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Can Your Independent Contractors be Deemed to be Employees?

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The current trend to "outsource" some jobs previously done by **employees** also carries a number of risks, one of which is that the new "**independent contractor**" may still be considered an employee. That may have serious implications for the company's federal income tax, social security and Medicare taxes liabilities. Recently, the **Department of Labor** (DOL) has undertaken investigations regarding workers who were incorrectly treated as independent contractors, under a new program known as the "**Misclassification Initiative**." Several of these investigations have led to substantial liability for employers.

The driving force behind this initiative is that misclassified employees are often improperly denied access to critical benefits and protections, including family and medical leave, overtime, minimum wage and unemployment insurance. Employee misclassification also generates substantial losses to the Treasury and the Social Security and Medicare funds, as well as to state unemployment insurance and workers compensation funds.

Beyond the tax consequences, the employee/independent contractor distinction also makes a profound difference in terms of the employer's liability for civil damages. As a general rule, an employer is vicariously responsible for the wrongs committed by its employees in the scope of their duties. That legal doctrine (*respondeat superior*) generally does not apply to pin liability on the employer for the wrongs of an independent contractor.

The employee/independent contractor distinction also makes a difference in terms of employment discrimination liability. For example, under New Jersey's Law Against Discrimination, *N.J.S.A. 10:5-1 to -49* (LAD), employment discrimination is prohibited by an "employer." However, the LAD's definition of "employee" is not very helpful because it provides only that an employee "does not include any individual employed in the domestic service of any person." The relatively undefined term creates substantial uncertainty about who is an "employee" and thus covered under the LAD.

New Jersey courts have consistently found that independent contractors are not deemed employees under the LAD, and are therefore not entitled to its protections. When courts must determine whether a claimant is an employee or an independent contractor, they generally consider factors set forth under New Jersey case law (*Pukowsky v. Caruso*, 312 N.J. Super. 171 (App. Div. 1998)), which closely parallel those established by the IRS. *Pukowsky* identifies the following 12 factors relevant to determine whether a worker is an employee or an independent contractor.

(1) The employer's right to control the means and manner of the worker's performance;

(2) The kind of occupation—supervised or unsupervised performed by the worker;

(3) The level of skill needed by the worker for the task;

(4) Who furnishes the equipment and workplace;

(5) The length of time the individual has worked for the employer;

(6) The method of payment;

(7) The manner in which the work relationship can be terminated;

(8) Whether annual leave is provided to the worker;

(9) Whether the work is an integral part of the employer's business;

(10) Whether the worker accrues retirement benefits;

(11) Whether the employer pays social security taxes; and

(12) The intention of the parties concerning the relationship.

Although the employer's right to control the means and manner of the worker's performance is usually given greatest weight, the circumstances of each case require a principled application of all of the factors.

In general, the *Pukowsky* test allows for examination of the extent to which the worker has been functionally integrated into the employer's business. Several questions elicit the type of facts that would demonstrate a functional integration: Has the worker become one of the "cogs" in the employer's enterprise? Is the work continuously and directly required for the employer's business to be carried out, or is it merely intermittent and peripheral? Is the professional routinely or regularly at the disposal of the employer to perform a portion of the employer's work, as opposed to being available to the public for professional services on his or her own terms? If the answers to these questions are "yes," an employer-employee relationship is more likely to exist.

This analysis echoes the IRS criteria laid out in Publication 1779 (March 2012), which broadly identifies three general categories: 1) behavior control, 2) financial control, and 3) relationship of parties.

The behavior control factor looks to whether the business has a right to direct or control how the worker does the work. A worker is considered an employee when the business has the right to direct and control the worker's performance. For example, if you receive detailed instructions on how your work is to be done, then you will be deemed to be an employee. If you receive instructions about what should be done, but not details as to how it should be done, you may be classified as an independent contractor.

Financial control is another determining factor of the employee and independent contractor classification. Generally, the test is whether the employer has a right to direct or control the business part of the work. For example, if you have significant investment in your work, you may be classified as an independent contractor.

Further, the ability to realize a profit or incur a loss in performing the work would suggest that you are in business for yourself and, thus, an independent contractor.

Finally, the third IRS category is designed to evaluate the relationship of the parties and, specifically, to see how the business and the worker each perceive that relationship. Among the elements to be considered is whether the worker receives benefits, such as insurance, pension, or paid leave, which would indicate "employee" status. The existence of a written contract, which defines and describes the relationship, is a weighty indicator of the parties' intent on the issue.

While the issue is not "black and white" in all circumstances, businesses should make sure they classify their workers correctly as either employees or independent contractors, not only for tax purposes but also to understand their obligations—and to limit future potential liabilities—whether under the LAD or under common law tort theories.