Legal Myths: About Managing Independent Contractors

In an effort to trim labor expenses, many businesses have cut costs by replacing employees with independent contractors. Some savings are certain-employers don't pay employment taxes to the IRS or benefits to these workers. But with independent contractors, the risks-and the hidden costs-may reduce or even wipe out the savings!

This article focuses on seven legal myths, and what you can do to protect your business.

MYTH #1:
Employers should use the IRS's "20 Common Law Factors Test" to determine worker status as employee or independent contractor.

REALITY:
The IRS no longer applies its long-standing, much-publicized and frequently used "20-Common Law Factors Test" to determine a worker's status as employee or independent contractor. The IRS has replaced this test with a new approach focusing on three categories to determine if a worker is an employee or independent contractor:

1. Behavioral Control
2. Financial Control
3. Type of Relationship

Companies relying on the "20 Common Law Factors Test" today risk costly fines and penalties for worker misclassification by IRS auditors.

The IRS is specifically targeting companies that laid off employees then hired back independent contractors to perform the same work (even those that rehired the same person as a contractor). Uncle Sam wants his payroll taxes, and to be safe you must classify your workforce properly, complying with the agency's new tests.

MYTH #2:
Employers can avoid costly worker misclassification risks by complying with the IRS Worker Status Test.

REALITY:
The overwhelming focus on the IRS's worker status tests has led many employers to believe they can avoid worker misclassification entirely by pleasing Uncle Sam. However, the IRS's worker status test only applies for employment tax purposes. Many other federal (and state) laws govern

the workforce, and each has its own tests to determine worker status. Four examples are:

1. Employee benefits: A 12-factor test determines whether a worker is an employee or independent contractor under ERISA, the federal law governing employee benefits.
2. Immigration: the Immigration Reform and Control Act (IRCA) applies a 7-factor test to determine worker status.
3. Employment discrimination: the Equal Employment Opportunity Commission (EEOC) applies a test based on the "right to control the means and manner of worker's performance" in federal employment discrimination cases.
4. Wage and hour laws: the Fair Labor Standards Act (FLSA) applies an "economic realities" test including six factors to determine whether the worker is economically dependent on the business to which the services are provided.

While it is important to learn the worker status rules under the various laws and regulations governing the workplace, just knowing that "all worker status tests are not the same" is an important first step in reducing legal risks.

MYTH #3:
You can avoid costly worker misclassification liability by complying with federal statutes and regulations governing the workforce.

REALITY:
Even if your company complies with all the laws and regulations governing the workforce, you still risk liability for misclassifying workers as independent contractors who our Courts and the IRS consider to be "common law employees."

The IRS defines a common law employee as "any individual who, under common law, would have the status of an employee…a person who performs services for an employer who has the right to control and direct the results of the work and the way in which it is done." For example, the employer provides the employee's tools, materials, and workplace, and can fire the employee.
Our Courts and the IRS will find that workers are employees if they meet the common law employee criteria, whether they are hired as independent contractors, free-lancers, temporary or other "contingent" workers.

Many high-profile worker misclassification lawsuits, whose staggering costs to employers made national headlines such as Vizcaino v. Microsoft (settled for $97 million in June, 2001), were based on courts' findings that plaintiffs were common law employees.

MYTH #4:
An employment contract expressly stating that a worker is an independent contractor means that the worker is an independent contractor.

REALITY:
In a series of recent cases, several Federal Appeals Courts across the country have ignored or rejected employment contracts that expressly designated workers as independent contractors. These and other courts have considered written contracts less important than the actual working relationships, control of worker performance and other factors when worker status is at issue.
In December 2001 the EEOC filed a $2 billion lawsuit against Allstate Insurance Company after its life insurance agents signed written agreements to convert from employee to contractor status as part of a company-wide restructuring program. The agency recently charged Allstate with "coercive and intimidating practices" when it forced its agents to sign written statements agreeing to the change of status from employee to independent contractor.

MYTH #5:
Hiring CEO's, CFO's and officers as independent contractors rather than employees is an acceptable, routine, legal business practice.

REALITY:
While hiring corporate chief executives, as independent contractors may be a common, routine and legal business practice, it carries its own legal risks for creditors, employees and shareholders. Our current corporate accountability crisis is exposing these risks every day. Consider the Enron case. When Enron hired Stephen Cooper as its new CEO his contract designated him as an independent contractor, not a full-time employee. SEC investigators characterized the designation as "inappropriate" and scolded the company for its independent contractor designation. The SEC forced Enron to change Cooper's contract status to "full- time employee" to promote corporate responsibility.

MYTH #6:
All contractors are the same when it comes to legal compliance.

REALITY:
All contractors are NOT the same. The IRS considers independent contractors to be self-employed. Each is a business owner with the right to choose from various forms of business entity, including a corporation. An independent contractor's business entity can affect the potential liability of any company that hires or manages that person when legal disputes arise. Recognizing that all contractors are not the same can help reduce the costs

of future potential legal disputes in contractor workforce management.

MYTH #7:
Workers compensation policies protect employers from liability for work-related injuries suffered by employees, but not independent contractors.

REALITY:
This is true, however the risks of potentially costly legal consequences also need to be considered. Because independent contractors aren't covered by an employer's workers compensation plan, hiring independent contractors (or converting employees to independent contractor status) can open the door to personal injury lawsuits when contractors suffer work-related injuries. Because they are not employees, independent contractors who are injured on the job can bring a personal injury lawsuit alleging negligence, defective machinery or equipment, or other grounds for liability just like any other business customer or client. Employers need to recognize the real costs of losing the protective shield that workers compensation provides against such lawsuits.

CONCLUSION - EDUCATION IS THE BEST DEFENSE

As businesses strive to enhance profits, alternative staffing arrangements should be considered. However, to avoid being faced with unexpected, costly legal surprises, business managers need to educate themselves-and understand the real legal risks in independent contractor workforce management and the potentially high costs of ignoring these costs in their business planning.

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