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HOT TOPIC ALERT

INDEPENDENT CONTRACTORS IN THE REAL ESTATE INDUSTRY



Who is an employee? And who is a contractor? Businesses face an ever-changing legal landscape when they classify workers as either employees or independent contractors. The difference in classification can have significant implications for both the worker and the employer. A worker's status as an employee or contractor will affect their taxes and payroll withholdings, eligibility for employee benefits, minimum wage and overtime payments, unemployment insurance, workers' compensation and legal protections afforded to employees, such as antidiscrimination laws, to name a few.

Unfortunately, proper classification is not always clear. There has been a recent trend at both the state and federal levels to crack down on businesses that misclassify employees as independent contractors as a way to avoid application of worker protection laws and providing employee benefits. Not only have state legislatures considered legislation to delineate the differences between employees and independent contractors, but Congress is also considering [proposed legislation](#) that would specifically delineate between these classifications in an effort to better protect U.S. workers.

Even where the lines between contractors and employees are distinct, carve-outs exist that allow real estate brokers to choose whether to classify their agents as either employees or independent contractors. However, some of the recent federal and state legislative proposals do not have specific carve-out exceptions for real estate professionals, which could significantly impact the way in which the real estate industry has been operating for decades.

Independent Contractor vs. Employee: Why does it matter?

Whether a worker is defined as an employee or independent contractor will dictate whether that worker enjoys certain baseline employment and labor law protections. It will also determine a business's obligations and requirements that a business must follow related to a worker under the law. To understand the distinction and its importance, it helps to take a jump back in time.

Between 1929 and 1941, the Great Depression saw unemployment rise to heights not seen before. The concerns of workers were highlighted in new and unprecedented ways. Two significant pieces of legislation, the [National Labor Relations Act \(NLRA\)](#) and the [Fair Labor Standards Act \(FLSA\)](#), were passed as part of President Franklin D. Roosevelt's New Deal. Among other things, these laws established a minimum wage and guaranteed workers the right to collective bargaining and to form unions. The National Labor Relations Board (NLRB) was created to oversee and investigate unfair labor practices. Congress left to the NLRB the task of defining employees and independent contractors.

Over the years, the definitions have changed and have varied dramatically between the federal government and among the various states. The definitions became increasingly relevant as Congress and state legislatures passed new protections for employees, including setting a minimum wage, prohibiting employment discrimination, creating workers' compensation and unemployment insurance programs, and implementing overtime requirements.

Historically, real estate agents and salespeople have been classified as independent contractors, rather than employees. The IRS has recognized the practice of treating agents as contractors, and regards agents as "[statutory non-employees](#)." Real estate agents are statutory non-employees and will be treated as self-employed contractors for all federal tax purposes if:

- Substantially all payments for their services are directly related to sales or other output, rather than to the number of hours worked; and
- Their services are performed under a written contract providing that they will not be treated as employees for federal tax purposes.

A real estate agent is thus different from the "gig worker" independent contractors who are becoming an ever-increasing part of the labor force. There is no standard definition of "gig worker," but the term is [usually understood](#) to mean a person who works in a non-permanent, temporary capacity. They are typically hired for a particular task or project, and when that task or project is completed, they move on. In contrast, real estate agents have a long-term or permanent relationship with a particular broker. They are not temporary workers, and they are with the brokerage for more than just a single transaction.

Increased protections for employees have led some businesses to try to circumvent the regulations by classifying employees as independent contractors who are not subject to these same protections. In the past thirty years, the number of independent contractors has been on the rise. The most significant jump happened over the past 15 years and has increased markedly in the past year as a result of the pandemic. The [Harvard Business Review](#) suggests that between 2005 and 2015, the number of independent contractors rose by 40% and now constitutes nearly 10% of the workforce. By 2020, estimates put the number of independent contractors [at over 33% of the workforce](#). With the onset of the COVID-19 pandemic, independent contractors are now estimated to constitute as many as [43% of the workers in the United States](#).

What is the difference?

The dramatic increase in numbers begs the question of whether so-called independent contractors are always properly classified. Courts across the country have been repeatedly asked to decide whether a worker has correctly been regarded as an independent contractor, with workers claiming they were improperly classified by a business as independent contractors, and suing for back wages or unemployment compensation.

While definitions vary from state to state and between state and federal laws, a general distinction is often made using “right of control” tests. This test means that the question of whether a worker is an employee depends on who has the most control over how, when, and where work is done. The greater the control a business has, the more likely the worker is to be classified as an employee; conversely, where the worker has greater control, that person is more likely to be an independent contractor.

Federal agencies have also addressed the question. In 1987, the IRS published a list of [twenty factors](#) to be considered when determining a worker’s classification for tax purposes. In 1989, in the case of [Community for Creative Non-Violence v. Reid](#), the United States Supreme Court also provided a similar list of eleven considerations for deciding if a worker is an employee for purposes of the Employee Retirement Income Security Act (ERISA).

[In 2008, the Department of Labor \(DOL\) issued guidance](#) pursuant to the Fair Labor Standards Act (FLSA) and outlined a list of seven factors to consider. The DOL noted that “[t]he U.S. Supreme Court has on a number of occasions indicated that there is no single rule or test for determining whether an individual is an independent contractor or an employee for the purposes of FLSA.” The DOL listed seven factors considered by the Court that the DOL would include in its guidance:

1. The extent to which the services rendered are an integral part of the principal’s business.
2. The permanency of the relationship.
3. The amount of the alleged contractor’s investment in facilities and equipment.
4. The nature and degree of control by the principal.
5. The alleged contractor’s opportunities for profit and loss.
6. The amount of initiative, judgment, or foresight in open market competition with others required for the success of the claimed independent contractor.
7. The degree of independent business organization and operation.

In the waning days of the Trump Administration, the [DOL proposed a new rule](#) that would have gone into effect beginning in March 2021. The new rule would have streamlined the considerations by using the [“economic reality test”](#). That test looks at how intertwined the economic considerations are between the business and the worker. Where the worker is in business for themselves, the relationship is likely one of an independent contractor. If the worker is economically dependent on the hiring entity, then an employee relationship is likely to exist. The rule called for two key considerations: (1) to what degree and nature does the employer have control over the work to be performed, and (2) which of the parties, the worker or the employer, absorbs profits and losses.

However, upon taking office, President Biden issued a regulatory freeze in order to review rules that had not yet gone into effect. This freeze included the DOL’s rule on independent contractors. Upon review, the DOL [decided to withdraw the Trump rule](#) and continue to look at the seven factors described in its 2008 guidance as the current standard of review. The DOL stated that “[b]y withdrawing the Independent Contractor Rule, we will help preserve essential worker rights and stop the erosion of worker protections that would have occurred had the rule gone into effect.”

While it is too early to know what direction the DOL will take under President Biden, early indications are that it will be aggressive in its pursuit of misclassification cases, but that it may not necessarily be targeted at “legacy” independent contractors like real estate professionals. However, evidence of the pro-employee agenda is in [new legislation](#) currently being considered by Congress that could strengthen the rights of employees and could also narrow the definition of independent contractors significantly.

Independent Contractors in Real Estate

Real estate brokers have long had the choice of classifying the agents who work for them as either employees or independent contractors. However, with the increase in attention being given to the problem of misclassification of employees as independent contractors, litigation on this issue has taken on a new importance. Some independent sales agents have brought suit, arguing that they should have been classified as employees rather than contractors. They contend that because they are supervised by brokers, among other factors, they should be classified as employees who are entitled to the benefits and protections of wage and labor laws under the “right to control” theory. For example, in Miami, agent Beatriz Sanatamaria [brought suit against Cervera Real Estate](#), alleging that she was misclassified as a contractor when she was in fact an employee. Her case was referred to arbitration. In New Jersey, the [Appellate Division of the Superior Court held](#) that the “significant level of control and direction” a brokerage exercised over its agents justified a finding that the agents were employees, not independent contractors. Real estate agents operate under a broker’s real estate license in large part because contracts for sale are generally between the broker and the client rather than the agent and the client. As such, state laws require a broker to supervise agents to various degrees regardless of whether the agent is an employee of or independently contractor of the broker. This supervisory requirement is often cited in litigation by plaintiffs as evidence of an employer-employee relationship.

The IRS, along with many state legislatures and state courts, has, however, provided carve-outs or exemptions from the definition of employee for real estate agents. These carve-outs authorize exemptions that allow workers to be regarded as independent contractors while permitting the broker to fulfill statutory requirements to supervise their agents. For federal tax purposes, the IRS has created a separate category of workers called “statutory non-employees.” In order for a broker to classify agents as statutory non-employees and have them work without the broker having to withhold taxes and Social Security or follow other wage and labor laws, a real estate agent must: (1) be licensed; (2) receive payment for services that is directly related to sales or other output as opposed to being based on the number of hours worked; and (3) perform his or her services pursuant to a written contract between the broker and agent, which specifically states the agent is an independent contractor for tax purposes.

California and the ABC test

The IRS’s categorization only applies to federal tax liabilities and responsibilities. Individual states are left to decide how to classify workers for the purpose of worker protections provided at the state level. While states vary in the criteria used to determine whether a worker is an independent contractor, some states have particularly stringent laws. Most notably, in 2018, the Supreme Court of California issued a ruling in the case of [*Dynamex Operations West, Inc. v. Superior Court et al.*](#), which established the “ABC test” for determining whether a worker should be classified as an independent contractor or an employee. The court ruled that independent contractor status is met only if three conditions are present:

- A. The employer has no right to control and direct the worker’s performance of the work or services. If the worker is subject to the type and degree of control that an employer typically exercises over its employees — such as how, when, or where work is to be completed — then the worker is an employee regardless of any agreement otherwise.
- B. The work or services performed are “outside the usual course of the hiring entity’s business.” For example, suppose a real estate brokerage hires an electrician to replace faulty wiring in its office. In that case, the electrician’s work is outside the usual course of the brokerage’s business, and thus, the electrician is an independent contractor. Conversely, if the brokerage hires an office manager to make sure that operations are run smoothly, that work would be within the usual course of the brokerage’s business. The office manager would thus be considered an employee.
- C. The worker has decided, *independently*, to go into business for him or herself by taking steps to establish and promote his or her business independently. These steps include incorporation, licensure, advertising, and offering similar services to other businesses or potential customers. Notably, the worker must have already been engaged as a business and not merely have the potential to do so. If the worker provides work to a single entity only, then this part of the test is not met.

After the court’s ruling in the *Dynamex* case, the California legislature passed [Assembly Bill 5](#) (AB 5), which codified the ABC test and became effective January 1, 2020. Thanks to extensive efforts by the California Association of REALTORS®, and supported by the National Association of REALTORS®, an exception to the test was carved out to allow real estate brokers and agents

to maintain the option to choose whether to be employees or independent contractors. In addition, [California Business and Professions Code § 10032](#) specifically authorizes a broker and an agent operating under the broker's license to elect between themselves to have the agent treated as an independent contractor. This carve-out is [not without limitation](#), however. To be properly classified as an independent contractor, certain factors must still be considered. These factors are similar to the "right to control" test, and the contract between the parties must also meet the criteria set out in the IRS's definition of a statutory non-employee.

Other state legislation and laws

Legislatures and courts in several states besides California are also addressing the employee/contractor issue. Massachusetts has a stringent law defining independent contractors in that state ([Mass. Gen. Laws ch. 149 § 148B](#)). That law, however, conflicts with real estate licensing laws that authorize agents to work as independent contractors while still being supervised by brokers ([Mass. Gen. Laws ch. 112 § 87RR](#)). In 2015, the state Supreme Judicial Court addressed the conflict in [Monell, et al. v. Boston Pads, LLC, 471 Mass. 566 \(2015\)](#). In that case, the court allowed agents to remain independent contractors despite the supervision requirement. The court analyzed the factors provided by state law to determine whether a worker is an independent contractor and held that real estate licensing laws, which require a salesperson to work under the supervision of a broker, make it impossible for the salesperson to be an independent contractor. The more specific real estate licensing laws, however, state explicitly that a salesperson may be an independent contractor. The court applied the maxim of statutory interpretation that a specific law applies over a non-specific law (such as the independent contractor statute).

Brokers and agents in Louisiana might have found themselves in the same situation as their Massachusetts counterparts if [Senate Bill 68](#) had become law in 2020. That bill would have codified specific definitions for "employee" and "independent contractor" utilizing a "right to control" analysis. However, like Massachusetts, Louisiana real estate licensing law also specifically authorizes independent contractor relationships between real estate brokers and agents using the conditions set out by the IRS's statutory non-employee definition. The conflict that the bill would have created is still only a theoretical possibility, as that bill did not pass out of committee and will not carry over to the next legislative session.

In Virginia, the state workers' compensation statute excludes licensed real estate salespeople from the definition of "employee" if "substantially all of [the salesperson's] remuneration is derived from real estate commissions;" the services of the salesperson are performed under a written contract specifying that he or she is an independent contractor, and the contract includes a provision that the salesperson will not be treated as an employee for federal income tax purposes. [Va. Code § 65.2-101](#).

Other states have taken steps in recent years to address the issue of misclassification of employees as independent contractors. Last year, in Nevada, the Office of the Labor Commissioner created a [Task Force on Employee Misclassification](#), which includes experts from the real estate profession, and meets regularly to consider the issue and make proposals for legislation .

In New Jersey, a law that went into effect on April 1, 2020 ([2020 N.J. Laws Ch. 375](#)) requires employers to post a notice for their employees regarding employee misclassification. The notice must explain, among other things, the prohibition against employers misclassifying employees and the standard applied by state agencies to determine whether a worker is an employee or an independent contractor. Under the law, an employer may not discharge or discriminate against a worker because the worker has made an inquiry or complaint regarding possible worker misclassification or because the employee has started any proceeding regarding worker misclassification. An employer who violates any of those provisions will be guilty of a disorderly person's offense and be subject to a fine. An employer will also be required to offer reinstatement to a discharged worker and correct any discriminatory action. It must also pay the employee's legal expenses for the action, all wages and benefits lost as a result of the discharge or discriminatory action, plus punitive damages equal to two times the lost wages and benefits.

With the shutdown caused by the COVID-19 pandemic having dramatically increased the number of gig workers and independent contractors within the labor force, some are calling for a reevaluation of whether the ABC test should continue to be the governing standard. Others, however, cite these increased numbers as a reason to revisit instituting further protections for workers. Those who support increased protections include major unions such as the AFL-CIO, Service Employees International (SEIU), the National Education Association, and Teamsters.

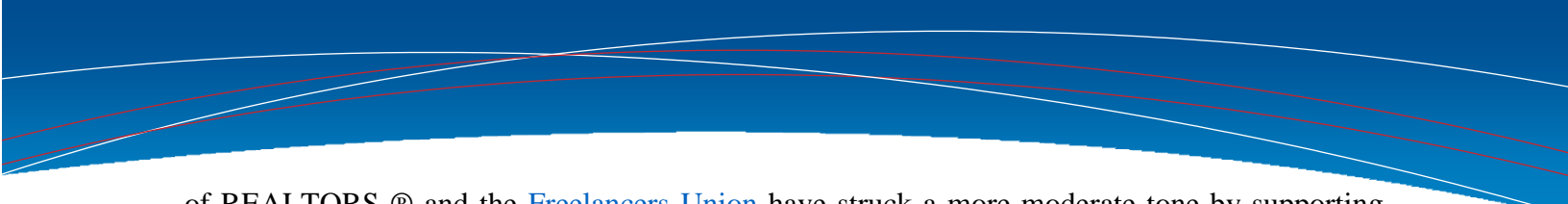
More information on specific items of state and federal legislation are available from [NAR Focus](#).

Federal Legislation

In March 2021, the U.S. House of Representatives passed the Protecting the Right to Organize (PRO) Act, [H.R. 842](#), which would codify the ABC test at the federal level under the [National Labor Relations Act \(NLRA\)](#). Among other things, the PRO Act seeks to protect the rights of workers to unionize without influence or interference by employers and would authorize monetary penalties against employers for violating the rights of workers. It would also allow workers who meet the criteria for classification as independent contractors to be considered "employees" for the purpose of the NLRA by codifying the ABC test to expand that pool of eligible workers. This would pave the way for those workers to unionize and negotiate wages and working conditions by being classified as employees.

In its current form, as passed by the House on March 9, 2021, H.R. 842 has no carve-out exception for real estate agents like California's exception. This has caused concern throughout the real estate industry as to whether agents may continue to be classified as independent contractors. Despite its passage in the House, the concern is likely premature at this point and remains limited to classification only under the NLRA. The PRO Act has an uphill climb before it becomes law as it must pass the Senate where there is no support from Republican lawmakers. A few Democrats are also hesitant to support the bill, and so long as the current filibuster rules remain in place, a minimum of 60 votes are needed to pass in the Senate, including both Republicans and Democrats.

Some groups have expressed opposition to the PRO Act, while others have expressed concern regarding only specific provisions included in the bill. The [U.S. Chamber of Commerce](#) and the [National Association of Manufacturers](#) have vowed to oppose the bill. The National Association



of REALTORS® and the [Freelancers Union](#) have struck a more moderate tone by supporting greater protections for independent workers while expressing concern that the PRO Act, including the ABC test, may negatively impact legacy independent contractors in certain sectors who should be exempted. NAR, along with state associations have been working with lawmakers and discussing compromises that will carve out protections for independent contractors in the real estate context. Current indications are that while there is no bipartisan support for the PRO Act itself, Democrats and Republicans alike tend to agree that exceptions for real estate professionals would be a necessary part of any changes that may be made to existing worker protection laws.

Conclusion

The real estate industry has a long tradition of allowing brokers and agents to choose whether agents will be independent contractors or employees, which is recognized under both federal and state law. This arrangement has worked well for decades, and many within the industry wish to maintain the long-standing tradition. With the current push to ensure that workers who should not otherwise be classified as independent contractors remain protected, changes in the laws have the potential to upset the traditional practice among real estate professionals. NAR and other organizations continue to encourage policymakers within the states and at the federal level to closely review existing and proposed labor and wage laws to determine whether the interests of the real estate industry will be caught up in these changes and to urge specific carve-outs to be included where necessary.

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