Legal Backgrounder

WLF Washington Legal Foundation

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Vol. 21 No. 19 June 2, 2006

ABUSING INDEPENDENT CONTRACTORS IMPERILS VITAL BUSINESS MODEL

By

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The "independent contractor" model of conducting business affairs is coming under increasing assault from government regulators, labor activists, and plaintiffs' attorneys, who often view the model as an impediment to maximization of tax revenues and to increased unionization of work forces. Such objections are generally wrong-headed and overlook the key role that independent contractors play in driving economic growth and business innovation.

But the free enterprise community is often its own worst enemy in the battle to preserve the independent contractor model. All too often, businesses are tempted to skirt the law by classifying individuals as "independent contractors" who quite clearly are employees. By doing so, businesses do not merely gain an unfair cost advantage over rivals. They also strengthen the hand of those who, if given the chance, would do away with the independent contractor model completely.

Why Independent Contractors?

When most of a person's time is devoted to providing services to a single entity or another individual, that person arguably is an "employee" and thus subject to numerous federal and state laws — *e.g.*, mandatory income tax withholding, minimum wage and overtime laws, employee and employer FICA, workers' compensation, and unemployment insurance. But there are many reasons why such individuals, if they genuinely operate independently, ought to be treated not as employees but as self-employed independent contractors.

Chief among those reasons is the entrepreneurial spirit that comes with being one's own boss. Those who operate their own businesses and whose incomes are dependent on how successfully they perform have much more incentive than do employees both to work hard and to find innovative ways to perform more efficiently. Allowing companies to farm out work to independent contractors rather than hire additional employees allows those companies to operate more efficiently as well. Companies that employ independent contractors can avoid being required to develop in-house expertise in performing specialized tasks and can instead concentrate on undertaking the core functions they do best. Companies can also use independent contractors to increase their flexibility in varying production output in response to fluctuating market demand.

How Much Independence Is Enough?

In general, the law permits an individual to be classified as an independent contractor if he or she controls most of the details regarding how and where work is to be performed. There will always be cases that

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are fairly close to the line that separates employees and independent contractors. In close cases, the analysis can get rather complicated, with administrative agencies applying variants of the infamous "twenty factor test." One can easily have sympathy for companies involved in those close cases; huge amounts of money are often riding on the outcome, yet they often lack clear guidance regarding how those providing services must be classified.

Nonetheless, in most instances the analysis is relatively straightforward, and it should be fairly obvious to a company whether it is controlling how and where the service provider performs his work, and thus whether he must be classified as an employee. An insurance or real estate agent who establishes her own working hours and meets with customers of her choosing on her own schedule quite obviously can be classified as an independent contractor, notwithstanding that all of her work is performed for a single insurance or real estate company. Conversely, individuals hired by Attorney General-designate Zöe Baird and Supreme Court Justice Stephen Breyer to perform assigned domestic chores within their households during assigned time periods quite obviously should have been classified as employees. Many of the classification controversies have arisen not because the outcome was debatable, but because one side or the other was over-reaching.

Over-Reaching Employers

Companies that should know better have succumbed to financial temptation and have classified as independent contractors many individuals who, based on extensive control over how and when they work, should properly be deemed employees. By so doing, companies are threatening the viability of the entire independent contractor model by providing regulators with the ammunition they need to justify efforts to expand the definition of "employee."

Perhaps the area most rife with employer abuse is the construction industry. Sometimes, it seems that virtually everyone present on a construction site is designated an independent contractor, even though the construction foreman is telling workers precisely what tasks are to be performed in what order and in what time frames. A recent study by the Construction Policy Research Center, affiliated with Harvard University, found that as many as 1 in 4 construction companies in Massachusetts have misclassified employees as independent contractors, and the prevalence of misclassification is on the rise. *See* Francoise Carre and Randall Wilson, *The Social and Economic Costs of Employee Misclassification in Construction* (Dec. 2004). Such worker misclassification can relieve employers of considerable employment tax responsibilities. It can also work to the advantage of workers, who realize that the absence of tax withholding on their wages can facilitate under-reporting of income[1] as well as employment of undocumented aliens. But worker misclassification significantly disadvantages other law-abiding employers, who pay their taxes yet must compete with the scofflaws. It also impacts the public at large, which endures underfunding of such programs as workers' compensation funds designed to compensate workers injured on the job.

Other industries with serious misclassification problems include limousine companies and delivery services. When the service that an individual provides to a company consists of driving a vehicle to benefit the company's customers, that individual should almost surely be deemed an employee when the company (as is often the case) retains significant control over when and how the individual performs his services. For example, if a limousine driver wears a company uniform; must service customers designated by the company within a time frame set forth by the company; drives a vehicle meeting detailed company specifications; performs virtually all of his services for that company; and must abide by a detailed set of operating procedures, there is virtually no basis for classifying the driver as an independent contractor. Yet numerous limousine companies that have adopted such working conditions nonetheless misclassify their employees in that manner.

One package delivery company that finds itself facing adverse administrative and court judgments

[1]The Internal Revenue Service estimates that taxpayers pay tax on less than one-half of the income for which the IRS receives little or no reporting information, such as payments made to independent contractors.

  ISBN 1056 3059

regarding misclassification of employees is Federal Express, which classifies drivers in its Ground and Home Delivery divisions as independent contractors. FedEx faces at least 36 class-action lawsuits filed by drivers who claim they really are employees; those suits have been consolidated before a federal court multi-district litigation panel in Indiana. In December 2005, a Los Angeles County Superior Court judge ruled, following a nine-week trial, that FedEx had violated California law by improperly classifying a group of drivers. The court ruled that the drivers were employees and ordered FedEx to pay them $5.3 million, given FedEx's substantial control over the drivers' work activities — including requiring drivers to comply with detailed work procedures, wear uniforms and drive trucks displaying company logos, work a minimum number of hours, deliver all packages assigned to them, and perform virtually all of their work for FedEx. The California court judgment is echoed by rulings from the National Labor Relations Board Region 22 (November 2004), Region 4 (June 2005), and Region 1 (January 2006) that FedEx drivers were misclassified as independent contractors and should be deemed employees.

In general, a company that engages large numbers of individuals to provide services for the company on a full-time basis should seriously consider whether those individuals should be classified as employees, particularly when they provide a service that is a core component of the company's operations. In such situations, the company very often out of necessity will prescribe large segments of the individuals' day-to-day activities — in which case the individuals almost surely should be classified as employees. Unless the individual brings some special "skill set" to the table (*e.g.*, a licensed insurance or real estate agent or an IT professional) such that the individual could easily transfer his services to another company at a moment's notice, a company that classifies such an individual as an independent contractor has little good-faith grounds for doing so. Such individuals cannot legitimately be deemed "entrepreneurs" if they are not building up a business that provides, or even realistically could provide, services to those other than the company's customers.

There are, of course, numerous reasons other than increased taxes why companies would want to keep to a minimum the number of "employees" on their books. For example, while governments impose regulations on the business community that in some cases can legitimately be categorized as onerous, statutes often waive those regulations for companies with fewer than a specified number of employees. But if a regulation is overly burdensome, the response of the business community ought to be to unite to seek a change in the regulation, not to adopt questionable worker classification policies to reduce a company's claimed employee roll as a means of evading the regulation.

Over-Reaching Regulators

But over-reaching is hardly limited to the business community. Government regulators have considerable financial and bureaucratic incentives to expand the definition of "employees" as far as courts and legislators will permit them. If regulators succeed in having those formerly classified as "independent contractors" reclassified as "employees," revenues derived from a variety of taxes and fees (income tax, FICA, unemployment) will rise sharply. Tax collectors are well aware that non-reporting of income is far higher among independent contractors, who generally are not subject to nearly as many reporting and withholding requirements as are employees. Regulators' natural inclination to expand the definition of "employees" is egged on by labor unions (who understand that employees are easier to organize than are independent contractors) and by lawyers (who view litigation regarding alleged misclassification of employees as a growth opportunity for the trial bar).

All too frequently, such over-reaching leads to truly unfortunate enforcement actions and litigation, such as *Fleece on Earth v. Vermont Department of Labor*, a case pending before the Vermont Supreme Court. The case involves a small country store in Vermont (Fleece on Earth, or "Fleece") that sells home-made sweaters. The sweaters are knitted by (usually elderly) women working in their own homes on their own schedules and at their own pace. The only store to whom the women sell is Fleece; the store pays the women on a per-sweater basis. Given the considerable control the women exercise over their own work schedules, Fleece quite

  ISBN 1056 3059

understandably has classified them as independent contractors. The Vermont Department of Labor, apparently seeking to position itself as the champion of elderly workers being "exploited" by the business community, sees things differently. It claims that the knitters should be deemed "employees" and has assessed Fleece for unpaid taxes, unemployment, and workers' compensation. Fleece has appealed that assessment to the Vermont Supreme Court.

In seeking to expand what constitutes an "employee," the Vermont Department of Labor appears to be oblivious to the needs of the business community or the economic value of encouraging entrepreneurial activity. It apparently did not occur to regulators that knitters might well decide not to engage in their craft if deprived of the flexibility to decide when and how often to work. Moreover, if the assessment is upheld, it is difficult to see how any individual performing services for a single company in Vermont could ever be deemed an independent contractor.

Conclusion

The existence of employer abuses has provided ammunition to those who are pushing state regulators and legislatures to crack down on use of the independent contractor model. Unless the free enterprise community can get its own house in order, we can expect to see more businesses like Fleece on Earth being threatened with financial ruin by over-reaching regulators. Given the tremendous entrepreneurial contribution that truly independent contractors make to the American economy, the business community needs to do all it can to ensure that the independent contractor model survives.

  ISBN 1056 3059