



# INDEPENDENT CONTRACTORS: PRESERVING THE MODEL IS AN ECONOMIC IMPERATIVE

by  
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Independent contractors play a key role in nurturing economic growth. They embody the U.S. economic system's flexibility, which allows our business and entrepreneurial sector to be the most dynamic, productive and innovative in the world. The independent contractor model is an effectual path to wealth creation through business start-up and growth. While abuse in the system exists, the transgressions of the few must not lead to injudicious changes that undermine an approach legitimately used by millions to build successful enterprises.

***Who are These Independent Contractors?*** They are the self-employed – consultants, freelancers and entrepreneurs. They take their own risks with the hope of reaping financial rewards. Control and choice over how one completes his or her work, how much they can charge, and what hours they work are key reasons why individuals pursue independent business ownership. They want to be their own boss.

According to the Bureau of Labor Statistics (BLS), there were 10.3 million people in 2005 working as independent contractors. They account for 7.4 percent of the “employed.” Compared to traditional workers, they tend to be engaged in professional and business services; construction and extraction; financial services; and sales and related occupations.

Independent contractors are content in their status. Fewer than one in ten reported “they prefer a traditional work arrangement,” according to BLS. Indeed, the lure of doing work “they really love” and “being their own boss” is the main appeal for 66 % of adults responding to a recent Harris Interactive/Yahoo! Small Business survey who say they considered starting their own business in the past year.

The U.S. Small Business Administration (SBA) Office of Advocacy reports that self-employment rates increased by more than 5 % between 1979-2003. The growth rates were significantly higher among women and ethnic groups during this period – 33 % for women, 37 % for blacks, and 15 % for Latinos. The explosive growth of business ownership among women and minorities has created more competition, diversity, and innovative products and services. A U.S. Census Bureau study released in April 2006 found black-owned businesses grew 45 percent from 1997-2002. Approximately 1.2 million black-owned firms generated \$88.8 billion in revenue in 2002. Latino and women-owned firms show similarly staggering growth and revenue generation rates.

Being or becoming an independent contractor is a path to financial success and personal fulfillment. Wealth generation and opportunity are not only byproducts for the entrepreneur, but for the economy as a whole.

***Independent Contractors Under the Microscope.*** At times, independent contractors feel they are being unfairly picked on by the government. Agencies at the state and federal level, in response to the shortcomings of a few (and sometimes under pressure to bring in revenues to make up for budget shortfalls), may reflexively clamp down on the entire sector by beefing-up enforcement, increase compliance requirements and fines, or seek to pass legislation aimed at correcting abuses – both real and perceived.

At the federal level, for example, the Internal Revenue Service (IRS) has allocated more resources towards enforcement and other activities that target the small business/self-employed sector. The agency has increased audits three-fold on these taxpayers, and controversial proposals are currently in the works that aim to close the \$345 billion “tax gap” (including withholding schemes proposed by the Taxpayer Advocate’s Office that would

effectively gut the “independence” that independent contractors now have).

For years, small business advocates have urged political leaders to simplify the tax system, streamline the infamous “twenty factor test” governing worker classification rules, and develop effective education strategies to increase compliance rather than punish the many for the misguided or ill-informed actions of a few. No doubt, the shortcomings and confusion of an imperfect system lead to innocent mistakes, hence noncompliance.

The longstanding tension between government and business regarding the need to clarify and simplify worker classification tests continues to simmer. Business advocates firmly believe there is a more effective way to determine employee versus independent contractor status. The IRS has an institutional self interest in making sure independent contractors are, in fact, not employees. The employer is not required to withhold payroll taxes under an independent contractor arrangement, and the agency is concerned that businesses are classifying those who work for them as the latter in order to save money.

At the state level, unemployment compensation insurance agencies, workers’ compensation insurance agencies and tax departments all have their reasons for being concerned about the proper classification of workers. The U.S. Department of Labor is also empowered with regulatory authority over these workers because of the minimum wage and overtime responsibilities of employers.

Being that so many government agencies are concerned with worker classification, one may think they are using the same play book with regards to uniform and straightforward determination rules. That is not the case. Each agency has its own practice, rules, and biases in classifying workers. Of course, such a system breeds complexity for business owners and the self-employed, particularly if they operate on a multi-state basis.

**Common Law “Plus” vs. Common Sense.** “Common-law rules” are used by various government agencies to determine whether an individual is an employee or independent contractor. In sum, these rules suggest an individual is an employee if the employer can control what will be done and how it will be done. What essentially matters is whether or not the employer has the right to control the details of how the services are performed.

Indeed this seems like a pretty simple test. Yet, the IRS (and other government agencies in varying degrees) pursue a common-law “plus” approach. Meaning “all evidence of control and independence” are on the table for examination. Therein lies the rub for independent contractors and the businesses that use their services; the examination of more complex issues above and beyond the simple and straightforward – that is, whether or not the employer controls the details of how services are performed, and where such services are performed to a large extent – leads to arbitrary decision making by examiners or regulators.

Confusing and complex state and federal laws governing independent contractors are no excuse, however, for those who willfully break the law, plead ignorance or test legal limits. In a February 2006 *workindex.com* article, Andrew E. Schultz, President, PrO Unlimited, writes that “corporate America’s ignorance of federal and state regulations is “chilling.” Particularly so given the fact that financial penalties and settlements can be staggering. For example, human resource departments throughout the land are closely following the case against FedEx where independent contractors sued the company claiming they weren’t actually “independent.” The financial hit could be as high as \$1.4 billion, excluding retirement benefits and paid vacation. Businesses across America are taking note.

Unfortunately, high profile cases against bigger corporations – justified or not – often lead to proposals or initiatives that clamp down on everyone. For independent contractors, that means the self-employed “little guy.”

Instead, a simple “common-sense test” must govern worker classification rules. For guidance on such a test, a simple review of why people seek the path of self-employment may be a logical approach: control and choice over how one completes his or her work; financial independence and control with regard to compensation and business investment issues; and, in general, control over when, where and how one works. Simple and straightforward, these components demonstrate both independence and individual control.

**Conclusion.** Simplifying and modernizing the rules governing independent contractors is an appropriate response to fixing a system that causes confusion and undue burdens for businesses and government agencies alike. Erecting barriers that prevent individuals from using a path that has led to the creation of thousands of successful enterprises would be foolish. It may be the instinct of government to impose more rules on business and individuals when laws are being broken or tested, but in the case of independent contractors a more thoughtful approach that includes a balance of enforcement, education, and reform is what’s required to maintain the flexibility and entrepreneurship that makes the U.S. economy the best in the world.