business or Travel Expenses.**

You reimburse the worker for the same kinds of business or travel expenses for which employees are reimbursed. (Key element)

### **Furnishing of Tools and Materials.**

You furnish tools, equipment, and expendable supplies. (Key element)

### **Significant Investment.**

You invest in and provide facilities that are used by the worker in performing services (i.e. office, lab, workshop, or other facilities). (Key element)

### **Realization of Profit or Loss.**

You cover the risk of accidents, provide insurance, cover cost overruns, and do not penalize the worker for failure to finish the project on time.

### **Working for More Than One Firm at a Time.**

You are the sole employer of record and there are no “multiple customers” to indicate that the worker owns his/her own business. (Key element)

### **Making Services Available to General Public.**

The worker does not advertise or otherwise make his/her services available to the public. (Key element)

### **Right to Discharge.**

You may discharge the worker “at will.”

### **Right to Terminate.**

The worker can terminate his/her relationship with you without liability.

piqued in the 1980s when companies created contingent workforce systems in order to manage fluctuating workloads. Microsoft Corporation was the highest profile firm doing this, signing on sometimes hundreds of what it called "freelancers" to develop software products for market. Microsoft freelancers signed contracts that identified them as independent contractors and specifically waived employee benefits. The freelancers then went to work with Microsoft's regular full-time workforce, often sharing work hours, workstations, supervisors, training programs, equipment, and even job responsibilities.

In the late 1980s, an Internal Revenue Service investigation concluded that freelancers were common law employees. Microsoft agreed and made the necessary corrections by issuing W-2 forms to the freelancers and paying their share of FICA taxes to the government.

But this would not be the end of the matter. The newly re-classified employees realized they could have been participating in Microsoft's pension plan and sued as a class under ERISA.<sup>1</sup> Microsoft countered, claiming that no benefits were due because the freelancers had waived their rights to them in written contracts. A federal appeals court ruled that the contracts had been based upon a mutual mistake (as to classification), and that Microsoft's agreement to retroactively recognize its freelancers as employees meant that it also owed them benefits.<sup>2</sup>

### Key Determining Factors

The IRS has developed 20 factors for making a determination as to a worker's employment status (see page 24)<sup>3</sup>. The IRS has a definite bias in favor of treating workers as employees, since employee taxes are withheld and submitted by the employer.

The Department of Labor (DOL) does not utilize the IRS's 20 factors test to evaluate entitlement to benefits under ERISA, so the U.S. Supreme Court listed the 12 factors as most significant to a determination of inclusion in ERISA-governed benefit plans.<sup>4</sup> The DOL uses an "economic reality test" for determining coverage under the Fair Labor Standards Act.<sup>5</sup>

State workers' compensation laws typically define employees as persons in the service of another under *any* contract of hire, express or implied, oral or written. Volunteers, however, may or may not be entitled to worker's compensation benefits, depending upon rulings in your state. Similarly, state unemployment insurance programs have their own standards to determine eligibility for unemployment benefits upon termination.

Finally, most state courts use a common law "right to control" test to determine employee status in cases where someone is suing the employer for damages based upon the independent contractor's acts or omissions. Again, these vary from state to state.

Using independent contractors is not a panacea for all employment problems. Used correctly, they are administratively convenient, economical, and make good business sense. The danger is in not characterizing a true employer-employee relationship correctly. This can lead to adverse tax and benefit liability consequences. Thus, if you decide to re-classify workers, be aware of the factors needed to create a true independent contractor relationship and make certain you heed them.

### A Word About Volunteers

You might want to supplement your workforce by using unpaid volunteers, including current employees who volunteer their services to help fill in during a worker shortage. However, the DOL is very wary of the use of non-employee volunteers to fill vacant positions, and will limit your use of them. To determine if a person is truly a volunteer and not an employee, the DOL ordinarily considers the following factors: benefit to your organization, time spent in the activity (the activity is less than a full-time occupation), whether services are of the kind typically associated with volunteer work, and whether the individual expects payment for services. Remember that a paid employee of a nonprofit organization generally may not volunteer to perform the same type of services that he or she performs as part of a regular job. ▲

### Endnotes

1. ERISA is the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1001 *et seq.*
2. The Microsoft Cases are summarized in *Vizcaino et al. v. Microsoft Corporation*, 120 F. 3d 1006; 1997 U.S. App. LEXIS 18869 (9th Cir. 1997).
3. The IRS offers a guide to establishing the proper classification in Form SS-8, Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding. Form SS-8 is available on the IRS' website at <http://www.irs.ustreas.gov/formspubs/index.html>.
4. They are: skill required; source of tools and instrumentalities; location where work performed; duration of relationship of parties; the hiring party's right (or lack thereof) to assign additional projects; the hired party's discretion over when and how long to work; method of payment; the hired party's role in hiring and paying assistants; whether the work is part of hiring party's regular business; whether the hired party is in business; whether "employee benefits" are provided; and the tax treatment of the hired party. See *Nationwide Mutual Ins. Co. v. Darden*; 03 U.S. 318; 112 S. Ct. 1344; 117 L. Ed. 2d 581 1992 U.S. LEXIS 1949 (1992).
5. Under the Fair Labor Standards Act (FLSA), to employ an individual is defined as "suffering" or permitting that person to perform work. Under normal conditions, any person who performs work for your organization is considered an employee who must be paid. A six-part test is discussed in *Reich v. Circle C Inv., Inc.*, 998 F. 2d 324 (5th Cir. 1993).

### Disclaimer

This article has been prepared to convey general information on topics of interest to child care agency boards and executive staff. Although prepared by an attorney, it should not be used as a substitute for legal counseling in specific situations. Readers should not act upon the information contained in this article without professional guidance.



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