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The media's focus on worker classification – which has often suggested that businesses are deliberately taking advantage of poor, uneducated workers to deprive them of employee benefits and the government of tax revenues – is largely biased and inaccurate. In fact, the issue is much more complicated and nuanced.

The Truth About Recent Attacks on the Independent Contractor Classification

By William Hays Weissman and Sarah Ross

In the last few years, the issue of worker classification has been the subject of numerous articles, such as a recent front page article on February 17, 2010, in the *New York Times*. Many of those articles claim that companies deliberately misclassify employees as independent contractors in order to save themselves money. These articles note that misclassification deprives workers of rights and benefits enjoyed by employees, while also depriving governments of much needed tax revenues. However, these articles are largely biased and inaccurate, containing incorrect statements about the laws relating to independent contractors, misrepresenting the motivations of employers, and ignoring the role that workers themselves sometimes play in how they are classified.

The real story is much more complicated and nuanced. Many workers are frustrated because the government has told them that they cannot be treated as independent contractors. This was tragically evident on February 18, 2010, when a self-described independent contractor attacked an IRS facility in Austin, Texas, purportedly, in part, because he was frustrated at being refused independent contractor status by the IRS.

Of course, such criminal conduct can never be condoned and has no place in civilized society. However, that tragedy does further illustrate the frustration over the complicated nature of worker classification issues.

History of the Definition of an "Employee"

One of the most confusing and difficult laws for businesses to apply is the dividing line between employees and independent contractors. Nonetheless, this distinction is critical for numerous reasons, including, but not limited to, whether a person paying a worker is liable for withholding and remitting federal Income, Social Security, and Medicare taxes from the worker's pay, how certain fringe benefits should be taxed, the right to deduct certain kinds of expenses, whether minimum wage or overtime laws apply, or whether the workers are governed by disability and medical leave laws.

As originally enacted, the Social Security Act (SSA) did not contain an express definition

of an "employee." However, shortly after enactment of the SSA, the U.S. Treasury Department enacted regulations that adopted the common law control test to determine whether a worker was an employee or an independent contractor for federal employment tax purposes.[1] The common law control test was well established at that time, being based on and summarized by section 220 of the Second Restatement of Agency. Despite the Treasury Regulation, the federal courts used conflicting tests to determine a worker's status for employment tax purposes. These conflicting tests culminated in 1947 in two U.S. Supreme Court opinions: *United States v. Silk*[2] and *Bartels v. Birmingham*.[3]

In *Silk* and *Bartels* the U.S. Supreme Court held that while control was an important factor to consider, it was not the only one. Rather, the worker's status should be considered in light of the purpose of the SSA, and thus the term "employee" included those who, as a matter of economic reality, were dependent upon the business to which they rendered services.

As a result of *Silk* and *Bartels*, the Treasury Department promulgated new regulations in 1947 "defining the employer-employee relationship on the basis of the economic reality test."[4] The proposed regulation caused considerable criticism in Congress and lead to enactment in June 1948 of the "Gearhart Resolution"[5] over President Truman's veto. The "Gearhart Resolution" was intended to "maintain the status quo in respect of certain employment taxes" by including a definition of "employee" in the Internal Revenue Code as follows: "'employee' does not include (1) any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an independent contractor or (2) any individual (except an officer of a corporation) who is not an employee under such common-law rules."[6] Congress made the definition retroactive to 1935, the year the SSA was enacted. Further, as a 1950 Eighth Circuit Court of Appeals case made clear: "the coverage of the statute in suit is not to be expanded by Treasury Regulations or court decisions relaxing or changing the common-law concept of the employer-employee relationship."[7] Thus, the usual common law rules – and not the "economic reality test" – have been applied for federal tax purposes without statutory change since enactment.

However, under other federal laws, such as the Fair Labor Standards Act (FLSA), the definition of an employee differs from the usual common law rules. For example, many federal courts use the economic reality test or a hybrid test for purposes of the FLSA.[8]. Nonetheless, at least since 1948, the federal courts recognized the distinction between an employee for federal tax purposes and for other federal legislative purposes. For example, in *In re Miller*,[9] a case dealing with whether or not a worker was an employee or self-employed for federal employment tax purposes, the court observed that "a separate line of decisions has attempted to define the term 'employee' in the context of the Fair Labor Standards Act. . . . that six-part test cannot be borrowed *in toto* for [federal employment tax] purposes. Congress and the courts have both recognized that, of all the acts of social legislation, the [FLSA] has the broadest definition of 'employee.'"[10]

As for state law, the usual common law rules are followed by about half of the states. Most of the other states follow an "ABC" test that determines independent contractor status if there is an absence of control, business is unusual or away from offices and the work is customarily done by independent contractors. While providing a fewer number of factors, this test is also convoluted and far from straightforward, making it very difficult for employers to know whether they are following the law correctly in the classification of their workers. Further, even within a state, the applicable test may vary from one state law to the next, just as it does from one federal law to the next.

Meaning of the Usual Common Law Rules

The usual common law rules state that if an employer has the right to control the means by which the worker performs his or her services as well as the ends, the worker is an employee.[11] The existence of the employer's right to control is critical; the exercise of that control is not. Thus, the Treasury Regulations state that "it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so."[12]

In contrast, "if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is an independent contractor."[13] Each case must be determined by its own facts and circumstances.

In 1987, the IRS issued Revenue Ruling 87-41 in which the IRS distilled years of case law into a more manageable 20-factor test. While these 20 factors are commonly relied upon, it is not an exhaustive list and other factors may be relevant. Further, some factors may be given more weight than others in a particular case.[14] In 1996 the IRS reorganized the twenty factors into three broad categories in its training materials:

(1) Behavioral Control: The facts that illustrate whether there is a right to direct or control how the worker performs the specific task for which he or she is engaged (*e.g.*, instructions, training, etc.).

(2) Financial Control: The facts that illustrate whether there is a right to direct or control how the business aspects of the worker's activities are conducted (*e.g.*, significant investment, unreimbursed expenses, method of payment, opportunity for profit or loss, etc.).

(3) Relationship of the Parties: The facts that illustrate how the parties perceive their relationship (*e.g.*, intent of the parties/written contracts, employee benefits, discharge/termination, regular business activity, etc.).

As many businesses know, putting these rules into action is no easy task. Reasonable minds can and do differ on whether a worker is an employee or independent contractor based on these factors. Thus, the proper classification of workers has long plagued businesses.

The Current Climate

As noted, the law used to determine whether a worker is an employee or independent contractor for federal tax purposes has remained unchanged for 75 years. While for other purposes the law has evolved somewhat over time, it still remains largely grounded in the concept of control.

Recently, the federal government has been stepping up enforcement of perceived abuse of worker classification laws. For example, the Obama Administration's 2011 Budget for the Department of Labor includes an additional $25 million to target the misclassification of workers as independent contractors. This would fund an additional 100 enforcement personnel as well as competitive grants to help states address this alleged problem.

Various states have also started stepping up their enforcement over the last few years. In 2006, New Jersey adopted a more distinct definition of "employee" and improved the coordination of enforcement actions between state agencies. In 2004, Massachusetts amended its existing laws to provide a strong presumption that a worker is an employee unless certain conditions are met. In 2009, Maryland passed the Workplace Fraud Act of 2009, which covers employers in the construction or landscaping industries and presumes that all individuals performing work for pay are employees, unless the employer can establish that the individual qualifies for a special exemption. Other states, including Colorado, Illinois, Massachusetts, New Jersey, and New Mexico have passed laws aimed at misclassification in the construction industry. In fact, in late 2009, the Illinois Department of Labor imposed a $328,500 penalty on a construction contractor based on the misclassification of 18 employees as independent contractors. Some states, such as Iowa, Michigan, New York, and Wisconsin, have even created taskforces designed to uncover misclassification.

Much of the impetus for the federal and state governments recent crackdown on employers is driven by the increased revenues it generates, rather than concerns about the unfairness of potential worker misclassification. The Obama Administration admits that it hopes that the new budget will bring an additional $7 billion in recovered taxes into the Treasury over the next 10 years. Many federal and state governments are facing budget deficits, and hope that by forcing companies to reclassify workers they will be able to collect millions in "unpaid" taxes.

The theory is that employee have taxes withheld directly from their paychecks, while self-employed independent contractors do not have anything withheld and are responsible for paying their taxes themselves. The governments argue that they are only attempting to collect the taxes that are owed and have gone unpaid – or what is often referred to as the "tax gap" – due to independent contractors' failure to report.

However, as explained in a 1991 U.S. Treasury Department study, both employees and independent contractors have the same tax burden. The real issue stems from independent contractors' failure to properly report all their income or overstating their expenses, not from the classification of the worker itself.[15] Thus, the government is proposing a solution to a problem that does not exist, while failing to address the real problems: the lack of clarity in the law and the non-compliance of independent contractors themselves.

Federal Safe Harbor Under Assault

Much like today, in the late 1960s and early 1970s there was a surge of employment tax audits by the IRS, which had become concerned about maintaining the Social Security Trust Funds and the perceived low compliance by many independent contractors in paying the self-employment tax. This resulted in many workers, who traditionally had been classified as independent contractors, being reclassified as employees. Pressure from employers, arguing that the IRS was inconsistent with this reclassification process, led Congress to enact a safe harbor provision in 1978 known as Section 530 of the Revenue Act of 1978 (Section 530). Originally intended to last for only one year, Section 530 was subsequently extended, and eventually, made permanent in 1982.

Under Section 530, employers can continue classifying individuals as independent contractors, even if that classification turns out to be incorrect. In order to qualify under Section 530, employers must consistently treat the workers as independent contractors, properly report the income on federal tax forms, and have had a reasonable basis[16] for classifying the workers as independent contractors.

However, Section 530 is now under assault. For example, last year the Taxpayer Responsibility, Accountability and Consistency Act of 2009 was introduced in Congress. The proposed legislation would limit the power of Section 530 by repealing Section 530 and adding a new code section that would limit the "reasonable basis" analysis to IRS examinations or determinations and put the burden of proof on the employer to prove it is appropriate to treat the workers as independent contractors. Similar legislation has been raised many times over the last 30 years. In fact, President Obama introduced a similar piece of legislation when he was in the Senate in 2007.

Additionally, in February 2010, the IRS will begin to audit 6,000 different employers over three years in order to provide statistical data for the IRS's first National Research Program study of employment tax compliance since 1984. One of the primary areas of focus for these audits will be on worker classification. This data will be used to develop new estimates of the "tax gap."

Both of these efforts appear to have the unstated goal of reducing the use of independent contractors. However, neither Congress nor the IRS has made any attempt to redefine who constitutes an employee in the first place. Thus, the same law that has been used to find workers to be independent contractors has not changed; only the enforcement has. This alone suggests that the government is being disingenuous. In other words, if there is no change in the law, workers that were found to be independent contractors 20 years ago should still be found to be independent contractors today.

The Myth of Independent Contractors as Poor, Uneducated Workers

The media's focus on big businesses taking advantage of poor, uneducated workers by forcing them to be independent contractors at best probably reflects only a small group of companies that may deliberately misapply the law. But this view does not comport with reality. First, most employers have made reasonable efforts to try to apply a nearly inexplicable legal distinction which has different rules depending on the context or law in question. For many businesses that utilize independent contractors, the frustration comes from the fact that a business model that has been used for years if not decades without question is now suddenly under assault when there have been no clear corresponding changes in the law. Many businesses feel that the only explanation is that the government is abusing the law solely to obtain needed revenues, and thus is being abusive and unreasonable.

Second, many independent contractors are highly educated and earn higher average incomes than employees earn. They want to be their own boss, controlling their own work schedule and making their own determination on how to best accomplish certain tasks, without much, if any, oversight from their clients. Many independent contractors consider themselves to be in business for themselves.

Besides the freedom, there are financial incentives. For example, unlike employees, who can only deduct business expenses as itemized deductions, independent contractors can generally fully deduct their business-related expenses. The independent contractors, and the businesses that contract with them, value those relationships.

Nonetheless, sometimes it is difficult for workers to be treated as independent contractors because of limitations on a federal tax law generally referred to as Section 530. For example, because of an exception to Section 530,[17] a safe harbor that allows employers to generally continue to treat workers as independent contractors even if they would not be able to do so under the federal common law, Section 530 status is not available when a business provides workers in particular fields to a client (in a three party situation), including as an engineer, designer, drafter, computer programmer, systems analyst or other similarly skilled worker. For example, if Company A contracts with Company B for engineering services and Company B pays C to provide the services to Company A and bills Company A directly for C's services, Company B does not qualify for Section 530 relief for its payments to C. Relationships excluded under Section 530 will need to be defended under the more conservatively interpreted common law.

Thus, at the same time the government is trying to eliminate the use of independent contractors, ostensibly for the workers' benefit, many workers and businesses are fighting to maintain independent contractor classifications because it provides advantages to both the workers and businesses and has been seen as proper under the law for many years. The current hostility to independent contractors is reminiscent of the sentiment in the 1960s and 1970s that gave rise for the need for the Section 530 safe harbor in the first place.

Where Are We Going?

All the increased media attention on the issue of worker classification is bound to increase the number of wage and hour class action suits based on claims of misclassification. Further, businesses will come under increasing scrutiny from various government agencies trolling for revenues. Businesses looking to minimize potential exposure may simply stop contracting with independent contractors. This can have significant negative impacts. For example, for the workers, their livelihood can dry up. Without their incomes, they could lose their homes and end upon on public assistance. The government's presumption that every independent contractor will be absorbed into the workforce as an employee is not based on reality. Further, businesses might lose access to a highly educated and specialized workforce whose services are needed for discrete purposes.

Other businesses will seek to rely upon contingent labor obtained through third parties such as professional employer organizations (PEOs). This presumes that the talent pool will contract with PEOs. However, such relationships can bring their own sets of potential issues, including joint employer liability.

Another trend is the incorporation of individuals. There is a belief that if a person just forms a corporation, then there the worker's status is not at issue. But that is incorrect. The existence of a validly organized and operated corporation does not preclude taxation of income to the service provider instead of the corporation.[18] Many individuals fail to follow the formalities of operating in corporate form, which can cause the corporate designation to be ignored. Thus, adding another layer between the independent contractor and the company does not guarantee that the issue of the worker's status disappears.

Given that it is an election year, the prospects for passage of any legislation eliminating Section 530 are probably not great. Nonetheless, employers should be concerned about such efforts to eliminate Section 530, which is the only remaining check on the government's efforts to make it harder for workers to be classified as independent contractors.

The frustration felt by many independent contractors and businesses today is quite real. The laws are difficult to apply. The standard for federal tax purposes has not changed in 75 years, yet enforcement is at its most aggressive in three decade. The media and government's portrayal of all independent contractors as being taken advantage of is simply inconsistent with a large contingent of educated and self-motivated individuals seeking to control their own American dream. Perhaps the most important point to remember is that everyone – businesses, independent contractors and the government – is mainly concerned with their own financial well-being.

Thus, the media's portrayal of worker classification issues issue should be more balanced in tone and recognize the legitimacy of independent contractors in many settings.

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[1] *See* 1 F.D. 1764 (1936) (reproduced and discussed in *United States v. Silk*, 331 U.S. 704, 714 n. 8 (1947)); see also *Illinois Tri-Seal Products, Inc. v. United States*, 353 F.2d 216, 224 (1965).

[2] *United States v. Silk*, 331 U.S. 704 (1947).

[3] *Bartels v. Birmingham*, 332 U.S. 126 (1947).

[4] *Illinois Tri-Seal Products*, 353 F.2d at 225.

[5] H.J. Res. 296 (62 Stat. 438) (1948).

[6] *Id*., at 225-226; *see also United States v. Webb, Inc*., 397 U.S. 179, 183-184 (1970) (tracing history of enactment of definition of "employee" for federal unemployment insurance tax purposes).

[7] *Dimmitt-Rickhoff-Bayer Real Estate Co. v. Finnegan* (8th Cir. 1950) 179 F.2d 882, 888.

[8] *E.g., Real v. Driscoll Strawberry Assocs., Inc*., 603 F.2d 748, 754-755 (9th Cir. 1979) (adopting economic realities test for FLSA purposes).

[9] *In re Miller*, 86 B.R. 817 (Bankr. E.D. Pa. 1988).

[10] *Id*., at 820 n. 1 (italics in the original) (internal quotations and citations omitted).

[11] Treas. Reg. § 31.3121(d)-(1)(c).

[12] Treas. Reg. § 31.3121(d)-(1)(c)(2).

[13] *Id*.

[14] IRS, "Independent Contractor or Employer? Training Materials," Training 3320-102 (October 30, 1996) ("IRS Training Guidelines"), at 2-4.

[15] DEPARTMENT OF THE TREASURY, TAXATION OF TECHNICAL PERSONNEL: SECTION 1706 OF THE TAX REFORM ACT OF 1986: A REPORT TO CONGRESS 12 (1991). The Treasury Report concluded that "current law does not consistently favor status as either an employee or an independent contractor." It went on to add:

> Prior to 1982, compensation earned by independent contractors was taxed at substantially lower rates under the Social Security and Medicare tax provisions of the Internal Revenue Code than wage income, apparently creating significant incentive for misclassification. Subsequent legislation has essentially eliminated this important difference.

[16] A *reasonable basis* has been found when (1) there is a judicial or IRS precedent supporting the employer's position, (2) there was a past IRS audit in which no assessment was made on account of improper treatment of the workers; or (3) there is a long-standing recognized practice of a significant segment of the industry in which the individual worked. Rev. Proc. 85-18, 1985-1 C.B. 518.

[17] Section 1706 of the Tax Reform Act of 1986, now Section 530(d).

[18] *E.g., Wilson v. United States*, 530 F.2d 772, 777-778 (8th Cir. 1976); *Haag v. Commissioner*, 88 T.C. 604, 610-611 (1987), *affd. without published opinion*, 855 F.2d 855 (8th Cir. 1988).