Principal
Richard H. Waxman
Member: NY & FL Bars

Law Offices
RICHARD H. WAXMAN, P.C.
445 Central Avenue, Suite 362
Cedarhurst, NY 11516
(Phone) 516-374-3733
(Fax) 516-706-2911
(E-mail) **rwaxman@waxmanlaw.com**

Counsel
Timothy P. Fisher
Member: NY Bar

S. Timothy Ball
Member: NY Bar

Joseph Lichter
Member: NY Bar

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Employee or Independent Contractor…the Pitfalls and What an Employer May do to Avoid Them!

Why is this Issue Significant to Employers? The basic issue is whether a company may treat a worker as an independent contractor or as an employee. The determination becomes significant when a government agency or a court disagrees with the company's treatment of a worker as an independent contractor, since this may lead to money judgments, financial assessments, penalties and audits.

Some History. In the "good old days" many a bookkeeper or controller acted as though the power to confer independent contractor status resided within the company and exercised this power by simply reporting a worker's payments on a Form 1099, rather than a W-2. In fact, many employers avoided taxes and other substantial financial responsibilities and liabilities in this manner. Well, those days are long gone and for more than a decade the federal and state tax and labor authorities have been carefully scrutinizing alleged independent contractor relationships.

Why Attempt to Label a Worker as an Independent Contractor?

When a worker is treated as an employee, the company must withhold income taxes; withhold and pay Social Security and Medicare taxes; pay unemployment insurance; allow participation in qualified employee benefit plans; make contributions to qualified retirement plans; comply with anti-discrimination laws[1]; and comply with other employee protective laws like COBRA and the Family and Medical Leave Act. Also, a company is more likely to be found liable when its worker injures a third party in the course of his work if the worker is an employee.

These items are all potentially very expensive and require administrative efforts and cost. Thus the enticements to label a worker as an independent contractor are powerful and many.

The Basic Tests.

The government agencies rightly take the position that the key determination is the nature and amount of control exercised by the company over the worker. For example, the IRS states the basic rule in this manner:

> "…anyone who performs services for you is your employee ***if you can control what will be done and how it will be done.*** This is so even when you give the employee freedom of action. What matters is that you have the right to control the details of how the services are performed. [3]"

while:

> "…an individual is an independent contractor if you, the person for whom the services are performed, have the ***right to control or direct only the result of the work and not the means and methods of accomplishing the result.*** [4]"

While this rule is simple to state, it becomes extremely complex and subjective when applied by the government agencies and courts. This complexity is evidenced and compounded by the reams of explanatory documentation generated by the agencies in recent decades, including 1987 IRS Revenue Ruling 87-41[5] which enunciates twenty factors to be considered, commonly referred to as the "twenty common law factors;" the 160 page Training Manual entitled "Independent Contractor or Employee" that the IRS has distributed to its examiners since 1969 and by Court decisions, including those by the United States Supreme Court in Nationwide Mutual Insurance Co. v. Darden,[6] and by the United States Court of Appeals in the often commented upon Microsoft cases.

In fact, the IRS recently acknowledged this complexity in a May 2009 National Phone Forum presentation entitled: "Proper Worker Classification"[7] where the IRS spokesman conceded:

> "Some factors may indicate that the worker is an employee, while other factors indicate that the worker is an independent contractor. There is no "magic" or set number of factors that make the worker an employee or an independent contractor, and no one factor stands alone in making this determination. Also, factors that are relevant in one situation may not be relevant in another."

In other words, IRS concedes that its own rules are not capable of application in a simple workable fashion! Moreover, different taxing authorities and different state labor agencies have each promulgated its own separate set of rules.

The Economic Exposure.

If you classify a worker as an independent contractor and a government agency decides that you are wrong, the economic exposure is manifold:

- Unpaid taxes that the company failed to withhold.
- Payroll expenses such as Social Security and Medicare taxes, unemployment insurance, disability and workers compensation premiums that the company failed to pay.
- Contributions to retirement plans and for other employee benefits, that the company failed to pay.
- Fines, penalties and interest.
- Professional fees incurred in defending the company's position.
- Legal fees incurred in defending law suits brought by aggrieved employees, and if the company loses, the employee's legal fees.
- Liability to an injured worker not covered by workers comp or general liability insurance.

How does a Company get caught by a Government Agency?

There used to be two principle ways:

- Random audit. Federal and state agencies (both taxing authorities and labor departments) recognize the huge tax and other revenues that are lost as a result of companies labeling workers as independent contractors.

- Complaint of a disgruntled former worker. It is quite common for a worker that was treated as an independent contractor to file a claim for unemployment insurance after the relationship has concluded.

Now there is at least a third way to get caught. In November 2007 the IRS and officials from 29 of the states (including New York) announced that they have entered into agreements to share the results of employment tax examinations, under the Questionable Employment Tax Practice (QETP) initiative, described as "a centralized, uniform means for the IRS and state employment officials to exchange data, thereby leveraging resources and encouraging businesses to comply with federal and state employment tax requirements." The IRS noted that "Combining resources will help IRS and the states reduce fraudulent filings, uncover employment tax avoidance schemes and ensure proper worker classification."[8]

The Administration's Viewpoint.

On September 12, 2007 then Senator Obama, along with Senators Durbin, Kennedy, and Murray introduced the Independent Contractor Proper Classification Act of 2007 (S. 2044), which addresses what some view as weaknesses in the current laws regarding independent contractors. If enacted, the effects of this legislation would include:

> Precluding employers from relying on industry practices as a reasonable basis for classifying workers as independent contractors;
>
> Requiring IRS audit of employers that have misclassified workers and require misclassifications to be reported to the Department of Labor;
>
> Requiring the Department of Labor's FLSA[9] poster to inform workers of their right to challenge their classification as independent contractors;
>
> Requiring employers to keep certain records relating to independent contractors for three years.

While this Act may not get through the Congress, it demonstrates that the Obama administration will, at the very least, be likely to increase federal scrutiny of independent contractor classifications.

Several Ways to Approach this Problem.

If you have been treating workers as independent contractors but are not sure this is correct, you may of course cross your fingers and hope to not get caught. If you wish to take a more pro-active approach

1. Do it Yourself.

You may study the voluminous literature and make decisions on your own.

2. Ask the Government.

A company (or a worker) may file IRS Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding to obtain (after a wait of six months or more) an official determination of the worker's status, at least for federal tax purposes.

Likewise the Unemployment Insurance Division of the New York State Department of Labor invites companies to let them decide whether workers are independent contractors by submitting the issue along with the circumstance and copies of documents to its Liability and Determination Section for a "formal determination."[10]

3. Terminate all Independent Contractors.

One simple solution is to "bite the bullet" and refuse to engage any worker on an independent contractor basis. While this can eliminate much of the substantial financial exposure described elsewhere in this letter, it may result in the loss of valuable workers and the payment of taxes and benefits that otherwise might not be due.

4. Seek Professional Guidance.

If you do not find the three above approaches appealing, you may seek professional advice. Qualified professionals can help a company analyze its situation and hopefully avoid the pitfalls described in this letter. The attorneys at Richard H. Waxman, P.C. are ready and able to advise companies that are touched by this issue and by other legal matters that affect employers in these difficult times. In providing advice and other support, we will not lose sight of the current economic climate and will work hard to insure that our fees are reasonable.

Very truly yours,

Richard H. Waxman

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We encourage you to pass this Newsletter on to people within your organization, and to your clients and friends.

You may have to print this letter or the attached .pdf copy to see the footnotes.

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[1] Such as Title VII of the 1964 Civil Rights Act, the Pregnancy Discrimination Act, the Equal Pay Act, the Age Discrimination in Employment Act and the Americans with Disabilities Act.

[2]

[3] See IRS web page: http://www.irs.gov/businesses/small/article/0,,id=179112,00.htm

[4] See IRS web page: http://www.irs.gov/businesses/small/article/0,,id=179115,00.html

[5] See Revenue Ruling 87-41, 1987 - 1 Cumulative Bulletin 296, 2980299.

[6] 503 U.S. 318 (1992)

[7] See transcript of presentation on IRS web page: at http://www.irs.gov/businesses/small/article/0,,id=209413,00.html

[8] See IRS website at: http://www.irs.gov/newsroom/article/0,,id=175457,00.html

[9] The Fair Labor Standards Act, generally referred to as the federal wage and hours law, is the law that generally requires the payment of "time and a half" to covered workers that work more than 40 hours in a week.

[10] See NYS Dept. of Labor website at http://www.labor.state.ny.us/ui/dande/ic.shtm