

## Seven Costly Myths About Managing Contract Workers

Businesses can be led to believe they are saving costs by classifying workers as independent contractors instead of employees. Ultimately, this could be costly.

**By Ronald E Wainrib, Esq.**

Businesses across the country are continuing to cut costs by replacing employees with independent contractors. Some savings are certain--employers don't pay employment taxes to the IRS or employee benefits to their workers. However, many hidden costs can reduce these savings or even erase them entirely.

This article focuses on seven legal myths, myths that can lead businesses to believe they are saving money by blinding them to the costly legal risks of hiring workers as independent contractors instead of employees. These myths result from being uninformed about the legal differences between employees and independent contractors. Shattering these myths is the best way to learn how these distinctions affect your business's legal compliance and why companies should include these risks in any cost-cutting calculations.

**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 that focuses on three categories to determine if a worker is an employee or independent contractor: Behavioral Control, Financial Control, and 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 have laid off employees to save costs and then hired independent contractors to perform the same work. Their incentive is the same as that of businesses being audited--*the huge amounts of money not being paid in employment taxes*. In short, employers' savings become Uncle Sam's losses, and Uncle Sam wants his money back! The answer lies in recognizing this risk and making sure that you are classifying 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 test by business and legal advisers has led many employers to believe they can avoid legal risks of worker misclassification entirely by pleasing Uncle Sam. However, the IRS's worker-status test applies only when businesses *need to determine worker status for employment-tax*

*purposes.* Precious little information is provided about the many other federal (and state) laws governing the workforce, yet each has its own test to determine worker status, and all differ from the new IRS approach. Four examples are:

**Employee benefits:** A 12-factor test determines whether a worker is an employee or independent contractor under ERISA, the federal law governing employee benefits.

**Immigration:** The Immigration Reform and Control Act (IRCA) applies a seven-factor test to determine worker status.

**Employment discrimination:** The Equal Employment Opportunity Commission (EEOC) applies a test based on the "right to control the means and manner of a worker's performance" in federal employment discrimination cases.

**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 lengthy lists of laws and regulations governing the workforce, you still risk liability by misclassifying as independent contractors any workers who are considered to be "common-law employees" by our courts and the IRS.

Many high-profile worker-misclassification lawsuits, whose staggering costs to employers made national headlines, were based on courts' findings that plaintiffs were 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." Unlike independent contractors, "common-law employees are not self-employed and cannot set up retirement plans for income from their work."

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, freelancers, or temporary or other "contingent" workers.

**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 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 the landmark case *Vizcaino v. Microsoft*, the Ninth U.S. Circuit Court of Appeals held that Microsoft's "permatemp" workers were common-law employees despite the fact that they had signed written agreements acknowledging that they were independent contractors.

**Myth #5: Hiring CEOs, CFOs, 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. The 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 an independent contractor, not a full-time employee. SEC investigators knew that the independent-contractor status would limit the new CEO's fiduciary responsibility to the company and its creditors. This would have freed Cooper from fiduciary responsibility to the company and its creditors. They characterized the designation as "inappropriate" and (joined by the Florida State Board of Administration, an Enron creditor and shareholder) 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 cost 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, and therefore the risks of potentially costly legal consequences also must 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 business customer or client. Employers must recognize the real costs of losing the protective shield that workers' compensation provides against such lawsuits.