

ARNSTEIN & LEHR LLP

**Employment Law for Businesses –
Easy Steps to Protect Your Business**

**Independent Contractor v. Employee -
Why it Matters and What You Can Do About It**

March 14, 2012

Independent Contractor v. Employee – Why it Matters and What You Can Do About It.

- I. Why Is This Topic Important?**
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- IV. What Is an Employee and Independent Contractor?**
- V. What Can You Do to Protect Your Company?**
- VI. Insurance Implications/Protections.**
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I. Why Is This Topic Important?

“Few problems in the law have given greater variety of application and conflict in results than the cases arising in the borderland between what is clearly an employer-employee relationship, and what is clearly one of independent entrepreneurial dealing.”

***NLRB v. Hearst Publications*, 322 U.S. 111, 121 (1944).**

I. Why Is This Topic Important?

- **Every employment law statute contains its own unique definition of the term “employee.”**
- **State and federal agencies use different tests.**
- **And an individual who may qualify as an independent contractor under one test may, in fact, be deemed an employee under a different test.**

I. Why Is This Topic Important?

Example: Class of workers deemed to be employees pursuant to the Illinois Department of Employment Security and independent contractors by the Illinois Department of Labor.

Example: FedEx Ground driver lawsuits – hundreds of lawsuits around the country by federal express drivers who are claiming they are employees, as opposed to independent contractors.

I. Why Is This Topic Important?

- No “one size fits all” answer
- Fact specific inquiry
- Leave today with a better understanding of how to identify the issues and help determine worker’s proper classification

II. Benefits of Independent Contractors.

- **Decreased FICA Contributions**
- **No Workers' Compensation Premiums**
- **No Unemployment Insurance Premiums**
- **No FLSA Overtime Pay**
- **No Requirement to Provide Employee Benefits**
- **Reduction of Training and Other Administrative Costs**

II. Benefits of Independent Contractors.

- **Reduction of Overhead Costs**
- **Expertise in Specific Area**
- **Flexibility in Increasing and Decreasing Workforce**
- **No Liability Under Federal Employment Laws (Title VII, ADA, ADEA, FMLA, WARN Act, IRCA, NLRA)**
 - Caveat: Still Do Not Allow Harassment (Section 1983, 1985).**

III. Drawbacks of Independent Contractors.

- 1. Loss of Control Over the Contractor.**
 - **Contractor generally set their own hours**
 - **Lack of uniformity in process**
 - **Not trained in a specific way**
 - **Potential restrictive covenant enforcement problems**
- 2. Increased Liability for Injured Contractors.**

III. Drawbacks of Independent Contractors.

3. Significant Liability for Misclassification.

- **IRS can re-characterize the relationship and seek back federal taxes plus penalties**
- **IDES can seek unemployment insurance compensation**
- **Entitlement to insurance and other benefit plans (ERISA)**

III. Drawbacks of Independent Contractors.

4. Potential Loss of Intellectual Property.

- **Absent a written agreement, intellectual property created by the independent contractor belongs to the contractor, and not the employer.**

5. Joint Employer Liability

IV. What Is an Employee and Independent Contractor?

Labels DO NOT Matter.

You can call a worker anything you want, but if a company treats the worker like an employee, the worker will be deemed an employee.

IV. What Is an Employee and Independent Contractor?

There are 4 primary tests used to determine whether a worker is an employee or independent contractor:

- 1. The Right to Control Test**
- 2. Economic Reality Test**
- 3. The Hybrid Test**
- 4. 20-Factor IRS Test**

IV. What Is an Employee and Independent Contractor?

Right to Control Test

Standard common law test traditionally used.

Emphasizes the importance of the employer's control over the worker.

IV. What Is an Employee and Independent Contractor?

Right to Control Test (cont'd)

There are several factors considered in this test, none of which is dispositive or conclusive:

- 1. Degree of control exercised by employer over details of work (e.g., hours, hiring of assistants, etc.)**
- 2. Whether the worker's occupation is usually done without supervision.**
- 3. Whether the worker provides his or her own tools, supplies and place of work.**

IV. What Is an Employee and Independent Contractor?

Right to Control Test (cont'd)

- 4. Whether the parties believe they are creating an independent contractor relationship.**
- 5. Method of payment (e.g., by job or paid hourly)**
- 6. Worker's opportunity to perform work for others**

Generally found to be too rigid, so other tests have been implemented largely replacing the Right to Control test.

IV. What Is an Employee and Independent Contractor?

Economic Reality Test

This test is most often used to determine worker status for purposes of federal remedial statutes, like the FLSA, FMLA, Equal Pay Act, etc.

There are many factors to consider in this test, none of which is dispositive or conclusive (totality of circumstances):

IV. What Is an Employee and Independent Contractor?

Economic Reality Test (cont'd)

- 1. Nature and degree of the alleged employer's control as to the manner in which the work is to be performed;**
- 2. The alleged employee's opportunity for profit or loss;**
- 3. The alleged employee's investment in equipment or materials required for his/her tasks;**

IV. What Is an Employee and Independent Contractor?

Economic Reality Test (cont'd)

- 4. Whether the services rendered are a part of the employer's regular business;**
- 5. Whether the services rendered require a special skill;**
- 6. The degree of permanency and duration of the working relationship.**

IV. What Is an Employee and Independent Contractor?

Hybrid Test

Courts have also evaluated employment relationships in the context of Title VII and the ADEA using a hybrid test, basically a combination of the Right to Control test and the Economic Realities test.

Among the elements above, the courts focus on the following elements:

IV. What Is an Employee and Independent Contractor?

Hybrid Test (cont'd)

1. Whether the employer has the right to hire and fire;
2. Whether the employer has the right to supervise;
3. Whether the employer has the right to set work schedule;

IV. What Is an Employee and Independent Contractor?

Hybrid Test (cont'd)

4. Whether the employer is paying the worker a salary (including withholding taxes and providing benefits);
5. Whether and to what extent the employer is setting the terms and conditions of the relationship.

IV. What Is an Employee and Independent Contractor?

IRS 20-Factor Test

For federal tax purposes, some administrative agencies may sometimes look to the 20 factors originally generated by the IRS to determine what kind of relationship exists between employer and worker.

IV. What Is an Employee and Independent Contractor?

IRS 20-Factor Test (cont'd)

While comprehensive, it was not originally designed for doctors, lawyers, other service industry professions, etc. As such, the 20-Factor test which used to be outlined in the CFR has been removed and the IRS now focuses on 3 main categories:

IV. What Is an Employee and Independent Contractor?

IRS 20-Factor Test (cont'd)

1. Behavioral Control.

Is there evidence that indicates whether the employer has the right to control or direct the worker in performing the responsibilities for which the worker was hired?

- *Example:* training given to worker, instructions given to worker, hours and location of work set by employer, etc.

IV. What Is an Employee and Independent Contractor?

IRS 20-Factor Test (cont'd)

2. Financial Control.

Is there evidence that would indicate that the employer has the right to direct and control the business aspects of the worker's activities?

- *Example:* whether the worker has other engagements, whether the worker incurs any personal expenses in the business operations, etc.

IV. What Is an Employee and Independent Contractor?

IRS 20-Factor Test (cont'd)

3. Relationship of the Parties.

Is there any evidence that would indicate how the parties view their relationship?

- ***Example:*** whether the parties are free to terminate the relationship at will, the duration of the relationship, etc.

V. What Can You Do To Protect Your Company?

I have developed a Checklist – The Tremblay Test – you can use at your company to ascertain whether or not you are on good footing to argue your workers are independent contractors.

V. What Can You Do To Protect Your Company?

Tremblay Test

- Does the worker provide services to the public at large?
- Does worker have his or her own office?
- Does the worker advertise his or her services in newspapers, yellow pages, journals or other media?

V. What Can You Do To Protect Your Company?

Tremblay Test (cont'd)

- Does the worker maintain a separate business bank account?
- Is the worker able to retain helpers and assistants without the employer's approval?
- Does the worker furnish his or her own tools and equipment?

V. What Can You Do To Protect Your Company?

Tremblay Test (cont'd)

- Does the worker have certificate of incorporation, partnership or other business filings?
- Does the worker file his or her own federal income tax schedules every year?
- Does the worker pay his or her own workers' compensation and/or provide a waiver of workers' compensation coverage?

V. What Can You Do To Protect Your Company?

Tremblay Test (cont'd)

- Has the worker made a significant investment in the business, for example, purchasing or leasing of a building or office space?
- Does the worker hold any particular license or other specific skills that the company does not maintain?
- Is the worker performing special, unique skills for the company?

V. What Can You Do To Protect Your Company?

Tremblay Test (cont'd)

- Does the company file and submit 1099 forms for the worker's pay?
- Does the worker get paid on a project basis rather than on a hourly, weekly or monthly basis?
- Does the worker invoice the company for the services provided?

V. What Can You Do To Protect Your Company?

Tremblay Test (cont'd)

- Is the worker allowed to dictate the when, where and how of the particular project?
- Does the worker generally set his or her own hours?
- Is the worker allowed to work off the company's premises?
- Is the worker allowed to work for more than one company at a time?

V. What Can You Do To Protect Your Company?

Tremblay Test (cont'd)

- Is the worker insulated from being terminated as long as he or she produces the result under the contract's specifications?
- Does the worker have his or her own business cards and marketing materials?
- Is the worker free from training by the company?

V. What Can You Do To Protect Your Company?

Tremblay Test (cont'd)

- Does the worker perform a function for the company that other employees at the company are unable to perform?
- Does the worker have his or her own federal identification or IDES number?
- Is the employee not entitled to benefits from the company?

VI. Insurance Implications/Protections

Workers' Compensation Implications

Why does it matter if you hire an independent contractor and they don't have Workers' Compensation coverage?

VI. Insurance Implications/Protections

Workers' Compensation Implications (cont'd)

- **Most insurance carriers in Illinois will consider the independent contractor an employee and will provide insurance coverage leading to increased premiums.**

VI. Insurance Implications/Protections

Workers' Compensation Implications (cont'd)

- **Many insurance carriers are requiring certificates of insurance evidencing coverage for each independent contractor. If not provided, the insurance carrier will add the cost of the contractor to the workers' compensation policy and the business will be charged the additional premium.**

VI. Insurance Implications/Protections

Workers' Compensation Implications (cont'd)

***Example:* ABC Construction Company hires an independent contractor - sole proprietor - to do specialty woodworking for one of their remodel clients. Contractor injures himself and sues ABC claiming he was an employee.**

VI. Insurance Implications/Protections

Workers' Compensation Implications (cont'd)

How does the hiring company protect itself?

- 1. Obtain certificates of insurance from all independent contractors which evidence coverage for both general liability and workers' compensation.**
- 2. Require all independent contractors to list you as an additional insured on their general liability and workers' compensation policies.**

VI. Insurance Implications/Protections

Workers' Compensation Implications (cont'd)

- 3. Have a written contract between the hiring company and the independent contractor.**
- 4. Have a discussion with your insurance agent prior to hiring an independent contractor—send over the certificate of insurance to make sure they have the correct coverage necessary.**

VI. Insurance Implications/Protections

EPLI Implications

What is Employment Practices Liability Insurance?

Employment Practices Liability Insurance (EPLI) typically covers allegations of discrimination, wrongful termination and sexual harassment of employees.

VI. Insurance Implications/Protections

EPLI Implications (cont'd)

Over the past decade, the number of discrimination cases has more than tripled in the United States.

Statistics show that businesses are more likely to face an employment claim than a property or general liability claim.

VI. Insurance Implications/Protections

EPLI Implications (cont'd)

At the close of 2011, the EEOC:

- received 99,447 charges from employees alleging employment practices violations;**
- obtained the highest ever monetary recovery on behalf of employees—\$364.6 million.**

VI. Insurance Implications/Protections

EPLI Implications (cont'd)

Including the cost of defense, the average cost to defend an EPLI claim is around \$125,000.

Small firms are just as vulnerable as large firms. Statistics show that firms with 15-100 employees actually suffer over 40% of all EPLI claims.

VI. Insurance Implications/Protections

EPLI Implications (cont'd)

How does any of this information apply to Independent Contractors?

If an independent contractor requires the company they contract with to indemnify them in case of liability, in an employment practices related matter these individuals are considered employees and would have actionable rights of recovery against the hiring company.

VI. Insurance Implications/Protections

EPLI Implications (cont'd)

Most Employment Practices Liability Insurance contracts consider Independent Contractors as employees and thus covered by the policy. Under an EPLI contract risk associated with Independent contractors could come in two forms:

VI. Insurance

Implications/Protections

EPLI Implications (cont'd)

- **First Party liability refers to claims made by an employee who alleges that another employee engaged in discrimination, harassment, retaliation, etc.**
- **Third-party employment practices liability refers to claims made by non-employees, usually customers, who allege that an employee engaged in wrongful conduct, typically sexual harassment or discrimination.**

VI. Insurance Implications/Protections

EPLI Implications (cont'd)

Claims Examples

VI. Insurance Implications/Protections

EPLI Implications (cont'd)

Example 1

Summer party harassment Award of \$250K

At Staffing Firm's summer picnic one of the partners, after he had consumed a number of alcoholic beverages, made derogatory remarks toward one of the firm's invited independent contactors. The contactor then tried to leave the situation only to have the partner continue on his tirade. A few other company partners over heard the insults yet did nothing to assist the contactor, who was noticeably uncomfortable.

VI. Insurance Implications/Protections

EPLI Implications (cont'd)

Example 1 (cont'd)

Soon after the party the company received a demand letter from an employment attorney on behalf of the contactor, alleging harassment and seeking emotional distress damages from the partner for the rude behavior and from the company for aiding and abetting in the harassment. The insurance carrier defended the suit but the contactor was eventually awarded \$250,000.

VI. Insurance Implications/Protections

EPLI Implications (cont'd)

Example 2

Department Stores Suit Award of \$1.56M

A federal jury in Kansas City, Kansas awarded \$1.56 million to a woman who said she had been stopped and searched by department store's contracted security guards because of her race. Evidence presented during her civil suit indicated that the department store in systematically placed black customers under intense surveillance even when they exhibited no suspicious behavior.

VII. Recent Legislation/Trends/IRS Guidance

DOL/IRS Information Sharing Agreement

The U.S. Department of Labor (“DOL”) has entered into agreements with the IRS, as well as some state agencies (including Illinois state agencies), to share information regarding employers who have improperly classified employees.

VII. Recent Legislation/Trends/IRS Guidance

Effect: If the DOL determines that an independent contractor is misclassified, it can share that determination and evidence with, for example, the Illinois Department of Employment Security or other state agencies, which could very well lead to additional investigations, fines, fees and liability upon the business beyond those by IDOL.

VII. Recent Legislation/Trends/IRS Guidance

Voluntary Classification Settlement Program

The VCSP is intended to encourage employers who have misclassified workers, for a relatively small payment to the IRS, to reclassify those workers as employees for federal employment tax purposes.

VII. Recent Legislation/Trends/IRS Guidance

Allows employers to avoid all but 10% of the past employment tax liability that the companies would have owed for prior years.

The IRS will also not conduct employment tax audits of the companies for prior years with respect to the classification of the workers.

VII. Recent Legislation/Trends/IRS Guidance

To be eligible for the VCSP, employers must:

- 1. consistently have treated the workers as non-employees;**
- 2. have filed all required 1099s for the workers for the prior three years;**
- 3. not currently be under audit by the IRS, Department of Labor or any state agency concerning the classification of workers.**

VII. Recent Legislation/Trends/IRS Guidance

- 4. agree to prospectively treat the workers as employees,**
- 5. pay 10% of the federal employment tax liability that may have been due on compensation paid to workers for the most recent year, and**
- 6. allow a six-year statute of limitations on the assessment of IRS employment taxes for the first three calendar years after the employer is enrolled in the IRS Program.**

VII. Recent Legislation/Trends/IRS Guidance

Potential Problems: Reclassifying workers as employees raises many issues other than federal employment tax issues, including retirement benefit plan issues, state tax classification issues, unemployment and workers' compensation tax issues and health and welfare benefit plan issues.

VII. Recent Legislation/Trends/IRS Guidance

Companies choosing to participate in the VCSP will also have to begin providing employee benefits, comply with wage and hour laws and comply with all other federal and state employee obligations to the reclassified employees.

And, since the VCSP would not provide any amnesty for violations of other laws, such as state or federal overtime laws or state tax law violations, care must be given before deciding to whether to participate in the VCSP.

VII. Recent Legislation/Trends/IRS Guidance

California “Job Killers” Act

California law provides for fines on employers who misclassify workers as independent contractors, mandates certain record keeping and notice requirements, as well as provides joint and several liability for any person who “knowingly advises” an employer to misclassify a worker as an independent contractor.

As a result, any company with workers located in California, especially those with workers that are classified as independent contractors, should be extremely careful as to how they classify those workers.

VII. Recent Legislation/Trends/IRS Guidance

Proposed Federal Legislation

There are always draft proposals in Congress trying to reduce use of independent contractors.

- **Employee Misclassification Act (H.R. 3178)**
- **Fair Playing Field Act of 2012 (H.R. 4123)**

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Questions?

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