

in the law

the potentially expensive line between “employee” and “independent contractor”

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The economic downturn is prompting states to step up their enforcement of labor rules with significant implications for our industry. Early this year, the New York Times discussed the many – sometimes unorthodox – tools states are considering and implementing to raise revenue. “What’s pushing it is this incredible desire to raise revenue,” says Scott Pattison, executive director of the National Association of State Budget Officers. “But it’s coupled with the desire not to raise the general and sales and income taxes.”

Among such efforts are the states’ aggressive collection of “unpaid” taxes and penalties from employers who misclassify their employees as “independent contractors.” We have observed an increase in employer audits in debt-ridden states like California, which are more vigorously scrutinizing worker classification in order to collect money without raising taxes.

Prior to the recent economic downturn, it was not uncommon for companies in our industry to retain the services of individuals or firms on an independent contractor basis to contribute to a project. But with the declining economy, our industry has significantly increased the practice of using independent contractors. However, as projects develop and expand, independent contractors often start showing up every day for work and otherwise acting like regular employees, blurring this important line.

It’s important to know the factors that differentiate an independent contractor from an employee so you can properly classify your workers and retain “independent contractor” status for those so classified. The applicable laws are essentially uniform across all states; most states have adopted some form of the

Internal Revenue Service’s “Common Law Rules” to determine whether a worker is an employer or an independent contractor. Those are:

1) Behavioral Control: The more a business has the right to direct and control how the worker does the job, the more likely it is that the worker is an employee. If a staff member performs project work under your consistent supervision and control, they should probably be classified as an employee.

- a. An employee, as opposed to an independent contractor, is generally subject to the business’ instructions about when, where and how to do the work.
- b. An employee likely receives training from the business as to how to perform the job; an independent contractor uses his own methods.

2) Financial Control: If your staff is largely financially dependent upon you, then they likely should be classified as employees.

- a. Independent contractors are more likely to have unreimbursed expenses than employees.
- b. Independent contractors often have a significant investment in the facilities or equipment he uses to perform work for someone else.
- c. Independent contractors are usually free to advertise their work and seek out other business opportunities. In the event of an audit, it is important to highlight that many in industry work on multiple projects simultaneously.
- d. An employee is generally guaranteed a regular, consistent wage amount, paid on a regular basis.
- e. An independent contractor can make a profit or loss.

3) Type of Relationship:

- a. Written contracts can be helpful, but not dispositive, in creating an “independent contractor” relationship. Employers are often well served by an independent contractor agreement which is designed to shape the parties relationship to meet this test. However, the mere fact that a contract describes a worker as an “independent contractor” is not determinative; the law requires an investigation of the true nature of the employment relationship.
- b. An employee receives benefits like insurance, vacation pay, sick pay, etc.
- c. Employees are usually engaged with the expectation of a permanent relationship, rather than for a specific project or period.
- d. If the worker performs work that is a key part of the business’ regular activity, that worker is more likely an employee.

When deciding how to classify someone, it is also useful to keep in mind that individuals with professional degrees (i.e. architects etc.) are generally more likely to be viewed as independent contractors by auditors.

Although classifying workers as independent contractors may seem like a cost-effective short-term strategy, the expense of defending an audit and paying penalties may far outweigh any savings. Moreover, in certain circumstances, states can hold business owners, officers and directors individually liable. It can be confusing and difficult to properly apply the independent contractor versus employee test. You may need to consult an experienced employment attorney to assess your unique circumstances and maximize your protection against adverse audit results. **ipm**

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