

## **New Focus on an Old Topic: Is That Worker an Independent Contractor or Employee?**

By Glenn E. Thomas,  
Lewis, Longman & Walker, P.A.

"In theory there's no difference between theory and practice. In practice there is."  
-Yogi Berra

Employers, both private and public, are keen to explore new strategies for avoiding the often unavoidable costs and liabilities associated with the hiring of each new employee. One attractive option often exploited to save money and circumvent liability is to label as an independent contractor a worker who would normally be designated as an employee. Although on average the hourly rate an employer ultimately ends up paying an independent contractor may exceed the hourly rate paid to an employee, it typically costs an employer more to hire an employee to perform the same work.

The hiring of an employee results in expenses beyond the hourly rate. Such expenses include employer-provided benefits, office space, training and equipment, Social Security and Medicare taxes, unemployment compensation insurance, and workers' compensation insurance. Extra expenses incurred by hiring an employee as opposed to procuring the services of an independent contractor can easily exceed 20% of payroll cost for that employee.

Flexibility in staffing decisions is another benefit of the independent contractor. Independent contractors can be engaged for a specific task or project, after which the relationship terminates; whereas termination of an employee is often an emotional and costly experience, frequently resulting in litigation.

Employees are protected from employer action by an abundance of state and federal laws, including wage and hour, labor union, worker's compensation, and civil rights laws. Employees may also be able to sue their employers for wrongful termination. Another benefit of hiring an independent contractor is that the relationship between an employer and an independent contractor is governed by the terms of the contract and only rarely do employment laws affect that relationship.

Considering the many benefits associated with hiring an independent contractor as opposed to an employee, it is not surprising that employers often go to great lengths to avoid the employee/employer relationship when making hiring decisions. And as additional labor regulations and taxes make hiring additional employees even more unattractive, employers are testing the bounds of misclassification in order to assign duties typically performed by employees to "independent contractors."

Some employers operate under the mistaken presumption that an independent contractor relationship is created by agreement of the parties. In fact, auditors will give very little weight to the classification designated in a contract. If a worker is an employee, it is of little note that the parties have elected the classification of independent contractor. The auditor will deem the individual an employee and the auditing agency will impose substantial financial hardship in the form of back taxes, Social Security, unemployment and workers' compensation. In addition, certain rights under federal law, such as the Fair Labor Standards Act, may not be contracted away.<sup>1</sup> Consequently, an employee who signed a contract agreeing that he or she is an independent contractor may later bring an action for unpaid wages and overtime.

That the Internal Revenue Service takes a dim view of independent contractor relationships that are improperly classified should not be surprising. The federal government has an interest in seeing as many workers as possible classified as employees, because the more workers who are classified as employees, the more tax and insurance money received by the government. The Office of Management and Budget estimates that misclassification could be costing the Treasury approximately \$7 billion in receipts over the next ten years.<sup>ii</sup>

In recent years, the federal government, through the Department of Labor (DOL) and IRS, has been conducting audits to scrutinize employers who have been misclassifying employees as independent contractors. These reviews have not been limited to larger, private employers where it would seem the most fertile ground for systemic abuses in misclassification might exist. Indeed, local governments within the state of Florida have been audited and misclassifications have been found with considerable financial consequence.

Any number of federal agencies may conduct an audit if they believe an employer has misclassified its employees as independent contractors. Employers may face an audit from the IRS; the Department of Labor, which enforces federal minimum wage and hour laws; the National Labor Relations Board, which enforces employees' rights to form a union; or the Occupational Safety and Health Administration, which enforces workplace safety laws.

The problem of misclassification has started to receive attention from the White House, which is now taking additional steps to correct the problem. In its Budget summary, the Office of Management and Budget cites the deprivation of benefits for employees, such as overtime and unemployment as the motivation for a coming crack down on misclassification. As part of the 2011 Budget, the Departments of Labor and Treasury are pursuing a joint proposal that would eliminate what the White House perceives as incentives for employers to misclassify their employees. The Joint proposal would enhance the ability of both agencies to penalize employers who misclassify and restore protections to employees who have been denied them because of improper classification. The Budget includes an additional \$25 million for DOL to hire 100 additional enforcement personnel and for grants to boost the states' incentives and ability to assist in enforcement.

To avoid or minimize the harsh remedies of an enforcement action, governmental employers should review current and future contracts to determine if employees have been or may be misclassified as independent contractors.

### **The “Test”**

Generally a worker is an independent contractor if the person or entity for whom the services are performed has the right to control or direct only the result of the work, and not the means and methods of accomplishing the result. For FICA purposes, an individual is an employee if, under the common law rules applicable in determining the employer-employee relationship, the individual has the *status of employee*.<sup>iii</sup> The general rule for determining whether an individual has the “status of employee” is that an employment relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result, but also with respect to the details and means by which the result is accomplished. To demonstrate an employer-employee relationship it is not necessary to demonstrate actual control by an employer; it is enough to show *the right* to control.<sup>iv</sup> Such determinations are arrived at on a case-by-case basis, by reviewing all relevant facts and circumstances.

Until recently the Internal Revenue Service employed a twenty question common law test to determine whether an individual was an employee or an independent contractor. Not all of the twenty common law factors may apply in any given situation. In addition, the weight assigned to a specific factor will vary depending upon the circumstances. As mentioned previously, the classification applied by the parties is not a significant factor. If an employment relationship exists, it is irrelevant whether the employee is called an independent contractor.

Recently the IRS replaced the “twenty factors” test with a more condensed analysis. However, the “twenty factors” test is still widely cited and because they were integrated into the current common law test, the factors are instructive.

### **‘Twenty Factors’ Test**

1. **Instructions** : Employees receive instructions about when, where and how the work is to be performed. Independent contractors are generally not required to follow instructions as to the details or methods of the work.
2. **Training** : Employees often receive training from the employer or are required to take specific training courses prior to or as a part of their employment. In contrast, independent contractors generally do not receive training by the hiring entity, and use their own methods to complete the work.
3. **Work essential to operation**: An employee’s services are merged into the employer's overall operation and are essential to the operation. An independent contractor's services are not an integral part of the operation, and are generally separate from the client's business and are not integrated or merged into it.
4. **Services rendered personally**: Employees do not hire their own substitutes or delegate work to them. An independent contractor may hire others to do the job and need not perform services personally.
5. **Hiring and supervising assistants**: An employee may act as a supervisor, but assistants are paid by the employer. Independent contractors select, hire, pay, and supervise assistants and are responsible for the results of their work.
6. **Continuing relationship**: An employee will generally continue to work for the same employer indefinitely, until the employment relationship is terminated. An independent contractor is usually hired to do a job of a specified duration that is typically set forth in a written agreement, and there is no expectation of continued work beyond the term of the agreement except as provided in the agreement.
7. **Hours of work**: Employees work during hours and days as set by the employer. An independent contractor works the days and hours he or she chooses.
8. **Full-time service**: Employees ordinarily devote full-time service to the employer, or the employer may have a priority on the employee's time. An independent contractor generally is not required to devote full-time service to one person or entity.
9. **Location of service**: An employer has the right to mandate where services are performed. Independent contractors may ordinarily work where they choose, often away from the client's place of business.

10. **Order of work:** An employee performs services in the order or sequence set by the employer. This shows control by the employer. An independent contractor determines the order and sequence in which they will perform their work.
11. **Interim reports:** Employees may be required to submit regular oral or written reports about work in progress. An independent contractor is usually not required to submit regular oral or written reports about work in progress.
12. **Regular pay:** An employee is generally paid in regular amounts at stated intervals, (e.g., an hourly rate for work performed during specified pay periods). An independent contractor is typically paid by the job or on a fee basis.
13. **Expenses:** An employee's business expenses are either paid directly or reimbursed by the employer. Independent contractors are generally responsible for their own business expenses, although certain expense items may be reimbursed pursuant to an agreement with the client.
14. **Tools and equipment:** Employees are furnished by their employer with the tools, materials, and equipment necessary to perform his or her job. An independent contractor will generally provide all of the tools and equipment necessary to complete the job.
15. **Significant investment:** Employees generally have little or no investment in the business, and are economically dependent on the employer. Independent contractors will normally have a substantial financial investment in their business.
16. **Profit or loss:** Employees are paid for services rendered and do not realize a profit or loss in the employer's business. An independent contractor can either realize a profit or suffer a loss depending on the management of expenses and revenues.
17. **Multiple firms:** An employee ordinarily works for one employer at a time and may be prohibited from joining a competitor. An independent contractor often works for more than one client or firm at the same time and is not restricted from serving additional clients.
18. **Services available to the public:** An employee does not make his or her services available to the public except through the employer's company. An independent contractor may advertise services to the general public, have business signs, possess a business license and keep an office.
19. **Ability to fire:** An employee can generally be discharged at any time without liability on the employer's part. In contrast, an independent contractor who is performing the job satisfactorily cannot be fired without liability for breach of contract.
20. **Ability to quit:** An employee may quit work at any time without liability on the employee's part. An independent contractor is legally responsible for job completion and becomes liable for breach of contract if he or she does not complete the job.

### **New IRS Common Law Test**

The IRS has recently attempted to simplify and refine the common law independent contractor test. It has consolidated the twenty factors by organizing them into three main groups with eleven tests. Facts that provide evidence of the degree of control and independence fall into three categories:

- Behavioral: Does the employer control or have the right to control what the worker does and how the worker does his or her job?
- Financial: Are the business aspects of the worker's job controlled by the payer? (These include things like how the worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)
- Type of Relationship: Are there written contracts or employee type benefits (i.e. pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?

There is no specific number of factors that determine whether a worker is an employee or an independent contractor, and no one factor stands alone in making such a determination. Moreover, factors which are relevant in one situation may not be relevant in another, or may hold considerably less weight. The key is to consider the factors in view of the circumstances of the entire relationship.

### **Behavioral Control**

Behavioral control refers to facts that show whether there is a right to direct or control how the worker does the work. A worker is an employee when the business has the right to direct and control the worker. The business does not have to *actually* direct or control the way the work is done – as long as the employer has *the right* to direct and control the work.

The behavioral control factors fall into the categories of

- Type of instructions given
- Degree of instruction
- Evaluation systems
- Training

Types of instructions given: This may be the single most important point of analysis in determining the appropriateness of a classification. An employee is generally subject to the employer's instructions about when, where, and how to work. All of the following are examples of types of instructions about how to do work.

- 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.
- What order or sequence to follow when performing the work.

As a starting point in its analysis, an auditing agency may look to where the work is performed. If the work is performed on the premises of the employer, that factor will suggest control over the worker, especially if it is possible for the work to be done from another location.<sup>v</sup> So, as an easy starting point for self-evaluation, an employer should look to where an individual is working. If a contract requires an individual to work at the employer's place of business, an employment relationship may be inferred unless other factors clearly indicate otherwise. If a true independent contractor relationship is desired, a contract should not require a worker's

presence, unless entirely unavoidable due to the circumstances of the work performed. Phrases such as “on-site” or “in-house” should be avoided.

Set hours of work will also indicate control and the existence of an employment relationship. A true independent contractor will typically not be bound by specific hours. If a contract indicates that a worker is to be “available” during the employer’s hours of operation, this will indicate control sufficient to suggest an employment relationship.<sup>vi</sup>

An employer should look to the degree of control it may have over how duties are to be performed. If an employer requires a worker to comply with specific instructions about how to complete a certain task or if a contract specifies that the employer has a “right” to require compliance with instructions on how, when or where services are to be performed, such a provision will strongly suggest an employee relationship.<sup>vii</sup> As a general rule, if you wish to control anything beyond the outcome, you should strongly consider hiring an employee.

If the worker hires, supervises and pays his or her own assistants, or provides supplies and equipment necessary to complete the work, these factors that will suggest an independent contractor status. However, if the employer provides the materials and labor necessary to do a job, an employment relationship will be inferred.<sup>viii</sup>

Degree of instruction: The more detailed the instructions provided to a worker, the more control the employer exercises over the worker. More detailed instructions indicate that the worker is an employee. Less detailed instructions reflects less control, indicating that the worker is more likely an independent contractor.

Evaluation system: If an evaluation system measures the details of how the work is performed, then these factors would point to an employee. If the evaluation system measures just the end result, then this can point to either an independent contractor or an employee.

Training: Employer-provided training on how to do a specific job indicates that the employer wants the task completed in a particular way and is strong evidence that the worker is an employee. Periodic or on-going training about the employer’s procedures and methods is even stronger evidence of an employer-employee relationship.

### **Financial Control**

Financial control refers to facts that show whether or not the person for whom work is performed has the right to control the economic aspects of the worker’s job. These factors fall into the following categories:

- Significant investment
- Unreimbursed expenses
- Opportunity for profit or loss
- Services available to the market
- Method of payment

Significant investment: An independent contractor often has a significant investment in the equipment or facilities he or she uses in working for someone else. However, in many occupations, such as construction, workers spend thousands of dollars on the tools and equipment they use and are still considered to be employees. There are no precise dollar limits that must be met in order to have a significant investment. Furthermore, a significant investment

is not necessary for independent contractor status as some types of work simply do not require large expenditures. Generally, a lack of investment by a worker in facilities or equipment indicates dependence on the employer for required facilities or equipment, and under such circumstances an employee relationship will be inferred.<sup>ix</sup>

**Unreimbursed 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 for their business.

**Opportunity for profit or loss:** The opportunity to make a profit or loss is another important factor. If a worker has a significant investment in the tools and equipment used and if the worker has unreimbursed expenses, the worker has a greater opportunity to lose money (i.e., their expenses will exceed their income from the work). Having the possibility of incurring a loss indicates that the worker is an independent contractor. Generally a worker who cannot realize a profit or suffer a loss is an employee.<sup>x</sup>

**Services available to the market:** An independent contractor is generally free to seek out additional business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.<sup>xi</sup> It is important to note, however, that the fact an individual performs services for more than one entity is not necessarily indicative of independent contractor status. Employers should avoid contract provisions restricting in any way the ability of the independent contractor to engage additional clients. Employers should also avoid contract language that suggests that the employer is the contractor's "primary" client or it is to receive "priority" over other clients.

**Method of payment:** 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 specified fee for the job.<sup>xii</sup> However, it is common in some professions, such as law, to pay independent contractors hourly.

## **Type of Relationship**

Type of relationship refers to facts that show how the two parties perceive their relationship to each other. These factors generally fall into the following four categories.

- Written contracts
- Employee benefits
- Permanency of the relationship
- Services provided as key activity of the business

**Written contract:** Although a contract may state that the worker is an employee or an independent contractor, this is not sufficient to determine the worker's status. The IRS is not required to follow a contract provision stating that the worker is an independent contractor, responsible for paying his or her own payroll taxes. How the parties work together determines whether the worker is an employee or an independent contractor.

**Employee benefits:** Employee benefits include things like insurance, pension plans, paid vacation, sick days, and disability insurance. Businesses generally do not grant these benefits to independent contractors. However, the lack of these types of benefits does not necessarily mean the worker is an independent contractor.

Permanency of the relationship: A continuing relationship between a worker and the person for whom services are performed is generally considered evidence that the intent was to create an employer-employee relationship. If the employer has the right to discharge a worker, an employment relationship is indicated. However, an independent contractor generally cannot be terminated so long as the contract specifications are being met.<sup>xiii</sup> Similarly, an independent contractor does not have the right to terminate the relationship with an employer until the terms of the contract have been met. A worker with the ability to terminate his relationship at will with the person for whom services are provided is an employee.<sup>xiv</sup>

Services provided as a key activity of the business: If a worker provides services that are a key aspect of the business, it is more likely that the business will have the right to direct and control his or her activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services will generally be subject to control and an employment relationship may be inferred.<sup>xv</sup>

## Conclusion

While a complete analysis of the relationship between a worker and employer is indispensable for determining potential liability for misclassification, much can be learned from simply considering the general rule of classification. An employment relationship exists when the person for whom services are performed has the *right to control and direct* the individual who performs the services, not only as to the result, but also with respect to the details and means by which the result is accomplished.

You, as an employer, should ask yourself whether you want to place restrictions on the time, place and manner work is to be performed, or if you only require a pre-determined outcome. If you mean to contract for a set dollar amount and for a specific result, you are correctly engaging the services of an independent contractor. However, keep in mind that with each additional contract requirement regulating the time, place or manner in which work is to be performed, the classification inches ever closer to employee-employer.

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<sup>i</sup> *Wethington v. City of Montgomery*, 935 F.2d 222, 229 (11th Cir.1991).

<sup>ii</sup> [http://www.whitehouse.gov/omb/factsheet\\_key\\_americas\\_workers/](http://www.whitehouse.gov/omb/factsheet_key_americas_workers/)

<sup>iii</sup> 26 U.S.C. § 3121(d)(2)

<sup>iv</sup> 26 CFR 31.3121 (d)-1(c).

<sup>v</sup> Rev. Rul. 56-660, 1956-2 C.B. 693.

<sup>vi</sup> Rev. Rul. 73-591.

<sup>vii</sup> Rev. Rul. 68-598; see also Rev. Rul. 66-381.

<sup>viii</sup> Rev. Rul. 63-115. Rev. Rul. 55-593.

<sup>ix</sup> Rev. Rul. 71-524.

<sup>x</sup> Rev. Rul. 70-309.

<sup>xi</sup> Rev. Rul. 56-660.

<sup>xii</sup> Rev. Rul. 74-389.

<sup>xiii</sup> Rev. Rul. 75-41.

<sup>xiv</sup> Rev. Rul. 70-309.

<sup>xv</sup> *U.S. v. Silk*, 331 U.S. 704 (1947).