

Independent contractors: more problem than promise?



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In the past few years, many companies have expanded their use of nontraditional workers, including part-time and temporary employees, agency temps, and independent contractors. Not only do these alternatives offer more flexible staffing than traditional full-time employees, but they also can free employers of certain costs and administrative burdens.

Independent contractors usually require no fringe benefits, no payroll taxes, and often no office space, tools, or equipment. They can be hired and terminated at will, and they require little or no day-to-day personnel administration. However, many companies have found that the benefit of using independent contractors is not without its trade-offs.

For one thing, establishing that someone who works for you is truly an independent contractor is not easy. The IRS has developed a 20-factor test for independent contractor status, and if you fail it, the penalties can be substantial. The dangers of misclassification can include unanticipated coverage under company pension plans and other employee benefits. Even if a worker is correctly categorized as an independent contractor, that does not protect management from risks, including some that do not apply in the normal employee setting.



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Potential problem areas

Workers' compensation is one example. When an employee is injured on the job, his or her only recourse is through the workers' compensation system. An independent contractor, however, can bring a lawsuit alleging negligence, defective equipment, or other grounds for liability. While a company can achieve some protection by negotiating appropriate terms into the agreement with the contractor, this problem simply does not arise in an employer-employee relationship.

In addition, independent contractors are not bound by the terms of a company's employee handbook or personnel policies. This can cause a variety of problems, but consider your non-compete and confidentiality policies as examples. Again, some of these issues can be addressed in the contract with the individual; however, a noncompete agreement may threaten the person's status as an independent contractor.

Even traditional assumptions about terminating an independent contractor relationship may be subject to question. Most companies assume they can end their relationship with an independent contractor whenever they want, unless they have agreed to continue it for a specific duration. Some courts, however, have permitted contractors to sue for discriminatory termination of the contract relationship, despite the fact that statutes prohibiting employment discrimination do not apply to independent contractors.

The ABC test

In addition, some companies find that when they end their relationship with an independent contractor, the contractor files for unemployment benefits, claiming the relationship was always one of employer and employee. In processing the claim, the Connecticut Department of Labor (DOL) will apply what is known as the ABC test, under

which any service rendered by a person to the company is considered employment unless and until the employer proves all of the following:

- A. The person is free from control and direction in the performance of such service, both under any written agreement and in actual practice
- B. The service is performed either outside the usual course of the business for which it is performed or is performed in a location removed from the enterprise for which it is performed
- C. The person performing the service is customarily engaged in an independently established trade, occupation, profession, or business of providing such services

All three parts of the ABC test must be established in order for a company to prove a benefit claimant is an independent contractor and not an employee. Although court cases indicate that the paramount factor is the right to control the results of the work and the methods of work, this is by nature a balancing test, where many factors may come into play, no one of which is—by itself—necessarily determinative.

Failing the ABC test can have major consequences. If the employer has not been paying payroll taxes on the assumption that the individual is a bona fide independent contractor, back taxes and possible penalties may be assessed. Failing the ABC test might also lead the DOL to question whether the employer has made other errors with respect to employee classification, such as a mistake involving exempt vs. non-exempt status.

Hiring an independent contractor can be an excellent solution to a company's labor needs, but beware of adopting this approach as a panacea, because the problems can outweigh the promise. An attorney, accountant, or human resources consultant can help you make the right choice.