WHITE & CASE

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Overseas Independent Contractor or *de Facto* Employee?

Cracking the Classification Conundrum

Challenge:

Engaging an overseas independent contractor (or "consultant"), rather than hiring as an employee, offers many advantages—but also opens a Pandora's box of legal issues.

A human resources professional posted a query on an Internet HR bulletin board saying: "Our company is looking to have independent contractors rather than employees work for us throughout Latin America. I wanted to know if the laws in those countries are just as strict as in the US." The short answer is simple: *No—they are even stricter.* Or, at least, rectifying independent contractor misclassification problems can be substantially more expensive outside the US because away from employment-at-will, extra areas of exposure lurk.

Multinationals often take their first steps into a new overseas market not by hiring an in-country employee but by engaging a local representative as an independent contractor—sometimes called a "consultant," "freelancer" or "entrepreneur." The contractor approach offers an enticing shortcut around expensive local payroll obligations, benefits mandates, employment laws, corporate registration rules and tax requirements. This approach is especially attractive where a multinational still has no local subsidiary or other corporate presence, and where local bureaucracy is slow.

Yet the independent contractor alternative to traditional employment, while attractive, is dangerous. The risk is real, not theoretical. Independent contractor status is fragile, with nominal "contractor" designations constantly getting attacked in courts and agencies from Europe to Latin America to the Philippines and Taiwan and beyond. Meanwhile, multinationals, even major ones, keep signing on nominal independent contractors even when the actual relationships reek of the smell of employment.

This newsletter addresses the international classification conundrum of genuine independent contractors versus misclassified *de facto* employees by discussing seven topics: the "four corners" of the contract; what happens when a nominal contractor gets held a *de facto* employee?; how likely is a claim?; when is a contractor not a contractor?; three action steps to insulate contractor classification; issues checklist; and strategy.

Pointer:

Understand when, under applicable local law, a nominal independent contractor gets classified as a *de facto* employee. When necessary, hire as an employee or engage as a leased employee/secondee on another employer's payroll.

Each monthly issue of *Global HR Hot Topic* focuses on a specific challenge to globalizing HR and offers state-of-the-art ideas for ensuring best practices in international HR management and compliance. White & Case's International Labor and Employment Law practice helps multinationals globalize business operations, monitor employment law compliance across borders and resolve international labor and employment issues.

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The "four corners" of the contract

An independent contractor by definition is party to a contract with a principal. There is a persistent myth of the "killer app" contractor agreement—the perfectly drafted form containing all a local jurisdiction's "legally blessed" boilerplate provisions, all its "bells and whistles" and all the right "magic words" shielding the parties' designation as an independent contractor. But few or no legal systems defer to parties' own classification as "contractor" and "principal." Laws most everywhere elevate substance over form to scrutinize the parties' actual relationship. This reduces the contractor agreement document to a mere starting point in the classification analysis. The 2007 English employment tribunal decision *Ministry of Defence Dental Services v. Kettle* reaffirms the near-universal rule that these cases require looking "outside the four corners" of the parties' agreement.

Of course, where the text of a sloppily-drafted contractor agreement betrays a misclassification, then a nominal contractor should be held a *de facto* employee. But where the contract makes the parties' independent contractor relationship seem airtight, the analysis merely shifts to the facts of the parties' actual relationship. Even so, there are a few classification issues that play into the drafting of an overseas independent contractor agreement:

- **Special jurisdictions:** Courts most everywhere look beyond the four corners of an agreement to assess the legitimacy of contractor status, but a handful of countries give substantial weight to certain special provisions, which therefore become vital. For example, in India an independent contractor agreement should (accurately) say the contractor has a "permanent tax account number" and withholds and pays his own taxes. In Israel an independent contractor agreement should (accurately) say the contractor has registered as a self-employed "consultant," and in Russia the agreement should (accurately) say the contractor has registered as an "individual entrepreneur." An independent contractor agreement in Turkey should expressly invoke the Turkish Code of Obligations and in Indonesia the IndonesianCivil Code, rather than those countries' labor codes. Vet the contractor agreement with local counsel to capture any special local clauses.
- **Contractual backstops:** While not strictly related to classification, there are some backstops that, when included in a contractor agreement, might act as a disincentive to a contractor later claiming to have worked as a *de facto* employee. Consider indemnities, set-asides, hold-harmless provisions and remedies that kick in if a contractor is ever held the principal's employee. In Israel, include an "apportionment" clause to recalculate paid contractor fees (after any misclassification determination) as salary and benefits. Check local-law enforceability and consider collectability.
- **"Business-to-business" contracts:** We have been discussing independent contractors engaged as individuals. Whenever a contractor can do business through a corporate entity, the principal gets an extra layer of protection by contracting only with that corporation. And this "business-to-business" independent contractor structure offers other advantages. For example, in the Netherlands it should be possible to terminate a contract with a corporation without having to seek permission—Dutch Labor Relations Decree of 1945 requires permission from a court or the Dutch Centre for Work and Income to terminate an employee, including a misclassified individual contractor.

What happens when a nominal contractor gets held a *de facto* employee?

If a US court or the US IRS determines a misclassified American contractor had worked as a *de facto* employee, liability should be confined to six categories:

1. back tax withholdings
2. back Social Security contributions
3. back state unemployment/workers compensation insurance
4. back overtime (*for non-exempt positions*)
5. back benefits due under the terms of certain employer plans
6. interest and penalties

Abroad, outside employment-at-will, a misclassified contractor triggers additional liabilities—the same six grounds as in the US plus four other, potentially more expensive grounds:

7. back vacation and back holidays
8. back mandatory benefits (*for example, profit sharing, thirteenth-month pay, mandatory bonus, payments to state housing funds and state-mandated unemployment funds*)
9. severance pay, notice pay and liability for unfair dismissal
10. fines (*for example, Spain's Law on Violations and Sanctions on Social Matters imposes fines in this context plus a percentage of unpaid withholdings and a penalty for "very severe" violations*)

These extra four grounds add up. In one exceptional case, a US multinational's former independent contractor sued in a Latin American labor court, claiming to have been a *de facto* employee and demanding *US$40 million*. Countless labor court judgments from even third-world countries award misclassified contractors hundreds of thousands, sometimes millions of dollars.

How likely is a claim?

When engaging an independent contractor abroad, many a multinational crosses its fingers and hopes the relationship "flies under the radar." And it may, for a while. But when the relationship finally ends, as inevitably it must, the contractor agreement's termination provision looks stingy in comparison with what a wrongly fired local employee wins under local employment law—pre-termination notice, severance pay, wrongful dismissal damages, accrued benefits including holidays, vacation and overtime. If the independent contractor agreement offers a mere 30 or 60 days' pre-termination notice (as is typical), any nominal contractor would feel tempted to turn to a local labor court and demand a fired employee's full entitlement. Foreign labor courts prove surprisingly sympathetic. Because the text of the independent contractor agreement does not determine classification, the obvious defense here—the claimant's signature on his own agreement concedes contractor status—usually goes nowhere.

- **Audits and whistleblowers:** Nor does it take a disgruntled ex-contractor to raise a misclassification claim. Tax and social security agencies worldwide increasingly target contractor classification in their audits, exploiting better technology to make audits more frequent and thorough. And whistleblowers denounce misclassifications to authorities.

When is a contractor not a contractor?

The very real likelihood of exposure emphasizes the importance of our threshold question: *When can a multinational legitimately engage an overseas services provider as an independent contractor—and when is it necessary to hire as an employee or leased employee/secondee?* In other words, *what is the difference, under applicable foreign law, between a genuine independent contractor and a de facto employee*?

The answer turns on local law where the service provider works. (Choice-of-foreign-law clauses in independent contractor agreements rarely divest the mandatory application of local employment laws, because of the public policy of protecting fundamental employee rights. *See* our *Global HR Hot Topic, July 2008*.) Most every country's local law offers up some list of factors to distinguish genuine contractors from *de facto* employees. Even within a single country, contractor vs. employee factor lists can differ—for example, the US IRS test has 20 factors (IRS Revenue Ruling 87-41) while American common law is usually said to include 13 factors. Speaking broadly, though, lists of contractor-vs.-employee factors from country to country end up looking surprisingly similar. In fact, contractor classification happens to be one of the very few points of employment law where we can make useful generalizations across jurisdictions. Most every country would uphold independent contractor status if a contractor can truthfully answer "yes" to six questions:

1. Do you have authoritative control to perform your tasks the way you want to—free from instruction on process, free from discipline, free from work rules, and free from your principal's supervision and control? (*Abroad this is called the "subordination" test*.)
2. Are you free to set your own schedule and work hours?
3. Do you provide your own office and supplies, pay your own business expenses and hire your own assistants?
4. Do you get paid only for work you actually do, such as hourly pay or task pay, no paid vacations/holidays? (*In the Dominican Republic, for example, a contractor should never receive a salary*.)
5. Do you take business risks and bear the ultimate risk of profit or loss? (*The "business risk" factor is vital in Puerto Rico, where it is called the "economic reality" test, as well as in parts of China, per an August 2009 Beijing declaration on contractor classification*.)
6. Can you, and do you, have other paying clients, and do you market your services to the public? (*Exclusive, full-time independent contractors pose a special risk; Peru, for example, applies a rebuttable presumption that a full-time contractor is a de facto employee*.)

These six questions may predominate, but nine others can also factor into contractor classification challenges:

7. Are you free from non-compete, non-solicitation and other post-termination restrictions?
8. Are you free to determine the order and sequence of your tasks?
9. Do you bear the possibility of casualty loss (property/personal injury) and do you buy insurance?
10. Is your pay free from employee-benefit/executive-compensation elements like health/life/disability insurance, bonuses and equity awards?
11. Do you make tax/social security payments and withholdings like a business? (*This is a vital issue in India*.)
12. Is your relationship explicitly temporary and short-term? (*In Sweden, a relationship of more than six to nine months risks challenge; in the Dominican Republic, serially renewed independent contracts risk challenge*.)

13. Do your business cards and letterhead clarify your independence from the principal and do you use a title unrelated to the company?

14. Are you kept off of the principal's organization charts and internal structure documents?

15. Do you refrain from attending the principal's training sessions as a student?

For a "reality check" in assessing whether an overseas services provider might be legitimately engaged as an independent contractor, just ask: *If structuring this position as an independent contractor is such a great idea, then why not go ahead and engage all this person's US counterparts as independent contractors, too?* Beware if your answer is: *That would never fly—the US IRS and other stateside authorities would see right through this and deem this job to be employment*. If that is the case, that same reasoning very likely applies abroad.

Three action steps to insulate contractor classification

It is easy to engage a "one-off" overseas independent contractor for a discrete task—no one ever questions the legitimacy of a genuine independent contractor like a lawyer, accountant, plumber, roofer or guest speaker at a corporate retreat. Problems arise in the grey areas, such as where a multinational signs up a long-term foreign sales agent to work full-time and exclusively. To avoid misclassification in these situations, consider three vital, if difficult, action steps:

1. **Consider hiring as an employee or leased employee/secondee:** Consider hiring the person as an employee. Doing so will likely cause administrative headaches, but those headaches hurt less than the pain a nominal foreign contractor inflicts after being deemed a *de facto* employee. Where the principal is not registered in-country and cannot issue payroll, consider engaging the services provider as a *leased employee/secondee*: Some other local business (affiliate, business partner, manpower/staffing agency) hires the person as an employee onto its local payroll and contracts with the principal to provide his services. This approach does not resolve permanent establishment problems and it raises the issue of dual/co-/joint employment. But the leased employee/secondee structure completely eliminates the threat of a *de facto* employee determination because it classifies the services provider, from the beginning, as an employee. *See, e.g., James v. Greenwich Council* (UK Employment Tribunal decision, 2006, holding customer of temp agency not employer of temp).

2. **Draft an agreement that establishes real independence:** Although the text of the independent contractor agreement, by itself, will not immunize the parties' "contractor" classification, the agreement should lay the groundwork for real independence. In drafting the contract, loosen the reins. Avoid the temptation to have it both ways, controlling the contractor like a "subordinate" servant. Reject non-compete clauses, bonus pay provisions, paid vacation, scheduled work hours and any term that smells like employment. Include provisions that grant the contractor freedom to structure tasks.

3. **Structure the day-to-day work relationship to establish real independence:** In day-to-day practice, respect the contractor's structural independence as spelled out in the contract. Keep the contractor off organization charts. Let him compete. Refuse to provide a title, an office or company business cards. Do not schedule hours. Do not invite the contractor to training sessions or office parties.

Issues checklist

After taking these three steps, account for these additional issues:

✔ **Permanent establishment:** We have been addressing the contractor misclassification issue under employment law. In addition, tackle the corporate law issue of *permanent establishment*. In the independent contractor context, permanent establishment comes up when a multinational has no formal corporate presence in a foreign country (is not registered as a branch, not incorporated, not licensed to do business locally), but ends up transacting business in-country through the acts of an independent contractor agent. Once a contractor's activities on behalf of a principal trigger a jurisdiction's definition of "doing business in" country, the principal is deemed to have a local "permanent establishment," a *de facto* corporate presence. This finding carries with it legal obligations to: register with the corporate registry (local equivalent of a US state secretary of state's office); file local corporate tax returns; get a local taxpayer identification number (and, if the organization is a non-profit, get local non-profit status). Permanent establishment is a corporate-law issue unrelated to employment-law classification; a multinational operating somewhere exclusively through an independent contractor might be deemed to have a local permanent establishment even if its contractor is legitimately classified. On the other hand, an unregistered multinational found to be the *de facto* employer of a local misclassified contractor likely *will* be held to have an in-country permanent establishment, because in most places, employing a local triggers the corporate-law definition of "doing business." Hence the question: *When do an independent contractor's activities trigger the local corporate-law definition of "doing business" on behalf of a principal*? The answer depends on the local corporate-law

definition of "doing business." This differs by country. In Qatar, for example, the "doing business in" test is whether the principal "engages in commerce"—a concept Qatari law does not define clearly. Singapore's statute is more precise: "carrying on a business" in Singapore means "administering, managing or otherwise dealing with [local property] as an agent,…legal representative or trustee"; in Singapore, "effect[ing] any [one single] sale through an independent contractor" does not itself trigger "carrying on" a local business, but a series of sales or other acts of a contractor might. Syria, as another example, deems an entity to be doing business locally under five concrete tests—the organization: employs someone; rents or buys real estate; opens a bank account; lists in a telephone directory; or takes out a post office box. Mexico's "doing business" standard turns largely on whether an entity has issued local powers of attorney or has a fixed place of business, which might be an independent contractor's home office.

- ✔ **Local independent contractor and sales agent regulations:** A small but growing number of countries has begun to enact laws protecting independent contractors and creating special contractor categorizations. Check for, and comply with, these. For example, since 2007 Spain has categorized independent contractors devoting 75 percent of full-time efforts to a single client as "economically dependant autonomous workers." The principals of these contractors must offer 18 days of annual time off—and must pay severance pay upon any pre-term, no-cause termination. France now has a special designation called *portage salarial* for self-employed freelancers who are autonomous in many ways, but each of whose "employers" must make payroll withholdings, contributions and deductions similar to those of a regular employer. A related issue is complying with special regulations on *sales agents*. Independent contractor arrangements with sales people need to account for local laws that impose protections (such as regarding compensation and termination) on sales agencies and, less commonly, on distributorships. In the European Union, these laws fall under the too-often-overlooked Directive 86/653, adapted ("transposed") into local member state laws such as UK Commercial Agents (Council Directive) Regulations 1993.

- ✔ **Embedded subcontractors:** Independent contractors sometimes engage their own employees or subcontractors who are invisible to the overseas principal that has privity of contract only with the foreign contractor and no direct relationship with contractor subordinates. The fact that a contractor has employees or subcontractors buttresses the argument that contractor classification is legitimate, but these "embedded subcontractors" might claim to be the principal's misclassified *de facto* employees or dual/co-/joint employees. Search out embedded employees and subcontractors. Develop a proactive strategy to contain exposure.

- ✔ **Contractor pay reporting:** In the US, principals must notify the IRS of payments to domestic US independent contractors using the 1099 form. Few other countries require reporting contractor pay in this manner, but be sure to check and comply with any overseas "local 1099 equivalent" report mandate.

- ✔ **Illegal subcontracting:** Laws in Brazil, Croatia and elsewhere actually ban subcontracting, at least of tasks central to a business. Be sure any independent contractor arrangement in these jurisdictions complies.

- ✔ **Mid-term conversions and "up or out" rules:** Nipping the misclassified independent-contractor problem in the bud, at the time of initial engagement, is a best practice. But even those multinationals already using dubiously classified foreign "contractors" can get into compliance. Indeed, liability grows as a mischaracterization lingers for years. Consider a global conversion project, hiring on misclassified contractors as employees and paying consideration for releases of accrued liabilities. Do this while relationships are still friendly: Deferring misclassification concerns until termination or an audit only increases exposure. Going forward, consider adopting the emerging best practice of a global "up or out" rule: Cap worldwide relationships with independent contractors at a set period, ideally between six months and two years. After the cap period, require hiring each contractor directly, engaging as a leased employee/secondee, or severing the relationship entirely.

Strategy

The misclassified overseas independent contractor conundrum bedevils even major multinationals. Engaging an independent contractor overseas rather than hiring as an employee may seem, on the front end, to offer attractive advantages. But these arrangements ultimately open Pandora's box. Challenges are frequent and liabilities run high. Where a multinational principal is not registered to do business in an overseas jurisdiction, the issues extend beyond employment law and trigger corporate and tax problems.

Know when a nominal independent contractor threatens classification as a "subordinated" *de facto* employee under local foreign law. When necessary, hire up-front as an employee or as a leased employee/secondee on someone else's payroll, or at least engage as a "business-to-business" contractor. Otherwise, take action steps before engaging any overseas independent contractor and use a checklist to spot other issues.

An earlier version of this newsletter appeared as our Global HR Hot Topics for September and October 2007.