

# Independent contractor classification can be a tricky issue

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One of the most basic questions a company may face is whether a worker should be classified as an employee or an independent contractor. As businesses adapt to fluctuating personnel needs, changing technologies, hiring freezes and administrative costs, they are selecting more independent contractors for short-term projects or for work that requires special skill and knowledge.

The employee versus independent contractor determination is not, however, always a simple matter.

The dangers and costs associated with misclassifying workers as independent contractors were highlighted in a class-action lawsuit filed against Microsoft Corp. on behalf of thousands of independent contractors seeking entitlement to benefits given to Microsoft employees. In an audit preceding the lawsuit, the Internal Revenue Service determined that certain free-lance personnel retained by Microsoft pursuant to independent contractor agreements were actually employees for federal withholding and payroll tax purposes.

A group of the misclassified workers filed a lawsuit against the company, claiming eligibility for various benefits under the company's lucrative deferred-savings and stock-purchase plans. Ultimately, in 2000, Microsoft settled for roughly \$97 million, compensating the workers for back salary and for the value of the stock they would have been eligible to buy if they had been on the payroll as employees.

As Microsoft found, misclassifying a worker can be a costly mistake and may lead to potential exposure to additional taxes, penalties and interest; additional wages and overtime obligations; workers' compensation and unemployment liabilities; and claims for entitlement to employee benefits, including medical insurance coverage and rights to 401(k) matches.

It is important for businesses to understand the factors that will be considered by courts, as well as the IRS, to determine a worker's classification.

How the parties themselves classify the relationship is not relevant. Instead, the courts will look to their actual relationship.

Generally, an employer-employee relationship exists where the employer retains the right to control and direct the manner and method of the work. A number of factors may be considered in determining which party retains the right of control and thus, whether the worker is an independent contractor or an employee.

These factors include:

- whether the worker is required to comply with the business' instructions and attend job specific training;
- whether there is a continuing, ongoing relationship between the worker and the business;
- whether the business sets the hours the worker must work;
- whether the business requires the worker to work full time, prohibiting the worker from performing work for others;
- whether the worker performs work on the business' premises, in a set order and using the business' tools;
- whether the worker is paid by the hour, week or month versus a lump sum;
- whether the worker works for more than one business at a time and makes his services available to the public;
- whether the business has the right to discharge the worker; and
- whether the employer pays Social Security taxes on behalf of the worker

No single factor in itself is controlling, and all of these factors aren't required to reach a determination. Instead, the courts and the IRS will consider each factor, along with all other circumstances, to determine whether the worker possessed the degree of independence necessary to be classified as an independent contractor.

In addition to tax, wage and benefits issues, these factors of control have been used to determine whether a business should be held responsible for the actions of its workers when, during the course and scope of their activities, they caused some injury to a third party. These factors can also determine a person's right to workers' compensation and unemployment benefits.

The employee-independent contractor distinction is critical also to determine whether a particular worker is entitled to the protection of state and federal laws designed to protect employees. These include the Fair Labor Standards Act, title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act, the Employee Retirement Income Security Act of 1974, and the Americans with Disabilities Act.

Businesses must be aware that simply designating an individual as an independent contractor will not result in a legal determination to that effect in the event the classification is challenged. Instead, to avoid finding themselves in the same position as Microsoft, businesses must carefully review the facts and circumstances of each situation to arrive at the appropriate classification for a particular worker.

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