

# Independent contractors done right

Independent contractors save organizations time, money and hassle by eliminating the hoops employers have to jump through to manage employees. Independent contractors assume responsibility for payroll taxes and workers' compensation. Employers pay invoices to a 1099 worker—no overtime, no timecards, no problems. What could go wrong? Plenty. It takes more than a signed independent contractor agreement to escape the sticky legal webs of employment.

Classifying a worker as an employee or independent contractor is tricky because the terms have many different definitions. Federal and state taxing authorities each have their view of what an employment situation looks like. The U.S. Department of Labor (DOL) and the National Labor Relations Board (NLRB) also have strong opinions on what makes an independent contractor. Additionally, each state's labor department and workers' compensation board also have rules governing independent contractors. The arrangement doesn't so much eliminate hoops as create a different set.

Employers are caught in the middle. Still, done properly, companies can create valid independent contractor agreements and make these workers 1099 contracted labor. The term 1099 worker is shorthand for independent contractors. It refers to the IRS form that organizations submit to the IRS and the worker showing payments to independent contractors.

## The virtual marketplace service provider and the DOL

Recently, the U.S. Department of Labor issued an opinion letter essentially supporting the Uber model of employment. DOL concluded that app-based workers are independent contractors. Uber, Lyft and other platforms that connect service providers with customers are known as virtual marketplaces. Uber drivers and those actually doing the work are virtual marketplace service providers.

The DOL opinion letter dealt with whether a virtual marketplace was an employee or an independent contractor. Based on a six-factor test, the DOL concluded that the worker in question was an independent contractor. The DOL's six-factor test is:

- The nature and degree of the potential employer's control;
- The permanency of the worker's relationship with the potential employer;
- The amount of the worker's investment in facilities, equipment, or helpers;
- The amount of skill, initiative, judgment, or foresight required for the worker's services;
- The worker's opportunities for profit or loss;
- The extent of integration of the worker's services into the potential employer's business.

Each of the factors can tilt toward an independent contractor relationship or an employment one. The more the employer controls the more likely the worker is an employee. Generally, independent contractors have contracts with specific end dates. Employees enjoy a more permanent bond with the employer. Independent contractors are more likely to invest in their own tools and equipment than employees. Factor four is closely related to factor one, but with a twist. Both deal with the worker's independence. This one also suggests that more highly skilled workers are more likely to be independent contractors. Independent contractors can lose money, employees can't. Work that is more specialized and different from the employer's main business is more

likely done by an independent contractor.

## The ABC Test

Several states subscribe to a test more likely to identify a worker as an employee. The ABC test used by Massachusetts, California, New Jersey, and other states applies three tests to work relationships:

1. the worker is **free from the control and direction** of the hirer in connection with the performance of the work, both under the contract for the performance of such work and in fact;
2. the worker performs work that is **outside the usual course of** the hiring entity's business; and
3. the worker is **customarily engaged in an independently established trade, occupation, or business** of the same nature as the work performed for the hiring entity.

Employers should consult with counsel to determine which test applies in their jurisdiction.

## The Internal Revenue Service weighs in

Independent contractors are an attractive option for employers because the contractor pays its own payroll taxes. The Internal Revenue Service (IRS) therefore has its own set of tests the relationship must pass. The IRS test three aspects when evaluating independent contracts - Behavioral Control, Financial Control and Relationship of the Parties.

**Behavioral Control:** A worker is an employee when the business has the right to direct and control the work. That's true even if that right is not exercised. Behavioral control categories are:

- Type of instructions given, such as when and where to work, what tools to use or where to purchase supplies and services. Receiving these types of instructions may indicate a worker is an employee.
- Degree of instruction. More detailed instructions may indicate that the worker is an employee. Less detailed instructions reflects less control, indicating that the worker is more likely an independent contractor.
- Evaluation systems to measure the details of how the work is done points to an employee. Evaluation systems measuring just the end result point to either an independent contractor or an employee.
- Training a worker on how to do the job. Periodic or on-going training about procedures and methods is strong evidence that the worker is an employee. Independent contractors ordinarily use their own methods.

**Financial Control:** Does the business have a right to direct or control the financial and business aspects of the worker's job? Consider:

- Significant investment in the equipment the worker uses in working for someone else.
- Unreimbursed expenses. Independent contractors are more likely to incur unreimbursed expenses than employees.
- Opportunity for profit or loss is often an indicator of an independent contractor.
- Services available to the market. Independent contractors are generally free to seek out business opportunities. Employees are often discouraged from doing so or prohibited entirely.
- Method of payment. An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. However, independent contractors are most often paid for the job by a flat fee.

**Relationship:** The type of relationship depends upon how the worker and business perceive their interaction with one another. This includes:

- Written contracts which describe the relationship the parties intend to create. A contract stating the

worker is an employee or an independent contractor is not enough. An independent contractor agreement is essential, but not determinative.

- Benefits. Businesses providing benefits such as insurance, a pension plan, vacation pay or sick pay have employees. Businesses generally do not provide these benefits to independent contractors.
- The permanency of the relationship is important. An expectation that the relationship will continue indefinitely indicated an employment relationship. An expectation that the relationship is for a specific project or period is evidence of independent contractor status.
- Services provided that are a key activity of the business. The extent to which services performed by the worker are seen as a key aspect of the regular business of the company. For example, arranging for a plumber to regularly service a facility when needed indicated an independent contractor. However, arranging for a plumber to do plumbing work for a plumbing supply business likely indicated an employee relationship.

## **What employers should do**

With all the different tests, which ones should employers follow? The IRS tests are well established and unlikely to change. Under the Trump administration, the DOL's interpretations have moved back to the more traditional models. The IRS and DOL will usually classify a worker the same way. Employers in states that follow the ABC test should run that analysis as well.

When telecommuting rose in popularity, some suggested that telecommuters were less under company control than other workers. They mused that telecommuters were drifting toward independent contractor status. Over time, this fear has eased. Telecommuting on its own does not affect any test's factors.

Leasing equipment or vehicles to independent contractors raises a red flag. Uber has moved away from leasing its cars to Uber drivers for this reason. The relationship raises questions about the contractor's independence. Assess any lease agreements you have with independent contractors for equipment or vehicles.

If you are the independent contractor's only client, you may wish to encourage the contractor to take on other clients. Both the DOL and IRS want to see that the service provider/independent contractor really is in business for herself. Otherwise, regulators may conclude the contractor is a misclassified employee.

Review existing agreements and, if necessary, redraft them to show the worker is in business to make a profit. The worker cannot be just an employee by another name.

Should you determine you've misclassified a worker, convert the independent contractor to an employee. Consult with counsel to do so without triggering a lawsuit, IRS and DOL scrutiny or other unwanted attention. This is usually accomplished by terminating the existing contractor agreement. If the worker is nonexempt, set an hourly wage. If the worker is exempt, set a salary. The worker should receive the same benefits as similarly situated employees moving forward.

## **Don't let sleeping dogs lie**

One misclassification leads to another. If the next employee you hire performs similar work to your misclassified contractor, it will be hard to explain. Get help from your attorney and correct misclassification now rather than later.