



## **DELIVERING STRATEGIC SOLUTIONS ACCA'S 2000 ANNUAL MEETING**

### **INDEPENDENT CONTRACTORS AND CONTINGENT EMPLOYEES: DETERMINING WHO IS ENTITLED TO BENEFITS AFTER VIZCAINO v. MICROSOFT**

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*Recent judicial and legislative developments have exerted pressure on traditional employee benefits and their administration. The flexibility of employers to exclude non-traditional employees from participating in employee benefit plans has been limited court decisions in the U.S. Court of Appeals for the Ninth Circuit involving Microsoft Corporation. The Microsoft cases provide a good illustration of the issues that arise under current federal tax and employee benefits laws (1) when an independent contractor is reclassified as an employee and (2) determining who is the employer responsible for providing employee benefits in joint or co-employer situation. This article describes the facts and the rulings in the Microsoft cases as well as the current tests for determining independent contractor/employee status and for determining who is the employer.*

#### **PART I: THE MICROSOFT CASES**

##### **Summary Chronology of "Freelancers" Litigation Vs. Microsoft**

- 1987 - 1990 – plaintiffs worked as "freelancers" for Microsoft
  - as freelancers, were not provided any employee benefits
- Fall 1989 – IRS rules that plaintiffs and other freelancers then working under "independent contractor" arrangements with Microsoft were not truly independent contractors but were instead employees for federal tax purposes.
- In response to IRS ruling–
  - Microsoft made offers of employment to some "freelancers" who accepted and became "regular" employees–entitled to benefits.
  - Remaining "freelancers" were offered the option of "converting" status to employees of several temporary employee agencies–no employee benefits.
  - Vizcaino and other plaintiffs refused to convert to temporary employee agency status and had their independent contractor status terminated by Microsoft.
- Plaintiffs brought class action on behalf of all persons denied benefits by Microsoft because they

were considered independent contractors or temporary agency employees.

## **Microsoft "Freelancers"**

Persons working at Microsoft in either "independent contractor" or "temporary agency employee" statuses who did not receive employee benefits.

Typical Freelancer job assignments–

- production editors
- proofreaders
- formatters
- indexers
- testers

## **Microsoft Agreements with Freelancers**

- Microsoft Corporation Independent Contractor Copyright Assignment and Non-Disclosure Agreement
  - Freelancer is "an Independent Contractor for [Microsoft]" and nothing in agreement should be construed as creating an "employer-employee relationship."
  - "Contractor. . . further agrees to be responsible for all federal and state taxes, withholding, social security and other benefits."
- Independent Contractor/Freelancer Information
  - "Operating as an Independent Contractor/Freelancer the following applies:
    1. That as an Independent Contractor to Microsoft you are self-employed and responsible to pay all your own insurance and benefits. You have acknowledged this by signing the Copyright and Nondisclosure Agreement with Microsoft."
  - "You are neither an employee of Microsoft, or a temporary employee of Microsoft."

## **Employee Status of Freelancers**

- Similarity to "regular" employees–
  - often worked side by side with "regular" staff who were doing work identical to that of the "freelancers"
  - often worked on teams made up of both "freelancers" and "staff" employees
  - work assignments made without regard to classification of team members
  - generally expected to have same core working hours as "regular" staff
  - required to work on-site
  - supplied office equipment and supplies
  - paid on hourly basis

- Distinctions from "regular" employees–
  - were not paid out of Microsoft's payroll budget – instead submitted invoices and were paid through the accounts payable department
  - not provided any benefits
  - responsible for income and social security taxes
  - given only brief orientation and training
  - not given employee handbooks
  - shared work space with other "freelancers"
  - different color passes and e-mail designations than "regular" staff
  - not invited to official company functions

## Freelancers' Arguments

- In General
  - Microsoft's refusal to provide them with employee benefits is based solely on Microsoft's labelling them as not entitled to benefits by calling them "freelancers".
  - Plaintiffs previously conceded that they were not entitled to benefits because they were misled by Microsoft's mislabelling.
  - In fact, Plaintiffs were employees and therefore were entitled to benefits under the terms of the handbooks and the plans.
- Employee Stock Purchase Plan
  - Since the Plan expressly was intended to comply with IRC section 423 and since IRC section 423 requires an employer to include all common law employees—the Plan by its terms applies to the Plaintiffs.
- Savings Plus Plan
  - Plaintiffs were common-law employees who should have been on the United States payroll of the Employer—and therefore met the eligibility requirements of the Plan.

## Microsoft's Arguments

- In General
  - The eligibility question can be answered by referring to the individual Independent Contractor Agreements signed by each Plaintiff which expressly provided that the individual is responsible for his or her own benefits.
  - The status of the Plaintiffs as independent contractors or employees was irrelevant in view of the clear provisions of the agreements.
  - None of the Plaintiffs contended that they were promised benefits by any Microsoft spokesperson. All of the Plaintiffs were aware that they were engaged by Microsoft

to work in one of the freelancer categories and that under the terms of their working relationship they were not entitled to employee benefits unless they attained "regular" employee status.

- Employee Stock Purchase Plan
  - The Plan was never offered to freelancers.
  - During all the years when Plaintiffs were working at Microsoft, the Plan was expressly limited to first "permanent" employees and then "regular" employees.
- Savings Plus Plan
  - Plaintiffs were not on the United States payroll.

### **Circuit Court's Analysis**

- Microsoft conceded common law employee status of freelancers.
- Independent contractor agreements were based on mutual mistake as to status. Therefore—
  - Plaintiffs were employees who did not give up or waive their rights to be treated like all other employees under the plans.
  - As a result Plaintiffs' benefit eligibility was incorrectly determined by assumption of independent contractor status.
  - Plaintiffs' benefit eligibility should be determined under the eligibility provisions of the Microsoft plans.
- The Circuit Court held that Plaintiffs were NOT eligible to participate under the terms of the following plans:
  - Vacation
  - Sick-leave
  - Holidays
  - Short-term disability leave
  - Group Health Plan
  - Group Health Option Plan
  - Group Life Insurance Plan
  - Long-term Disability Plan
- Circuit Court held that Plaintiffs entitled to participate under the terms of the Employee Stock Purchase Plan.
- Circuit Court remands issue to plan administrator of the Savings Plus Plan to determine the meaning of the phrase "on the United States payroll."

### **Other Court Rulings Involving Reclassification**

- **Abraham v. Exxon Corp.** [85 F.3d 1126 5<sup>th</sup> Cir. 1996]
  - Leased employees and "special agreement" workers held not eligible to participate because expressly excluded by terms of Exxon plans.
- **Clark v. E.I. Dupont De Nemours Co.** [1997 U.S. App. LEXIS 321 4<sup>th</sup> Cir. 1997]
  - "Contract" worker held not eligible to participate because plan administrator's determination based on plan terms was not arbitrary or capricious.
- **Trombetta v. Cragin Federal Bank** [102 F.3d 1435 7<sup>th</sup> Cir. 1996]
  - Loan originators held not eligible to participate because plan administrator's determination that originators were independent contractors and not employees was not arbitrary and capricious.
  - Unlike Microsoft, Exxon, and DuPont, the Bank never conceded that the loan originators were employees either for tax or ERISA purposes.
- **Bronk v. Mountain States Telephone and Telegraph, Inc.** [140 F.3d 1335 10<sup>th</sup> Cir. 1998]
  - ERISA does not mandate that "leased employees" be covered under a plan, unless the plan language includes such employees.
- **Capital Cities/ABC, Inc. v. Ratcliff** [141 F.3d 1405 10<sup>th</sup> Cir. 1998]
  - Newspaper carriers held not eligible to participate based on the terms of individual agreements with the carriers and the specific eligibility provisions of the plans.
- **Burrey v. Pacific Gas & Electric Co.** [159 F.3d 388 9<sup>th</sup> Cir. 1998]
  - Individual classified by employer as a "leased employee" but who met standard for common law employee was eligible for benefits under the plan's terms.
- **Wolf v. Coca-Cola Company** [200 F.3d 1337 11<sup>th</sup> Cir. 2000]
  - Although individual raised material issue as to whether she was a common law employee, she could not establish that she was eligible for benefits under the terms of the plan.
  - The court emphasized that the issue of whether the individual is eligible for benefits under an ERISA plan is determined by terms of the plan itself. Citing *Abraham v. Exxon Corp.* and *Bronk v. Mountain States Telephone and Telegraph*.

### Lessons from Microsoft

- Microsoft is the ONLY case involving contract workers where the defense to denying eligibility to the workers was based SOLELY on individual agreements signed by the workers. In all of the other cases, the defense to eligibility was based on plan terms. ONLY Microsoft lost.

- Nothing in ERISA or the Internal Revenue Code requires an employer to cover ALL employees BUT –
  - tax-qualified retirement plans – such as, 401(k) plans – must meet certain minimum employee coverage percentage requirements (based on comparison of highly compensated employee eligibility to non-highly compensated employee eligibility);
  - tax-qualified retirement plans are prohibited from excluding employees solely because they are classified as "part-time", "temporary", or "seasonal" employees; and
  - certain other plans may be required to cover a broader group of employees in order to obtain special tax treatment for participants—for example, IRC section 423 applicable to employee stock purchase plans.
- Sample eligibility provisions excluding contract workers–
  - "Common law employees who are paid off the Payroll Budget." or "Common law employees who are paid by the Payroll Department." [suggested by the Magistrate in *Vizcaino*]
  - "An individual who is hired by the Company pursuant to an employment agreement or personal services agreement if such agreement provides that such individual shall not be eligible to participate in the Plan." [*Capital Cities/ABC, Inc.*]
  - "You're eligible for coverage under the plan if you're a regular employee of [the company] or one of its participating subsidiaries. You're not eligible for coverage under the plan if you're a temporary employee or seasonal employee, as defined by your employer . . . ." [*Coca-Cola Company*]
  - "Specifically excluded from all coverages under the Plan are: (i) independent contractors, (ii) individuals whose services are leased, temporary, or otherwise provided to the Plan Sponsor through unrelated entities, and (iii) notwithstanding any subsequent determination of employment status, an individual with whom there is an agreement that provides that the individual will not be covered under the Plan."

## **PART II: INDEPENDENT CONTRACTOR/EMPLOYEE STATUS**

### **Federal Employment Tax Regulations [Income, Social Security, and Medicare Taxes]**

The status of an individual as an independent contractor or an employee for purposes of the Federal tax laws is, with few exceptions, determined under the common law tests for determining whether an employment relationship exists. The Employment Tax Regulations provide that an individual generally is an employee if, under the usual common law tests, the relationship between the individual and the person for whom he performs services is the legal relationship of employer and employee. Such a relationship generally exists if the person for whom the services are performed

has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but [also] how it shall be done.

The Regulations state that the determination is to be based upon the particular facts in each case and warn that the designation or description of the relationship by the parties will not be determinative where the facts prove otherwise.

## **Employee Retirement Income Security Act**

"Employee" is defined in section 3(5) of the "Employee Retirement Income Security Act (ERISA) as "any individual employed by an employer." In light of the circularity of this definition, the Supreme Court, in *Nationwide Mutual Insurance Company v. Darden*, 112 S. Ct. 1344 (1992), was called upon to construe the term "employee" for ERISA purposes. In *Darden* the Supreme Court adopted a common-law test for determining who qualifies as an employee under ERISA.

## **IRS Common Law Factors**

Over the years, the IRS has developed a list of 20 common law factors which may be used as guidance in assessing whether sufficient control exists to establish an employer-employee relationship. *IRS Revenue Ruling 87-41*. The IRS guidance states, however, that some of the common law factors do not apply to certain occupations and that the degree of importance to be given to any factor may vary in a particular case. The IRS guidance also states that any single fact or small group of facts will not necessarily establish conclusive evidence of employee or independent contractor status.

As a result, the application of these factors is extremely subjective and the IRS itself has acknowledged that "in many cases, applying the common law test in employment tax issues does not yield clear, consistent, or satisfactory answers, and reasonable persons may differ as to the correct classification." In sum, even the IRS apparently acknowledges that the factors do not provide reliable practical guidance in assessing the status of the workers for employment tax purposes.

Because of the difficulty in applying the twenty-factor test and because business trends have changed over the years, the IRS recently has begun using a new approach with respect to worker classification. See *Internal Revenue Service Training Materials on Worker Classifications for Tax Purposes as Independent Contractors or Employees* (issued 3/4/1997). Rather than listing items of evidence under the twenty factors, the approach now is to group the items of evidence into the following three main categories: behavioral control, financial control, and the relationship of the parties.

### ■ Behavioral Control

Evidence in this category includes facts regarding whether the business has the right to direct and control how the worker performs the specific tasks for which the worker is hired. Facts that show behavioral control include the type and degree of instructions given to the worker and the training the business gives the worker.

### ■ Financial Control

Evidence under this category includes facts regarding whether there is a right to

direct and control how the business aspects of the worker's activities are conducted. Facts that show financial control include whether the worker has a significant investment or incurs significant expenses in the business and whether the worker provides services to the relevant market.

- **Relationship of the Parties**

Evidence under this category includes facts which illustrate how the parties perceive their relationship. Relevant facts include those which show the intent of the parties with respect to their relationship and whether the parties were free to terminate their relationship at will. The permanency of the relationship between the worker and the business is also relevant in assessing the relationship.

### **Probable IRS Position Regarding Classification As Independent Contractors**

The following is a summary of some key factors for IRS review:

- Where the IRS has found that the provision of the services to clients is an essential part of the business operation of the firm, it almost always has found that the firm is an employer. The IRS stated that in such case the firm can be assumed to exercise direction and control over the workers to the extent necessary to protect its business operations and to ensure that it obtains future contracts with clients.
- The IRS generally has concluded that the workers do not have a risk of loss where they do not make a substantial investment in equipment or supplies relating to their work. In several rulings, the IRS stated that the risk that a worker will not receive payment for services rendered does not constitute a sufficient economic risk to support treatment as an independent contractor.
- The IRS considers whether the worker performs services for a client under the firm's name or under their own business name and whether the worker can show that they in fact represent themselves to the public as performing services through an independent trade or business.
- The IRS has determined that the firm has a continuing relationship with a worker where work is performed at frequently recurring although irregular intervals.
- The contractual agreement between the parties is only one of the factors considered by the IRS.
- The fact that an individual is incorporated does not by itself guarantee independent contractor status. The IRS applies the standard common law test of employee status when a personal services corporation is involved.
- Whether the worker is providing essentially similar services to the company as provided by the company's employees.

### **PART III: DETERMINING WHO IS THE EMPLOYER**

The courts and the Internal Revenue Service generally have indicated that the traditional common law rules for determining whether an individual is an employee or an independent contractor also should be applied in determining whether an entity which entity of two potential employers is the common law employer of a



particular individual for employee benefit purposes under the Code and the Employee Retirement Income Security Act (AERISA<sup>®</sup>). However, the traditional common law test does not provide clear guidelines when applied in the independent contractor context and the test is even more problematic when applied in determining which entity is the employer of a particular individual. As noted above, the IRS has acknowledged that the determination of whether an individual is an employee of a particular entity depends upon the facts and circumstances of the particular case.

### **Common Law Test**

The analysis of whether an employment relationship exists typically arises in the context of determining whether an individual is an employee or an independent contractor under the usual common law rules. The U.S. Tax Court has held that this same common law analysis applies in determining whether an individual is a common law employee of an employer for purposes of the tax-qualification requirements of Section 401(a) of the Code. *See Professional & Executive Leasing, Inc. v. Commissioner*, 89 T.C. 225 (1987), *aff'd*, 862 F.2d 751 (9<sup>th</sup> Cir. 1988).

The U.S. Tax Court and the Internal Revenue Service also have stated that the principles used in determining whether a person is an employee or an independent contractor apply to determine which of two potential employers is treated as the employer of a particular individual. *See Professional & Executive Leasing, Inc. v. Commissioner; Edward Burnetta, O.D., P.A.*, 68 T.C. 387 (1977); *Packard v. Commissioner*, 63 T.C. 621 (1975); *IRS Revenue Ruling 75-41*. The IRS has acknowledged that the determination of whether an individual is an employee of a particular entity depends upon the facts and circumstances of the particular case. *See, e.g., IRS Chief Counsel Advice Memorandum 199948001*.

### **Other Analysis Suggested for Determining Employer Status**

Several recent cases and rulings suggest different analyses for determining for identifying whether a party should be considered to be the employer of a worksite employee.

- **Determination of Whether Employer-Employee Relationship is Established.**

The decision by the Ninth Circuit Court of Appeals in *Vizcaino v. United States District Court for the Western District of Washington* (a continuation of the Microsoft independent contractor misclassification class action claim for employee benefits) suggests one possible approach. In that case, the court held that the common law test should be applied in a three-party employment situation to determine whether an employer-employee relationship had been established between the worksite employee and Microsoft without considering the relationship between the worksite employee and the staffing company. It should be noted that the Department of Labor consistently has applied a similar analysis in taking the position that leased employees are employees of the client organizations for ERISA purposes. For example, see *DOL Advisory Opinions 95-29A and 91-47A*.

Under this analysis, it is possible that an employer-employee relationship may be established between the worksite employee and both the client company and the staffing company. As a result, this approach does not resolve the single employer issue necessary to apply the tax law employee benefit nondiscrimination requirements.

## ■ Determination Based on Analysis of Economic Realities

Another analysis suggested to determine employer status focuses on the economic realities of the relationship of the parties to the worksite employees. In short, is the relationship between the worksite employee and the staffing company dependent on the continuing relationship between the staffing company and the client company?

For example - (i) if a client company fails to pay, would the staffing company continue to employ the worksite employee, (ii) would (or could) the staffing company reassign a worksite employee to another company (iii) who sets the level of pay, benefits, fringes, vacations, leave, etc. for worksite employees, (iv) who enforces standards of conduct and discipline at the worksite, (v) who is responsible for grievance procedures, (vi) does the staffing agency have any expertise to hire, direct, or evaluate the day to day services provided by a worksite employee.

## ■ Determination Based on Modified Common Law Test

The U.S. district court in *Vizcaino v. Microsoft* suggested that the following factors be used to determine which entity an individual is an employee of the staffing company or the client company:

- whether the client company or the staffing company recruited the worker;
- the extent of training that the client company provides to the worker;
- the duration of the worker=s relationship with the client company;
- the client company=s right to assign additional projects to the worker; and
- whether the client company may influence the relationship between the worker and the staffing company.

## ■ IRS Technical Advice Memorandum 199918056

The IRS recently issued a technical advice memorandum discussing a three-party employment situation similar to a staffing company arrangement. *IRS Technical Advice Memorandum 199918056*. In the TAM, the IRS analyzed the employer status issue using factors combining the economic realities approach and the district court modified common law test described above.

The IRS concluded that  $\frac{3}{4}$

- The operating companies, and not the service company, should be treated as the common law employer of the worksite employees.
- The service company could be treated as the employer for purposes of income tax withholding. This conclusion was based on Section 3401(d)(1) of the Code which provides that if the person for whom an individual performs services (in this case, the operating company) does not have control of the payment of wages, the term

Aemployer@ means the person who controls the payment of the wages (the service company).

Under the analysis suggested in the TAM, it would be difficult for a staffing company to establish common law employer status regardless of what obligations the staffing company agreed to undertake. It is important to note that the TAM applies only to the parties involved and it is not possible to ascertain whether it represents the IRS= final views regarding the treatment of staffing companies.

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