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EMPLOYEES vs INDEPENDENT CONTRACTORS

Understanding the distinction between contractors and employees and the re-characterisation of a contractor into an employee

An L&E GLOBAL Publication

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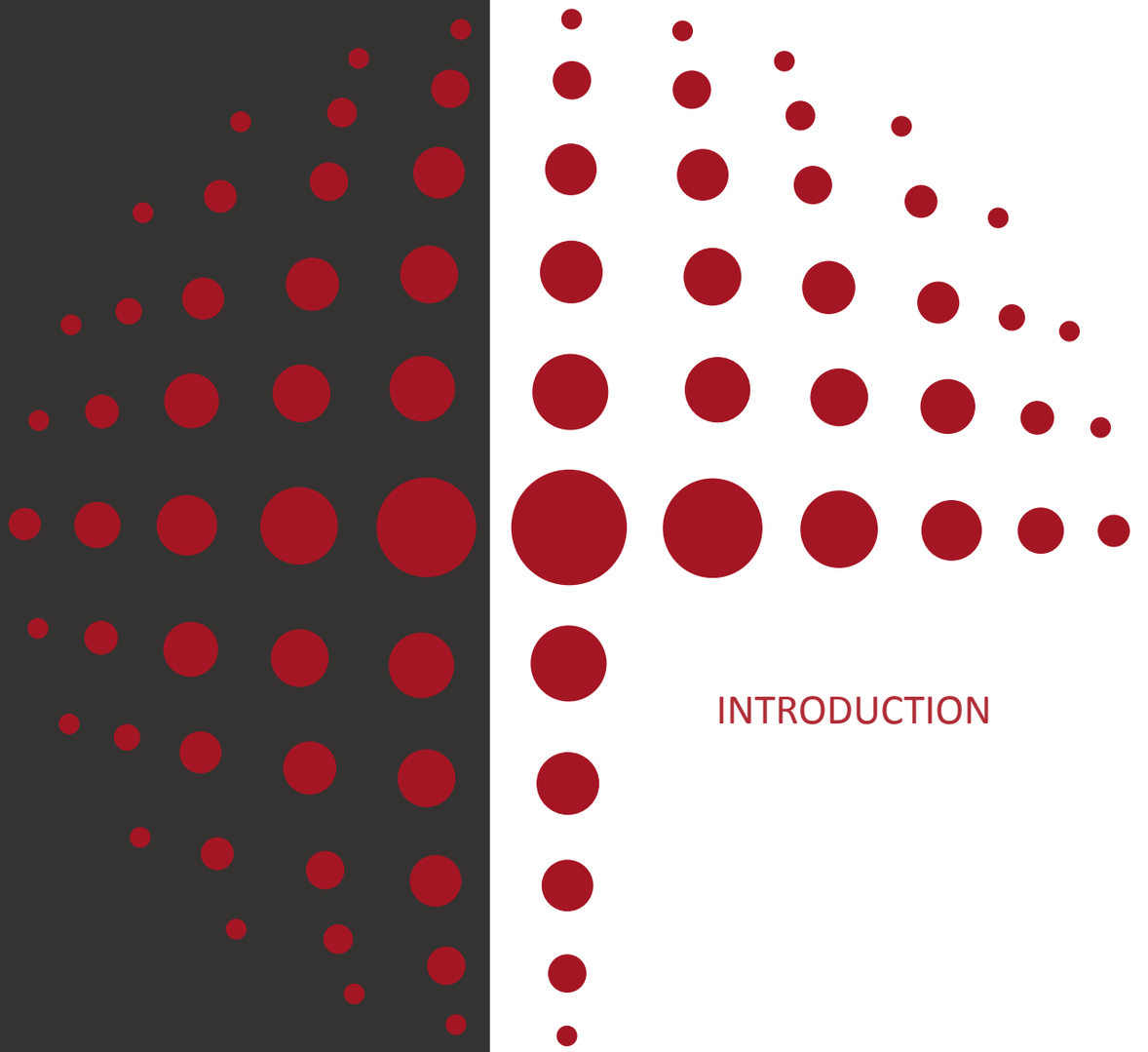

INTRODUCTION

Since we last touched upon the issue of employees vs independent contractors and the consequences of the re-characterisation of a contractor into an employee back in 2014, there has been a universal effort to eliminate sham contracts, which seek to hide the true nature of the relationship as an employer and employee agreement. Sham contracts are generally utilised so that the employer may avert the costly burdens of guaranteeing employee benefits, such as paid leave (holiday, maternity, paternity, etc.), having to pay the employer's social security contributions and income taxes on wages, and refraining from hiring unskilled, and at times undocumented migrants, who lack the bargaining power to safeguard their rights as workers.

Despite the risks of re-characterisation, in recent years, the use of independent contractors has increased significantly. So too has the use of fixed-term contracts, temporary commercial agency agreements and labour outsourcing services. This trend is not without its faults. The rise of the on-demand sharing economy (online business transactions) in areas such as carpooling, apartment/home lending, peer-to-peer lending, reselling, co-working and talent-sharing and the enterprises that drive these new workforces, including Uber, Didi, Bpost, Airbnb, Snapgoods and Zaarly, has led to an increase in litigation, with the qualification of the contracts and work agreements as the central issue.

Surprisingly, there are several similarities between nations with regards to the definition of an "employee" and the classification of an "independent contractor". Generally, an employment contract is defined as an agreement by which an individual works for another person (natural or legal), under the latter's subordination, for which s/he receives remuneration. On the other hand, it is likely that an independent contract applies if an individual is responsible for organising his/her own workload and occupational activities, without being subject to the 'authority' of another.

Presented with an employee vs independent contractor situation, the most important distinction revolves around the concept of subordination, wherein the relationship is characterised by performance of duties under the authority of an employer who has the power to give orders, monitor execution of assigned duties and punish his subordinate's breaches of duties. To determine whether subordination exists, it matters less how the parties define their relationship in their agreement, but rather, the most important factor is the reality of the situation, i.e. whether or not subordination actually exists based on the actions of the parties.

Concluding that the circumstances warrant a re-characterisation (to change the status of a contractor into an employee or an employee into an independent contractor), certain legal consequences will apply, both for the self-employed person and the other party, with regards to tax (payments and arrears), social security (payments and arrears), and labour relations (civil or even criminal fines).

So what steps can an employer take to effectively establish an independent contractor relationship?

- a contract for service should be devoid of any kind of control or supervision from the principal employer or employer, as the case may be. Therefore, such employers should avoid involvement in day-to-day management of the work undertaken by the independent contractors and contract labourers.
- payment should be based on specified deliverables/results being achieved.
- limit the assignment. The agreement should not make inferences to, or guarantee, the length of assignment or future employment.
- the contractor should be free to contract with and do work for other companies.
- the nature of the services, the apportionment of risk, remedies in the event of breach, and liability for taxes, should be clearly and expressly provided for.

A well-drafted contract will not be sufficient to protect a company from an adverse finding of sham contracting. The substance of the relationship, as evidenced by its day-to-day nature, must also be maintained. The principal should therefore ensure that its managers manage the relationship with the independent contractor in a manner that is consistent with its independent nature, rather than in the same manner and with the same expectations that the Principal may have of its own employees.

Furthermore, it is important to prepare for the possibility that the nature or characterisation of a relationship may be questioned. To that end, it may be useful to keep a record of any information that supports a verbal contract or the interpretation of a written contract, this may include; email communications, notes from meetings, quotes from conversations, diary entries, lists of specifications and any form of reporting or tasks lists.

For employers with operations in multiple jurisdictions, successfully entering into a working relationship, whether with an employee or an independent contractor, is a very real challenge and one that impacts every sector of industry, in every region of the world. To that end, L&E Global is pleased to present our 2017 Global Handbook, which serves as an introduction to the complex issue of employees vs independent contractors, with analyses from 32 key jurisdictions, across 6 continents.

UNITED STATES OF AMERICA

I. Overview

a. Introduction

The past decade, particularly during the years of the Obama Administration, has seen an increased administrative focus on potential independent contractor misclassification by the U.S. Department of Labor ("DOL") and the Internal Revenue Services ("IRS"). Independent contractor misclassification is a nationwide issue, spanning all industries – both on-demand and more traditional business models, and all regions. Commonly cited industries include: transportation, ride sharing, janitorial, food services, IT services, courier services, day care, commercial cleaning, and startups. The DOL estimates that approximately 3.4 million workers in the U.S. are misclassified as independent contractors resulting in a lack of employee entitled benefits and protections, as well as an approximate 3.4 billion U.S. treasury revenue loss in Income Tax, Social Security, Medicare, and unemployment insurance trust fund contributions.

Employer risks resulting from independent contractor misclassification include:

i. Liability for unpaid employment taxes

- past federal payroll taxes (3 years back, or more)
- state payroll taxes
- up to 100% penalty—if willful failure
- income tax not withheld
- trust fund recovery penalty for responsible persons

ii. Failure to pay minimum wage and overtime

- recovery by administrative authorities or civil litigants of unpaid minimum wage/overtime
- liquidated damages (100 % percent penalty)
- application of damage model to all workers in same job, not just individual worker
  - i.e. liquidated damages paid to all workers in the postion misclassified as independent contractor.
- DOL supervision over payment of wages
- attorneys' fees and cost

iii. Unfair labor practices liability under the National Labor Relations Act

iv. Immigration liability to the extent employers hire non-U.S. citizen workers as independent contractors to avoid verification of their citizenship status or obtaining of proper work visas.

v. Exposure to claims for coverage under employee benefit plans (Note: No statute of limitations)

The distinction between employees and independent contractors is defined somewhat differently depending on the statutory context. Key legislation relating to independent contractor misclassification includes:

- IRS: U.S. Tax Code (federal income tax withholding)
- U.S. Department of Labor:
  - FLSA (Fair Labor Standards Act – minimum wage and overtime);
  - FMLA (Family and Medical Leave Act);
  - ERISA (Employee Retirement Income Security Act)
- State Unemployment Laws/Agencies

- State Workers' Compensation Laws/Agencies
- State Income Tax Withholding
- Federal Anti-Discrimination Laws (Title VII, ADA, etc.)
- State and Local Anti-Discrimination Laws
- NLRA (National Labor Relations Act)
- IRCA (Immigration Reform and Control Act)

In September 2011 the DOL announced its "Misclassification Initiative" [1] – a program designed to establish joint/coordinated efforts between the DOL and the states. Since 2011, 35 states have signed a Memorandum of Understanding with the DOL and have passed bipartisan legislation to limit independent contractor misclassification. This form of state legislation typically includes: increased penalties for independent contractor misclassification, more stringent independent contractor status testing, and establishment of a state task force to address independent contractor issues. As a result of this joint initiative between the DOL and the state legislatures, in 2015, DOL investigations resulted in $74 million in back wages for more than 102,000 workers. It should be noted that during this same period there has been no new federal legislation addressing independent contractor misclassification.

With the transition to a new Presidency and new leadership in US administrative agencies in 2017, it is possible that a more pro-employer direction will ultimately take hold in interpretation of the relevant statutes and regulations.

II. Legal Framework Differentiating Employees From Independent Contractors

a. Factors that Determine Who is an Employee and Who is an Independent Contractor

As mentioned above, there is no uniform definition of "employee" under the laws of the United States, and no single standard or test exists to determine conclusively whether a worker should properly be classified as an independent contractor or employee. Classification issues may and frequently do arise in the U.S. under an intricate patchwork of federal and state laws and legal principles relating to taxation, employee benefits, employee wages and work hours, collective bargaining, workplace safety and health, employment discrimination and other employment-related matters. As discussed below, courts and government agencies have developed different and often divergent classification standards. The outcome of any classification analysis, therefore, is highly context-dependent.

Navigating the manifold standards and expectations under federal and state laws in the day-to-day implementation of an independent contractor arrangement can be a challenging task and the risk of misclassification is by no means insignificant. Enforcement efforts by government agencies have been stepped up markedly in recent years, while private collective and class action lawsuits abound. Any independent contractor relationship should be carefully reviewed and managed to avoid the potentially serious consequences of an adverse agency ruling or court judgment.

The Common-Law Test

The United States Supreme Court has held that when a statute does not adequately define "employee," the term must be interpreted by reference to the common law of agency.[2] The common-law test has been applied in a variety of contexts. Such contexts include claims by allegedly misclassified employees seeking participation in employer-provided welfare or retirement benefit plans under the federal Employee Retirement Security Act ("ERISA");[3] claims to determine collective bargaining rights under the National Labor Relations Act ("NLRA");[4] claims to decide whether a company is required to withhold from compensation for state unemployment compensation benefits;[5] and various other statutory and common-law claims.[6]

The central question to be answered under the common-law test is whether the hiring party retains the right to control the manner and means by which the work is to be accomplished. This means that courts must focus their inquiry on whether the hiring party "has the right to control and direct the work, not only as to the result to be accomplished by the work, but also as to the manner and means by which that result is accomplished."[7] When the hiring party retains the right to control the manner and means by which the work is to be accomplished, the worker is considered an employee – even if the hiring party actually never exercises the right.[8]

Although the extent to which the hiring party actually supervises the "means and manner" of the worker's performance is a core factor under the common-law misclassification test, it is far from the only one. Among the numerous additional factors courts must weigh as part of their overall analysis are the following:

- the skill required;
- the source of the instrumentalities and tools;
- the location of the work;
- the duration of the relationship between the parties;
- whether the hiring party has the right to assign additional projects to the hired party;
- the extent of the hired party's discretion over when and how long to work;
- the method of payment;
- the hired party's role in hiring and paying assistants;
- whether the work is part of the regular business of the hiring party;
- whether the hiring party is in business;
- the provision of employee benefits; and
- the tax treatment of the hired party.[9]

The common-law test requires a careful balancing of all relevant factors. No one factor controls the outcome. The weight given to each may vary from case to case depending on the particular facts and circumstances. In no case, however, will the terms of any written agreement between the company and the worker by themselves prove dispositive of the outcome.

A recent federal district court decision illustrates the common-law approach. In this decision [10], the court refused to dismiss a class action lawsuit filed by insurance agents they were employees under the common-law test and therefore entitled to certain employee benefits under ERISA. The court denied the company's motion to dismiss the case, finding that a series of factors could be interpreted to indicate employee status. These factors included the insurance company's requirement that agents sell company products exclusively and only use company-owned hardware and software; the

1 Wage and Hour Division, *Misclassification of Employees as Independent Contractors,* DOL, *available at* https://www.dol.gov/whd/workers/misclassification/.
2 *See Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318, 322-24 (1992).
3 Employee Retirement Security Act of 1967, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 United States Code ("U.S.C.") §§ 1001–1461 (2006) and in scattered sections of the Internal Revenue Code).
4 National Labor Relations Act of 1935, 29 U.S.C. §§ 151–169.
5 *See, e.g., Cantor v. Cochran,* 184 So. 2d 173 (Fla. 1966); *Leone v. United States of America*, 910 F.2d 46 (2d Cir. 1990), cert. denied, 499 U.S. 905 (1991) (applying New York law).
6 For example, variants of the common-law test have been used by courts and government agencies to determine whether a worker is entitled to protection under federal and state laws prohibiting workplace discrimination and retaliation.
7 *N.L.R.B. v. Steinberg,* 182 F.2d 850, 857 (5th Cir. 1950).
8 *N.L.R.B. v. Associated Diamond Cabs, Inc.*, 702 F.2d 912 (11th Cir. 1983).
9 *Darden,* 503 U.S. at 323-24.
10 Case No.1:13 CV 437 (N.D. Ohio Aug. 9, 2013) : Jamal v. American Family Insurance.

company's ability to fire the agents at any time with or without cause; the company's right to determine where agents' offices were located and what their office hours would be; and the company's actual monitoring of agents' daily work and compliance with production and conduct requirements.

The IRS Right to Control Test
Perhaps the most commonly used test is a variant of the common-law test developed by the U.S. Treasury Department's Internal Revenue Service ("IRS") to determine whether a worker should be deemed an employee for income tax purposes. The IRS has historically applied a lengthy 20-factor test.[11] In recent years, however, the agency restructured its approach and now applies a simplified "Right to Control Test," which groups 11 factors into three broad categories.[12] As with the common-law test, the critical inquiry focuses on the degree to which the business retains the right to control the manner and means by which the work is performed.

The Right to Control Test can be summarized as follows:

A) Behavioral control. Behavioral control refers to the degree to which the company retains the right to direct and control how the worker performs the task for which the worker is hired. Whether or not the business in fact exercises that right is irrelevant.[13] The focus is simply on whether the company has reserved the right of control to itself. There are two behavioral control factors:

- does the business provide instructions to the individual regarding (a) when and where to perform work, (b) what tools or equipment should be used, (c) where supplies and services should be purchased, (d) whether and what assistants the worker my hire, (e) whether the work must be performed by a specified individual, and (f) in what order or sequence the work must be completed?
- does the business provide training to the worker?

Independent contractors normally use their own methods to perform work and require little to no training. Positive answers to the above questions therefore point to the existence of an employment relationship.

B) Financial control. Financial control factors are intended to capture the degree to which the business has the right to control the business aspects of the job:

- does the business pay the worker's business expenses? Routine reimbursement of a worker's business expenses can be indicative of an employment relationship.
- has the worker made a significant investment in the services performed? Typically, independent contractors, but not employees, have invested substantially in the work, for example by maintaining an office or other facilities where services are performed.
- does the worker make his or her services available to the general public? Independent contractors generally remain free to advertise their services and are available to work in the relevant market.
- is the worker paid a flat fee, or by the hour, week or month? Employees commonly receive a regular wage based on a certain time interval, whereas payment on a flat fee, per-job basis suggests independent contractor status.
- does the worker have the opportunity to realize a profit or loss from the work? This is ordinarily a hallmark of independent contractor status.

11 *See* IRS Worker Classification Training Manual (March 4, 1997); IRS Publication 15A (2013 edition).
12 *See* IRS Worker Classification Training Manual (March 4, 1997); IRS Publication 15A (2013 edition).
13 *See Gierek v. Comm'r,* 66 T.C.M. (CCH) 1866, 1868–69 (1993) (when a company has a right to control the worker, the worker may be considered an employee, even if the company did not actually exercise control).

C) Type of relationship. As the nature of the relationship between the business and the worker can provide further evidence of control, the IRS also examines the following additional factors:

- does the worker have an opportunity to participate in certain employee welfare and pension benefits, such as health insurance, a pension plan, vacation pay, or sick pay? Benefits typically are provided only to employees.
- how permanent is the relationship? An independent contractor relationship is ordinarily of limited duration and defined by the length of the specific project for which the contractor is hired. Hiring a worker on an indefinite basis indicates intent to create an employer-employee relationship.
- are the worker's services a key aspect of the company's regular business? If so, an employment relationship is more likely to exist.
- do the terms of a written contract between the business and the worker show that the parties intended to create an independent contractor relationship? This factor is normally the least important, because courts must examine first and foremost the parties' actual practice.

The Economic Realities Test
Neither the common-law test nor its IRS variant governs where federal wage-and-hour laws are concerned. In the United States, federal minimum wage and overtime pay standards are established by the Fair Labor Standards Act ("FLSA").[14] Recognizing that the FLSA was enacted to remedy low wages and long working hours, the United States Supreme Court has long held that the common-law distinctions between employees and independent contractors do not apply when determining FLSA coverage.[15]

Instead, courts must decide whether a worker has been properly classified as a matter of "economic reality."[16] The key question to be answered under the Economic Realities Test is this: Is the worker economically dependent on the hiring party, or is the worker truly in business for him- or herself? If economic dependence is found, the worker will be classified as an employee, even if the employer does not exercise full control of the means and manner of the worker's performance.

Resolution of this question requires a balancing of the following factors in light of the totality of the circumstances:

- the degree of control the business exerts over the worker;
- the worker's opportunity for profit or loss;
- the worker's investment in the business;
- the permanence of the working relationship;
- the degree of skill required to perform the work; and
- whether the services are an integral part of the company's business.[17]

Various additional factors may also be considered as part of the economic realities test, such as whether the business has the power to hire and fire employees, supervises and controls employee work schedules or conditions of employment, determines the rate and method of payment, and maintains employment records. No one factor is determinative.[18] All must be carefully weighed and take account of the factual circumstances of each particular case.

14 Fair Labor Standards Act of 1938, as amended, 29 United States Code §§ 201 et seq.
15 *See Goldberg v. Whitaker House Coop.,* 366 U.S. 28, 33 (1961).
16 The Economic Realities Test is used not only to resolve independent contractor/employee issues under the FLSA but also to determine whether a business must make employer tax contributions on behalf of an individual to the U.S. Social Security system, which provides certain retirement and disability benefits, See United States v. Silk, 331 U.S. 704, 713 (1947).
17 *See, e.g., Barlow v. CR England, Inc.*, 703 F. 3d 497, 506 (10th Cir. 2012); *Brock v. Mr. W Fireworks, Inc.*, 814 F.2d 1042 (5th Cir. 1987).
18 *See Rutherford Food Corp. v. McComb*, 331 U.S. 722, 730 (1947).

The ABC Tests
Many U.S. states have wage-and-hour laws that provide additional or greater protections beyond those set out in the FLSA. These states employ any one of a number of different tests to determine whether misclassification issues exist. The "ABC Test" represents one of the more commonly used alternatives not only to determine exempt status under state wage-and-hour laws but also to evaluate whether a worker should be deemed an employee for state unemployment tax purposes.

Although applications of the ABC Test are not uniform, it generally places the burden of establishing independent contractor status squarely on the hiring party. In its broadest form, the ABC Test provides that a worker should be considered an employee unless the business can establish that:

- the worker has been, and will continue to be, free from control or direction over the performance of the work under both the terms of the contract and in fact;
- the services are either provided outside the usual course of the business or performed outside of all the places of business of the enterprise; and
- the worker is customarily engaged in an independently established trade, occupation, profession, or business.

In most, but not all, states, all three conditions must be met. As a result, meeting independent contractor requirements can be particularly onerous where the ABC Test applies.

As the above reflects, courts and legislatures in the United States have woven a complex tapestry of legal standards for determining independent contractor status. Further complicating the analysis, employee status may also need to be determined under laws governing workers' compensation insurance for individuals who suffer work-related injuries or illness; laws protecting whistleblowers or prohibiting discrimination in employment; and various other employment-related statutes. Depending on the statute, state agencies and courts may use variants of the common-law, IRS, economic-realities and ABC tests discussed above.

Not surprisingly, application of the many different tests for determining employment status can lead to diverging results. An individual may, for example, be classified as an independent contractor for state or federal income tax purposes, yet is deemed an employee for purposes of workers' compensation law and be qualified for such benefits. Businesses should remain mindful of the fact that each situation must be evaluated on its own merits.

Summary of Tests Used Under Key Federal Statutes
Certain Federal Laws explicitly require that a particular test be used to determine the status of a worker as an employee or independent contractor. Below is a list of which test applies to which statute.

Common Law Test

- Federal income taxes, Medicare taxes, Social Security taxes, Federal unemployment taxes
- National Labor Relations Act (NLRA)
- Employee Retirement Income Security Act of 1974 (ERISA)
- Immigration Reform and Control Act of 1986 (IRCA)
- Americans with Disabilities Act (ADA)
- Copyright laws

Economic Realities Test

- Fair Labor Standards Act of 1938 (FLSA)
- Title VII of the Civil Rights Act of 1964 (Title VII)
- Age Discrimination in Employment Act of 1967 (ADEA)
- Family and Medical Leave Act (FMLA)
- Migrant and Seasonal Agricultural Worker Protection Act

b. General Differences in Tax Treatment

There are significant tax advantages for businesses when workers are classified as independent contractors. U.S. employers must pay one-half of an employee's required social welfare taxes for government-provided Social Security retirement and medical benefits (known as "Medicare"). Typically, these equal approximately 7.65 percent of an employee's wages. Independent contractors, by contrast, must pay the full amount without any contribution from the hiring business. Employers must also withhold state and federal employee income taxes from an employee's paycheck, whereas independent contractors pay these taxes on their own in the form of a self-employment tax. Finally, the amount of an employer's contributions to federal and state unemployment insurance funds depends on the size of the employer's workforce, but does not take into account independent contractors.

From the perspective of the individual as well, substantial financial benefits can be reaped from holding independent contractor status. Independent contractors need only make quarterly tax contributions and can thus realize benefits from the greater control the absence of mandatory withholdings from each paycheck can afford. Social welfare benefits, in turn, need to be paid only once a year and one-half of the contribution can be deducted from the individual's income tax. Moreover, unlike employees, independent contractors are able to deduct a wide range of direct and indirect business-related expenses from their taxable income. The increased flexibility and potential for greater actual earnings therefore render independent contractor status an attractive option for many workers.

That said, the adverse tax consequences flowing from misclassification of employees as independent contractors, can be a matter of significant concern, particularly when large groups of similarly-situated workers are found to be similarly misclassified. Recent years have seen an increasing focus on aggressive enforcement actions on the part of not only the Department of the Treasury, but also other federal and state agencies. As a result of new information-sharing agreements between agencies, a finding by the IRS that a business has misclassified employees may now lead to audits and further enforcement proceedings by the Department of Labor (which enforces the FLSA), as well as potential investigations by state tax and workers' compensation agencies. And as further discussed below, workers claiming to be misclassified may also pursue costly class action litigation, with the attendant risk of potentially very large liability verdicts. A misclassification finding therefore can place the very survival of a business at risk. This underscores the need for careful assessment before entering into any independent contractor arrangement.

c. Differences in Benefit Entitlement

Workers' Compensation
Most state laws require U.S. employers to provide their employees with workers' compensation insurance, which provides compensation for wage loss, medical treatment and death benefits in the event of a work-related injury or illness. No requirement exists to provide workers' compensation coverage for independent contractors hired to perform services for the business. Since workers' compensation coverage can be

costly, many businesses find it financially advantageous to hire independent contractors, where appropriate, in order to lower premiums.

Health Insurance
In 2010, the United States Congress passed the *Affordable Care Act* ("ACA"),[19] colloquially known as "Obamacare," which for the first time in the country's history makes health insurance protection mandatory for most Americans. Beginning on January 1, 2015, employers with 50 or more full-time employees must offer health insurance coverage to their full-time employees.[20] Under the ACA, a "full-time" employee is one who works 30 hours or more per week or 130 hours or more per month. No mandate exists for businesses to provide similar coverage to part-time employees or independent contractors. Persons falling into these categories will instead be required to obtain individual coverage in the marketplace or incur a tax penalty.

Leave Benefits
The *federal Family and Medical Leave Act of 1993* ("FMLA"),[21] which covers companies with at least 50 employees, allows eligible employees to take up to 12 weeks of unpaid leave in a 12-month period for certain family and medical reasons.[22] These include the birth, adoption or placement for foster care of a child and incapacity due to an employee's or family member's serious health condition. In addition, employees may take leave for certain purposes in the event a family member is called to active duty or sustains injury or illness as a result of military service. The FMLA applies only to employees and affords no benefits to independent contractors.

Various states have statutes that provide leave benefits greater than, or in addition to, the FMLA. As with the FMLA, most of these state-level statutory benefits are restricted to individuals classified as employees.

Other Employee Benefits
Generally, U.S. employers are not legally mandated to provide other types of benefits to employees. Thus, except where state law provides otherwise, businesses need not offer vacation, sick leave, disability or retirement benefits to their employees, and when employers do provide such benefits, independent contractors are typically excluded. Some states offer state-funded benefits, such as disability payments, to employees. Independent contractors' eligibility for such benefits would depend on the particular state law at issue.

The contractor/employee distinction is particularly important for employee benefit plans covered by ERISA, which can lose their tax-favored status if they cover independent contractors. Independent contractors generally are precluded from participating in a company's tax-qualified retirement plans, because such plans can only cover employees. It would be permissible for an independent contractor to participate in a company's health plans, assuming the insurance policy allows it, but if the company were to make premium payments on behalf of the independent contractor, the payments would be includable in the contractor's gross income. Employees, by contrast, may exclude such payments from gross income.[23]

Unemployment Compensation
Generally, a company is liable for making unemployment insurance withholdings from the compensation paid to employees (including temporary employees), but not from compensation paid to independent contractors. If a worker classified as an

19 Patient Protection and Affordable Care Act of 2010, Public Law 111–148, 124 Stat. 119, codified as amended at scattered sections of the Internal Revenue Code and in title 42 of the United States Code.
20 ACA § 6055, 6056. In July 2013, the deadline was extended by one year from January 2014 to January 2015.
21 29 U.S.C. §§ 2601 *et seq.*
22 29 U.S.C. §§ 2601 *et seq*.
23 26 U.S.C. § 106.

independent contractor subsequently makes a claim for unemployment compensation benefits, the relevant state agency will likely re-examine this classification, and the employer may be held liable if the agency determines that the individual was misclassified and contributions should have been paid.

d. Differences in Protection from Termination

With the exception of the State of Montana, employment in the United States is deemed to be "at will" absent a written contract to the contrary. This means both employer and employee are free to terminate the employment relationship at any time, with or without notice, and for any or no reason. This basic common-law principle, however, is limited by an intricate framework of state and federal statutory and common-law rights providing employees – but not independent contractors – with protection against termination decisions that arise from an unlawful motive. Unlawful motives include discrimination based on an employee's race, color, national origin, religion, age, gender, disability and other legally protected statuses, as well as retaliation against a worker for complaining of discrimination, for blowing the whistle on alleged illegal activity, for exercising legal rights to certain employee benefits, and for a myriad of other legally protected activities.

By contrast, the duration and termination of an independent contractor arrangement is generally regulated by contract. An independent contractor relationship is, by its very definition, one that is limited in duration and that ends upon completion of the project for which the contractor was hired. The parties may by agreement specify conditions on which the agreement may be terminated at an earlier time.

e. Local Limitations on Use of Independent Contractors

There are no laws that limit the use of independent contractors to specific purposes or circumstances. Rather, the primary limitation is the risk of misclassification. Increasingly, states are passing laws that create a presumption of employee status for individuals performing services in certain industries, such as construction, where misclassification has historically been the most prevalent. These statutes squarely place the burden on the employer to provide evidence that a worker is sufficiently independent to qualify as an independent contractor. The statutes generally impose civil and criminal penalties on employers who knowingly or willfully misclassify employees. Among the states that have passed such laws are Pennsylvania, Delaware, Colorado, Illinois, Minnesota, New York, and Maine. Other states are considering similar legislation.

In slight contrast to the state laws discussed above placing the burden on the employer to prove that a worker qualifies as an independent contractor, Arizona passed a law, Declaration of Independent Business Status ("DIBS"), effective August 6, 2016 allowing employers contracting with independent contractors to prove the existence of such arelationship through a signed declaration by the independent contractor. A declaration by the independent contractor is considered, under the law, a rebuttable presumption that an independent contractor relationship exists. Examples of declarations include the contractor's acknowledgement that: he/she is paid per project and not hourly or through salary, not covered by employer health insurance or worker's compensation, not restricted to perform services for other parties, and is not dictated by employer on how to perform services. The employer is not required to include such a declaration, and lack of such does not raise a presumption that an independent contractor relationship does not exist.[24] The Arizona statute stands in some tension with the 2015 DOL guidelines which advise that labels should not be a determinative factor in deciding whether an employee is a worker or independent contractor.

24 Arizona's new Declaration of Independent Business Status (DIBS) amends Title 23 of the Arizona Revised Statutes by adding two new statutes: A.R.S. § 23-10601 and A.R.S. § 23-1602.

In addition, the terms of collective bargaining agreements may impose limitations on the use of independent contractors with respect to the work performed by the bargaining unit. A company that hires independent contractors to do work covered by a union contract could be held liable for breach of the collective bargaining agreement and may risk the filing of an unfair labor practice charge with the National Labor Relations Board, which enforces labor law in the United States.

f. Other Ramifications of Classification

Wage-and-Hour Laws
The federal FLSA and similar state wage-and-hour laws afford many U.S. employees the right to be paid a minimum wage and overtime compensation for hours worked in excess of the statutory threshold.[25] Some states also have laws requiring employers to provide employees with paid rest periods and unpaid meal breaks. These statutory protections are available solely to employees. As a result, a company found to have misclassified workers as independent contractors may be liable for unpaid wages and, in particular, overtime compensation due to employees for hours worked in excess of the statutory threshold.

Labor Law
The federal NLRA protects employee rights to form unions and to engage in collective bargaining and other concerted activity, affords remedies to employees who have been harmed by any violation, and protects employees and union members against unfair bargaining practices.[26] By its express terms, the NLRA covers only employees and not independent contractors.[27] Independent contractors have no statutory collective bargaining rights.

Other Statutory Protections
Employees in the United States are entitled to a broad range of additional statutory protections under federal and state laws that prohibit workplace discrimination and harassment. Many statutes also provide relief from retaliation against employees who have exercised their statutory right to complain about or report unlawful activity or to obtain certain benefits of employment provided by law. At the federal level, these statutes include *Title VII of the Civil Rights Act of 1964*, which protects employees from discrimination on the basis of race, color, national origin, sex and religion;[28] the *Age Discrimination in Employment Act of 1967*, which protects employees against age discrimination;[29] and the *Americans with Disabilities Act of 1990*, which protects employees against discrimination based on disability.[30]

In addition, the FMLA prohibits employers from interfering with employees' use of statutorily-guaranteed leave and from retaliating against employees who avail themselves of such leave.[31] ERISA, in turn, makes it unlawful to discriminate against any employee for exercising any right under an employee benefit plan.[32] These federal statutes are limited to employees and do not cover independent contractors.[33] Note, however, that in some states, state and local employment discrimination laws have been interpreted to cover certain independent contractors. Thus, it is critically important to be cognizant of the

25 Employees classified as executive, professional and administrative employees, as well as certain other classes of employees, are generally exempt from these provisions.
26 29 U.S.C. §§ 151–169.
27 29 U.S.C. § 152(3); see also Eastern, Inc. v. N.L.R.B., 60 F.3d 855, 857-858 (D.C. Cir. 1995) (holding that the jurisdiction of the NLRB extends only to the relationship between an employer and its "employees" and not to independent contractor arrangements).
28 42 U.S.C. §§ 2000 *et seq.*
29 29 U.S.C. §§ 621 *et seq.*
30 42 U.S.C. §§ 12101 *et seq.*
31 29 U.S.C. § 2615.
32 29 U.S.C. § 1140.
33 *See Brown v. J. Kaz, Inc.*, 581 F.3d 175, 181 (3d Cir. 2009) (Title VII).

applicable jurisdiction.

Numerous statutes also afford various types of whistleblower protections – among them the Sarbanes-Oxley Act of 2002, which protects employees of publicly-traded corporations who report alleged shareholder fraud or violations of federal securities laws.[34] In most (but not all) cases, whistleblower protections may be unavailable to independent contractors. Federal and state occupational safety and health laws likewise in most cases apply only to employees.

Vicarious Liability
The United States recognizes the common-law doctrine of *respondeat superior,* under which an employer can be held liable for the negligent acts of its employees if the acts were committed in the scope of employment and in furtherance of the employer's business. By contrast, under the common law of most states, the hiring party has – with limited exceptions - no responsibility for the negligence of an independent contractor.[35] Liability can arise if a third party is physically harmed by an act or omission of the contractor pursuant to orders or directions negligently given by the hiring party, or because the hiring party failed to exercise reasonable care to retain a competent and careful contractor.[36] The risk of liability can be lowered significantly by hiring independent contractors, rather than employees, where permissible under applicable law.

g. Leased or Seconded Employees

One way to avoid the legal pitfalls of misclassification is to enter into an agreement with a third-party employee leasing or workplace management firm. Such an agreement typically provides that the staffing firm, not the business, is responsible for hiring, placing and terminating workers; ensuring appropriate tax payments are made and tax reporting is performed; providing workers' compensation insurance coverage; and offering employee benefits, if available, directly to employees. Where an outside vendor has been engaged, the company's responsibilities can be limited significantly, reducing the possibility that an employer-employee relationship will be found to exist.

There exists considerable variability in this area. Some staffing companies hire the workers as their own independent contractors and thus assume the risk of misclassification. Others perform the full panoply of functions traditionally associated with an employment relationship, such as withholding of income taxes, payment of Medicare and Social Security contributions, payment of workers' compensation and unemployment insurance premiums, provision of employee welfare and retirement savings benefits, performance management, and implementation of employee discipline, transfer and promotion decisions. Since companies must be well-informed about the ramifications of each arrangement, entering into an arrangement with a reputable and knowledgeable provider is of critical importance.

Using a staffing company is not a cure-all. Under various employment statutes, the client of a staffing agency is potentially considered a "joint employer" for purposes of liability, such as those prohibiting discrimination and harassment. In that case, an employee leasing arrangement will afford only limited liability protection. Additionally, some state laws regulating staff leasing companies may expressly require the staffing company and its client to agree that both will assume joint employer responsibility in specific aspects of the worker's employment.

For example, regulations implementing the FMLA provide that "[w]here two or more

34 18 U.S.C. § 1514A.
35 See RESTATEMENT (SECOND) OF TORTS § 409.
36 See RESTATEMENT (SECOND) OF TORTS §§ 410 et seq.

businesses exercise some control over the work or working conditions of the employee," or where the work performed "simultaneously benefits two or more employers," a joint employment relationship may exist.[37] A company will likely be considered a joint employer of employees supplied by a staffing agency and be subject to many of the requirements of the FMLA, if the company and the agency: (1) share control over the worker; (2) share the worker's services; or (3) act in each other's interest with regard to the worker. Indeed, some courts have found that a joint employment relationship exists for FMLA purposes anytime a staff leasing agency places employees with a client employer.[38]

Where employee rights to welfare and retirement benefits governed by ERISA are concerned, the specific language of the benefit plan may control whether workers are entitled to participate in a client company's plans. Several recent court decisions hold that when workers appear to be employees under the common-law test and the language of the plan does not expressly exclude individuals on the payroll of third-party contractors, the workers may be entitled to participate in the client company's ERISA benefit plans.[39]

h. Regulations of the Different Categories of Contracts

There is no regulatory scheme that governs employment contracts or independent contractor agreements. The parties are free to contract as they see fit, subject only to the provisions of the various employment laws discussed in the preceding sections. Many employees do not have written contracts, but are employed on an "at-will" basis. The details of an at-will employment relationship are often described in policies and procedures promulgated by the employer for all employees. Contractual disputes arising from independent contractor agreements are commonly resolved through litigation. Employment laws are enforced through agency actions such as audits, investigations and legal proceedings, as well as through private litigation initiated by employees claiming to be aggrieved.

III. Re-Characterisation of Independent Contractors as Employees

a. Laws and Guiding Principles

As discussed in Section I of this chapter, classification of independent contractors and employees is subject to an intricate framework of statutory and common-law approaches. A fundamental principle, however, is that courts must undertake a comprehensive examination of all relevant facts. No single factor is dispositive. Instead, careful balancing of all relevant factors is required to reach a determination based on the specific situation at hand.

That said, there are common themes that run through each of the various tests. Although an independent contractor agreement should be detailed and carefully documented, the written agreement between the parties never controls the outcome. Certainly, the parties' intent matters. However, it is the actual implementation and the realities of the parties' performance that determines how courts will characterize the relationship. For purposes of the common-law and Right to Control tests, the focal point of the analysis will be the company's ability to control and direct the manner and sequence of the worker's

37 29 C.F.R. § 825.106(a).
38 *See Grace v. USCAR*, 521 F.3d 655 (6th Cir. 2008); 29 C.F.R § 825.106(b)(1).
39 *See, e.g., Curry v. CTB McGraw Hill, LLC*, No. 06-CV-15397, 296 Fed. App'x 563 (9th Cir. Oct. 9, 2008) ("we have not held that all common law employees are entitled to benefits under ERISA . . . , [i]nstead we look to the terms of the plans at issue to determine who is entitled to coverage") *Schultz v. Stoner,* No. 00-CV-439, 2009 BL 36510 (S.D.N.Y. Feb. 24, 2009); *Bendsen v. George Weston Bakeries Distribution, Inc.*, 2008 BL 216258, No. 09-CV-50 (E.D. Mo. Sept. 26, 2008).

performance. Under the Economic Realities test, the analysis turns on the degree of the worker's dependence on the company. At bottom, the fundamental question under any test is whether the facts demonstrate that the worker is truly in business for him- or herself. If so, an independent contractor relationship exists.

b. The Legal Consequences of a Re-Characterisation

When independent contractors are reclassified as employees, employers may be subject to payment of back income tax withholdings and Social Security and Medicare tax contributions, as well as for penalties for misclassification. Employers also risk potential claims by employees for unpaid hourly and overtime compensation, and past workers' compensation and employee benefits liabilities. In addition, government agencies may conduct audits and investigations and impose additional obligations, combined with penalties and interest for noncompliance. Moreover, only employees, and not independent contractors, have the right to form unions. Reclassification thus entails the risk of greater unionizing activities and potential collective bargaining obligations if such activities are successful.

In some situations, reclassification of independent contractors as employees may increase the number of employees and render an employer subject to other laws that were previously inapplicable, because the employer did not meet the threshold. For example, the FMLA covers only employers with at least 50 employees, while most federal employment discrimination laws cover only those employers who have at least 15 or 20 employees, depending on the statute. Employers with 100 or more employees must additionally file annual EEO-1 reports with the United States Equal Employment Opportunity Commission. Other reporting requirements similarly come into play once a particular employee size threshold is crossed. Employers thus must take careful account of the implications once coverage under a particular statute is triggered.

c. Judicial Remedies Available to Persons Seeking 'Employee' Status

If a worker believes he or she has been incorrectly classified as an independent contractor, the worker can request a determination of worker status for purposes of federal employment taxes and income tax withholdings from the IRS. In the event of a determination that the worker was misclassified, the business is sent a letter notifying it of its obligation to pay employment tax and to adjust any previously filed employment tax returns accordingly. Workers may also file complaints for unpaid wages with the U.S. Department of Labor, which enforces the FLSA. An individual complaint will result in anadministrative investigation, but may also trigger a broader audit of independent contractor classification practices for similarly-situated workers. When the agency finds that misclassification has occurred, enforcement actions may result seeking relief not only on behalf of the complaining individual, but also for other misclassified workers throughout the organization.

Apart from seeking relief through administrative agency determinations and enforcement actions, workers seeking employee status may also file civil lawsuits. At the state level, an increasing number of state legislatures are enacting misclassification statutes, many of which grant workers the right to file a private suit for misclassification, with varying remedies. Some laws are limited to particular industries, such as constructions. Others have broad applicability. For example, Massachusetts' misclassification statute applies broadly to a wide range of industries and places the burden on the employer to prove each element of a more stringent version of the ABC Test discussed in prior sections.[40] In addition to the penalties imposed by other laws, the Massachusetts statute authorizes the Attorney General to impose substantial civil and criminal penalties, and in certain circumstances, to debar violators from public works contracts.

40 *See* Mass. Gen. Law ch. 149, § 148B.

Regardless of whether a state law affords the right to file an action for misclassification, workers may also bring lawsuits under many employment laws, claiming they were improperly classified and treated as independent contractors. For example, the FLSA permits individuals to file "collective actions" – actions filed by a plaintiff as the representative of a class of others similarly situated who elect to participate – in order to seek unpaid wages and overtime compensation based on their alleged independent-contractor misclassification. Under ERISA, persons may file both individual and class-action lawsuits to contest eligibility determinations denying them benefits as a result of having been designated as independent contractors. Civil lawsuits for discrimination, retaliation or interference with benefits can also be filed under various non-discrimination statutes such as Title VII, ADEA and ADA, under the FMLA and other various state and federal whistleblower statutes, as well as under various common-law theories protecting employees, based on the assertion that the contractor should have been classified as an employee protected by the statute.

Class and collective actions asserting misclassification under the FLSA, ERISA, and related laws represent a significant source of potential liability for employers. In some cases, especially where the alleged misclassification has affected broad job categories with numerous incumbents, the potential class size, and with it the potential liability exposure – not to mention the costs of defense – can be truly enormous. One recent case, for example, combined over 42 class action lawsuits filed in 28 states on behalf of thousands of delivery drivers for FedEx Ground, who alleged they had been misclassified as independent contractors and sought reimbursement of business expenses as well as payment of back wages and overtime.[41] At the end of 2010, a federal district judge ruled in favor of FedEx Ground under the laws of 20 of the 28 states. That ruling remains on appeal. In the meantime, individual state class actions against FedEx Ground continue to progress, often with divergent and inconsistent results, depending on the applicable state law.

d. Legal or Administrative Penalties or Damages for the Employers in the Event of Re-Characterisation

The remedies and penalties flowing from independent contractor misclassification in the United States vary depending on the particular statute implicated in a given legal proceeding. A synopsis of penalties and damages based on federal law appears below. It is important to recognize, however, that the availability of collective and class action mechanisms under many statutes can expose employers to liability verdicts of potentially massive proportions.

Tax Considerations
The federal Internal Revenue Code ("IRS Code") imposes significant potential liability on businesses that fail to withhold and pay employment taxes as a result of employee misclassification. In addition to payment of back taxes and accrued interest,[42] if an employee is found to have been misclassified in an IRS audit, a company found to be in violation of federal tax law could be held liable for substantial penalties based on the company's failure to withhold and collect federal income tax, FICA, and FUTA taxes (accruing monthly up to 25% of the net amount due); for failure to file timely and accurate tax reports (also accruing monthly up to 25%); as well potentially for civil fraud.[43] A knowing violation of the statute might also result in criminal prosecution.[44]

The good news for employers is that in some cases, assuming the misclassification was not willful, liability can be avoided under the safe harbor provision established by section

41 *In re FedEx Ground Package System, Inc. Employment Practices Litigation*, Civil Action No. 3:05-MD-527 (RM) (MDL-1700), in the United States District Court for the Northern District of Indiana, Fort Bend Division.
42 26 U.S.C. § 3509(a).
43 See 26 U.S.C. chapter 68.
44 26 U.S.C. §§ 7202, 7204.

530 of the Revenue Act of 1978.[45] This provision allows an employer to continue to treat a worker as an independent contractor even if the worker would have been treated as an employee under the Right to Control test, if three conditions are met: (i) the employer has filed all required returns reporting payments to the worker as an independent contractor; (ii) the employer has not treated the worker or any similarly situated worker as an employee; and (iii) the employer had a "reasonable basis" to have treated the worker as an independent contractor. A "reasonable basis" can include reliance on prior case law, a past IRS audit, industry practice, as well as other reasonable considerations. If all of these requirements are satisfied, the employer's liability for payment of employment taxes, interest and penalties may be terminated even though the worker is properly classified as an employee.

Wage-and-hour Considerations
Under the FLSA, employees (other than those exempt from the relevant provisions of the FLSA) must be paid no less than a specified minimum wage for each hour worked, as well as an additional premium of one-half the employee's regular rate for each hour of overtime work. Independent contractor misclassifications can result in liability for unpaid wages and overtime wages, an equal amount as liquidated damages, attorneys' fees and costs. Also, because the statute permits lawsuits to be brought as collective actions on behalf of similarly-situated others, an employer's liability exposure can be quite significant if a large group of workers is found to have been improperly classified as independent contractors.

Employee Welfare and Retirement Benefits
Employers who misclassify employees as independent contractors and deem them ineligible for participation in the company's employee benefit plans can incur signifi cant tax penalties for failing to offer or provide sufficient coverage or make necessary premium payments. In addition, such employers run the risk of individual and class action lawsuits on behalf of all misclassified employees seeking rights to benefits.[46] Class action lawsuits may also be filed under the federal Family and Medical Leave Act, which provides employees, but not independent contractors, a right to unpaid leave for certain family and health reasons and protects against termination for having taken such leave.

Workers' Compensation Insurance
Misclassification of employees as independent contractors for workers' compensation purposes can result in an award of benefits, as well as assessments of civil penalties and potential criminal liability, depending on the particular state's workers' compensation statute.

State Misclassification Statutes
Many state misclassification laws impose civil penalties and restitution requirements, particularly if the employer is found to have knowingly misclassified workers. Such statutes may also grant workers a private right of action.[47]

IV. How to Structure an Independent Contractors Relationship

a. How to Properly Document the Relationship

Given the potentially devastating consequences of misclassification, every independent contractor relationship should be carefully and fully documented. Before entering into

45 Pub. L. No. 95-600, § 530, 92 Stat. 2763, 2885–86, as amended. Although not directly a part of the Internal Revenue Code, the text of section 530 is included in the notes accompanying 26 U.S.C. § 3401(a).
46 *See* 29 U.S.C. § 1132(a)(1).
47 *See, e.g.*, the Massachusetts Misclassification Act, Mass. Gen. Law ch. 149, § 148B; the Maryland Workplace Fraud Act, Md. Code Ann., Lab. & Empl. §§ 3-901 to -920; the Kansas misclassification statute, Kan. Stat. Ann. § 44-766(a); and the New Mexico misclassification law, N.M. Stat. Ann. § 60-13-3.1(C).

the relationship, the hiring company should obtain basic information and supporting documentation from the prospective contractor, including:

- the structure of the independent contractor's business (e.g., sole proprietorship, limited liability company, corporation, partnership, etc.);
- whether the independent contractor has any employees or work under subcontracts;
- whether the independent contractor has performed similar services for other companies;
- whether and where the independent contractor maintains an office (other than the contractor's home);
- how and where the contractor markets and advertises services;
- the types of insurance coverage maintained by the independent contractor; and
- the contractor's tax identification number.

If the information obtained demonstrates to the hiring party's satisfaction that the prospective worker meets basic prerequisites to qualify as an independent contractor and that the work to be performed suits the criteria for an independent contractor arrangement, the next step normally is to document the relationship in an independent contractor agreement. That agreement should, at a minimum, specify the following:

- the duration of the relationship (which should be tied to the duration of the project for which the worker is retained);
- the nature and scope of services to be provided (which should be different from those performed by rank-and-file employees);
- the manner and conditions for payment of compensation (e.g., a fixed sum upon completion of the project or identified milestones);
- that the service provider is an independent contractor and not an employee;
- that the independent contractor will not be eligible to participate in any employee benefits;
- that the independent contractor, and not the company, will be responsible for payment of all applicable taxes and legally required contributions;
- that the independent contractor will provide his or her own workers' compensation coverage;
- what other insurance coverage the independent contractor is required to carry for the duration of the relationship;
- that the contractor is free to set his or her own hours of work and to determine in what manner and sequence the work should be completed;
- that the independent contractor will supply and use his or her own equipment;
- that the contractor will be required to pay his or her own business expenses;
- that the independent contractor is free to hire his or her own employees;
- the conditions on which the relationship may be terminated and the consequences of early termination, including any notice requirements and potential penalties; and
- any desired indemnification (e.g., independent contractor's agreement to indemnify and defend the company in the event of loss, damage or liability caused by the contractor's own negligence).

Given the great variability in relevant classification testing, particularly in light of the many different approaches under state law, it is strongly recommended that the agreement be reviewed by counsel, in light of applicable standards and actual practice. Careful structuring of the independent contractor agreement is imperative to ensure that the agreement itself does not contain terms suggesting that the business has a right to control the manner and means by which the worker performs the tasks set forth in the contract.

b. Day-to-Day Management of the Relationship

Even the most well-drafted independent contractor agreement is of little value if it does not accurately reflect reality. Companies should make every effort to grant independent contractors the level of independence required to preserve the integrity of an independent contractor classification. Whenever possible, the independent contractor should be a separately incorporated business. Ideally, contractors should be able to set their own hours, have freedom in selecting the site at which work is performed and be free to offer their services to other potential clients. Day-to-day supervision and direction of the contractor's work in particular should be avoided.

Contractor work assignments should not mirror those given to employees. Rather, employers should carefully and clearly define projects designated for independent contractors, and set specific start and end dates. Any internal evaluation of the performance of independent contractors should focus on the quality and acceptability of the final work product rather than the manner in which it was produced. Under no circumstances should an employer use its employee performance review process to evaluate the work done by an independent contractor. It is also advisable to require independent contractors to provide periodic progress reports and to submit regular invoices as defined targets are met. Moreover, independent contractors should never be paid as part of the company's regular employee payroll.

Where it is not possible in practice to conform the relationship to the legal requirements, employers may wish to consider alternatives such as re-documenting the relationship to align it with the applicable standards, or retaining a third-party staffing or workforce management company. Although not a panacea, the use of third-party staffing organizations can provide a meaningful buffer to liability under many circumstances and could greatly simplify day-to-day management of the relationship.

V. Trends and Specific Cases

a. New or Expected Developments

Recent years have seen vastly stepped-up enforcement efforts on the part of federal and state government agencies seeking to remedy revenue shortfalls in the wake of the economic downturn that began in 2008. All the while, the plaintiff's bar has increasingly targeted employer use of independent contractors, and the number of class action lawsuits alleging misclassification under federal and state laws has risen steeply. All these developments have placed companies who enter into independent contractor relationships at substantial risk of adverse findings and judgments.

Increased Internal Revenue Service Enforcement and Voluntary Settlement Programs
In 2010, the IRS launched an intensified enforcement program involving widespread audits of businesses to uncover misclassification issues. A year later, the agency announced a new Voluntary Classification Settlement Program ("VCSP"), allowing employers to voluntarily reclassify workers previously treated as independent contractors without incurring tax obligations or penalties for past misclassifications. Under the VCSP, employers receive immunity from IRS misclassification audits in exchange for payment of 10% of the employment tax liability for misclassified workers for one year. Interest and penalties are waived. To be eligible to participate in the VCSP, an employer must, among other matters, have consistently treated the affected workers as nonemployees in the past and have filed the required Forms1099 for these workers for at least the previous three years.

Participation in the VCSP has been relatively sparse, most likely because the VCSP resolves only an employer's potential federal tax liability, but not any potential liability arising from misclassification under state tax, employee benefits, wage-and-hour, workers' compensation and other employment-related laws. Concerned that participation in the program may highlight the existence of potential misclassification issues and invite further audits and lawsuits, many companies have remained wary.

Stepped-up Interagency Cooperation
In September 2011, the United States Department of Labor announced that it had entered into an unprecedented Memorandum of Understanding ("MOU") with the IRS. The MOU provides the foundation for future cooperation and information sharing among the two agencies to facilitate enhanced enforcement of federal tax, wage-and-hour, workplace safety and benefits laws in response to alleged misclassification of employees.

Several states have likewise formed interagency and joint task forces to combat the perceived misclassification problem. The task forces are generally responsible for facilitating the sharing of information and resources among the relevant administrative agencies, developing joint investigative and enforcement strategies, and encouraging the reporting of alleged violations. Agencies in at least 14 states have additionally signed MOUs with the federal Labor Department's Wage-and-hour Division. At the same time, 34 state agencies now share information concerning misclassification issues with the IRS as part of the IRS Questionable Employment Tax Practices initiative, which aims to identify unlawful employment tax practices.

As a result of this vastly improved communication and collaboration among different federal and state agencies, a single audit by one agency may now result in investigations and enforcement actions at multiple levels under multiple different laws, each with its own potential penalties and other consequences. This means that misclassification of even a single position carries the risk of expansive agency enforcement. As agencies have intensified the publicity of enforcement proceedings, such actions now more easily attract the attention of the plaintiff's bar, resulting in a greater risk of private lawsuits.

Department of Labor (DOL) Updates and Guidelines
On December 19th, 2016 the Department of Labor ("DOL") updated its Independent Contractor misalignment webpage, reissuing its resources on independent contractor misclassification and grouping these resources together with resources from other federal and state agencies on the issue. Although no information provided is new, it signifies the DOL's continued focus on the issue of independent contractor misclassification, bringing awareness to both workers and employers of this issue.

- **DOL Guidance On Application of the Economic Realities Test and the FLSA** [48]

On July 15, 2015, in light of a perceived increase in misclassification of employees as independent contractors[49] largely due to how businesses are being restructured of late, the Department of Labor (the government agency which enforces the FLSA) issued guidelines regarding the application of the FLSA's definition of employee as "to suffer or permit to work" standard to the identification of workers misclassified as independent contractors. The DOL clarified that the factors found in the Economic Realities Test should be applied in consideration of the broad scope of the FLSA's "suffer or permit" standard, which was "specifically designed to ensure as broad a scope as coverage as possible". The FLSA 's statutory definitions rejected the more narrow common law control test, in deference

48 Administrator's Interpretation No. 2015 Issued by Administrator David Weil, The Application of the FLSA's "Suffer or Permit" Standard in the Identification of Employees Who are Misclassified as Independent Contractors, available at https://www.dol.gov/whd/workers/Misclassification/AI-2015_1.pdf.
49 According to the Bureau of Labor Statistics, approximately 3.4 million workers are classified as independent contractors when they should be classified as employees. 10 – 20% of employers misclassify at least one worker.

to the economic realities test which should read in line with the FLSA's "suffer or permit" standard which "stretched the meaning of 'employee' to cover some parties who might not qualify as such under a strict application of traditional agency law principles"[50]. Thus the Economic Realities Test should be construed with awareness to the FLSA"s "overarching principle" of broad coverage for workers. The main analysis rests on whether the worker is economically dependent on the employer as opposed to in business for him/her self. If the worker is economically dependent on the employer, then the worker is an employee.

Guiding the determination of whether a worker is economically dependent on the employers are the factors from the Economic Realities Test. The DOL provides interpretation of the six factors of the Economic Realities Test, factor-by-factor, citing case law mentioned throughout this article. "All of the factors must be considered in each case, and no one factor (particularly the control factor) is determinative of whether a worker is an employee," David Weil, DOL Administer said. He emphasized that the factors "should not be applied in a mechanical fashion, but with an understanding that the factors are indicators of the broader concept of economic dependence." Moreover the label given to a worker by his employer, or even agreed upon by both the worker and employer, is not determinative. The DOL advised that this same analysis should be applied when considered the status of a worker under the Family and Medical Leave Act, and the Migrant and Seasonal Agricultural Worker Protection Act, both of which use the FLSA's definition of "employ". In addition to the factors of the Economic Realities Test, the DOL also provides the following factors for consideration of whether a worker is an employee or independent contractor.[51]

- the method of payment
- how free the employer is to replace one employee with another
- whether the alleged independent contractor is listed on the payroll with appropriate tax deductions
- whether the possible employer must approve the employees of the alleged independent contractor
- whether the possible employer keeps the books and prepares the payroll for the possible employee
- whether the alleged independent contractor is assigned to a particular territory without freedom of movement
- whether the independent contractor has an independent economic interest in his or her work
- how the respective tax returns of the parties list the compensation paid

In addition, the DOL provides a list of factors, which it finds "irrelevant" to the determination of a worker as an employee or independent contractor[52]:

- whether the worker has a license from a state or local government
- the measurement, method, or designation of compensation
- the fact that no compensation is paid and the worker must rely entirely on tips
- the place where the work is performed
- the absence of a formal employment agreement

Although the DOL guidelines, legally, contain nothing new, they signify a heightened focus on the concept of "economic dependence" in the employee v. independent contractor analysis, as well as confirmation that the issue of independent contractor misclassification is a key issue for the DOL, and one which employers should analyze with caution.

50 *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 326 (1992).
51 *See* U.S. Dep't of Labor, Field Operations Handbook ch. 10, §§ 10b05(a), 10b07(a) (1993) (FOH 2.10b).
52 *See* U.S. Dep't of Labor, Field Operations Handbook ch. 10, § 10b07(c)(1993) (FOH 2.10b).

Proposed Federal Legislation

- **Independent Contractor Tax Fairness and Simplification Act of 2015** [53]

In May 2015, Representative Erik Paulsen of Minnesota introduced the Independent Contractor Tax Fairness and Simplification Act which expressly states that the term "employment status" shall mean the classification of an individual as an employee or IC under the common law rules, and would codify a new form of "safe harbor" if worker met all four of the following factors:

- incurs significant financial responsibility for providing and maintaining equipment and facilities;
- incurs unreimbursed expenses or risks income fluctuations because remuneration is "directly related to sales or other output rather than solely to the number of hours actually worked or expenses incurred";
- is compensated on such factors as percentage of revenue or scheduled rates and not solely on the basis of hours or time expended; and
- "substantially controls the means and manner of performing the services" in conformity with regulatory requirements, or "the specifications of the service recipient or payor and any additional requirements" in the parties' written IC agreement.

This bill has a narrow scope, limited to independent contractors who bill for services such as drivers and message couriers. The bill would have no impact on whether a worker was deemed employee or independent contractor under the FLSA. Similar bills have been proposed in the past, and no congressional action was taken[54].

Other proposed bills relating to independent contractor misclassification include – the Fair Playing Field Act (introduced in 2010, and again in 2012, and 2013) [55], the Payroll Fraud Prevention Act (introduced in 2011, and again in 2013, and 2014) [56], and the Employment Misclassification Act (introduced in 2008, and again in 2010 and 2011)[57]. None of these bills have resulted in enactment.

b. Recent Amendments to the Law

Emergent State Misclassification Legislation
As state agencies are collaborating with the federal government at increasing rates to curb misclassification, a significant number of state legislatures have also entered the fray by passing legislation. Some of the new laws are specific to certain industries where worker misclassification is perceived to have been particularly rampant. For example, in 2007, New Jersey passed the Construction Industry Independent Contractor Act.[58] The statute creates a rebuttable presumption that full-time construction workers are employees and not independent contractors, for purposes of many New Jersey labor and employment statutes. Penalties for violations include suspension of the contractor's registration, "stop-work" orders, and civil fines. Similar statutes have been enacted in

53 113th Congress, 2d Session, H.R. 4611. Amendment to the FLSA, available at https://www.gpo.gov/fdsys/pkg/BILLS-113hr4611ih/pdf/BILLS-113hr4611ih.pdf.
54 See Independent Contractor Tax Fairness and Simplification Act of 2012, H.R. 4611, available at https://www.gpo.gov/fdsys/pkg/BILLS-112hr6653ih/pdf/BILLS-112hr6653ih.pdf.
55 Fair Playing Field Act of 2013, S.1706, available at https://www.gpo.gov/fdsys/pkg/BILLS-113s1706is/pdf/BILLS-113s1706is.pdf.
56 See Payroll Fraud Prevention of 2013, S.1687 available at https://www.gpo.gov/fdsys/pkg/BILLS-113s1687is/pdf/BILLS-113s1687is.pdf.
57 Employment Misclassification Prevention Act of 2008, H.R. 6111, available at https://independentcontractor-compliance.com/legal-resources/state-ic-laws-and-selected-bills/.
58 N.J.S. 34:20-1 to 34:20-11.

Delaware[59] Maine,[60] New York,[61] Pennsylvania,[62] as well as several additional states.

Other states have laws that apply more generally to all industries. California's Independent Contractor Law, for example, which took effect in 2012, prohibits any form of "willful misclassification," and makes it unlawful for employers to charge misclassified employees for business expenses and to make improper deductions from their pay. The statute not only imposes harsh penalties on violators, but also holds outside non-legal consultants jointly liable for "knowingly advis[ing] an employer to treat an individual as an independent contractor to avoid employee status" if it turns out the individual was not in fact an independent contractor.[63] Other states that have enacted misclassification laws within the past decade include Colorado,[64] Connecticut,[65] Illinois,[66] Louisiana,[67] Maryland,[68] Massachusetts,[69] New Hampshire,[70] and New Mexico.[71] In September 2014 California also passed Assembly Bill No. 1897, adding a section to the Labor Code regarding labor contracting and client liability[72]. This increases liability risk for companies that use workers supplied by "labor contractors" that fail to pay all wages due to the workers. The law requires client employers to "share with a labor contractor all civil legal responsibility and civil liability for all workers supplied by that labor contractor for . . . the payment of wages and failure to secure workers' compensation coverage ." Three key exclusions in the law include: 1) those exempt from overtime payment (executive, administrative, or professional employees), 2) business with workforces of less than 25 individuals or a workforce with less than 5 independent contractors, and 3) bona fide independent contractors supplied by a labor contractor.

As discussed earlier Arizona passed a law, Declaration of Independent Business Status ("DIBS"), effective August 6, 2016 allowing employers contracting with independent contractors to prove the existence of such a relationship through a signed declaration by the independent contractor. A declaration by the independent contractor is considered, under the law, a rebuttable presumption that an independent contractor relationship exists. The employer is not required to include such a declaration, and lack of such does not raise a presumption that an independent contractor relationship does not exist.[72]

Recent Cases
Companies with a business structure, which either uses independent contractors to supplement its workforce or maintains a primarily independent contractor workforce, are increasingly targeted by plaintiffs' class action lawyers. Both large and small business organizations have become targets. Although no industry is free from this type of lawsuits some industries are more vulnerable than others. Industries that are particularly vulnerable include on-demand businesses, and Silicon Valley startups.

In March 2015 federal court judges in California issued two separate decisions in independent contractor misclassification class action lawsuits[73]. Both *O'Connor v. Uber Technologies*, Inc. and *Cotter v. Lyft* are class actions brought by drivers of the respective companies who allege that Uber and Lyft misclassified them as independent contractors instead of employees, depriving them of employee rights and benefits. In both cases the

59 Del. Code Ann. tit. 19, § 3501.
60 Me. Rev. Stat. Ann. § 105-A.
61 N.Y. Lab. Law art. 25-B.
62 43 P.S. §§ 933.1 -- 933.17.
63 Cal. Lab. Code Ann. §§ 226.8, 2753.
64 Colo. Rev. Stat. § 8-70-115(b).
65 Conn. Gen. Stat. § 31-222(a)(1)(B)(ii).
66 820 ILCS 185/1-999.
67 La. R.S. 23:1021.
68 Maryland Gen. Stat. 9-402.1.
69 Mass. Gen. Laws ch. 149, § 148B
70 RSA 281-A:2.
71 N.M. Gen. Stat. § 51-1-42.
72 Assembly Bill No. 1897, Chap. 728, Sec. 2810.3.

court denied motions and ruled that a jury would decide whether the workers are considered independent contractors or employees. Moreover both courts concluded that some of the factors signaled an employee designation, while other factors signaled an independent contractor designation. Both companies allow the workers to determine when and how much they want to work, and whether to accept or reject rides. On the other hand, both companies expressly reserve the right to terminate the relationship if the driver's user rating is deemed low or for any reason at all (a key employee status factor). As a result of these decisions, Uber, Lyft, and any "on demand" business (an increasingly popular business model) are at risk if they do not structure their employee – independent contractor relationship in a manner which remains in line with federal and state requirements. This however does not mean that companies cannot prevail on IC misclassification claims, as the *Uber* court noted that recent California cases found in favor of the employer, where "all the factors weighed and considered as a whole establish than an [individual] was an independent contractor and not an employee".

In August 2014, the ninth circuit issued two decisions regarding Fedex Ground drivers class actions in Oregon[73] and California[74]. The drivers sought unpaid wages, reimbursement of unpaid driving expenses and similar types of state law damages. The Ninth Circuit looking at the two class actions together analyzed the Fedex Ground contract (Operating Agreement) that each driver entered into, in addition to standard Fedex policies and procedures. The Court concluded that the Fedex Ground drivers were employees and not independent contractors on grounds that: Fedex has the right to and ultimately controls driver appearance, can and does control driver vehicles, can and does control the time drivers work, can and does control when and how drivers deliver packages, and requires drivers to "conduct all business activities… with proper decorum at all times". The significance of these decisions is that despite reliance on an explicit Independent Contractor Agreement, upon close scrutiny the Court found several key factors out of line with the legal standard for an independent contractor classification.

In June 2015 Fedex announced that its Ground Division "has reached an agreement in principle with [drivers] in the independent contractor litigation that is pending in California [federal court] to settle for $228 million dollars". To prevent a similar outcome companies should: 1) restructure the independent contractor relationship in a manner which still serves business objectives, 2) redraft independent contractor contracts in close consideration of federal and state laws regarding independent contractor misclassification, and 3) reimplement the employer – independent contractor relationship in a manner consistent with the restructure and redraft.

Many tax- and employment-related statutes implicated by misclassification distinguish between businesses that believe in good faith that they have correctly interpreted applicable classification standards and those that have willfully violated the law. However, this is not always the case. In *Somers v. Converged Access, Inc.*,[75] the Massachusetts Supreme Court held that the state's independent contractor law is a strict liability statute, which means it is irrelevant whether an employer who misclassified an employee acted in good faith. The plaintiff, a temporary worker, filed a private lawsuit alleging violation of the

Massachusetts statute after the company failed to hire him for a permanent position.

The company argued that the plaintiff had sustained no damages, because he actually realized greater earnings than he would have had as an employee. The Supreme Court disagreed, observing that the plaintiff had not received the vacation, holiday, or overtime

73 Arizona's new Declaration of Independent Business Status (DIBS) amends Title 23 of the Arizona Revised Statutes by adding two new statutes: A.R.S. § 23-10601 and A.R.S. § 23-1602.
74 *O'Connor v. Uber Technologies, Inc.*, No. 3:13-cv-03826-EMC (N.D. Cal. Mar. 11, 2015); Cotter v. Lyft, Inc., No. 3:13-cv-04065-VC (N.D. Cal. Mar. 11, 201.5)
75 *Slayman v. FedEx Ground Package System, Inc.*, No. 12-35525 and 12-35559.

pay paid to employees. If the plaintiff could demonstrate that he was a misclassified employee, the Massachusetts statute would thus entitle him to recover treble damages for any lost wages and other benefits.

The seminal misclassification case under federal tax and benefits laws is *Vizcaino v. Microsoft Corporation*.[76] The case involved a group of workers Microsoft had classified as independent contractors and referred to as "freelancers."The freelancers were compensated at an hourly rate that was higher than the wage paid to employees performing similar work, were paid through Microsoft's accounts payable department rather than its payroll department, wore different badges and were not included in company functions. Despite these efforts to distinguish "freelancers" from regular employees, however, the IRS determined, following a classification audit, that the freelancers had been misclassi fied and were actually employees.

This conclusion prompted an ERISA class-action lawsuit by the freelancers, who demanded that Microsoft allow them to participate in a variety of employee benefits, including two of the company's employer-sponsored ERISA retirement plans. On appeal, the federal Ninth Circuit Court of Appeals noted that the freelancers could not be materially distinguished from Microsoft's remaining workforce: they often worked on teams with regular employees, they performed the same functions, they shared the same supervisors, and they worked the same hours. Microsoft then conceded that the workers were employees under the common-law test. The company argued, however, that the plan administrator had correctly refused to award benefits under the retirement plans, because the workers had agreed in their independent contractor agreements that they were not entitled to participate.

The court disagreed. The mere fact that the agreements labeled the workers as "independent contractors" was not dispositive, the court held, and the agreements were ultimately based on a mutual mistake and unenforceable. Accordingly, Microsoft was directed to fund the workers' retirement benefits retroactively. The case continued through several appeals, but was ultimately settled for close to U.S. $97 million.

The Microsoft decision stands in sharp contrast to the decision by the federal Tenth Circuit Court of Appeals in Capital Cities/ABC, Inc. v. Ratcliff.[77] Like the workers in Microsoft, the plaintiffs in Ratcliff had signed independent contractor agreements affirming that they were not entitled to participate in the company's ERISA benefits plans. The court of appeals found that the agreements had been voluntarily executed and that it was therefore immaterial whether the workers could be deemed employees under common law. Since the workers had voluntarily relinquished their right to receive any benefits under the company's employee benefit plans, the court held that the terms of the agreement controlled and should be given effect.

The inconsistent holdings in Microsoft and Ratcliff highlight the importance of context and jurisdiction when evaluating any independent contractor relationship in the United States.

VI. Business Presence Issues

a. How the Use of One or More Independent Contractors Creates a Permanent Establishment in Country and the Ramifications

A foreign entity with a permanent establishment in the United States may be subject to U.S. federal taxation. As a general rule, foreign corporations are subject to federal income

76 *Alexander v. FedEx Ground Package System, Inc.*, No. 12-17458 and 12-17509
77 454 Mass. 582, 590-591 (Mass. 2009).

tax on income that is effectively connected with a U.S. trade or business[78] Such income may, however, be subject to exemption if a tax treaty so provides.[79] A common tax treaty exemption limits federal income taxation to amounts attributable to a permanent establishment maintained by the foreign entity in the United States. Such an exemption exists, for example, under the tax treaty between the United States and Canada.[80]

Under the terms of this and other treaties containing such an exemption, a permanent establishment exists if the foreign company maintains in the United States either (1) a "fixed place of business" or (2) employees or "dependent agents" who have, and habitually exercise, authority to conclude contracts on behalf of the foreign company. By contrast, no permanent establishment is created if business is carried out through a broker, general commission agent, or other independent agent acting in the ordinary course of their business.

Court decisions interpreting these provisions are sparse. However, consistent with the language of the applicable treaty, courts customarily distinguish between an independent agent or contractor, retained to perform a specific project without authority to contract on behalf of the foreign principal, and a dependent agent who has such authority.[81] In other words, independent agents or contractors who operate in the normal course of their own business and merely represent the products or services of the foreign resident generally do not create a permanent establishment of the foreign resident. On the other hand, when an agent is both legally and economically dependent on the foreign company, the presence of the agent is likely to give rise to a permanent establishment.[82]

b. How the Employment of One or More Individuals Creates a Permanent Establishment in Country and the Ramifications

As discussed in the preceding section, tax treaties between the United States and many other countries provide an exemption from U.S. federal taxation for income derived by a foreign corporation from a U.S. trade or business if the foreign corporation lacks a permanent establishment in the United States. Treaties differ in their definition of "permanent establishment," and the factors indicating the existence of a permanent establishment vary. Very commonly, however, the presence in the United States of a fixed place of business of the foreign entity or of employees of the foreign entity who habitually exercise the authority to bind the foreign company contractually will reflect the existence of a permanent establishment.

It is important to recognize that the federal government has no authority to enter into tax treaties with other countries that affect individual states. Each state has its own laws and criteria that determine when and under what circumstances a foreign company is considered to be transacting business in the state and thereby potentially subject to state taxation and regulation. It is commonly agreed that when a company exploits the state's marketplace – for example by employing individuals in the state to sell its

products, produce its goods or perform services on its behalf to customers – state taxation and regulation is likely to be invoked.

78 120 F.3d 1006 (9th Cir. 1997) (en banc) cert. denied, 522 U.S. 1098 (1998); *see also Vizcaino v. United States District Court, 173 F.3d 713 (9th Cir. 1999), amended by 184 F.3d 1070 (1999), cert. denied*, 528 U.S. 1105 (2000)
79 141 F.3d 1405 (10th Cir. 1998).
80 26 U.S.C. § 882.
81 See 26 Code of Federal Regulations ("C.F.R.") § 1.894-1.
82 See Canada – US Income Tax Convention, Article VII (1980).

VII. Conclusion

In a 2006 report on employee misclassification, the U.S. Government Accountability Office highlighted the many inconsistencies in classification standards and aptly observed that "the tests used to determine whether a worker is an independent contractor or an employee are complex, subjective, and differ from law to law."[83] That observation remains true today. Indeed, not only do the tests vary, but so does their interpretation. Outcomes may vary from jurisdiction to jurisdiction and indeed from case to case. Navigating this legal maze can be challenging and treacherous. Any company doing business in the United States should tread with caution when hiring independent contractors and seek legal advice to manage the complexi es of the legal landscape.

The use of independent contractors remains a viable and often a valuable means to supplement a company's labor force. In light of increasing state and federal regulatory focus and ever-increasing class action activity, however, it is important that employers (particularly those in scrutinized industries) assess the applicable laws in their jurisdiction, implement lasting changes across their organization which accurately distinguish between employees and independent contractors, and (where independent contractors are used) document and structure independent contractor relationships in a compliant manner.

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83 *See Donroy, Ltd. v. United States*, 301 F. 2d 200, 206 (9th Cir. 1962).

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