

# Independent Contractor

## Historical

The historical practice of including independent contractors as plan participants in fully insured plans presented no particular challenge for these reasons:

- Insurance companies were fairly relaxed in having such non-employees added as a matter of contractual right. Where the letter and spirit of the Internal Revenue Code were met, a Form 1099 for modest insurance premiums would be the worst case scenario for such non-employee.
- The disciplines of the Internal Revenue Service were not so well developed; statutory and common law directions as to when a person was or was not an independent contractor were largely absent.
- ERISA guidance as to (a) what is a plan? (b) what harm to the plan will independent contractors as participants bring? was absent.
- The Internal Revenue Service was not pressed with either huge deficits nor alarming instances of recent independent contractor abuses (computer consultants; general corporate practice of cutting back on staff and outsourcing).

## Congress Addresses The Issue

The Tax Reform Act of 1986 included provisions as to who could be considered an independent contractor. The target in that law was the consultant. The intent was that if a person was retained by an employer (other than just the initial assignment), such person should be considered an employee, not a separate independent contractor. That also means that the employer would be responsible for providing to them employee benefits, FICA, income tax withholding and all other costs of employment.

Since many employers use such consultants from time to time for extended periods, such employers should establish documentation and customs which would support the contention that the person(s) were not employees, but truly independent contractors. The Internal Revenue Service is reportedly getting ready to enforce a wider array of independent contractors. So again, if an employer has independent contractors of any kind, such employer should be sure that it has adequate documentation and customs to show that they are really independent, and not merely an indirect employee. Having other client, work sites, and working schedule is good evidence that such consultants are not employees.

Why does the Internal Revenue Service and the Congressional General Accounting Office care? They say that they lost \$1.65 billion in tax revenue in one sample year because of pseudo-independent contractor arrangements. For example, if a consultant claims to be an independent contractor of the employer, such person is able to deduct a home computer, part of such person's home as an office, a car mileage to/from

the employer's place of business, etc. On the other hand, an employee doing the same job cannot deduct any of those expenses.

## Courts Address the Issue

### Background

The ERISA drafters use *circular* language to define employees; namely, "the term employee means any individual employed by the employer."

The traditional practice in plans, both insured and self-funded, has been to permit plans to include some persons who are not common-law employees as participants. Examples would be:

- Sole proprietors and partners or sole shareholder-employees
- Independent contractors.

Generally speaking, unless under an IRC §501(c)(9) trust where the 10% *de minimis* rule may be claimed, there are both tax and ERISA consequences to non-employees in a health care plan.

Consider:

<u>Type of Non-Employee</u>	<u>ERISA Plan Participants?</u>	<u>Tax Consequences?</u>	
		<u>General Asset</u>	<u>IRC§501(c)(9)</u>
<b><u>Independent Contractors</u></b>			
Work-Related	Uncertain	Yes	No*
Not Work-Related	No	Yes	Yes
<b><u>Other Non-Employees</u></b>			
Partners	Yes	Yes	Yes
Sole Proprietors	Yes	Yes	Yes
Sub S Owners	Yes	Yes	Yes

\*Subject to 10% *de minimis* rule.

The adding of independent contractors to a self-funded plan is basically a fairly dangerous act. Where the plan is clearly amended to include such independent contractors as a statutory right the dangers from (a) the stop-loss carriers finding a reason to deny claims thereon and (b) the *tainting* of an employee benefit plan with only a few or occasional non-employees are removed. What has not been eliminated is the need to give the independent contractor a Form 1099 on the value of such contractor's benefits. A large claim where the specific is also large could well be disastrous for such contractor. This Form 1099 difficulty may be avoided, or at least minimized, where the plan is funded through an IRC § 501(c)(9) trust and the 10% *de minimis* rules applied.

In analyzing the self-funded plan-independent contractor issues, the reader should bear in mind the two separate practical problems:

1. Person is a *bona fide* independent contractor who simply wants both plan participation as well as continuation of such independent contractor status for tax purposes.
2. Person is not a *bona fide* independent contractor but only a non-employee (other than former employee, surviving spouses, e.g.). An example could be a preferred customer included on the plan as a business courtesy. Other classes of non-employees (partners, and sole proprietors) are discussed in the next section.

## Minimizing the Problem

One practical way to avoid the independent contractor problem is for the employer to establish an IRC §501(c)(9) trust for the governing of the plan and its funding. By so doing, the Internal Revenue Service will permit up to 10% of the plan participants to be independent contractors so long as they share a common employment bond with the other plan participants. See Treasury Regulations §1.501(c)(9).

**Common Employment Bond.** This phrase would include employer-paid consultants, insurance agents otherwise deemed not-employees, long-haul, independent truck drivers, e.g. This phrase would not include partners, sole proprietors.

**Example of the IRC § 501(c)(9) Trust as a Solution.** Employer A has a plan of 400 participants which is self-funded by its general assets. It includes as participants four outside consultants, one Sub S Owner and 20 long-haul truck drivers who have favorable contracts with employer but who are not included as employees for FICA purposes.

- **Problem**

The amount of paid benefits and fixed costs to each of these 25 persons is taxable to them as evidenced by an employer-provided Form 1099. The existence of these 25 persons must be disclosed on the Form 5500.

- **Solution**

Bring the plan under an IRC § 501(c)(9) trust and in so doing the *de minimis* rule will permit up to 40 work-related independent contractors to be covered. This will cover the four outside consultants and 20 long-haul truck drivers; it will not solve the problem for the Sub S Owner, however. Reason: the *de minimis* does not apply to such Sub S Owner.

**Surviving Spouses and Dependent Children.** When the final Treasury Regulation §1.501(c)(9) were issued, non-employees in the *de minimis* test included surviving spouse and dependent children of former employees. Since COBRA has effectively declared COBRA beneficiaries to be plan participants in their own right, tax consequences therefrom have been eliminated.

## Treasury Regulations §1.501(c)(9)-Meaning of Employee

The term *employee* includes an individual (1) considered an employee, (2) treated as an employee for income tax purposes or (3) deemed to be an employee for purposes of collective bargaining; it is not necessary that rules of common law applied. The term *employee* may include a former employee on leave of absence, layoff, disability or

retirement; a plan for retired-only lives is permissible so long as the retired lives were at one time active employees. Specifically recognized is the instance of a worker (e.g., in the building trades) who works intermittently for several employers. The term *employee* includes a surviving dependent and a surviving spouse subject to the so-called 90% test.

The definition of *employee* is fairly restrictive, tracking the labor law definition of *employee*. An employee is taxable as an employee under the Code or treated as one in a collective bargaining agreement. Common-law definitions of *employee* have no applicability. As examples of the expansiveness of the employee definition, these persons may be *employees*:

- Former employees
- Temporary and part-time employees
- Independent contractors (if they share a common employment bond) but within the 10% *de minimis* limits
- Surviving spouse or children of former employees
- Employees on leave of absence.

Membership in a 501(c)(9) trust must be only by individuals; an association of welfare and pension funds could not qualify, even though the qualified employees were members of such welfare and pension funds.

## **ERISA Court Decisions**

Employees of employers that purchase coverage from a MEWA would not be deemed to be employees in the ERISA 3(6) meaning.

In determining whether or not a person was an employee or an independent contractor, some of the factors to be considered are these:

- Control of work details
- Method of compensation
- Common-law master-servant principles
- Does person have a separate enterprise
- Definity of relationship
- Permanency of relationship.

An independent contractor cannot sue the plan. An insurance agent, who signs an *exclusive agreement* whereby only the insurer will be represented, is an employee and not an independent contractor; that the agent was cosmetically held out to be an independent contractor was of no concern to the court.

Where the plan permitted self-employed sole proprietors to participate in a plan, the court held that plan assets should never insure to their benefit because they are not employees in the plan sense.

Where the terms of the plan are *overexpansive*, the courts will deny the plan to be an ERISA plan.

The court believed that owner-drivers could be treated as either employees or independent contractors; the scales were tipped in favor of their being employees, however.

Employer argued that it did not have to treat its agricultural employees as eligible for the plan, relying on the Labor-Management Relations Act's exclusion of such workers. The court found no justification for such an exclusion.

Employee on indefinite and extended leave from employer to work for the union ceases to be an employee.

Plans covering partners only are acceptable as ERISA plans.

Employer may use a traditional group life plan to fund insurance where the beneficiaries are officer-shareholders-even though the plan is established for full-time employees only.

Being a *leased* employee is not being an employee in the ERISA or IRS sense.

A sole proprietor may not be considered an employee for ERISA plan purposes. A plan with the proprietor as the sole participant is not an ERISA plan.

The employer allowed a consultant to join its plan as a gift or perk. This did not make the consultant a plan participant in the ERISA sense.

It is appropriate for an employer to distinguish between two classes of employees-active and disabled.

## **Guidelines in Determining Who Is An Employee**

The determinants set forth by the courts in determining who is an *employee* are these:

- Degree of control and supervision.
- Existence and nature of pay.
- Permanency of relationship.
- Services rendered in normal course of business.
- Conduct of parties in demonstrating *employee/employer* relationship.

## **Internal Revenue Service**

IRC §§ 105 and 106 are available only to those individuals that come within the classification of an employee. Employee status is determined in accordance with the usual common law criteria. Self-employed individuals [within the meaning of Section 401(c)(1)] are specifically excluded from the scope of Section 105. An employee-stockholder would fit the definition of an employee and should be entitled to the tax benefits of accident and health plans if such person or persons are in fact rendering services on behalf of the employer. If, however, the arrangement is dedicated exclusively to the advantage of this restricted group, the issue may be raised as to whether a *plan for employees* was created.

A nonresident alien employed in the United States has been awarded employee status for purposes of the various exclusions available under Section 105. This appears to confirm with the general approach taken by the Code in allowing this class of taxpayer only those deductions (and exclusions) connected with income from sources within the United States.

## **Special Treatment of Life Insurance Salesmen**

The Internal Revenue Code specifically permits life insurance agents to be treated as employees for purposes of those sections of the Code dealing with benefits so long as such person is treated as an employee of FICA purposes.

## State Insurance Statutes

The NAIC Model Group life statute defines employee as follows:

“The employees eligible for insurance under the policy shall be all of the employees of the employer, or all of any class or classes thereof determined by conditions pertaining to their employment. The policy may provide that the term *employees* shall include the employees of one or more subsidiary corporations, and the employees, individual proprietors, and partners of one or more affiliated corporations, proprietors or partnerships if the business of the employer and of such affiliated corporation, proprietors or partnerships if the business of the employer and of such affiliated corporations, proprietors or partnerships is under the common control through stock ownership or contract. The policy may provide that the term *employees* shall include the individual proprietor or partners if the employer is an individual proprietor or a partnership. The policy may provide that the term *employees* shall include retired employees. No director or a corporate employer shall be eligible for insurance under the policy unless such person is otherwise eligible as a bone fide employee of the corporation by performing services other than the usual duties of a director. No individual proprietor or partner shall be eligible for insurance under the policy unless he is actively engaged in and devotes a substantial part of his time to the conduct of the business of the proprietor or partnership”.

The NAIC Model Group Health Statute defines employee as follows:

“The term *employee* as used here in shall be deemed to include the officers, managers, and employees of the employer, the individual proprietor or partner, if the employer is an individual proprietor or partnership, the officers, managers, and employees of subsidiary or affiliated corporations, the individual proprietors, partners and employees of individuals and firms, if the business of the employer and such individual or firm is under common control through stock ownership, contract, or otherwise, the term *employees* as used here in may include retired employees. A policy issued to insure employees of a public body may provide that the term *employees* shall include the trustees or their employees, or both, if their duties are principally connected with such trusteeship”.

## Commentary On State Statutes

The reader should note that both model statute contemplates employees including partners and sole proprietors but *not* independent contractors. Some states, North Carolina, e.g., have a special provision allowing for agents (life or non-life) being

deemed participants if they perform all, or substantially all, of their activities to their principal.

### **Initial Sign of Difficulty**

The *Kwatcher* decision gave an initial sign of problems to come. *Kwatcher* was the sole owner of a corporation. The issue faced by the court was this: might a sole shareholder who is employed by his corporation be deemed an employee for ERISA purposes? The court said no he could not.

### **Final Sign of Difficulty**

The *Darden* decision puts the final touch on the issue when it held, in a unanimous vote, that a non-employee could not be a plan participant as contemplated by ERISA. *Darden*, a non-life agent and independent contractor was a participant in Nationwide's benefit plan. Even though a non-employee, *Darden* wished to wear the cloak of ERISA. Nationwide argued to the contrary. After much legal maneuvering, the Supreme Court settled the issue relying on ERISA's undefined term *employee*. The Supreme Court decided to define *employee* in the usual common law sense; by so doing *Darden* failed to be an employee. He could be a member of the plan but not with ERISA citizenship.

### **Commentary on Darden**

Had *Darden* been a life insurance agent with special statutory status in the code, he might well have been permitted to retain his plan participant-ERISA cloak.

What *Darden* has done is to put a strict constructionist interpretation to the term employee. In the past, particularly in labor law, a broader construction of the term employee has prevailed. If *employ* means to *suffer or permit to work*, then employees may well include independent contractors.

Both the *Darden* and the *Kwatcher* decisions involved pension plans.

### **Unanswered Questions After Darden**

- Do the factual situations with *Darden* and *Kwatcher* which come from a pension plan apply to a welfare plan?
- Should the hundreds of thousands of small pension plans with sole owners as participants contemplate termination or amendment?
- Would not the best, if not the only solution, be for ERISA to be amended with a meaningful definition of employee?
- Should health care plans with Sub S owners or partners or independent contractors contemplate amendment?
- Is a plan self-funded, with 80 employees and 20 independent contractors (long haul truck drivers, e.g.) a tainted plan, failing ERISA; or a bifurcated plan part ERISA and part unauthorized insurer? Most states require a self-funded plan, failing an ERISA exemption, to be unauthorized insurer required to meet

certain of the states' statutes (reserves, mandated benefits, registration, e.g.). North Carolina has such a statute which reads as follows:

The purposes of this Article are: To give the State jurisdiction over providers of health care benefits; to indicate how each provider of health care benefits may show under what jurisdiction it falls; to allow for examinations by the State if the provider of health care benefits is unable to show it is subject to another jurisdiction; to make such a provider of health care benefits subject to the laws of the State if it cannot show that it is subject to another jurisdiction; and to disclose the purchasers of such benefits whether or not the plans are fully insured.

- If plan X, underwritten by excess loss carrier as regular corporation becomes a Sub S during the plan year, and a benefit to the Sub S owner is expanded as a result, is the excess loss carrier liable?

## **What to Do**

The safest course of action for the plan administrator would be to have each plan document and booklet define eligible employee to include only those persons for whom the employer pays FICA-unless specifically set forth otherwise by plan amendment. These classes of persons will be affected by such amendment.

- Independent Contractors.
- Partners.
- Sole Proprietors.

Such are not routinely covered unless shown by amendment to be specifically covered. The stop loss carrier is alerted to the true status of the participants where such are covered. By amendment, you may have a non-ERISA participant in an ERISA plan. That a self-funded plan may carry a non-employee as a participant appears to be obvious. To do so, however, will necessarily expose the employer and the TPA to potential difficulty. Where such are added, they should be added carefully with full disclosure to the participant.

## **Internal Revenue Service Addresses The Issue**

To be reasonably certain that a person is an employee and not an independent contractor for purposes of federal taxes, there should be twenty issues addressed.

### **Issue Number 1. Control Factor**

If the person complies with the employer's instruction as to when, where and how the work is to be performed as an employee. This is the so-called *control factor*. The employer need only have the right to require such compliance.

### **Issue Number 2. Training Factor**

If the person has to submit to the training factor, it indicates the person to be an employee because the employer wishes the work performed in a particular manner.

### **Issue Number 3. Integration**

If the person services are integratable, significant and needful of the employer, the implication is that the person is needed and therefore more of an employee than an independent contractor.

### **Issue Number 4. Services Personally Rendered**

Where the services must be done by the person (as opposed to his assistant, associate, etc.), such person will be treated as an employee.

### **Issue Number 5. Hiring, Supervising and Paying Assistants**

Where the person hires, supervises and pays assistants on his/her own, without the control of the employer, such person will likely be deemed an independent contractor.

### **Issue Number 6. Continuing Relationship**

Where there is a continuing relationship and/or the work is performed at frequent and recurring intervals, the relationship will likely be deemed an employee-employer one.

### **Issue Number 7. Set Hours of Work**

The establishment by the employer of set hours of work is strongly indicative of an employee-employer relationship.

### **Issue Number 8. Full Time Required**

An independent contractor who devotes substantially full-time to the service of the employer will likely be deemed to be an employee and not an independent contractor.

### **Issue Number 9. Doing Work on Employer's Premises**

Work done on-site is suggestive of employee status. Work done off-site does not automatically suggest an independent contractor status, however, control will be the determinant.

### **Issue Number 10. Order of Sequence Set**

If the employer sets the order/sequence in which work must be performed, the person will likely be deemed an employee because of these control considerations.

### **Issue Number 11. Oral or Written Reports**

Where the employer requires either oral or written reports, it is likely that the person will be deemed an employee.

### **Issue Number 12. Payment Basis**

A regular payment basis (per month e.g.) is strongly indicative of an employee-employer relationship. Being paid *by the job* is strongly suggestive of an independent contractor status.

### **Issue Number 13. Treatment of Expenses**

If the person is reimbursed by the employer for business and/or travel expenses it is suggestive that the person is an employee.

### **Issue Number 14. Furnishing Tools and Materials**

The fact that the person for whom the services are performed furnishes significant tools, materials and other equipment tends to show the existence of an employer-employee relationship.

### **Issue Number 15. Significant Investment**

If the person invests in facilities that are used by such person in performing services and are not typically maintained by employees (such as maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the person is an independent contractor.

### **Issue Number 16. Realization of Profit or Risk of Loss**

A person who can realize a profit or suffer a loss as a result of such person's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor.

### **Issue Number 17. Working for Multiple Firms**

If a person performs more than *de minimis* services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the person is an independent contractor.

**Issue Number 18. Services Available to General Public**

The fact that the person makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship.

**Issue Number 19. Rights to Discharge**

The right to discharge a person is a factor indicating that the person is an employee and the person possessing the right is an employer.

**Issue Number 20. Right to Terminate**

If the person has the right to end such relationship with the person for whom the services are performed at any time such person wishes without incurring liability, the factor indicates an employer-employee relationship.

