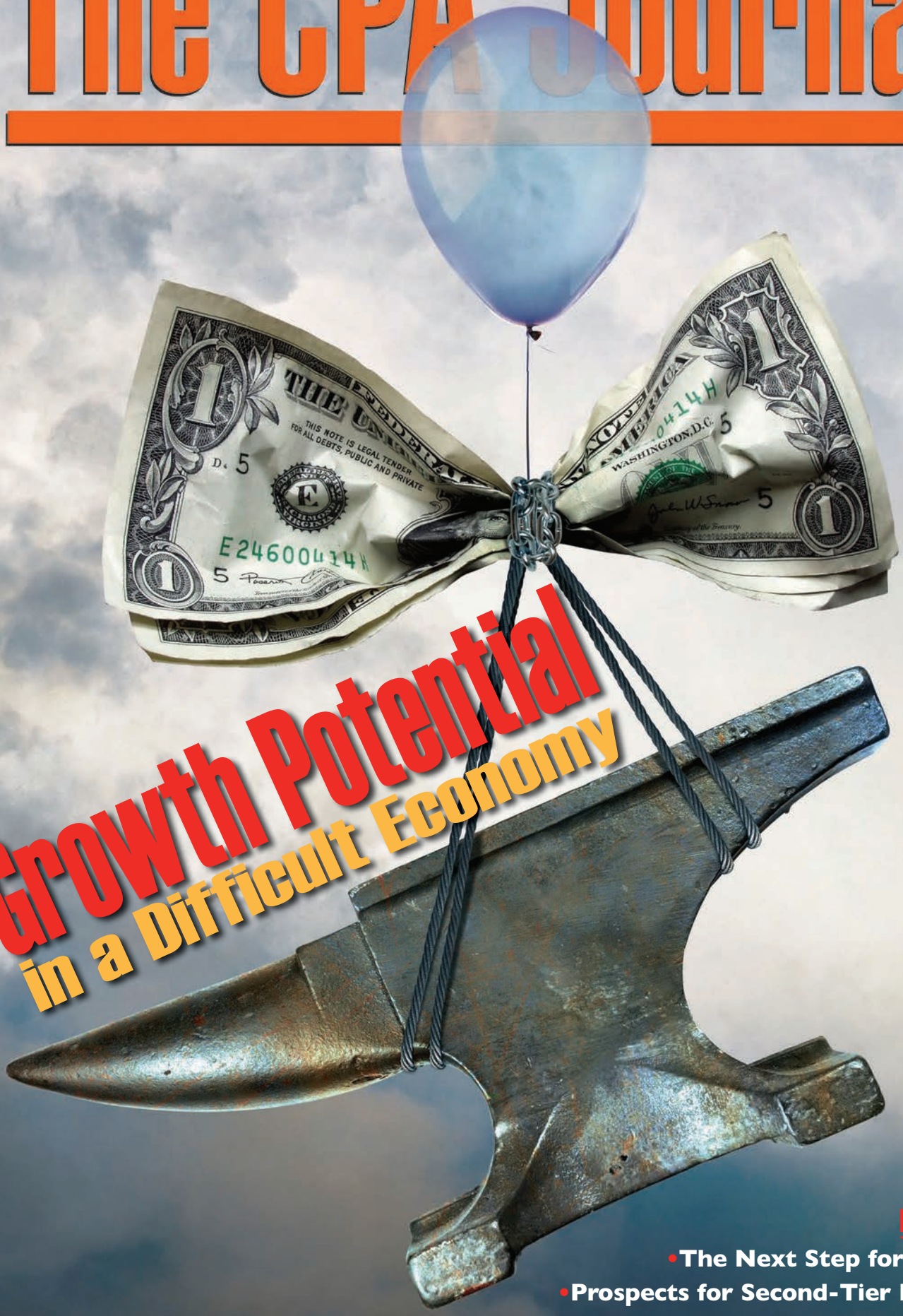
www.cpaj.com June 2011

The CPA Journal



Growth Potential in a Difficult Economy

Plus

- The Next Step for IFRS
- Prospects for Second-Tier Firms
- Independent Contractor or Employee?

Independent Contractor or Employee?

A Complex Answer with Tax and Legal Consequences

By Barry Leibowicz

Whether a worker is an independent contractor or employee is a question that often has no definitive answer. By its nature, the determination requires a weighing of multiple imprecise factors, many of which may point to different conclusions. Getting the answer wrong can leave businesses subject to significant tax and penalty assessments.

Getting the answer right has recently taken on new urgency. Recognizing that the employment tax system now accounts for more than 60% of federal revenues, the IRS has increased its focus on compliance, which includes a renewed emphasis on the worker classification issue. In February 2010, the IRS began its first Employment Tax National Research Project (NRP) in 25 years. The NRP program is aimed at gathering information on employment tax compliance, which will allow the IRS to recognize and focus on the employment tax areas with the most noncompliance. Agents will be specially trained to gather information to improve its regular employment tax audit program (see "IRS Reminds Taxpayers of Agency's Focus on Worker Misclassification and Importance of Compliance," CCH Federal Tax Day, June 30, 2010). Under the NRP, the IRS will random-

ly select 2,000 taxpayers from various business divisions for each of the next three years and audit their payroll records, focusing on employment tax compliance.

Several New York State agencies have increased enforcement of the Fair Labor Standards Act (FLSA), Unemployment Insurance and Workers' Compensation Insurance laws, and wage and hour laws, as well as state and local income and payroll tax issues (see Executive Order No. 17, 9/5/07, Executive Order No. 9, 6/18/08, and "The Annual Report of the Joint Enforcement Task Force on Employee Misclassification to David A. Paterson, Governor, State of New York," Feb. 1, 2010). In addition, both the federal (see H.R. 5107 and S.3254, 111 Congress, 2009-2010, and H.R. 3408 and S.2882, 111 Congress, 2009) and New York State governments are well along in adopting legislation designed to address the worker classification issue. (The "New York Construction Fair Play Act" was signed into law on August 27, 2010, creating a statutory test for construction industry workers; another bill, A.06793, would establish criteria for worker classification to be determined by the Tax Department.)

Background

When a worker is classified as an employee, an employer must withhold and remit income, Social Security, and Medicare taxes. It must also pay unemployment taxes, pay for workers' compensation coverage, and abide by the wage and hour laws, as well as comply with immigration right-to-work verification requirements. An employer generally avoids all of these obligations when work is performed by independent contractors. The choice of one form or another can often be predetermined by the structure of the business-worker relationship, which in turn is generally derived from the contractual relationship between the parties. A mere assertion in a contract that a worker is independent is meaningless, however, unless it is consistent with actual independence in the performance of the worker's duties.

There are several reasons why an employee would prefer to be categorized as an independent contractor rather than an employee. When an employer does not withhold or pay Federal Insurance Contributions Act (FICA) tax, Federal Unemployment Tax Act (FUTA) tax, workers' compensation, or provide health insurance coverage, it often pays additional gross amounts directly to the worker. The employee in turn may seek to take deductions as an independent contractor on Schedule C, which would not be of any benefit if treated as an employee business expense (*Feaster v. Comm'r*, TC Memo 2010-157). The existence of an independent contractor relationship can even eliminate an employer's need to collect sales tax from the ultimate consumer of the goods by selling the goods for resale to the contractor. (For more on this issue, see *Matter of O'Keh Caterers Corp.*, New York State Tax Appeals Tribunal, June 3, 1993, and *In the Matter of Manhattan Fire Extinguisher, Inc.*, New York State Division of Tax Appeals, No. 813561, 813562, 813563.)

The IRS places the responsibility of correctly determining "whether the individuals providing services are employees or independent contractors" upon business owners ("Independent Contractor [Self-Employed]) or Employee?" www.irs.gov/businesses/small/article/0,,id=99921,00.html). Business owners in turn often rely on their accountants and advisors to make the proper classification. They sometimes even develop structures and business practices to achieve a desired classification, holding advisors accountable for the consequences when tax authorities reach a different conclusion.

Liability attaches if an employer does not deduct and withhold Social Security, Medicare, and income taxes when it classifies an employee as a nonemployee. In many cases, the resulting employer liability can be personally assessed against responsible persons even when the employer is a corporation (IRC section 6672[a]). To further complicate matters, a person can be a statutory employee for FICA, FUTA, and Medicare purposes even if she is not an employee under common law rules. In contrast, a person performing services who meets the common law standard of an employee can still be a statutory nonemployee for FICA, FUTA, and Medicare purposes. In addition, workers' compensation and unemployment insurance auditors augment the common law tests with separate and distinct rules in determining whether a worker need be covered as an employee, and typically are not bound by IRS determinations of independent contractor status.

Given the significant costs and responsibilities associated with a worker being an employee, businesses generally prefer to treat individuals as independent contractors rather than employees whenever possible. Predictably, tax authorities, as well as those charged with enforcement of the labor and workers' compensation laws, prefer classification as an employee. The classification of individuals performing services as independent contractors is constantly under scrutiny and often a subject of controversy between taxing authorities and taxpayers. The new NRP audit, Joint Enforcement Task Force, and similar initiatives make proper execution of a business's responsibility to correctly classify workers more important now than ever.

Even if an employee is misclassified as an independent contractor, various forms of relief are available to mitigate the consequences of an innocent misclassification. If a business had a reasonable basis for nonemployee treatment, it may be relieved from having to pay federal employment taxes for that worker. The Revenue Act of 1978 (P.L. 95-600, section 530[a][1], 92 Stat. 2763, as extended by the Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248, 269[c], 96 Stat. 324), prevents the IRS from reclassifying independent contractors as employees where employers have consistently treated their workers as independent contractors "unless the [employer] had no reasonable basis for not treating the worker as an employee." Even the availability of federal relief from misclassification can create problems of its own, because many states do not offer corresponding relief. An employer can find itself in the uncomfortable position of properly treating an employee as an independent contractor for federal payroll tax purposes while having other responsibilities under federal and state tax and labor laws to treat the same worker as an employee.

Common Law

Income taxes are a relatively new phenomenon in the United States, but the need to distinguish between an employee and an independent contractor has a long and colorful history in the English Common Law. The need to distinguish between the categories of workers was originally derived from the tort doctrine of "respondeat superior," which in turn evolved from the legal relationship of master and servant. Because

the common law imposed tort liability upon an employer for the negligence of an employee, but not for an independent contractor, a large body of case law depends upon the classification of workers.

In negligence cases, respondeat superior liability was properly imposed when the tortfeasor was the "servant" of the party against whom liability was sought (*Krueger v. Mammoth Mountain*, 873 F.2d 222, CA-9, 1989, citing *Prosser and Keeton on Torts*, section 70, 5th ed., 1984; *Restatement [Second] of Agency*, section 219, 1958). "Master and servant" is "an archaic generic legal phrase that is used to describe the relationship arising between an employer and an employee. … A servant is also distinguishable from an independent contractor, who is an individual entering into an agreement to perform a particular job through the exercise of his or her own methods and is not subject to the control of the individual by whom he or she was hired" (*West's Encyclopedia of American Law*, Thomson Gale).

IRC section 3121(d) contains four separate categories of employee (with certain exceptions specified in Treasury Regulations sections 31.3121[d]-1[b] and 3121[d]-1[d][1][i]-[iv]). A worker is an employee if he is one of the following:

- Any officer of a corporation;
- A common law employee;
- Certain statutory employees; or
- An employee covered by an agreement under section 218 of the Social Security Act.

Although particular occupations or relationships can cause a worker to be automatically classified as an employee, the IRC generally attributes employee status to any individual "if under the usual common law rules the relationship between him and the person for whom he performs services is the legal relationship of employer and employee" (Treasury Regulations section 31.3121[d]-1[c][1]; see also, IRC section 3121[d][2]). The nature of an individual's relationship to his employer under the common law standard determines the status of the majority of workers under the tax law. The common law standard for employees has also been adopted for FICA and FUTA purposes (IRC section 3306[i], referencing IRC section 3121[d]). The problem of determining worker status is complicated by the fact that, in addition to providing statutory employee status to non–common law employees (see Internal Revenue Manual [IRM] 4.23.5.3 at www.irs.gov/irm/part4/irm_04-023-005r.html), the IRC also provides for statutory nonemployees deemed independent regardless of their common law status (IRC sections 3508[a], 3506[a]).

Twenty Factors or Three—the Test Is the Same

According to Treasury Regulations section 3121(d)-1(c)(3): "Whether the relationship of employer and employee exists under the usual common law rules will in doubtful cases be determined upon an examination of the particular facts of each case."

In 1987, the IRS published a list of 20 common law factors used by the courts to distinguish between an independent contractor and an employee (Revenue Ruling 87-41, 1987-1 CB 296). The IRS recently attempted to simplify the 20-factor analysis traditionally applied in employment classification audits by focusing on "three main categories" to be used in making determinations of employment status, along with discussions of the available relief from an incorrect characterization (IRM 4.23.5.6.1[2]). Nevertheless, these three categories are simply each an amalgam of several of the 20 factors. Each of these factors helps the IRS to determine the amount of control retained over the work performed—the overwhelming and dispositive consideration—but no one factor is determinative.

Following the common law standard, the employment tax regulations provide that an employer-employee relationship exists "when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished" (Treasury Regulations section 3121[d]-1[c][2]). An employee, unlike an independent contractor, must not only accomplish the task given, but must do so in the manner specified by the employer. It is the power to direct the manner of performance that determines the worker to be an employee, not its exercise.

The three categories of facts focused upon by the IRS in making its determinations are as follows:

Behavioral control. Behavioral control is indicated by "facts that illustrate whether there is a right to direct or control how the worker performs the specific task for which he or she is hired" (IRM Exhibit 4.23.5-1). Thus, giving workers instructions on how to perform their job is evidence of the degree of behavioral control necessary to vest a worker with employee status. In contrast, if a worker is subject to the control or direction of another merely as to the result, not as to the means and methods for accomplishing the result, she is an independent contractor.

The courts have made it clear that control exists when the employer exercises only "such supervision as the nature of the work requires" (*McGuire v. United States*, 349 F. 2d 644, 646, 9th Cir., 1965). Professionals who work for an employer remain bound by the standards of the profession and not just of the employer. Although the level of control exercised over professional workers may differ from that exercised over nonprofessional workers, they may still be employees for federal tax purposes (Revenue Ruling 57-21, 1957-1 CB 317).

Financial control. Financial control is established from facts that reflect who directs or controls the business aspects of a worker's activities. These include a determination of whether a worker has made a significant investment in the business, gets reimbursed for expenses, makes services available to the public at large, or gets paid for the work, as well as whether a worker can both make a profit or incur a loss.

Relationship of the parties. The relationship of the parties is determined by facts that reflect the parties' perception of their relationship. Whether the employer provides employee benefits, the nature of the relationship expressed in the parties' contracts, whether the relationship is permanent or has limitations on discharge or termination, and the extent to which the parties' activities are integrated into the employer's business are all helpful in determining a worker's classification. Merely designating a worker as an independent contractor in a written agreement will not by itself prevent classification as an employee when the actual, factual relationship of the parties is one of employer and employee. A contract can be useful in determining methods of compensation, which expenses are to be borne by whom, and the rights and obligations of

each party with respect to the work to be done, which can in turn affect the worker's classification.

Twenty Factors of Common Law

The IRS's 20-factor test is "the number of objective pieces of information identified as relevant by analyzing the approaches that courts have developed in making employee status determinations" (IRM 4.23.5.6.1[1]). The IRM takes pains to emphasize the following points:

- There is no "magic number" of relevant evidentiary factors.
- Whatever the number of factors used, they merely point to facts to be used in evaluating the extent of the right to direct and control.
- As in any examination, all relevant information needs to be explored before answering the legal question of whether the right to direct and control associated with an employment relationship exists.
- The evidence must be factual, be well documented, and support the determination; it is not sufficient to state a legal theory (IRM 4.23.5.6.1[3]).

Court decisions have long confirmed that there is no bright-line demarcation between an employee and an independent contractor. In the seminal FICA case of *United States v. Silk* (331 U.S. 704, 67 S.Ct. 1463, 91 L.Ed. 1757, 1947), the court stated:

> Probably it is quite impossible to extract from the statute a rule of thumb to define the limits of the employer employee relationship. The Social Security Agency and the courts will find that degrees of control, opportunities for profit or loss, investment in facilities, permanency of relation, and skill required in the claimed independent operation are important for decision. No one is controlling, nor is the list complete. … where the arrangements leave the driver owners so much responsibility [for] the investment and management as here, they must be held to be independent contractors. … It is the total situation, including the risk undertaken, the control exercised, the opportunity for profit from sound management that marks these driver owners as independent contractors.

As was the case more than 60 years ago in *Silk*, there is no single factor or specific weighted list that is sufficient to make the determination. An analysis of all of the facts and circumstances is necessary in each case to determine whether the level of involvement and control is sufficient to warrant employee status. With that in mind, the 20 factors as set forth in Revenue Ruling 87-41 are as follows:

Instructions. A worker who must comply with the employer's instructions about when, where, and how he is to work is ordinarily an employee. There is control if the employer has the *right* to require compliance with instructions, whether or not that right is exercised. Thus a driving instructor who must follow specific standards set by a driving school as to fees and teaching methods is an employee (Revenue Ruling 68-598, 1968-2 CB 464).

Training. Training a worker by requiring collaboration with an experienced employee, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the worker is required to perform services in a particular method or manner. A temporary sales clerk trained by an employee service company that retained the right to direct him in the performance of his duties is an employee (Revenue Ruling 70-630, 1970-2 CB 229).

Integration. Integration of a worker's services into the business operations generally shows that a worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the worker performing specific services, it implies control by the employer. In *Silk*, the Supreme Court determined that unloaders of coal were employees because their work was substantially integrated into the business of the corporate employer, while truckers were independent contractors because the trucking operation was separate and independent from the corporate business.

Services rendered personally. If the services must be rendered personally, the employer is presumably interested in the methods used to do the job as well as in the results, suggesting employee status (Revenue Ruling 55-695, 1955-2 CB 410).

Hiring, supervising, and paying assistants. If an employer hires, supervises, and pays assistants, it implies control over the workers on the job. But if one worker hires, supervises, and pays assistants pursuant to a contract under which the worker agrees to provide materials and labor, and is responsible only for the attainment of a result, this suggests independent contractor status. Drivers were independent contractors where they drove delivery trucks and supplied their own insurance, provided an owned or rented vehicle, and engaged others to work under their direction or control (Revenue Ruling 55-593, 1955-2 CB 610). However, where additional drivers were hired by employees of a trucking company at the direction, and with the consent, of the trucking company and the additional drivers were paid by the company, the additional drivers were also employees of the trucking company (Revenue Ruling 63-115, 1963-1 CB 178).

Continuing relationship. A continuing relationship between a worker and an employer is indicative of an employer-employee relationship, which can exist even where work is performed at frequently recurring, but irregular, intervals.

Set hours of work. Set work hours specified by an employer indicates control. For example, a beautician who "leases" space in a salon but must conform to a specific schedule and fee reporting requirements set by the salon owner is an employee (Revenue Ruling 73-591, 1973-2 CB 337).

Full time required. An employer controls a full-time worker's hours and the amount of time spent working, and by implication restricts the worker from doing other gainful work. On the other hand, an independent contractor is free to work when and for whom she chooses.

Doing work on employer's premises. Performing the work on the employer's premises suggests control over the worker, especially if the work could be done elsewhere. Work done off premises, such as at the worker's office, indicates some freedom from control. The nature of the service involved and the extent to which an employer generally would require that employees perform such services on premises must be considered. Control over the place of work is inherent in an employer's right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places. Thus, a photographer instructed to take portraits at people's homes on behalf of the studio remains an employee while working outside of the employer's premises (Revenue Ruling 56-694, 1956-2 CB 694).

Order or sequence set. When work must be performed in the order or sequence set by the employer, workers cannot control their own pattern of work. In some occupations, however, the employer does not set the order of the services or sets the order infrequently. Nevertheless, if the employer retains the right to do so, it is sufficient to show control. A photographer going to people's homes to take portraits in an order directed by the employer is an employee (Revenue Ruling 56-694, 1956-2 CB 694).

Oral or written reports. A requirement that a worker submit regular or written reports to the employer indicates a degree of control.

Payment by hour, week, month. Payment by the hour, week, or month generally points to an employer-employee relationship, unless such payment is a means of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally implies an independent contractor (Revenue Ruling 74-389, 1974-2 CB 330).

Payment of business and travel expenses. If an employer ordinarily pays a worker's business and travel expenses, he is ordinarily an employee. An employer able to control expenses generally retains the right to regulate and direct a worker's business activities (Revenue Ruling 55-144, 1955-1 CB 483).

Furnishing of tools and materials. The fact that an employer furnishes significant tools, materials, and other equipment tends to indicate an employer-employee relationship. A truck driver driving an employer's truck is likely an employee (Revenue Ruling 71-524, 1971-2 CB 346). Nevertheless, merely using your own tools, as is common in certain industries such as automobile repair, does not in and of itself preclude treatment as an employee.

Significant investment. If a worker invests in facilities that are used in performing services that are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), the worker is likely an independent contractor. In contrast, a lack of investment in facilities implies dependence and an employer-employee relationship. Special scrutiny is required with respect to certain types of facilities, such as home offices (Revenue Ruling 71-524, 1971-2 CB 346).

Realization of profit or loss. A worker who can realize a profit or suffer a loss is generally an independent contractor. For example, if a worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses (e.g., salary payments to unrelated employees), he will be an independent contractor. The risk that a worker will not receive payment for his services is common to both independent contractors and employees, and thus does not constitute a sufficient economic risk to support treatment as an independent contractor. Oil well pumpers whose income was unaffected by market fluctuations were determined to be employees (Revenue Ruling 70-309, 1970-1 CB 199).

A worker who can realize a profit or suffer a loss is generally an independent contractor.

Working for more than one employer at a time. A worker performing more than de minimis services for multiple unrelated employers at the same time suggests independent contractor status. A freelance jockey riding horses for several owners is therefore an independent contractor (Revenue Ruling 70-572, 1970-2 CB 221). A worker who performs services for more than one person may be an employee of each of the persons, however, especially when such persons are part of the same service arrangement.

Making service available to general public. The fact that a worker makes her services available to the general public on a regular and consistent basis indicates an independent contractor relationship. If employment precludes doing work for the general public, a worker is likely an employee (Revenue Ruling 56-660, 1956-2 C. B. 693).

Right to discharge. The right to discharge a worker is a factor indicating that the worker is an employee. An employer exercises control through the threat of dismissal, which causes a worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the result meets a contract's specifications (Revenue Ruling 75-41, 1975-1 CB 323).

Right to terminate. If a worker has the right to end his relationship with an employer at any time without incurring liability, this indicates an employer-employee relationship (Revenue Ruling 70-309, 1970-1 CB 199).

Statutory Employees

When a statute characterizes a worker as an employee, the 20-factor analysis is irrelevant. As noted above, corporate officers are employees of the corporation for which they work under IRC section 3121(d)(1). Nevertheless, an officer who performs only minor services for the corporation and does not receive any compensation, whether direct or indirect, is not deemed an employee under Treasury Regulations section 31.3121(d)-1(b). In addition to corporate officers, IRC section 3121(d)(3) lists other statutory employees. These include home workers, traveling salesmen, full-time insurance salesmen, and commission or agent drivers. Before a worker in one of these four categories is considered a statutory employee, three general requirements must be met:

- The contract of service must specify that the work will be performed by the worker personally;
- The worker must have no substantial investment in facilities; and
- There must be a continuing work relationship with the employer.

Establishing the Employment Relationship on Audit

Worker classification is a question of fact to which the 20 factors of the common law are applied to make a determination. Any audit concerning worker classification requires fact finding as to the existence and nature of the relationship. This fact finding includes interviews of employers and workers, as well as examination of any contracts between them.

An employment contract is of substantial value in establishing the relationship. If independent contractor status is desired, the employment agreement should address

each of the 20 factors to clearly establish consistency with treatment as an independent contractor under common law. An agreement should also address the increasingly popular "ABC" test factors that have been adopted in numerous states (see discussion below). While auditors often insist that the absence of a written employment agreement is indicative of an employee rather than an independent contractor, they all too often are willing to dismiss the terms of such an agreement as self-serving when present. Nevertheless, as long as the actual conduct of the parties is consistent with a written employment agreement that embodies the 20 factors in establishing worker independence, the employer is likely to prevail.

An employer that is required to withhold federal income tax is required to keep all records of employment taxes for at least four years. These records include the following:

- The employer's identification number (EIN);
- Amounts and dates of all wage, annuity, and pension payments;
- Amounts of tips reported to the employer by the employees;
- Records of allocated tips;
- Fair market value of in-kind wages paid;
- Names, addresses, Social Security numbers, and occupations of employees and recipients;
- Any employee copies of Forms W-2 and W-2c returned as undeliverable;
- Dates of employment for each employee;
- Periods for which employees and recipients were paid while absent due to sickness or injury, and the amount and weekly rate of payments the employer or third-party payers made to them;
- Copies of employees' and recipients' income tax withholding allowance certificates (Forms W-4, W-4P, W-4[SP], W-4S, and W-4V);
- Copies of employees' Earned Income Credit Advance Payment Certificates (Forms W-5 and W-5[SP]);
- Dates and amounts of tax deposits the employer made and acknowledgment numbers for deposits made by the Electronic Federal Tax Payment System (EFTPS);
- Records of fringe benefits and expense reimbursements provided to the employees, including substantiation (IRS Publication 15 Circular E, *Employer's Tax Guide*, www.irs.gov/pub/irs-pdf/p15.pdf).

Many of these records do not exist when the worker is classified as an independent contractor. In such cases, the records kept and required would typically document the nature of the relationship; the extent, magnitude, and manner of performance; the rate and amount of compensation; and the underlying substantiation for the charges made. As set forth previously, there should be a carefully crafted and executed employment agreement consistent with the actual conduct of the parties. Finally, and of particular importance with regard to IRC section 530 relief, Form 1099 reporting records should be made, documented, and kept to establish consistency in the treatment of similarly situated independent contractors. Documentation of industry-standard treatment of these workers as independent contractors would also be appropriate.

Consequences of Mischaracterization as Independent Contractor

The consequences of misclassifying an employee as an independent contractor can be grave. Penalties and interest can result in a huge assessment of non-dischargeable trust fund taxes. Fortunately, there are some federal income tax relief provisions available.

Section 530 relief. An employer that complies with the conditions of Section 530 of the Revenue Act of 1978 will not be liable for employment taxes, even if the worker would be considered an employee under common law. Section 530 does not, however, affect the worker's status. It merely provides relief to the employer who makes an incorrect classification. The worker remains responsible for his share of FICA. Section 530 can also lead to inconsistent reporting in which the worker is treated as an independent contractor for federal purposes, but must be treated as an employee in those states, such as New York, that do not provide similar relief.

Section 530's safe harbor depends upon the employer's treatment of the worker and the reasonableness of his belief regarding the classification. An employer with a reasonable belief that the worker is an independent contractor who has consistently treated the worker as such satisfies the first two safe harbor conditions. In addition, the employer must have timely filed all necessary informational returns, and must not have treated other similarly situated workers as employees. If the employer did not treat the alleged employee consistent with that of a worker with independent contractor status, such as by failing to file Forms 1099 for payments made, section 530 relief will not be available (*Bruecher v. U.S.*, 2010, No. 09-50312, U.S. App. Lexis 12598, 5th Cir. 2010, unpublished).

The reasonableness of the employer's classification is essential for section 530 relief. When the employer relies upon judicial precedent, a revenue ruling, or even a private letter ruling, it is acting reasonably in making the independent contractor classification (section 530[a][2] of the Revenue Act of 1978, as amended). If the employer's worker classification was addressed in a previous audit that did not determine similar workers to be employees, the employer's belief that they are independent contractors is reasonable. The custom and practice of the particular industry can also establish a reasonable basis for the classification. Even if the employer's belief does not arise from one of the sources above, it may still be granted under section 530 if there is some other reasonable basis for classification as an independent contractor.

Revenue officers conducting an employment classification audit are instructed to determine whether section 530 relief applies before making any other classification analysis. If section 530 applies to a particular set of facts, the IRS will terminate the classification audit, because any finding of employment status would be economically moot.

Several bills have been introduced in Congress in recent years to narrow the circumstances where section 530 relief is available by eliminating the "industry standard" safe harbor, mandating the use of the traditional common law test for independent contractor status, and increasing penalties for misclassification.

Other forms of federal relief. Section 530 is not the only source of relief for employers that have misclassified workers. IRC section 3509 provides somewhat imperfect relief when section 530 relief is unavailable. It provides that an employer's liability may be limited to 1.5% of the wages paid, in addition to the employer's portion of FICA and 20% of the employee's portion of FICA. The downside to this

provision is that the employer's liability is not reduced by any credit for the income tax actually paid by the worker. If reclassification occurs in the context of a determination that the employer intentionally disregarded the tax laws, it will be liable for 20% of the withholdings that should have been collected and the full employee and employer portions of FICA.

Non-Payroll Classification Issues

There are several worker classification problems that can arise in addition to those inherent in meeting federal and state payroll tax obligations. In some cases, such as determining the vendor for sales tax purposes, classification is based upon the same criteria as the payroll tax in assessing responsibility (*Matter of O'Keh Caterers Corp.*). However, workers' compensation, unemployment insurance, and Fair Labor Standards Act determinations are made by several separate agencies that often use alternate or additional criteria to determine employer obligations. Employers must not only make determinations under varied and disparate laws, but satisfy numerous independent agencies often applying disparate and inconsistent employment classification criteria.

For example, the New York Joint Enforcement Task Force on Employee Misclassification (JETF), established in 2007, has attempted to "address the serious problem of employee misclassification" (Executive Order 17, 9/5/07, as continued by Executive Order 9, 6/18/08). The complexity and diversity of the problems presented to an employer in dealing with this issue is apparent from the variety of agencies participating in the task force itself, among them the New York State Department of Labor, Workers' Compensation Board, Workers' Compensation Fraud Inspector General, Department of Taxation and Finance, and Attorney General's Office.

Teams engaged in the "joint enforcement sweeps, coordinated assignments, systematic referrals and data sharing between agencies" implemented by the JETF "included investigators from the Department of Labor's Unemployment Insurance and Labor Standards Divisions, the Department of Labor's Office of Special Investigations, the Workers' Compensation Board Bureau of Compliance, and the Workers' Compensation Board Office of the Fraud Inspector General. On sweeps involving public works construction projects and some private construction jobs, the Department of Labor, Bureau of Public Work or the New York City Comptroller's Office provided members of the sweeps teams." The targeted employers therefore had to deal with satisfying not one, but often as many as eight different agencies, each enforcing multiple differing statutes with their own objectives and criteria (JETF Annual Report to the Governor, February 1, 2010).

When the New York courts address worker classification, they generally apply a singular common law standard to the various statues. This common law approach was recently summarized by the Court of Appeals in *In Re: Empire State Towing and Recovery Association (*No. 160, Oct. 26, 2010, 2010 NY Slip. Op. 7576, 2010 N.Y. Lexis 3031, 2010), in which it stated:

> It is well-settled that "[w]hether an employment relationship exists within the meaning of the unemployment insurance law is a question of fact, no one factor is determinative and the determination of the appeal board, if supported by substantial evidence on the record as a whole, is beyond further judicial review even though there is evidence in the record that would have supported a contrary decision." An employer-employee relationship exists when the evidence shows that the employer exercises control over the results produced or the means used to achieve the results. However, "[c]ontrol over the means is the more important factor to be considered" … "Incidental control over the results produced without further evidence of control over the means employed to achieve the results will not constitute substantial evidence of an employer-employee relationship."
>
> In some cases, this Court has applied the "overall control" test where "substantial evidence of control over important aspects of the services performed other than results or means" is sufficient to establish an employer-employee relationship … This test is applicable to services where the details of the work performed are difficult to control because of considerations such as professional and ethical responsibilities. … This analysis has been typically applied in the context of professionals such as physicians and attorneys. [Citations omitted]

Although New York agencies generally use this "common law" standard in determining employment status, legislation proposed by the JETF would replace the common law criteria with the "ABC" test already adopted by a majority of states. Under the ABC test, an individual who provides a service will be classified as an employee unless the following three factors apply:

- A—The individual is free from the control and direction in performance of the service, both under the contract and in fact;
- B—The service is performed outside the usual course of the employer's business or outside of all of the employer's places of business;
- C—The individual is customarily engaged in an independently established trade, occupation, profession, or business of the same nature as that involved in the service performed.

The adoption of the ABC test might benefit business in New York if it is able to address its stated goal of providing "consistency in determinations among State agencies and develop[ing] a general approach to defining worker classifications, while also developing industry specific guidelines where needed" (Report and Recommendations, New York State Small Business Task Force, December 2009).

Fair Labor Standards Act

The Fair Labor Standards Act (FLSA) is enforced by both federal and state labor departments. Under FLSA, workers are provided protections under the minimum wage and overtime laws. The standard for employee classification under the FLSA is "necessarily a broad one in accordance with the remedial purpose of the Act" (*Brock v. Superior Care, Inc.*, 840 F.2d 1054, 1058-59, 2d Cir. 1988). In New York, these provisions are generally enforced by the New York State Department of Labor, which conducts extensive audits. The audits are often triggered by worker complaints or even tips from competitors.

The factors used under the FLSA to determine worker classification were established in *U.S. v. Silk*, are collectively known as the "economic reality test," and are as follows:

- The degree of control exercised by the employer over the workers,
- The workers' opportunity for profit or loss and their investment in the business,

- The degree of skill and independent initiative required to perform the work,
- The permanence or duration of the working relationship,
- The extent to which the work is an integral part of the employer's business (*Brock v. Superior Care Inc.*).

In applying these factors to a given case, no one factor is dispositive; rather, the test is based on a totality of the circumstances. The ultimate concern is whether, as a matter of economic reality, the workers depend upon someone else's business for the opportunity to render service or are in business for themselves (*Brock v. Superior Care, Inc.*).

Workers' Compensation

An employer is required to "secure compensation" for employees in designated employments for such injuries or death as the statute renders compensable. (For employer status, see N.Y. Work. Comp. Law section 2[3]; for how an employer can pay for workers' compensation coverage, see sections 10 and 50; for enumerated occupations, see sections 2[4] and 3; for the definition of employment, see section 2[5]; for definition of injury and death, see N.Y. Work. Comp. Law sections 10 and 2 [7]-[8].) Proper worker classification is therefore a prerequisite to determining any coverage obligations.

Under New York's Workers' Compensation Law, an employee is defined as a person engaged in one of the enumerated occupations covered by the statute, or is in the service of an employer whose principal business is that of carrying on or conducting a hazardous employment upon the premises or at the plant, or in the course of his employment away from the plant, of his employer (section 2[4]). In such cases where the status of a worker is unclear, the Workers' Compensation Board (WCB) will determine the nature of a particular business relationship (*Matter of Richter v. Buffalo Air Park*, 125 AD2d 809, 509 N.Y.S.2d 914, N.Y. App. Div. 1986). In making such a determination, the board follows the IRC, in adopting the common law definition of independent contractor and employee (*Duffy v. Kedenburg*, 278 A.D. 31, 103 N.Y.S.2d 457, 3d Dep't, 1951; *Ferro v. Leopold Sinsheimer Estate*, 256 N.Y. 398, 176 N.E. 817, 1931; *Clark v. Monarch Engineering Co.*, 248, N.Y. 107, 161 N.E. 436, 1928; *Schweitzer v. Thompson & Norris Co. of New Jersey*, 229 N.Y. 97, 127 N.E. 904, 1920). The ordinary and usual understanding and meaning of the terms employee, employer, and employment as used in the common parlance are assumed to be intended by the legislature (*Toomey v. New York State Legislature*, 2 N.Y.2d 446, 161 N.Y.S.2d 81, 141 N.E.2d 584, 1957).

Despite ostensibly following the IRC's common law definitions, the WCB has established its own means of determining the nature of an employment relationship. In determining who is an "employee" within the meaning of the law, the WCB is not bound by other agencies' decisions, including the IRS. In fact, the Supreme Court has stated that common law tests do not control with

regard to social legislation, so that an individual can be an independent contractor for one purpose and an employee for purposes of social legislation (*Comm'r of State Insurance Fund v. Lindenhurst Green & White Corp.*, 101 AD2d 730, 475 N.Y.S.2d 42, 1st Dept. 1984, quoting *NLRB v. Hearst Publications, Inc.*, 322 U.S. 111, 88 L. Ed. 1170, 64 S. Ct. 851, 1944).

The WCB uses two tests interchangeably—the common law control test and the relative nature of work test—to determine the nature of the relationship. Under the control test, four factors are assessed: the direct evidence of the owner's right to or exercise of control; the method of payment; the extent to which the owner furnishes equipment; and whether the owner retains the right to discharge (*Mace v. Morrison & Fleming*, 267 A.D. 29, 44 N.Y.S.2d 672, 3d Dept, 1943; *Beach v. Velzy* 238 NY 100, 143 N.E. 805, 1924). Under the relative nature of the work test, the court looks at the following facts: the character of the work; how much of a separate calling that work is from the owner's occupation; whether it is continuous or intermittent; whether it is expected to be permanent; its importance in relation to the owner's business; and its character in relation to whether the worker should be expected to carry his own accident insurance burden (*Matter of Gordon v. New York Life Ins. Co*, 300 NY 652, 90 N.E.2d 898, 1950; *Paly v. Lane Brush Co.*, 174 N.Y.S. 2d 205, App. Div., 1958). A recent trend by the WCB has been to use a combination of the factors in both tests in determining the employee-employer relationship. Though the WCB has established these aforementioned tests and factors, the board is not bound by any single factor in making its determination, including a contractual provision purporting to establish the existence of an employer-employee relationship (*Matter of Pilku v. 24535 Owners Corp.*, 19 AD3d 722, 723, 796 N.Y.S.2d 190, 2005; see *Matter of Fisher v KJ Transp.*, 27 AD3d 934, 935, 811 N.Y.S.2d 476, 2006; see also *Matter of Cabrera v. Two-Three-Nought-Four Assoc.*, 46 AD3d 1255, 1257, 848 N.Y.S.2d 748, 2007; *Matter of Hasbrouck v International Bus. Machs. Corp.*, 38 AD3d 1146, 1147, 833 N.Y.S.2d 685, 2007).

The statutory definition and administrative standards established by the WCB differ from those established by the IRS. Therefore, a worker can potentially be an employee under one statute or standard and not an employee under another. Examples include the treatment of corporate officers and directors, employees of subcontractors, newspaper carriers, taxicab drivers, volunteer firefighters, and performing artists. Furthermore, though the WCB's standards for classifying nonstatutory workers as employees spring from the common law right-to-control test, it has created its own jurisprudence that varies from the IRC. The board interchangeably uses the common-law right-to-control standard with the nature-of-work standard; however, no one factor is determinative.

To make matters even more confusing for potential employers, even if a worker is characterized as an independent contractor under the Workers' Compensation Law and falls outside the statutory scope, there are certain instances when an employer is still required to pay for workers' compensation coverage. One such instance is when a general contractor becomes liable for the injuries sustained by the employees of a subcontractor (*Dennison v. Peckham Road Corp.* 295 NY 457, 68 NE2d 440, 1946; *De Stefano v Consolidated Tile Co.*, 308 NY 721, 124 NE2d 336, 1954; *Passarelli v Baker & Yettman, Inc.*, 241 App Div 639, 269 NYS 203, 1934; *Nyholm v Cauldwell-Wingate Co.*, 12 App Div 2d 802, 209 NYS2d 1016, 2d Dept, 1961). A general contractor is not usually bound to secure compensation for the employees of a subcontractor (*Clark v. Monarch Engineering Co.*, 248 N.Y. 107, 161 N.E. 436, 1928; *Matter of Passarelli v. Columbia E. & C. Co.*, 270 N.Y. 68, 75, 1936). A general contractor who subcontracts all or any part of a hazardous employment contract is, however, potentially liable for injuries or death sustained by the subcontractor employees during the course of the hazardous employment (N.Y. Work. Comp. Law section 56). In such instances, a general contractor is required to make payments to certain special funds if the subcontractor would have been liable for such payments. This often results in the odd situation for a one- or two-person–owned corporation that would not otherwise be legally required to include corporate officers in a workers' compensation policy being required to purchase or include themselves in such a policy in order to work for a particular general contractor.

Statutory exceptions to coverage. If a worker falls within one of the enumerated employee definitions, then workers' compensation may be denied only if the worker comes within certain statutory exceptions under New York Workers' Compensation Law section 2(4). Among those excluded are the following: certain members of supervised amateur athletic activities operated on a nonprofit basis; babysitters; domestic servants employed for less than 40 hours per week (see also section 3[1]); farm laborers (except those in hazardous conditions); certain insurance brokers and insurance agents; minors (defined as under the age of 14); and other persons engaged in casual employment such as yard work and household chores in and about single-family, owner-occupied residences not involving power-driven machinery; licensed real estate brokers and sales associates whose employment satisfies certain statutory requirements.

The classification of an executive officer of a corporation under the Workers' Compensation Law varies depending upon the number of corporate officers, employees, and stock ownership. The executive officer of a for-profit corporation that has no employees is not an employee if the executive officer owns all the issued and outstanding stock of the corporation and holds all of the offices pursuant to law (see N.Y. Bus. Corp. Law section 715[e]). If there are two executive officers and no employees, neither are considered employees if both officers own all issued and outstanding stock and offices, provided that each officer owns at least one share of stock (N.Y. Work. Comp. Law section 54[6]). No corporate officers may be excluded, however, if a for-profit corporation with no employees has more than two corporate officers or more than two shareholders, or if the one or two corporate officers do not own all the shares of stock.

If the for-profit corporation has employees, the executive officer who owns all the shares of stock and holds all offices of the corporation is automatically included in the corporation's workers' compensation insurance policy unless he chooses to exclude himself by filing an exclusion request form with the insurance carrier.

Unemployment Insurance

Employee misclassification impacts unemployment insurance as well. Unemployment insurance tax obligations are addressed independently by Labor Department audits that

are separate and distinct from those conducted by tax authorities (see N.Y. CLS Labor section 530); such audits can possibly result in worker reclassification and liability for back taxes and tax penalties (see N.Y. CLS Labor section 575.1). If an audit occurs, an employer (as defined under N.Y. CLS Labor section 512) must permit the inspection of the employment records (NY CLS Labor section 575; see also *Veverka v. Dept. of Labor*, 94 Misc. 2d. 224, 404 N.Y.S. 2d. 276, Sup. Ct. Green County, 1978). Such records must be open to inspection at any time and as often as may be necessary to verify the information contained therein (N.Y. CLS Labor section 575).

The records required for unemployment insurance purposes differ somewhat from those required for payroll taxes in general. Every employer subject to the Unemployment Insurance Law is required to maintain, for the current year and at least the three preceding years, true and accurate records of each person employed. The records must show each employee's name and Social Security number; and for each payroll period, the date that the period began and ended, the days the employee worked, the amount of pay earned each day, and all other payments received by the employee, including vacation, bonuses, severance pay, gratuities, and the reasonable value of board and lodgings (N.Y. CLS Labor section 575; 12 N.Y.C.R.R. section 472.2).

While the Unemployment Division of the New York State Department of Labor recognizes that worker classification is generally based upon the common law factors enumerated by the courts, "certain types of services are excluded or covered by the statute regardless of the degree of direction and control" such as the exemption for the spouse or child of a sole proprietor ("New York State Covered and Excluded Employment," www.labor.state.ny.us/ui/dande/covered1.shtm).

Immigration Reform and Control Act Obligations

The Immigration Reform and Control Act of 1986 (IRCA) imposes record-keeping responsibilities upon employers to ensure they do not hire any undocumented aliens. The act makes it unlawful to hire someone without first verifying documentary evidence of the prospective employee's identity and right to work in the United States or knowingly employ someone who the employer knows is not authorized to work in the United States (8 CFR section 274a.1[l][1]).

The primary mechanism for compliance with the statute is the employer's obligation to prepare and execute an I-9 Employment Eligibility Verification form within three days of the employee's hire, which in turn must reference one or two required documents evidencing the right to work in the United States. These records must be kept at least three years after hire or one year after termination, if later.

Failure to comply with the verification process can lead to civil and possibly criminal sanctions. Compliance is enforced through the audit power of the U.S. Department of Homeland Security's Immigration and Customs Enforcement (ICE) and by the U.S. Department of Labor's Employment Standards Administration (Wage and Hour Division).

Employer obligations established under the IRCA do not apply to independent contractors—meaning that worker classification issues can impact decisions and consequences outside of the obligation to collect and remit payroll taxes.

To a great extent, ICE has adopted similar, though not identical, criteria to those of IRS for worker classification determinations. The key to the determination is whether the employer has the right to control the work of the contractor or its workers (8 CFR section 274a.1[j], 2010).

Using an independent contractor to employ an illegal alien is treated as if the employer has illegally "hired" the alien as an employee (8 USC section 1324a(4), 8 CFR section 274a.5). An employer is specifically prohibited from using any contract, subcontract, or exchange to utilize the services of an unauthorized alien in a manner designed to avoid otherwise applicable employee verification obligations.

No Simple Answer

There is no bright-line test for whether an individual performing services is an employee or an independent contractor. Even the tests that do apply vary depending upon the nature of the obligation to which the classification relates, such as federal and state payroll taxes, sales taxes, workers' compensation, unemployment insurance, or even immigration law requirements.

Some criteria span the various areas of responsibility. Thus, unless a worker is a statutory employee or nonemployee, the determination of employment status will often depend upon the application and weighting of the 20 historical common law factors or the more recent ABC test in the context of the services performed and the nature of the underlying relationship. Some factors, such as control over the manner of performance, are generally given more weight than others in every context. Nevertheless, the circumstances of the task performed and nature of the work often affect the weight to be given to any factor. As recently recognized by the New York Court of Appeals in *Empire Towing*, a professional, such as a doctor or attorney, must always give priority to his own professional judgment, regardless of his employer's instruction, but he can still be an employee if the other factors mitigate in favor that status. When a worker determines means, manner, and time of performance, in the context of a relationship where he can either profit or lose money in the process, any job, regardless of how complex or menial, can be performed by an independent contractor. Each circumstance is unique and must be carefully weighted and reviewed with particular regard to the criteria applied to the particular statute at issue.

Given the often draconian consequences that can arise from misclassification, it is critical to keep all of the records associated with a classification determination, and the nature and extent of compensation paid under the records retention guidelines of each of the many agencies with audit and enforcement authority. When a worker is classified as an independent contractor, one should meticulously document the reasonable basis for the classification and file all required reports and records consistently to protect against penalties in the event of an error, as well as to ensure relief under section 530 and similar provisions where applicable. ❑

Barry Leibowicz, JD, LLM, *is an attorney in Great Neck, N.Y., and an associate professor in the department of accounting and information systems at Queens College of the City University of New York.*