

EMPLOYEE OR INDEPENDENT CONTRACTOR: ONE WAY OF THINKING IT THROUGH

Publication
Nov 1, 2011

(Labor Letter, November 2011)

Deciding whether an individual is an employee or independent contractor is becoming an ever more important question. Employers should carefully scrutinize each and every independent contractor relationship which exists within the business before the Labor Department, the IRS, or a state agency does it for you.

While the issue is taking on a new importance in light of federal and state attention, the criteria for the determination of bona fide independent contractor status have not gotten any clearer. Nor will this article provide a way for you to determine with legal certainty which is which. While we have no magic formula which answers every question, we do want to provide a “rule of thumb” or a “quick-scan” way of thinking about the subject which can help to raise questions about independent contractor relationships where they should be raised.

SHOW ME THE MONEY

One fact that is certain is that the price and penalties for misclassification of employees will get ever higher. As one example of the increasing danger to employers who utilize independent contractors, earlier this year the DOL and the IRS entered into a Memorandum of Agreement by which the two agencies as well as a number of participating states (Connecticut, Maryland, Massachusetts, Minnesota, Missouri, Utah, Washington, Hawaii, Illinois, Montana and New York) have agreed to share information about independent contractor relationships.

Much of the reason for the renewed interest in the distinction between employees and independent contractors has to do with state and federal revenues. Employers pay payroll and other taxes on wages they pay to employees – but not on payments to independent contractors.

This apparent benefit quickly becomes illusory in light of the penalties and back taxes which are levied when independent contractors are found to actually be employees. Another argument against a too-quick designation of independent contractor status is the presumption that everyone working for an employer is an employee. This presumption can be overcome by facts that establish a lack of employee status, but in case of doubt, the default position is inevitably in favor of employee status.

If it were easy to distinguish between employees and independent contractors, there would be no reason for this article. But as you may have guessed, it is actually quite complicated. The tests to determine whether an individual is a bona fide independent contractor are multi-tiered and subject to different interpretations. And if this weren't bad enough, the rules for determining an individual's status can differ, depending on which agency is asking the questions.

Rather than review each agency's tests for determining a legitimate independent contractor relationship, we can draw analogies to an indisputably independent contractor relationship – putting a new roof on a home. While this analogy only goes so far and is an oversimplification, it nonetheless illustrates a number of the tests used to distinguish between legitimate independent contractors and employees.

DEALING WITH A ROOFER

A typical homeowner in need of a roof will find one or more contractors in the business. After locating one or more, the homeowner reviews qualifications, discusses price, and gets bids. After settling on details such as when the job will be completed, a contractor is ultimately selected to install the roof.

From there, it's the contractor who hires the proper number of individuals to install the roof, and who directs their work. The homeowner will not tell the contractor how the job is to be done (so long as it is done safely, and the premises are not harmed). The contract between them will include agreement about the job's completion date and the required quality of the final installation. Typically also there would be agreement on a schedule of payments which would be tied to the progress of the job.

When the roof is finished to contract specifications, the contractor receives the final agreed upon payment and the homeowner and contractor go their separate ways, likely never to do business with each other again.

APPLYING THE ECONOMIC REALITIES TEST

The roof installation model is a simplistic illustration but it reflects a number of factors used by government agencies and courts to scrutinize the legitimacy of a claimed independent contractor relationship. While this model doesn't include all of the relevant factors relied upon, it does provide a preliminary view into the examination which must be undertaken. It should be considered an initial screen, which, if not passed, at a minimum will be sufficient to alert employers that their use of independent contractors should be further analyzed before any federal or state authorities begin to consider the situation.

We will use the DOL set of criteria called the "economic realities test." Again we add that these are not the only criteria used by state and federal agencies, but they provide a reasonably comprehensive overview for the initial self-examination we are proposing for employers who use independent contractors in their businesses.

CONTROL OF THE WORK

In our example the homeowner imposed very little direction on the actual roof installation. The homeowner set the requirements as to what final results were expected, but the method of obtaining that final result was left to the contractor. In a business context, the more control the business exerts over the manner in which the required work is accomplished, the more likely the relationship is that of employer and employee.

INVESTMENT BY THE CONTRACTOR

Our hypothetical roofing contractor provided all the tools and equipment he needed to install the roof on the home. On the other hand, the more a business provides the tools and equipment needed to perform the work, the more the relationship looks like that of employer and employee.

OPPORTUNITY FOR PROFIT

The roofing contractor was in charge of the ultimate amount charged for the work. He could have charged more or less for the job, depending on a number of factors exclusive to himself, such as how much profit he wanted to make on that particular job, the efficiency of his roofing crew, whether or not he was busy, etc. The less opportunity for profit, or the more an individual appears to be paid on an hourly basis, the less likely is a finding of independent contractor relationship. Payment on an hourly basis does not by itself negate a finding of independent contractor, but it is not helpful to that end.

USE OF INITIATIVE AND JUDGMENT

The more efficient the roofing contractor, the greater is his opportunity for profit. If he has a highly trained roofing crew, he can increase his competitive relationship to other contractors. If he has invested in more efficient roofing equipment, he may be able to finish jobs faster and thus have a competitive edge over other contractors he is competing against. If he has developed a more efficient system for the installation of a certain roofing product, he will lower his costs and improve resulting profit margins.

In contrast, an employee works for an agreed-upon wage and does not have the opportunity for profit or loss. Of course, there is the possibility for career advancement for an employee, but this would take place over a period of time and an employee does not have the same opportunity for profit – or loss – as does the independent contractor.

PERMANENCY OF THE RELATIONSHIP

Our roofing contractor finished the job and moved on to the next job with another homeowner. When the roof was installed, the relationship was over. Shorter or clearly defined discrete projects with a beginning and ending point are more closely associated with the independent contractor relationship and longer engagements look more like employment relationships.

INTEGRATION WITH AN ORGANIZATION'S BUSINESS

In our example putting a roof on the house had no connection to the homeowner's primary employment or means of making a living. By the same token, the more central the work performed by the independent contractor is to the proper functioning of the business, the more the relationship looks like that of employer – employee. And certainly if the same work is done by employees and by independent contractors, that would be an extremely strong argument that the independent contractor is actually an employee.

Obviously each factor listed above does not always have one clear answer and a state or federal agency or court will consider all of the above factors as well as others in reaching a final determination whether there is an employment relationship rather than one of independent contractor.

DON'T TRY THIS AT HOME

While not fail-safe, this cursory summary can help you to identify where problems may exist. If you find questionable situations after this cursory examination, it is much preferable to contact your employment counsel to get certainty rather than let the government answer the question for you. You can get some additional information by visiting our [website](#) or our [Wage and Hour Laws Blog](#).

For more information contact the author at jmclachlan@fisherphillips.com or (415) 490-9000.