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Revisit Independent Contractor Classifications

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Telecommuting and flextime are becoming more common, but there is an older alternative arrangement that continues to have broad appeal—that of engaging independent contractors.

More freewheeling and typically self-starters, independent contractors can offer employers attractive cost savings and enjoy working away from the office. The apparent “win-win” has led to a quiet but steady increase in the use of independent contractors in many areas. Over the 35 years from 1969 to 2004, the percentage of workers who were independent contractors in New York City, for example, more than doubled from 7.8 percent to 16.2 percent. (See “Who’s the Boss? More Often, You” in the Jan. 19, 2007, issue of the *New York Post*).

However, the misclassification of employees as independent contractors benefits employers, which enjoy the cost savings, at the expense of workers. Throughout the year, there have been calls for more action against misclassifying employers. For example, New York Gov. Eliot Spitzer signed an executive order on Sept. 7, 2007, to bolster enforcement against misclassifying employers.

As pressure mounts at the federal and state levels to crack down on employers misclassifying workers as independent contractors, employers should revisit their classification of workers, despite the fact that the tests used in identifying an independent contractor vary under a patchwork of federal and state laws.

Far-Reaching Implications

Determining whether a worker is an “employee” or “independent contractor” requires a legal and factual analysis of myriad details pertaining

to the relationship between the worker and the entity engaging that worker. This fact-sensitive determination can have far-reaching implications not only for the way in which a business operates, but also for a company’s bottom line and potential liabilities.

The determination of whether one is an employee or an independent contractor serves as the basis for various federal, state and local tax obligations imposed on a business, as employers must generally withhold and pay federal income taxes, Social Security and Medicare taxes, and pay unemployment taxes, on employee wages. Employers generally need not make such withholdings and payments with respect to monies paid to an independent contractor.

While there is variation among the tests, each test used by federal and state authorities focuses—at least in part—on the putative (i.e., “the alleged”) employer’s right to control the worker in the performance of the task(s) for which he or she is retained.

IRS ‘Right to Control’ Test

For years, the Internal Revenue Service (IRS) applied the so-called “20-factor” test that it promulgated in 1987 to determine whether an individual is properly classified as an employee or an independent contractor.

Under pressure from Congress and business and labor representatives to simplify and streamline its analysis, the IRS subsequently reduced the former 20-factor test into an 11-part test. The essential inquiry, however, remains unchanged: Does the alleged employer retain the right to control the method and manner in which services are performed?

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The engagement of a worker with the expectation that the relationship will continue indefinitely is generally viewed as demonstrating the intent to create an employer-employee relationship. The performance of services that are a key aspect of the regular business of the company renders it more likely that the alleged employer will be deemed to have the right to direct and control the worker's activities.

No one factor in the IRS test is determinative in classifying an individual as either an employee or independent contractor.

While the IRS has attempted to simplify the 20-factor test, the revised test merely eliminates some of the specific factual inquiries that were included in the original 20 factors. This revision, however, does not obviate the need for businesses and their counsel to continue considering some, if not all, of these inquiries.

'Relative Nature of the Work'

In determining who truly is an employee vs. an independent contractor, employers should consider using the IRS test in tandem with other tests, such as the "relative nature of the work" test that is commonly applied in workers' compensation determinations.

The relative nature of the work test is used in many states to determine whether a worker is an employee and thus eligible to receive workers' compensation benefits. This test, which has existed literally for decades, requires an examination of the extent of the economic dependence of the worker upon the business he or she serves and the relationship of the nature of the work to the operation of that business.

The relative nature of the work test comprises two components:

- The character of the claimant's work or business.

- The relationship of that work or business to the alleged employer's business.

The relative nature of the work test is used when the common law "right to control" test is inconclusive in classifying a worker due to the business's lack of control over the performance of the individual's work.

'ABC' Test

A majority of states use the "ABC" test in determining whether an individual is an employee or an independent contractor for the purpose of determining eligibility for unemployment benefits. (See U.S. Dept. of Labor, Employment & Training Administration, Comparison of State Unemployment Laws, Jan. 1, 2006, pp. 1-6.)

Under this test, a worker will be considered an employee unless each of the three following factors (hence, the reference to "ABC") is satisfied:

- He or she has been and will continue to be free from direction or control from the employing unit in the performance of his or her work.
- He or she performs services outside the usual course of, or places of business of, the employing unit.
- He or she—although performing services of the same nature as the employing unit—customarily is engaged in an independently established trade, occupation, profession or business wholly apart from the employing unit.

Differences in Various Tests

As is evident from the discussion above, the IRS test differs in significant ways from the relative nature of the work test and the ABC test.

The relative nature of the work test emphasizes the character of the worker's

vocation or business and the relationship of such work to the alleged employer's business, including the extent to which the worker "can be expected to bear the risk of industrial accident." This analysis de-emphasizes the significance of control and supervision, which are the very foundations of the IRS test, as Richard Carlson notes in his law review article (Carlson, "Why the Law Still Can't Tell an Employee When It Sees One and How it Ought To Stop Trying," 22 Berkeley J. Emp. & Lab. L. 295 (2001)).

The ABC test requires a more stringent analysis of far fewer factors in comparison to the 11 factors used in the IRS test. Furthermore, while the ABC test mandates some consideration of the alleged employer's right of control, application of all three parts of the ABC test places a much greater emphasis on the nature of the worker's vocation or business and relationship of such work to that of the alleged employer.

Monitor Status of Relationships

A challenge to an employer's classification scheme may be initiated through several mechanisms, from audits by federal and state administrative agencies to litigation initiated by individuals who have been classified as independent contractors.

Businesses should continually monitor the nature of their work relationships as duties, responsibilities, and the facts and circumstances relating to the retention of workers change over time. ♦

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