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Do's and Don'ts When Using Independent Contractors

By Robert W. Wood

Business lawyers must be flexible and advise their clients on a plethora of legal issues. Clients expect them to not only provide accurate legal advice, but to also provide it in a practical and digestible form. Often, particularly given the fast pace of business today, business lawyers are in the unenviable position of being forced to give a kind of template for how a situation should be resolved.

This is understandable, because their clients must make many decisions. It is not always possible to stop the flow of business and to seek legal advice on every point. Yet actions the client may take can have enormous implications for overall liability, as well as particular employment law and tax implications both immediately and for many years into the future.

The decision whether to hire a worker as an employee or an independent contractor is a significant one with fingers in a large number of pies, with regulations from the IRS, the Department of Labor and employment statutes, and state unemployment insurance authorities. In fact, it is hard to think of a more consequential business decision. Yet paradoxically, the question whether to hire someone in one capacity or the other may garner little attention from business people.

Because of the potential for staggering tax and other liabilities such decisions can trigger, business lawyers must be vigilant. Far from being a one-time or immediate problem, the issue has significant legal implications down the road. When a business client hires workers in any capacity, they understandably focus on business objectives. Whether or not the arrangement works out well, clients tend not to revisit fundamental questions such as whether the workers should be independent contractors or employees.

Businesses can avoid major landmines if they consider these topics from time to time. Business lawyers can serve a key function in this regard. Business lawyers should encourage their clients do so when additional workers are brought on, when the tenure and nature of the relationship changes, when the tasks expected of the worker expand or contract, or when other terms and conditions of the work change. The worker's role may morph into something quite different from what it was at the inception of the relationship. That can impact the status of the worker as an employee or independent contractor.

Here are the top 10 mistakes I see committed by companies in using workers the company may believe are safely independent contractors but who may actually turn out to be reclassified as employees.

1. **Not Having a Written Contract**
   Failing to have *any* written agreement for independent contractors is a recipe for disaster. If you hire a plumber for a one-time toilet fix and pay out $200, I would not worry that he or she is an employee. Yet it is surprising how many businesses have regular and long-term workers—on their premises or off—paid month after month and year after year as independent contractors without a written contract.

   As a business lawyer, if you become aware of such a situation, take steps to warn your client. Without a written contract, your client is virtually doomed to fail in any dispute over the status of the worker, no matter how strong the client's independent-contractor facts may be.

   The taxing, labor and employment, and insurance authorities expect a written contract that states that the worker is an independent contractor and will be paid as such with no tax withholding, no benefits, etc. *See Illinois Tri-Seal Prods., Inc. v. United States*, 353 F.2d 216, 218 (1965). Plainly, such a contract does not by itself mean the worker is really an independent contractor, but the lack of a written contract will make employee status much more likely.

   Furthermore, your client may even have a dispute with the worker directly. If the worker later claims that he or she considered him or herself to be an employee, to what will your client point as a contrary indication?

2. **Treating Similar Workers Differently**
   Many businesses have some employees and some independent contractors, and

there is nothing improper in so doing. However, it is inappropriate to have to have one worker selling shoes on an independent-contractor basis and another similarly situated worker doing the same thing as an employee. The same can be said for having some employee messengers and some independent-contractor messengers (or sales people, computer programmers, or what have you).

The risk of treating similarly situated workers differently is that the workers you are trying to treat as independent contractors may be reclassified as employees. For example, in *Institute for Resource Management Inc. v. United States*, 22 Cl. Ct. 114 (1990), no safe harbor was available for employment tax treatment of any worker who was treated as an independent contractor if the business treated any worker holding a substantially similar position as an employee for employment tax purposes. In other words, you set yourself up for trouble by having the two differently classified workers for ready comparison by the IRS, state tax authorities, labor or employment agency, or other authority. They all look for this tell-tale sign.

Advising a client in this area requires that you help the client to make significant distinctions between the two types of workers. Some companies are able to have two groups of workers do essentially the same type of work—such as independent-contractor sales agents and employee sales agents. However, business lawyers need to be very careful in helping clients navigate these waters.

3. Providing Tools and Supplies

One of the hallmarks of independent contractors is that they are required to supply their own tools, equipment, and supplies. Rev. Rul. 71-524, 1971-2 C.B. 346 ruled that a trucker working for a trucking company that leased vehicles (and provided maintenance) was an employee. *See also* Rev. Rul. 87-41 1987-1 C.B. 296, point 14. As with just about everything else in the contractor versus employee characterization realm, this is not dispositive by itself. However, it is certainly something reviewed in making a thumbs-up or thumbs-down decision.

After all, independent contractors are classically independent business people or professionals. It makes sense that they would bring their own ladder, shovel, or paint brush. A company that purports to have independent contractors but that supplies a desk, chair, computer, software, and telephone—everything they need—may not be very convincing in a worker status dispute. As this example suggests, this problem may be most common with office work. Still, it can arise in virtually any setting. In this age of high technology, it is not easy to determine exactly what will be regarded as tools, supplies, and equipment. The safest bet may be to make sure you don't provide anything. But that can be impractical. (For possible ways around this conundrum, *see* No. 5 "Paying By the Hour" below.) As a lawyer advising in this area, get as many facts from your client as you can, and try to be creative.

4. Reimbursing Expenses

Another red flag is the extent to which your client reimburses workers for their business expenses. *See* Rev. Rul. 55-144, 1955-1 C.B.483, where an individual had his business expenses recouped by his auto dealership employer and was deemed to be an employee. *See also* Rev. Rul. 87-41, 1987-1 C.B. 296, point 13. If workers work late, does your client pay for their dinner or a taxi? If they need special paper for the report they are producing, does your client provide it or reimburse them?

There is no bright line saying one can't cover the expenses of an independent contractor, but doing so can suggest the worker is an employee. Classically, all such items are supposed to be factored into the price you are paying the independent contractor for a finished product. As a result, reimbursements and reimbursement policies are likely to be reviewed if your client becomes involved in a worker classification dispute.

Lawyers should point out these risks to clients. Your clients might think they are being magnanimous to cover such items. The reality is that the clients may be blurring the line between the employees and independent contractors.

5. Paying By the Hour

How a business pays someone is about a fundamental a work-variable as one can get. And it can be one of the most fundamental indicators of whether a worker is an employee or an independent contractor. *See* Rev. Rul. 87-41, 1987-1 C.B. 296, point 12. Classically, one pays a contractor for a job, like putting a pool in your backyard, repairing your computer system, or putting in a break room at your office. In contrast, one classically pays employees by the hour or by the week.

Yet it is surprising how many businesses don't think about this issue, much less explore ways to package it. There is no rule saying that one cannot pay an independent contractor by the hour. After all, that is how most lawyers bill time to their numerous clients.

But when one has alternatives, paying by the hour can be unwise. Consider whether you can come up with a payment regimen that fairly covers all the elements going into the work and yet that is independent contractor-like in scope. Ideally, a project fee or success fee is more consistent with independent-contractor status than an hourly rate. Help your clients to be creative in considering compensation alternatives.

Furthermore, you may be able to help your client to address any tool, equipment, and supply issues, and even expense reimbursements, as part of the payment formula you devise. As the discussion of those topics noted (*see* No. 3 "Providing Tools and Supplies"

and No. 4 "Reimbursing Expenses" above), you don't want to provide items that are employee-indicators. Yet if an independent-contractor worker arrives at the job site with no hammer, understandably, you may want to provide one.

The answer may be to do so but to have the business charge back the worker for the item provided. The worker could have the charge subtracted from his invoice at the end of the week. As a lawyer, you may find that a little creative thinking with independent contractors will help your clients to remain in the same place economically but with a vastly better appearance, viz., the likelihood independent-contractor treatment will be upheld.

6. Failing to Have Consistent Forms and Documents

The fact that your client calls someone an independent contractor does not make it so. An "employee lounge" sign in an office does not mean only employees can go there. The fact that one pays a worker based on a time card and then issues a check and paystub does not make him or her an employee. But all these things add up.

Sometimes, after all, something is what you call it. So help your clients consider whether they should have an "employee file" for each employee and use a different name for independent contractors. Ask your clients to consider if independent contractors should turn in an "invoice," not a time card. Ask your clients to consider whether independent-contractor discipline should be handled in exactly the same way as employee discipline. Usually, changes in terminology or substance can be made that may not impact your client's business but that may help your client materially to bolster independent-contractor treatment.

7. Over-Supervising

With an independent contractor, one is paying for a product or result. With an employee, one is paying for him or her to do what is asked, whatever that might be. With employees, one controls not only the nature of the work, but the method, manner, and means by which they do it. In *Alford v. United States*, 116 F.3d 334 (8th Cir. 1997), for example, a church pastor was ruled at the district court level to be an employee, but the ruling was reversed by the Eighth Circuit based on the lack of institutional control the national and regional churches had over the operation of his church.

This control factor is the most over-arching point in this area. It is also the most over-arching way in which clients can end up in trouble with workers they believe are independent contractors but who might be ruled otherwise. How much does your client check in with workers, monitor what they are doing, or make suggestions? How frequently must the workers check in with your client and report how and what they are doing?

Urge your clients to be very careful with supervision and control. The mere fact that an independent contractor must provide a weekly progress report on how the installation of the new laundry room in your house is going does not mean the builder is an employee. But if the report involves constant tweaking and redirecting of the effort, it might be otherwise. *See* Rev. Rul. 70-309, 1970-1 C.B. 199; Rev. Rul. 68-248, 1968-1 C.B. 431; Rev. Rul. 87-41, 1987-1 C.B. 296.

Note that the important inquiry is not merely whether the business is exercising control over the method, manner, and means by which the worker is doing the job. It can even be fatal if your client has the legal right to do thi—even if the client fails to exercise it. Treasury Regulation Sections 31.3121(d)-1(c)(1) and 31.3401 make clear that the common law right-to-control standard is generally controlling in these matters. For that reason, urge your clients to be careful what their contracts and other documents say about reports, supervision, and the like.

8. Requiring Set Hours

One of the classic signs of employee status is a time clock or set office hours. In contrast, with independent contractors, one should normally pay for the result, not exactly when or how the worker does it. *See* Rev. Rul. 87-41, 1987-1 C.B. 296, points 7–8. That does not mean an employer cannot have some control over the hours an independent contractor works.

For example, the fact that you tell your building contractor not to work on your kitchen remodel past 7:00 p.m. does not make him or her an employee. Nevertheless, it is surprising how many businesses fail to consider which workers need to be on a set schedule and which workers do not. Lawyers can be good issue spotters, and should help the client to consider whether certain workers can be allowed to complete work on their own schedule as long as they meet applicable deadlines. Such flexibility can help to show that the workers involved are independent contractors. Conversely, it can be telling if your client dictates a 9 to 5 and fulltime schedule.

9. Prohibiting Competition

Many businesses using independent contractors require full-time work, prohibit competition, or both. Neither of these points alone is likely to be dispositive of an independent contractor versus employee characterization battle. They are merely factors in the determination. For example, an anesthesiologist who entered into contracts with hospitals guaranteeing to have anesthesia services available at any time (a marker of employee status) was deemed to be an independent contractor (*see* Rev. Rul. 57-380, 1957-2 C.B. 634, Rev. Rul. 87-41, 1987-1 C.B. 296, point 17).

For that reason, lawyers should urge business clients to consider whether the business needs such rules and why. Optimally, if your client is paying for a particular result—such as selling a minimum dollar volume of goods each

month—the client should stick to that target. Point out to the client that it may be inappropriate to focus on how long the worker may take to do it or where else they may work during the same period. Those details are arguably irrelevant.

Since requiring full-time work and/or no competition will be viewed as more employee-like in nature, ask your clients to consider whether it is a good idea to dictate these terms. Always bear in mind the paradigm case: an independent contractor like a lawyer or plumber serving many clients or customers. If your clients are worried about the worker giving away the company's business methods or intellectual property to a competitor, make those concerns explicit. Focus on prohibiting the worker from disclosing the company's property. That may accomplish the client's major goal and may be cosmetically much more pleasing.

10. Attempting the Impossible

As a lawyer, it is never easy to be the bearer of bad news. Yet failing to point out obviously flaws in the client's operations or documents can be a mistake and can even result in malpractice liability. If your clients cannot possibly keep their influence and direction over workers to a minimum, cannot possibly let them come and go as they please, cannot allow them to work part-time and for other companies, and can't abide the thought that they may make some of their own decisions, is it realistic for your clients to even try to treat them as independent contractors?

Probably not. In that situation, even if you urge your clients to apply some of the points noted here, the clients may be asking for trouble—either immediately or down the road—if they do not admit face facts.

That may mean simply treating the workers as employees. Sometimes cutting corners ends up costing the business considerably more money in the long run than if appropriate actions were taken in the first place. This occurs over and over with independent-contractor issues. Lawyers are uniquely qualified to offer such perspectives.

As an alternative to a wholesale reclassification, the business could apply this principle in stages, such as by focusing on particular types of workers or even time periods. Lawyers can help business clients engage in a kind of triage to help limit their exposure. Plainly, it is technically wrong to suggest that all short-term workers are independent contractors.

However, a business could try independent-contractor status for short-term workers and those it is trying to evaluate. If the business tries working with someone on an independent-contractor basis for three months as a kind of evaluation period, that might keep them out of company health plans, payroll processing and employment tax returns, and even worker's compensation and unemployment insurance rolls.

If the worker settles in well, the company could bite the bullet and treat them as employees. If the worker fails, the company could assume that even if the person is later recharacterized as an employee, the company's financial exposure should be fairly limited. For example, if your client "fires" such a worker after two months, will he qualify for unemployment benefits?

The object of this kind of approach is to limit the business client's exposure. At least the big picture would be better because the company's long-term workers would be employees. Even if the company ends up losing a worker-status dispute later, the employment tax or other liabilities for short-term workers should be fairly limited. In contrast, if the company is aggressive with widespread independent-contractor treatment and fails to take some of the steps I advocate here, the company could have staggering liabilities.

Conclusion

Business lawyers must often wear multiple hats, and this may particularly be true in such fundamental legal issues as worker status. Yet the role of the lawyer in helping clients through these circumstances should not be underestimated. Help your clients to evaluate what you are trying to do, what is realistic to expect, and whether your clients are being reasonable.

Moreover, urge your clients not to make this a static or one-time process. Like an annual medical checkup or annual visit with an estate planning lawyer over the terms of a will, companies and their counsel should periodically evaluate workers, their status, duties, and treatment. The more frequently companies do it the less likely it will be that they have major problems to address. As a lawyer, you should be suggesting these evaluations even if your clients are not volunteering. The optimum time for evaluations and for addressing these worker status issues is before there is a lawsuit, audit, or investigation. Don't wait.

Robert W. Wood *practices law with Wood & Porter in San Francisco and is the author of Taxation of Damage Awards and Settlement Payments (4th Ed. 2009), Qualified Settlement Funds and Section 468B (2009), and Legal Guide to Independent Contractor Status (5th Ed. 2010), available at www.taxinstitute.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.*