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## **Free: The Risk of Using Independent Contractors**

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The legal landscape involving independent contractors has dramatically and swiftly changed. For decades, legal challenges to an employer's use of independent contractors were infrequent, and many companies were willing to risk the remote chance that they would have to defend a lawsuit or a regulatory inquiry that they had misclassified certain employees as independent contractors.

Over the last year, however, there has been a wave of regulatory and legislative initiatives at both the federal and state levels seeking to stem the use of independent contractors. In addition, companies have been faced with substantial judgments in highly visible lawsuits brought on behalf of classes of workers who have successfully established that they were common law employees improperly classified by their employers as independent contractors.

### **Regulatory Initiatives**

Within the past year, there have been a number of initiatives regulating the use of independent contractors. In May 2007, the Internal Revenue Service undertook a worker misclassification program and announced that the misuse of independent contractors would be a major area of emphasis for the IRS in fiscal 2008. By Nov. 6, 2007, the IRS had entered into data-sharing agreements with 29 state workforce agencies to share the results of employment tax examinations. The IRS has also started to focus in earnest on large corporate employers that allegedly have misclassified employees as independent contractors. In December 2007, the IRS assessed FedEx Ground for \$319 million in unpaid employment taxes and penalties, just for calendar year 2002, following the IRS's determination that FedEx Ground drivers had been misclassified as independent contractors.

Meanwhile, many states, including New York, embarked on their own independent worker misclassification initiatives in 2007. Former Governor Eliot Spitzer signed an Executive Order in September 2007 establishing the Joint Enforcement Task Force on Employee Misclassification. Members of the task force include the heads of the New York state departments of Labor, Taxation and Workers' Compensation as well as the New York Attorney General. The departments have been charged with sharing information among themselves about employers suspected of improperly classifying employees as independent contractors, increasing awareness of the harms inflicted by illegal worker misclassifications, creating hotlines for the public (which can be used by competitors) and referring cases to prosecuting authorities as appropriate.

The task force issued its first report on Feb. 1, 2008, and called for far-reaching proposals including legislation that would extend individual liability for worker misclassifications to corporate officers, shareholders, members of LLCs and LLPs, and corporate successors and affiliated entities.

### **Legislative Initiatives**

In 2007, the New Jersey State Legislature passed, and Governor Jon S. Corzine signed into law, the Construction Industry Independent Contractor Act. This law is the most aggressive law in the country governing hiring practices involving the use of independent contractors. It is based on a belief by New Jersey legislators that employers in the construction industry commonly engage in unchecked misclassifications of employees as independent contractors.

Two bills have been introduced in New York that are similar to the independent contractor legislation in New Jersey: New York Assembly Bill A06643 and its companion New York Senate bill S04925.

At the federal level, Senator Barack Obama (D-Ill.) has introduced S.2044, the Independent Contractor Proper Classification Act. If enacted, this legislation would limit the availability of the "safe harbor" provisions in the Revenue Act of 1978,<sup>1</sup> permit workers to petition the IRS for a determination of their status as an independent contractor or employee, and mandate that employers post notices to employees and independent contractors informing them of their right to challenge their classification as an independent contractor. The legislation is being considered by the Senate Finance Committee.

### **Recent Judicial Developments**

The transportation industry has been on high alert in the past year, not only because FedEx Ground has been assessed more than \$300 million by the IRS over its classification of drivers but also because several lawsuits have challenged the industry practice of classifying drivers as independent contractors. In November 2007, the California Supreme

Court affirmed a lower appellate court ruling that more than 200 drivers used by FedEx Ground in that state were employees and not independent contractors. As a result, FedEx Ground is required to reimburse its drivers in that state for work-related expenses, which together with payment of the plaintiffs' legal fees is expected to exceed \$13 million. FedEx Ground is also defending a nationwide ERISA class action involving allegations that its 20,000 drivers are common law employees and therefore entitled to employee benefits under certain of its Employee Retirement Income Security Act plans.

The medical profession in New York has also been thrown into disarray regarding the use of independent contractors. For years it has been assumed that physicians on the medical staffs of hospitals were independent contractors. The U.S. Court of Appeals for the Second Circuit recently ruled, however, that a lower court erred when it held that a gastroenterologist at an upstate New York hospital was an independent contractor and not an employee for purposes of her Title VII lawsuit.<sup>2</sup>

The New Jersey Supreme Court also issued two important independent contractor decisions in the past year. It held that a chiropractic medical director of a life insurance company's automobile insurance claims review department, as well as a public defender whose duties had been integrated into a city's municipal services, were both employees for purposes of their claims under the state's Conscientious Employee Protection Act, even though each had signed agreements that they were independent contractors.<sup>3</sup>

### **The Risks of Misclassification**

Some of the most substantial risks faced by employers that are found to have improperly reported the income of employees as independent contractors are liability for unpaid federal, state and local income tax withholdings and liability over Social Security and Medicare contributions that are not paid on a Form 1099. Other large financial risks include unpaid unemployment insurance premiums, unpaid Workers' Compensation premiums and unpaid overtime compensation and work-related expenses. These types of liabilities (plus interest and penalties for non-payment) can be potentially devastating for employers that make considerable use of independent contractors.

Another substantial risk is a claim of benefit entitlement by or on behalf of common law employees misclassified as independent contractors. Claims have been successfully brought for pension and profit-sharing benefits, medical benefits and even stock options.

Employers have allowed themselves to be imperiled by such risks because there is a very significant economic inducement to avoid an array of payments required to be made for employees but not for independent contractors. Along with lax enforcement in the past by the IRS and state agencies, these financial incentives have led many businesses to overuse the independent contractor classification.

It is of course perfectly lawful to retain independent contractors who are properly classified as such. Many 1099ers are legitimate and are not entitled to any employee

benefits, nor must the company pay any employment and other taxes on their account. The use of independent contractors only becomes problematic and costly when employees are misclassified as such.

Companies can, however, take one of several different steps outlined below to comply with laws governing the use of independent contractors and thereby minimize or avoid any potential exposure they may face in the future.

## **Reclassification**

One way to avoid future liability is to reclassify questionable independent contractors as employees. After determining the identity of the 1099ers, counsel should undertake an individualized assessment as to whether each person or class of persons so identified is legally an independent contractor or actually a common law employee.

The legal test for independent contractor or employee status varies according to the law being enforced. The IRS abandoned its fabled 20-factor test several years ago; its current test is supposedly more simplified, focusing on three principal aspects of the worker's relationship with the business: (1) the degree of behavioral control that the business can exercise over the individual; (2) the degree of financial control that the business can exercise over the individual; and (3) the parties' views and perceptions of the relationship. In the employee benefits arena, the U.S. Supreme Court has stated that the test under ERISA focuses upon the hiring party's "right to control the manner and means by which the product is accomplished."<sup>4</sup> Although the Supreme Court, the IRS and state agencies have articulated their criteria for determining employee status, the application of these criteria is oftentimes vexing, even to experienced legal practitioners.

Once a company has completed its assessment for each 1099er, those who do not qualify as independent contractors can be converted to employee status if the company wants to retain their services yet completely avoid future liability. Conversion of a 1099er to an employee classification requires several steps, including withholding of federal, state and local income taxes; payment of Social Security, Medicare and unemployment contributions; payment of premiums for Workers' Compensation coverage; and providing coverage under each of the company's employee benefit plans that cover "employees" generally. Not all employees are required to be covered under all of a company's employee benefit plans, but exclusion is only permissible if the governing documentation for the company's plans is drafted properly and the exclusion does not violate applicable tax or ERISA rules.

## **Bona Fide Restructuring**

Another way to minimize the potential for liability is to restructure the company's relationship with its 1099ers. Where the individuals in question are in the "gray area," a company may be able to solve the problem by making certain adjustments to 1099ers' relationship with the company. Allowing certain 1099ers to set their own hours of work,

perform services from home, supervise their own work, limit their retention to a prescribed period of time, confine their work to specific projects and permit them to work for other companies (subject to applicable confidentiality restrictions) strengthens the independent contractor classification.

Some perfectly legitimate 1099ers work under agreements that may actually lend support to an argument that they are common law employees. A company's independent contractor agreements should be reviewed and revised to confirm a genuine independent contractor relationship and, where appropriate, to reflect any restructurings of the company's relationship with the 1099ers.

## **Employee Leasing**

The use of a responsible employee leasing organization is a practical and viable alternative that allows 1099ers to continue to provide services to the company, yet it substantially minimizes a company's exposure to liability under the tax, employee benefits and labor laws. This alternative can dramatically reduce a company's risk of liability and substantially diminish the likelihood of a lawsuit or an audit by a governmental agency.

Unlike payrolling companies, an employee leasing organization is a third-party employer. Some or all of the company's 1099ers (as well as its long-term temps, project employees, per diems and consultants) can be hired as employees of the leasing organization, which withholds taxes; makes Social Security, Medicare and unemployment payments; pays Workers' Compensation premiums; and may also provide basic medical and dental benefits and offer participation in a 401(k) plan maintained by the leasing organization.

## **Conclusion**

Now that the IRS and the states have prioritized and targeted employer misuse of independent contractors, companies that use 1099ers to supplement their work force should examine whether they may have legal exposure for employee misclassification. If the potential tax, employee benefits or labor law liability is significant, companies would be wise to seek the most appropriate ways to eliminate or minimize their exposure and comply with laws governing the use of independent contractors. A coordinated, interdisciplinary approach may best serve the company's interests.

There is a significant economic inducement to avoid an array of payments required to be made for employees but not for independent contractors. Along with lax enforcement in the past by the IRS and state agencies, these financial incentives have led many businesses to overuse the independent contractor classification.

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#### **Endnotes:**

1. Some businesses may be able to take refuge in a safe harbor provided in §530 of the Revenue Act of 1978. This provision generally permits a business to treat a worker as an independent contractor for employment tax purposes, regardless of the worker's individual status under common law or statutory designation, if certain requirements are met. The two general conditions necessary for possible §530 safe harbor relief is that the taxpayer did not treat the worker as an employee for any prior period, and the taxpayer had a reasonable basis for treating the workers as independents. Safe harbor relief is available in limited situations. It may therefore have no applicability to legal challenges by agencies other than the IRS or in lawsuits by workers who claim they are common law employees.
2. See *Salamon v. Our Lady of Victory Hospital*, 514 F.3d 217 (2d Cir. 2008).
3. See *D'Annunzio v. Prudential Ins. Co. of America*, 192 N.J. 110 (2007); *Stomel v. City of Camden*, 192 N.J. 137 (2007).
4. *Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318, 323 (1992).