Employee or Independent Contractor: Why It Matters?

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Every employer eventually tackles the question of whether its labor force is composed of employees, independent contractors, or a combination of both. The appeal of the independent contractor classification is understandable because the benefits are significant, including the elimination of the need to pay payroll taxes, secure workers’ compensation insurance or make unemployment insurance withholdings. Independent contractors also do not receive overtime pay, or meal or rest breaks.

Not surprisingly, many employers simply assume that an independent contractor classification is defensible and that if it is challenged, a finding that the employee was misclassified will not cause any serious harm. This assumption is wrong.

Liability for Misclassifying Employees
Misclassifying employees has very serious consequences. Failing to properly classify workers can subject the employer to administrative enforcement actions, civil penalties, fines, unpaid wages, class-action and representative-action lawsuits, and the assessment of back taxes, premium payments, and related penalties. In addition, misclassification in certain industries, such as general contracting, or certain states, such as California, could result in discipline or even license revocation from state licensing boards.

Some employers may be tempted to misclassify workers because they believe that the government is unable or unwilling to audit or fine them due to a lack of resources. While this may have been true in the past, in recent years a number of state and federal agencies have begun to aggressively police this issue.
Moreover, because wage and hour laws in many states allow attorneys to recover fees in a private lawsuit filed against employers who misclassify workers, attorneys are now highly motivated to pursue claims on behalf of independent contractors either on an individual or class basis. When these claims are filed as class actions, every worker you hired as an independent contractor over the past few years may join in and the resulting damages can easily bankrupt a company.

Although the consequences of misclassifying employees can be disastrous, it’s possible to avoid liability and lawfully classify service providers as independent contractors. In order to do so, you must be able to show that they satisfy the tests for determining independent contractor status.

Various Independent Contractor Tests
There are a number of different tests used by the Internal Revenue Service (IRS), state agencies and courts, federal courts, and the U.S. Department of Labor to decide if the service provider is a genuine independent contractor. While the tests are all slightly different they contain three key similarities.

First, all of the tests use multiple factors to determine if someone is an employee or a genuine independent contractor. Second, the tests all agree that the existence of an independent contractor agreement will not on its own establish that someone is an independent contractor. Third, they all focus on the level of control that the employer has over the worker. If the employer has significant control over the individual, including how services are performed and treats that individual as their employee, then that individual is most likely an employee. But if the individual has a great deal of autonomy and is not subject to the control of the employer, then the person likely will qualify as an independent contractor.

In conducting their independent contractor tests, courts and government agencies ask a number of key questions. No single question will decide the issue but the answers to each of these questions will tilt the scale in favor of a finding that the individual is an independent contractor or an employee. These questions include:

1. Does the Employer Control How, Where and When the Person Performs the Job?
The more control you have over the way someone does their job, the more likely it is that the person is an employee. For example, if you develop strict guidelines and provide extensive training on those guidelines, the person doing the job is more likely to be an employee.

If you set the person’s work schedule and work hours, this will weigh in favor of an employer-employee relationship. If you control the location where the work must be performed, this too will weigh in favor of the existence of an employee-employer relationship. Specifically, if the service can be provided offsite or from home but the individual is required to work from your facility, that will be evidence of an employer-employee relationship.
2. Who Provides the Tools and Materials?
If you provide or pay for all of the tools and materials necessary to do the work, then the person performing the service is more likely to be an employee. This includes reimbursement obligations that you assume.

3. What is the Length of the Job?
If the person performing the service is hired for one short project, the person is likely an independent contractor. But if the individual remains on staff for a long period of time, the person is more likely to be an employee.

4. How is the Person Paid?
People paid by the job are more likely to be independent contractors. Those paid by the hour or a regular salary are more likely to be employees.

5. Does the Individual Provide the Type of Service Normally Provided by the Employer?
If the individual is hired to provide the essential work offered by the company, the person is typically going to be considered an employee. For example, if an air conditioner installation business hires someone to do masonry work on its building, the work is not essential to installing air conditioners so this individual will likely be an independent contractor. On the other hand, if the same company brings in another person to help finish installing an air conditioner, that person is probably going to be deemed an employee.

6. Is the Contractor Working Elsewhere?
If those providing the service work full time or close to full time for the employer and do not work for other employers, they are more likely to be considered employees. But if a person works for several companies at the same time for just a few hours per week, that person is far more likely to be found to be an independent contractor.

7. Did the Parties Create a Written Independent Contractor Agreement?
If there is a written agreement between the parties stating that an independent contractor relationship exists, this will help establish the existence of an independent contractor relationship. But as explained above, the fact that the agreement exists, on its own, is not enough to show that the service provider is an independent contractor.

8. Does the Company Mandate Training?
Required training sessions will be evidence of an employer-employee relationship.

9. Can the Worker Terminate the Job at Any Time Without Liability?
Absent an employment contract, an employee is free to quit and walk off a job at any time or can be fired by the employer at any time without liability to either party. A contractor though cannot be terminated at any time without violating the terms of a contract or suffering consequences for the incomplete project.
10. Is it Possible for the Contractor to Lose Money on the Project?
If the project runs longer than anticipated or involves higher material costs than anticipated, a contractor can lose money on the project. Employees never have to encounter this problem since they are paid the same regardless of the material or labor costs. Therefore, if the service provider takes on a financial risk by taking the job, he or she is more likely to be an independent contractor.

This list of questions is not exhaustive and cannot substitute for the guidance of a skilled employment law attorney. But it is a good place to start when examining if your classification of labor providers as independent contractors is correct.

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