

# WHICH HAT IS RIGHT FOR YOU?

## **Deciding between independent contractor and employee status requires you to be aware of the laws.**

The independent contractor status of real estate salespeople is an issue that interests the whole industry. Many managers elect the independent contractor relationship rather than the employee relationship with their salespeople. In fact, research by the NATIONAL Association of REALTORS® shows that in 1987, 90 percent of salespeople were independent contractors and 10 percent were employees.

In a competitive market, managers ask, What can I do to make my sales force more effective? They have been cautious in this regard, however, because according to the common law, they have less control over independent contractors than over employees.

Salespeople as well as their managers must be vigilant and knowledgeable about their status as independent contractors or employees.

In 1982, federal tax law changed to the extent that managers can control the actions of salespeople who are statutory independent contractors. But the common law prevails in many states on certain state tax and insurance issues if the state has not enacted legislation that matches the federal legislation.

What has happened since 1982? And what is happening at the state level? To find answers to these and other questions about the independent contractor relationship, Real Estate Today® interviewed Laurene K. Janik, chief counsel of the NATIONAL Association of REALTORS®

### **Has independent contractor status proved to be a better business arrangement between brokers and salespeople than employee status?**

Brokers I know favor having independent contractors. It's better for brokers in two regards: It's less expensive because brokers don't have to make FICA [Federal Insurance Contributions Act, or Social Security] contributions, and they don't have the administrative burden of withholding taxes.

Brokers reward salespeople for their independent successes and let them have a lot of control over what they do, where they go, and when they work. The good side of independent contractor status for many salespeople is that they're free to set their own hours. The entrepreneurial spirit is alive in the real estate industry, and that's conducive to having independent contractors.

The salesperson is rewarded not on the basis of coming to the office and sitting at a desk 40 hours a week but on the basis of a record of sales success. Listing and selling real estate seem to mesh very well with having an independent contractor sales force.

If a broker is concerned with turnover and wants to keep salespeople, one way to do so is by providing benefits. Legally, however, the benefits that can be provided to independent contractors are quite limited. So a broker who is concerned with turnover and wants to provide employee benefits might want to have employees rather than independent contractors.

**Aren't brokers relinquishing some of their control to maintain an independent contractor sales force? What have been some of the difficulties with independent contractor status?**

Brokers can't exercise as much control over an independent contractor as they can over an employee. Yet brokers are liable; they're responsible for everything salespeople do in the field. Salespeople are the broker's agents. Brokers hold the salespeople's licenses, and they're ultimately responsible for what the salespeople do. And I can imagine brokers, knowing they're responsible, are concerned that there are restraints on the amount of control they can exercise over salespeople.

If brokers inadvertently jeopardize the independent contractor status of their sales force, and they haven't made the proper withholding or Social Security contributions, they're going to face some substantial back-tax liability.

**What effect did the change in federal law in 1982 have regarding who's a "qualified real estate agent" for tax purposes and who is or is not an independent contractor?**

After 1982, to be a statutory independent contractor under federal tax law, a salesperson has had to meet a three-part test. First, you must have a license, which almost everyone does, since every state has a licensing law. Second, you must have a written agreement with a broker. Third, substantially all your remuneration must be based on output as opposed to hours worked. Very simple. Those three things make you a nonemployee for federal tax purposes.

**You said that meeting the three-part test makes the salesperson a statutory independent contractor for federal tax purposes. Is there another kind of legally recognized independent contractor?**

There are two types of independent contractors. One is the "statutory nonemployee" or "statutory independent contractor," which I just described. "Statutory nonemployee" is the way the tax code refers to qualified real estate agents. National Association members, however, tend to use the term independent contractor because the common law uses this term.

The second type is the "common-law independent contractor." Common law is "judge-made" law--meaning the law is made in the courts as opposed to in the statehouse. The legislature makes statutes, and the courts develop common law. And common law has evolved so that we have this concept, this creature known as an independent contractor, with all the various do's and don'ts.

To illustrate the difference between common law and statutory, let's say I am a licensed salesperson and am paid on the basis of output only, on commission, but for some reason I don't have a written agreement with my broker. We just never signed one. Therefore, I don't qualify under the three-part test that determines whether I'm a statutory nonemployee.

I may still be a common-law independent contractor, however. Over the years, the concept has

evolved that you're a common-law independent contractor if the broker doesn't control how you go about doing your job.

If salespeople have no written contract, they should ask themselves, How am I compensated? How do I pay and report taxes? Does my broker have the right to control my activities? Depending on the answers to these questions, they'll be defined either as employees or common-law independent contractors.

It's not just a case of meeting the statutory test or nothing; the federal law still recognizes common-law independent contractors as well. But

then the test of "Does the broker possess the right to control?" must be applied. And if the broker does, the salesperson is not an independent contractor.

### **What happens to those brokers who are still operating with common-law independent contractors? What are the limits to their managerial control over the sales force?**

Under common law, brokers can't require independent contractors to work certain hours or direct them to handle a certain prospect who walks in the door.

A broker can tell salespeople that their job is to obtain listings or to sell an inventory of listings, but the broker can't be specific: "Okay, today I want you to go out and farm this neighborhood, and tomorrow I want you to attend the board's educational session on getting more listings." A broker can't mandate how salespeople should go about getting listings or making sales.

### **So it's better for a broker to operate with --statutory independent contractors?**

The broker can now control activities of statutory independent contractors. The broker can set working hours and require floor time, training sessions, or open houses, for example.

But it's good only to a certain extent as far as the broker is concerned. The statutory nonemployee is a creature of the federal tax code. So a salesperson may have met the three-part test, and the broker is able to exercise control and not have the salesperson be an employee for federal tax purposes. But the broker must also consider state tax law, state workmen's compensation law, and state unemployment compensation law. And those statutes haven't all fallen in line. "If your state law varies from the federal law, you should comply with the most restrictive," as stated in our Legal Liability Series booklet *Independent Contractor or Employee: What's in a Name?*

Those are the major statutes that brokers need to be aware of for purposes of state law.

They have to know whether salespeople are encompassed by the workmen's compensation law. If a salesperson is injured in an automobile accident while taking someone to a showing, is that compensable under workmen's compensation? In most states, it is if the salesperson is an employee. And in many states, it isn't compensable if the salesperson is an independent contractor.

The test that's going to be used by the state industrial commission to determine whether the salesperson is an employee or an independent contractor is most likely going to be a lot more like the common-law test than like the three-part statutory test for federal tax purposes. So the broker has to be aware of the implications of state workmen's compensation, state unemployment compensation,

and state income tax laws, if there is a state tax [see "Know Your State Laws" within this article].

### **Then it's almost as important for real estate professionals to know their state laws as it is to know the federal laws?**

Within the states, there have been issues percolating involving the independent contractor status of salespeople. Recently, we received a call from Texas regarding unemployment compensation. It was a definite issue there with regard to independent contractors. Or for example, in Tennessee, a tragic accident happened. Passengers in a car driven by a salesperson on the way to a showing were severely hurt. Is that salesperson covered under workmen's compensation? Who is liable for injuries to the passengers? The independent contractor issue comes up in different contexts.

I think there's not enough appreciation that there's an issue here. It would be wise for the states to try to get their laws to apply the same test as the federal law. Otherwise, all the benefits that brokers get from the new federal tax law will be completely lost. In those states where the tests are not the same, the broker can't exercise control without damaging the case for state law purposes.

Brokers should learn what their legal responsibilities are. Ignorance of the law is no excuse. Just because they may not be aware of what's required doesn't mean that if someone comes in and audits them or some salesperson has an accident, they won't be liable. Then the issue becomes relevant: Is the salesperson an independent contractor or not?

### **Could the salesperson be getting the short end of the stick here and not be eligible for workmen's compensation in some states that are revising their laws with respect to independent contractors?**

In states that limit compensation to employees, the independent contractor salesperson would not have the benefit of workmen's compensation and would be left to other legal remedies, such as bringing a lawsuit against whoever may be responsible for the loss or injury sustained. The salesperson could also purchase insurance, but since disability insurance is extremely expensive, it's probably a luxury the typical real estate salesperson will forgo. It's not as easily affordable as car insurance.

It's true that the laws in some states favor the broker and not the salesperson, who may be injured and not have workmen's compensation that's available to employees.

### **How can the broker maximize management control with either type of independent contractor?**

I would strongly encourage all brokers to have written agreements with their salespeople, whether they're common-law independent contractors or statutory independent contractors. I think a contract does a lot more than just meet the tax code requirements, however.

It lets the broker and the salesperson know what's expected of them and of each other. That's the one thing I can be definitive about. We strongly encourage them to have a written agreement. Since the changing of the federal tax law in 1982, what goes into that agreement may be a little different from what it would have been before. We don't have specific recommendations in that regard other than that the written agreement has to provide specifically that "for federal tax purposes the salesperson will not be treated as an employee." That magic language has to be in the contract to satisfy the federal requirement for a statutory nonemployee. The written agreement must make it clear that for federal tax purposes, the salesperson will not be treated as an employee.

**We've seen that the broker or manager of a real estate company has many advantages in the independent contractor relationship. Doesn't the salesperson lose something in the bargain? Fewer benefits or perks?**

The Internal Revenue Service (IRS) has proposed regulations to explain the part of the law that says qualified real estate sales agents must receive substantially all their remuneration on the basis of output. According to the IRS, "substantially all" means 90 percent. So a broker can give them 10 percent perks. But how do you know what 10 percent is until you get to the end of the year?

In terms of tangible benefits, such as life insurance and medical insurance, as far as brokers actually reaching into their pockets and making any kind of payment, they'll have a problem under the common law. They're going to run into the 90 percent-10 percent rule under the new federal law, so brokers are very limited in what they can do.

**Is there any alternative?**

The comment I've heard from some salespeople at the seminars and meetings I attend is that they've never really realized that independent contractor relationships are so heavily weighted in favor of the broker.

Granted, independent contractors have freedom, but along with the freedom comes the responsibility to handle a lot of things on their own, such as tax reporting, record keeping, and personal finances. What I've often suggested is that new people, new licensees, who don't have a lot of experience, probably need some guidance and training, so brokers should consider having these salespeople be employees for the first six months or the first year until a comfort level and a confidence level are reached. Then make them independent contractors.

**What are salespeople's responsibilities?**

They're responsible for making their quarterly estimated tax payments to the federal government and for the state tax if any. They have to keep track of all their expenses, their mileage, whatever would be a deductible business expense.

When they're just getting started, it might be in their best interest to find a broker who's willing to provide them with the assistance and training they need to get started. That's not the type of thing they're taught when preparing for the licensing exam.

**Let's discuss managers who also sell. They may be hybrids-independent contractors and employees at the same time. Is that proper?**

It's permissible under the federal tax law for them to manage as employees and sell as statutory nonemployees. For bookkeeping purposes, they have to separate the compensation they're receiving for each activity. Their management activities are subject to withholding and everything else that you do for employees. They can be treated as independent contractors when engaged in activities in which they're actually earning on the basis of output.

If they're compensated on the basis of the output of those who work under them, they're still independent contractors under the federal tax code. If they're just drawing a salary as managers, they're treated as employees.

The company owners or bookkeepers have to make sure to pay the managers properly and withhold the right amount from their salary.

### **What is the relationship of the real estate industry to the IRS with regard to independent contractor status?**

I think the IRS has shifted its focus away from the real estate industry as a source of revenue. The IRS maintained that independent contractors underreport their income to the IRS. That's what their whole thesis was: Because there's no withholding, independent contractors won't report all their income to the government and, therefore, don't pay sufficient taxes.

Since the 1982 revision of the federal tax code, however, I'm not aware of a single court case or a single IRS audit involving the statutory independent contractor. The IRS has virtually ceased auditing real estate brokers. I'd almost declare victory.

*This interview was conducted by associate editor Philip A. Perry.*

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## **Independent Contractors, Employees, and Brokers: What's Your Responsibility?**

Because each state has its own laws governing employees and independent contractors (ICs), owners and managers of real estate companies must be aware of the legal requirements in their state. In some states, the laws are being changed to match the Internal Revenue Service (IRS) federal tax code definition of independent contractors.

Owners and managers in those states may find there is more latitude in managing their sales force; salespeople may find they have more legal responsibilities under the changing laws.

With the passage of the Tax Equity and Fiscal Responsibility Act of 1982, which added a new definition to the federal tax law regarding independent contractor status (statutory nonemployee status, as it's known in legal terms), fears of IRS audits of real estate companies diminished. The lack of IRS challenges to real estate companies from 1982 to 1987 indicated that the amount of management control a broker exercised over an independent contractor was no longer an issue at the federal level.

Oregon is one example of a state that passed laws to bring many of its state regulations about ICs into line with the federal statutes. Theoretically, those new laws should be advantageous for managers seeking more control over their sales force. But the impact of the Oregon laws appears to be limited.

"It's made for a clearer definition of the independent contractor status," said John VanLoo, designated broker of Gibson Bowles, Inc., REALTORS® in Portland, Oregon. "We do't have to fight the battle with the state anymore."

J. Robert Bills, president of Realestaters-Better Homes & Gardens® in Medford, Oregon, said the new state laws have relieved the company of much paperwork. "It's meant less of an administrative burden."

How much control brokers have over their salespeople is another factor that can be determined by the state. What if all legal barriers to control salespeople were eliminated? According to Bills, "The area that would be the most affected would be their work habits: prospecting, a certain number of daily reports--asking the salespeople how many calls they'd made, how many FSBOs [for-sale-by-owners] they'd contacted."

### **Doing It My Way**

Historically, owners and managers of real estate companies have based their choice between an employee or an independent contractor sales force on how much control they wanted.

Control was a factor that convinced one New York broker to hire employees instead of independent contractors. Hal Kahn, president of Kahn, Inc., REALTORS®-Better Homes and Gardens® in Newburgh, started in the late 1960s with independent contractors but switched to employees in the early 1970s. The reason: "So much concern existed about how much control you can have with your independent contractors," he said. "We wanted our salespeople to attend sales meetings, to do things in a certain fashion--such as go through qualifications--to be at the company certain times, and to represent our services in certain, specific ways."

Kahn's company returned once again to having independent contractors in the late 1970s. Was the switch a problem? Not from a financial standpoint, according to Kahn. "People who were vested in profit sharing were concerned with their savings more than anything else. And then when plans such as Keoghs and IRAs were developed, salespeople could establish their own savings plans."

Also, Kahn believed that successful business techniques had already been established. No longer did he have to "require" salespeople to act accordingly; they knew what was expected from them. "Our salespeople are pleased with the relationship, and we have been pleased with the results," he said.

The workmen's compensation situation changed just recently for real estate brokers in New York. "The insurance companies in New York State used to require us to carry compensation, but there was an agreement a year ago through specific real estate legislation, and now we don't have to," said Kahn.

Vince Aveni, chief executive officer of Realty One in Cleveland, Ohio, said his state does not pay for workmen's compensation or for unemployment benefits. "There's no way to determine whether salespeople are actually unemployed; the only time would be when they're not face-to-face with prospects."

Aveni said he has seen brokers try the employer/employee relationship, but that it has failed. "I don't think employees make as much money as ICs. And when brokers pay employees, they never know whether they're paying the salary to the wrong person--someone who doesn't have a burning desire to succeed and serve people or move heaven and earth to find the right house for the buyer."

Don Ursin, president of Coldwell Banker Residential Real Estate for the Chicago region, went through "the thought process" of employees versus independent contractors in the mid-seventies and chose to continue the independent contractor relationship. "If there's any hesitancy, it's that independent contractors sometimes think too independently. We managers need to get voluntary cooperation as opposed to arbitrary compliance."

Russell Booth, managing partner of the commercial-investment division of Mansell & Associates in Midvale, Utah, has always had independent contractors and concurred with Ursin. "It's [the IC relationship] been very productive. The only drawback is that they really are independent; they're like free agents."

The company's guidelines are indicated in a 25-page written policy and procedures manual, which serves as a contract. Attending sales meetings is one subject covered in the manual. But Booth said he goes further than strongly encouraging attendance by simply stating it in the manual. "We give more leads and referrals to people who show up, because they're the ones who are the most involved in supporting the company's activities and programs."

The manual also includes information on commission splits and on errors and omission insurance. To control production, Booth also states minimum performance standards in his contract. "If people don't achieve the standards consistently, we tell them to go practice somewhere else."

Meeting standards could be one tough hurdle to clear for new salespeople, who must act on their own behalf from the start. But if the inexperienced want or need more guidance and training, Booth is ready to offer assistance. "We structure a training program for them if they're interested."

### **Employees Still an Option**

About 90 percent of real estate salespeople are associated with their companies as independent contractors, according to the National Association's Economics and Research Division's report Membership Profile 1987. However, the question of which alternative--employees or independent contractors--to use in a real estate company can still be debated. And although only a small percentage of companies still use employees, the managers and brokers who do so seem to be quite pleased with the results. Erdine Schaefer, a sales coordinator for Arvida Realty Sales, Inc., in Boca Raton, Florida, is one such person. Arvida has about 80 employees who are involved in residential real estate.

"The idea came up about changing to independent contractors in the first part of 1988, but we decided against it," Schaefer said. "The general consensus was that it wouldn't work out. This is the way we've been operating, and it's been successful. So why change something that works?"

Many of the employees were formerly independent contractors. Did they have a hard time switching? No, according to Schaefer, who recalled one incident that surprised her. "I remember one salesperson who came to our weekly sales meeting in the morning, and we had juice, soda, and doughnuts in the refrigerator. She thought if she took a can of soda, she'd have to pay for it."

Arvida pays for those little luxuries as well as for phone calls, materials for mailings, and "every other tool imaginable," said Schaefer. The company also reimburses its salespeople for attending classes that lead to designations. The salespeople pay for the class up front and are then reimbursed as long as they pass the class. Other benefits for the employees include health, major medical, and dental insurance and reimbursement for eyeglasses. Because of their employee relationship, Schaefer said she thinks the group has more camaraderie. "We had an arts-and-crafts fair in Boca Raton called Meet Me Downtown. We set up a flower cart and asked for volunteers from the company to pass out flowers to people at the fair. All the salespeople volunteered without hesitation; they were eager to be involved."

Their devotion to the company is also evident by the number of years they're with the company, which averages about five. "Very seldom do people want to leave us; if they leave, it's because they

haven't met the company's objectives," said Schaefer.

Marjorie DeMarco, a former independent contractor, joined Arvida because of its employer/employee arrangement. "I think I'm better off dollar for dollar because I receive more benefits--insurance, retirement, mailings, advertising-and I could go on and on."

Anthony Barbar, president of Barbar Realty, also in Boca Raton, has 32 employees and believes he attracts a higher-caliber group of salespeople with the company benefits he offers, such as insurance, retirement programs, and marketing and public relations tools for mailings, newsletters, and advertisements. One added expense for the company with employees is the accounting and record keeping that are needed to track employee withholding, benefits, and other records. Barbar's company has a centralized accounting department that takes care of all the bookkeeping needed with regard to the benefits and enough personnel to accommodate those needs.

Barbar said the time and added expense are worth it. "Our people have been more effective and more productive. We all have a common purpose and goal, and we're working toward that goal as a unified company rather than as a group of individuals who share the same office. Having an employer/employee relationship is more costly, but we believe it's the only way to go."

### **Keep Up with the Laws**

No matter what type of arrangement you have with your salespeople, it's your responsibility to be up-to-date with any statutes that affect your business. Contact your legal counsel if you're confused about what you can and can't do as a broker.

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