Employee or Independent Contractor? The Implications of Microsoft III

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Would you like to accomplish some of your company's tasks with workers where you don't have to verify eligibility for U.S. employment or collect I-9 forms? Where you don't have to collect W-4's, issue W-2's or withhold income taxes? Where you don't have to collect the employee's share of FICA or pay the employer's contribution to either FICA or FUTA? Where you don't have to allow the workers to participate in ERISA—qualified employee benefit plans? Where you don't have to worry about compliance with Title VII, the Pregnancy Discrimination Act, the Equal Pay Act, the ADA, the ADEA, COBRA, the FMLA or WARN? Where you are not liable under the doctrine of Respondeat Superior for the worker's injuring of a third party in the course of his work? Most companies would say: "Sure, where can we get these low-maintenance/low-cost workers?"

The attributes described above are only some of the legal, practical and economic advantages associated with the proper use of independent contractors. Unfortunately, some employers find these advantages too good to resist and mischaracterize de facto "employees" as so-called independent contractors.

Implications

One might ask: "Who cares?" Until recently, the answer was: "The Internal Revenue Service (https://www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee) cares." Obviously, an employer's report of an employee's earnings is presumed to be more accurate than an employee's individual return (if any). Further, withholding by the employer creates a more steady cash flow for the government than does the worker's

annual return, even if quarterly estimated payments are made. More recently, however, the answer has been: "The misclassified employees care and so do their lawyers." This is because, due to the misclassification, the so-called independent contractors (https://www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-defined) are deprived of lucrative fringe benefits enjoyed by the company's acknowledged "employees."

Speaking of lucrative, the Plaintiff's Employment Bar hopes class actions based on such misclassification will be exactly that. Presumptively, the plaintiff attorneys will be compensated with some percentage of the denied benefits recovered. And, depending on the statute of limitations in the state where the employment occurs, liability for the benefits can stretch back for a substantial number of years, assuming the so-called independent contractors were de facto employees during the time period.

Microsoft 1

Microsoft I occurred because the IRS audited Microsoft for open tax years 1989 and 1990. Applying its twenty factor test (https://www.irs.gov/pub/irs-utl/x-26-07.pdf), the IRS advised Microsoft that a large portion of its "contingent workforce" was composed of actual employees, although Microsoft called them "freelancers (https://corporate.findlaw.com/human-resources/ban-the-label-freelancer-avoiding-the-pitfalls-of-improperly.html) " and treated them as independent contractors tax-wise (no W-2's, no FICA contribution, no withholding). Indeed, each so-called freelancer signed an agreement stating that he "was an independent contractor and nothing in the agreement should be construed as creating an employer-employee relationship." The agreement also specified that the freelancer agreed to be responsible for all of his own federal and state taxes, withholding, social security, insurance and other benefits. Finally, in a separate document, the freelancer expressly acknowledged that Microsoft had informed him he was responsible for his own insurance and benefits.

Microsoft engaged the "freelancers" on specific projects where they performed a number of different functions, such as production editing, proofreading, formatting, indexing, and testing. Microsoft "fully integrated" them into its regular workforce. They often worked on teams along with the "regular employees," sharing the same supervisors, performing identical functions, and working the same core hours. Microsoft required that they work on-site and, thus, they were given admittance key cards, office equipment and supplies by Microsoft. Instead of being paid by the Payroll Department, however, they submitted "invoices" to and were paid by the Accounts Payable Department.

Taking what then may have appeared to be the course of least (economic) resistance, Microsoft conceded that the IRS was correct in determining the workers were de facto employees, not independent contractors. Microsoft issued W-2's for the workers' past two years of earnings and paid the employer's share of FICA. It apparently was not concerned about benefits because, after all, the workers had signed agreements stating that they, not Microsoft, were responsible for such benefits.

Twenty Factor Test

The classic test of whether an employer-employee relationship exists is whether the putative employer has the right to control not just the end result to be accomplished but also "the manner and means" by which the result is accomplished. In making this determination, the Internal Revenue Service examines 20 different facets or factors pertaining to the

parties' relationship. See Rev. Rule 87-41, 1987 - 1 Cum Bull. 296, 2980299. No single factor or facet is determinative, the test being of the "totality of circumstance" type, but some factors apparently are more important than others. The twenty facets/factors are:

1. **Instructions**: How detailed are they can the hiring party tell the worker what tools or equipment to use, when to work and how physically or procedurally to do the job?
2. **Training**: If none is required or given, the worker is probably an independent contractor.
3. **Integration into Business Operations**: If the worker is called in only to fix a broken machine, he is probably an independent contractor. If he is running production on the same machine, he is probably an employee.
4. **Services Rendered Personally**: If the worker can accomplish the job through assistants or delegates, he is probably an independent contractor. If the worker personally is required to do the work, he is probably an employee.
5. **Hiring, Supervising, and Paying Assistants**: If engaging assistants is totally up to the worker, he is probably an independent contractor; if such can be done only by or with approval of the owner, the worker is probably an employee.
6. **Continuing Relationship**: If the worker was an admitted employee for a long period of time and then is "converted" to an "independent contractor" who works at the same job for another substantial period of indefinite duration, the worker is probably an employee. If he only comes when called and that is infrequently, he is probably an independent contractor.
7. **Set Hours of Work**: If there are none, the worker is probably an independent contractor.
8. **Full-Time Required**: If full-time work is required, the worker is probably an employee; if the work hours are discretionary, the worker is probably an independent contractor.
9. **Work Performed on Employer's Premises**: If one takes the broken TV set to the worker's shop, the repairman is probably an independent contractor. If he must come to the company's place of business and regularly works on an integrated part of its main operation, he is probably an employee.
10. **Order or Sequence of Work Set**: If the putative employer sets the order or sequencing of the work, the worker is probably an employee.
11. **Oral or Written Reports**: If written or oral reports are required, the worker is probably an employee.
12. **Payment by Hour, Week, Month**: If the worker is paid based on time increments worked rather than jobs completed, he is probably an employee.
13. **Payment of Business or Travel Expenses**: The concept of "independent contractor" is that the worker is in his own business thus he should absorb his own business and travel expenses as part of the overhead.
14. **Furnishing of Tools and Materials**: Again, if the independent contractor has his own business, he will own his tools, equipment and expendable supplies.
15. **Significant Investment**: What does the worker have at risk? Does he own the major equipment needed to accomplish the work? If so, he is probably an independent contractor.
16. **Realization of Profit or Loss**: Does the worker bear the risk of loss if the expenses of performing the work exceed the "contract price"? If so, he is probably an independent contractor.
17. **Working for More Than One Firm at a Time**: Multiple customers indicates the worker owns his own business, i.e., is an independent contractor. Exclusivity indicates he is merely an employee.
18. **Making Services Available to the General Public**: Advertising and making one's services available to the public indicates the worker is an independent contractor.

19. **Right to Discharge**: Either an employee or an independent contractor may be "discharged" for breaching the contract to be performed, but if the putative employer may discharge "at will," as opposed to "for cause only," the worker is probably an employee.
20. **Right to Terminate**: Again, if the putative employer can terminate the contract at his discretion without a breach on the worker's part, the worker is probably an employee, not an independent contractor.

Results of Microsoft 1

After settling with the IRS for tax years 1989-1990, Microsoft revamped its contingent workforce (https://corporate.findlaw.com/human-resources/vizcaino-v-microsoft-raises-the-stakes-on-worker-classification.html) system by putting many of the workers on the regular payroll. Some, however, instead were "terminated," but given the opportunity to become employed by temporary employment agencies which then could supply them back to Microsoft on an as needed basis. The plaintiffs, headed by Donna Vizcaino, were not retained as regular employees and only some opted to accept employment by the temporary employment agencies. Those "terminated" freelancers sued Microsoft for certain fringe benefits which should have been made available to them as "employees," which Microsoft had conceded (to the IRS) that they were. Included in the items sought were past contributions to the Savings Plus Plan and participation in the Microsoft Employee Stock Purchase Plan (ESPP).

Regarding the Savings Plus Plan, the plaintiffs had applied to the plan's Administrator for an eligibility determination. The Administrator concluded they were not eligible because they had signed independent contractor agreements which constituted a "waiver." As to those agreements, the Ninth Circuit Court of Appeals (https://caselaw.findlaw.com/court/us-9th-circuit/1183051.html) held that since Microsoft had agreed the workers were "employees," the contracts were premised on a "mutual mistake of fact" and, thus, were not enforceable by either party. (The Court also chastised the Administrator for construing a collateral agreement rather than the Plan itself.)

The Court remanded the case for reconsideration of each worker's individual eligibility now that the so-called Independent Contractor Agreements (https://corporate.findlaw.com/contracts/compensation/consulting/) had been legally voided. (The ESPP specified that the employee had to be employed for at least five months per year or work more than half time in order to be "eligible.")

Appellate Court Reverse and Remand

When an Appellate Court reverses and remands a case to the trial court, it issues a mandate telling the trial court: "Here's the law; apply it after making such factual decisions as are necessary." In this instance, instead of simply making findings as to which workers were "eligible," the trial court decided to "redefine" the class that had been previously approved by the Court of Appeals. Now, the trial court said the class was only those freelancers reclassified by the IRS or converted by Microsoft as employees. Moreover, it said the class would be limited to those who had worked as independent contractors from 1987-1990 and who were, in fact, reclassified by the IRS.

But, the class did include those meeting such criteria as to "claims brought by the same workers for their work after 1990" when many of them had been transferred to the temporary employment agencies. This new definition excluded all groups not reclassified by the IRS or converted by Microsoft, any other "temps" (https://corporate.findlaw.com/human-resources

/temporary-twilight-zone.html) hired post-conversion into the reclassified or converted positions, and all other common law employees not treated as employees by Microsoft. The trial court acknowledged that this redefinition reduced the class to "only a sliver of Microsoft's contingent workforce."

Court of Appeals Findings

The Plaintiffs' lawyers then took the trial court "to court," so to speak, and brought a mandamus action in the Court of Appeals (https://corporate.findlaw.com/human-resources/recent-decisions-in-vizcaino-v-microsoft-corp-redefine-the-term.html), designed to require the trial court to follow the original mandate. The Court of Appeals agreed and "re-expanded" the class back to its original size. The Court had three memorable quotes:

First, it had a caustic comment about Microsoft's lawyers. (No oral argument was permitted.)

"Microsoft's basic contention is that the district court properly exercised its discretion to modify the scope of the class. Its brief takes a scatter-gun approach, laying down heavy fire but consisting largely of blanks."

Second, and of more practical use, it said that the class is composed of all of Microsoft's common law employees even if technically "employed" by a temporary employment agency and that:

"The determination whether a worker was or is a Microsoft common law employee will be governed by the "Darden factors" set forth by the Supreme Court in Nationwide Mutual Insurance Co. v. Darden."

Third, the Court stated:

"We conclude, therefore, that the determination of whether temps were Microsoft's common law employees turns NOT on whether they were also employees of an agency, but rather on application of the Darden Factors to their relationship with Microsoft."

Microsoft's petition for an En Banc rehearing by the entire Ninth Circuit Court of Appeals has been denied. Thus, unless and until that is granted and the three judge panel's decision is reversed or until the U.S. Supreme Court rules to the contrary, Microsoft III is the law in the Ninth Circuit.

The *Darden* Case

In the *Darden (https://caselaw.findlaw.com/court/us-supreme-court/503/318.html)* case, which the Ninth Circuit found to be controlling in Microsoft III, an agent for Nationwide Mutual Insurance had eligibility under Nationwide's "Agents' Security Compensation Plan." That was a two-part plan under which Nationwide annually credited an agent's "retirement account" with a sum based on his business performance and, upon retirement or termination, paid him a lump sum equal to the total of his policy renewal fees for the previous twelve months. However, if after retirement or termination the agent sold policies for a competitor within twenty-five miles of his home base or persuaded any Nationwide policyholder to cancel his policy, he "forfeited" his entitlement to any then unpaid benefits under the plan.

Agent Darden was terminated by Nationwide. He began selling for competitors out of his same insurance office. Nationwide informed him that his prospective benefits under the Agents' Security Compensation Plan had been forfeited.

Darden's response was: "You can't take those benefits away; they are vested under ERISA." Darden sued Nationwide.

The trial court granted summary judgment for Nationwide which had pointed out that ERISA stands for Employee Retirement Income Security Act and argued that Darden was an independent contractor, not an employee. Darden appealed. Although the Circuit Court acknowledged ERISA contains no "helpful definition of employee" (it defines "employee" as "any employee of the employer"), it then concluded the statute should be construed in light of mischief it was designed to prevent (employer default on funding employee pension plans).

It developed a three-pronged test entailing the worker's expectations, his reliance on the expected payment, and his lack of bargaining power to negotiate the forfeiture clause out of the agreement. Based on this newly fashioned test, the appeals court remanded the case to the trial court which now found Darden to be an employee.

Nationwide then appealed to the same Court of Appeals which had fashioned the test and, of course, lost. Next, it petitioned the U.S. Supreme Court to review the decision and that petition was granted. On review, in an unusual unanimous decision, the Supreme Court held that where Congress failed to provide a meaningful definition of employee, the definition to be utilized was that of the "conventional master-servant relationship as understood by the common law agency doctrine."

Supreme Court Factors

While not adopting the IRS's twenty factors test in to, the Supreme Court acknowledged the factors and listed the twelve following as most significant:

1. skill required;
2. source of tools and instrumentalities;
3. location where work performed;
4. duration of relationship of parties;
5. hiring party's right (or lack thereof) to assign additional projects;
6. hired party's discretion over when and how long to work;
7. method of payment;
8. hired party's role in hiring and paying assistants;
9. whether the work is part of hiring party's regular business;
10. whether the hired party is in business;
11. whether "employee benefits" are provided; and
12. the tax treatment of the hired party.

The Supreme Court remanded the case for the ultimate determination of agent Darden's status under such test.

Conclusion

How does one avoid a Microsoft III donnybrook as to his own company's benefit plans? How does one keep true temporaries and part-timers from being eligible for employee benefits?

ERISA is administered by the Department of Labor (https://www.dol.gov/). It has a general rule of thumb regarding permissible exclusions to which the IRS (generally) defers. The rule of thumb is that an employer may exclude any employee who works less than 1000 hours in a relevant twelve-month period. This means the ongoing employees who work less than twenty hours per week per year and the "temporary" employees who work forty hours per week for less than a full six-months within the relevant twelve-month period are mathematically eliminated.

But, this is not an automatic exclusion; your plan MUST have the correct language implementing the intended exclusion or you will lose it, i.e., you will have to provide the benefits to "temporary" and part-time employees, as well as to any so-called independent contractors who, factually, are determined to be your common law employees.

Under Microsoft III, this result is obtained regardless of any so-called independent contractor agreement between the company and the worker.

The use of independent contractors is not a panacea for all employment problems. Utilized correctly, they are administratively convenient, economical and make good business sense.

The danger is in mischaracterizing a true employer-employee relationship. Mischaracterization can lead to adverse tax and benefit liability consequences. Thus, one must know the factors necessary to the creation of a true independent contractor relationship and must heed them.

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