

Avoiding Expensive Employer Mistakes

Mis-Classifying Employees as Contractors

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One of the most expensive mistakes that employers frequently make is to mis-classify employees as “independent contractors.” Many companies use individuals classified as “independent contractors” or temporary workers to perform their work, to perform work not usually performed by the company’s regular employees, or to enhance the capabilities of their regular workforces, adding skills or abilities that the company’s own employees do not have. Such mis-classifications can bring down upon the employers the enforcement powers of at least three government agencies: The Internal Revenue Service (for the withholding, and payroll taxes), The U.S. Department of Labor Wage and Hour Administration (to ensure payment of minimum wage and overtime pay), and your State’s Department of Labor Unemployment Insurance Liability Adjudicators (to collect unpaid unemployment insurance taxes). These can bring tax penalties, interest, and, in the case of the laws enforced by the U.S. Labor Department, “liquidated damages.” Mis-classified employees also can bring their *own* lawsuits, with their own lawyers. In such a case, the employer who loses will have to pay not only the wages and overtime they failed to pay properly, but an equal amount of liquidated damages, interest, and the employees’ attorney fees.

To avoid the perils of mis-classification of employees as independent contractors you'll want to make certain that you are treating these people as independent contractors and not employees. Use the following checklist to determine if workers are truly independent contractors (ICs) or if it is possible that they have been turned into employees (EE) with overtime and other employment rights.

Independent Contractors Checklist	Yes/EE	No/IC	N/A
Worker must comply with instructions.			
Worker is trained by person hired.			
Worker's services are integrated in business.			
Worker must personally render services.			
Worker cannot hire or fire assistants.			
Work relationship is continuous or indefinite.			
Work hours are preset.			
Worker must devote full time to this business.			
Work is done on the employer's premises.			

Independent Contractors Checklist	Yes/EE	No/IC	N/A
Worker cannot control order or sequence.			
Worker submits oral or written reports.			
Worker is paid at specific intervals.			
Worker's business expenses are reimbursed.			
Worker is provided with tools or materials.			
Worker has no significant investment. Worker has no opportunity for profit/loss.			
Worker is not engaged by many different firms.			
Worker does not offer services to public.			
Worker may be discharged by employer.			
Worker can terminate without liability.			

The economic and tax advantages associated with the independent contractor relationship are rather significant for most, if not all, employers. Therefore, the temptation to pursue and establish such agreements instead of permanent employment arrangements is a practical reality. In order to minimize intentional or inadvertent abuse that can result in substantial penalties, the IRS has recently developed additional guidelines to assist the employer in correctly identifying and classifying employment relationships.

Reasonable Basis Test

The "reasonable basis" test provides a "safe harbor" to employers based on existing government or court classifications of workers in a particular business or industry and was mandated by the **Revenue Act of 1978** (PL 95-600, Sec. 530), which provides that a worker may be appropriately classified as an independent contractor exempt from federal employment taxes if one or more of the following conditions are met:

- Judicial precedent treating workers in similar circumstances as non-employees
- A Revenue Ruling issued by the Internal Revenue Service (IRS) indicating that similar workers are exempt;
- An IRS Technical Advice Memorandum stating that the worker in question is not an

- employee;
- A long-standing and recognized practice in the industry of treating similar workers as non-employees;
- A prior IRS audit finding that individuals in substantially similar positions were not employees

Common-Law Test

The common-law test may be used as an alternative to the "reasonable basis" test to classify workers. To determine whether an individual is an employee or an independent contractor under the common law, the relationship of the worker and the business must be examined. In any employee-independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered. Facts that provide evidence of the degree of control and independence fall into three categories: behavioral control, financial control, and the type of relationship of the parties.

1. Behavioral control. Facts that show whether the business has a right to direct and control how the worker performs his job functions include the type and degree of:

- **Instructions that the business gives to the worker.** An employee is generally subject to the business's instructions about when and where to do the work, what tools or equipment to use, what workers to hire or to assist with the work, where to purchase supplies and services, what work must be performed by a specified individual, and what order or sequence to follow. The amount of instruction needed varies among different jobs. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. A business may lack the knowledge to instruct some highly specialized professionals; in other cases, the task may require little or no instruction. The key consideration is whether the business has retained the right to control the details of a worker's performance or instead has given up that right.
- **Training that the business gives to the worker.** An employee may be trained to perform services in a particular manner. Independent contractors normally use their own methods.

2. Financial control. Facts that show whether the business has a right to control the business aspects of the worker's job include:

- **The extent to which the worker has unreimbursed business expenses.** Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services that they perform with their business.
- **The extent of the worker's investment.** An independent contractor often has a significant investment in the facilities he or she uses in performing services for someone else. However, a significant investment is not necessary for independent contractor status.
- **The extent to which the worker makes his or her services available to the relevant market.** An independent contractor is generally free to seek out business opportunities. They often advertise, maintain a visible business

location, and are available to work in the relevant market.

- **How the business pays the worker.** An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is usually paid a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.
- **The extent to which the worker can realize a profit or loss.** An independent contractor can make a profit or loss.

3. Type of relationship. Facts that show the parties' type of relationship include:

- **Written contracts describing the relationship the parties intended to create.**
- **Whether or not the business provides the worker with employee-type benefits such as insurance, a pension plan, vacation pay, or sick pay.**
- **The permanency of the relationship.** If employers engage the worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that the employer's intent was to create an employer-employee relationship.
- **The extent to which services performed by the worker are a key aspect of the business of the company.** If a worker provides services that are a key aspect of the employer's regular business activity, it is more likely that the employer will have the right to direct and control his or her activities.

Note: Be careful of the lure of past practice. Even though similar positions or the same position may have been classified as an employee or independent contractor in the past, working arrangements typically change over time. Therefore, be certain to evaluate the current status of the position in light of these factors.

Contact your D C B & F attorney for advice on how this applies to your company.