

INDEPENDENT CONTRACTOR CLASSIFICATION



Companies can avoid significant wage, tax and other obligations by engaging independent contractors instead of employees. Using independent contractors can result in considerable cost savings and increased workforce flexibility. These advantages are particularly beneficial during times of economic downturn. In addition, independent contractors are a major component of the on-demand economy, in which companies like Uber rely almost exclusively on contractors to deliver the services customers request.



INDEPENDENT CONTRACTOR CLASSIFICATION

Individuals often choose to become independent contractors because they desire greater control over their work environment and schedules. Others prefer more variety in their day-to-day work and more control over the methods they use to accomplish that work. In addition, some workers are interested in operating their own business and using their entrepreneurial skills to more directly impact their earning capacity.

While it can be advantageous for both parties, independent contractor classification involves careful consideration of several factors, application of multiple standards, and exposure to liability in several areas, including potential liability for years of unpaid overtime pay, taxes, and employee benefits.

Simply referring to a worker as an independent contractor, even in a written agreement, does not prevent legal challenges to that classification by workers, the Department of Labor (the “DOL”), the Internal Revenue Service (the “IRS”), or state and local authorities. In addition, the DOL and its state counterparts have made independent contractor misclassification a top enforcement priority. Misclassification audits, investigations, and lawsuits are increasingly common and can result in steep costs and penalties.

The following will discuss the classification of individual workers as independent contractors, including: the independent contractor classification generally; the benefits of engaging independent contractors; the consequences of misclassification; the tests for independent contractor status, including the economic realities test under the Fair Labor Standards Act (the “FLSA”) and the IRS's control test; how to request a determination of worker status from the IRS; best practices for engaging independent contractors; and, recordkeeping obligations.

WHAT IS AN INDEPENDENT CONTRACTOR?

An independent contractor is a worker who contracts with individuals or entities to provide services in exchange for compensation. An independent contractor does not work regularly for any single company and is not an employee. An independent contractor typically: charges fees for service; is engaged only for the term required to perform an identified service or task; retains control over the method and manner of work; retains economic independence; is responsible for paying his income, Social Security, and Medicare taxes; and, is not protected by most federal, state, or local laws designed to protect employees.

An entity contracting with an independent contractor generally has the right to control only the end result of the project and not how the independent contractor accomplishes it.

Companies that engage independent contractors issue them Form 1099-MISC for income-reporting purposes. The contracting company has no obligation to provide benefits to the independent contractor or withhold or pay employment taxes on the contractor's behalf (except when backup withholding is required, in the case of a missing or incorrect tax identification number for the independent contractor).

In addition, independent contractors are generally free to offer their services to the public and to perform work for other clients. Independent contractors often own their own businesses and provide services according to their own terms.

An employee, by comparison, is subject to significant oversight by a company. The company has the right to control the method and manner of the employee's work. In addition, an employee: is paid wages (which may include overtime compensation) and company-sponsored benefits; is employed for a continuous period of time and performs whatever tasks the company requires; pays the full amount of his income taxes and a portion of his Social Security and Medicare taxes, generally through the amounts his employer is obligated to withhold from his wages; is economically dependent on the employer; and, is protected by applicable federal, state, and local employment laws.

Companies cannot rely on generalizations to determine employee or independent contractor status. Classification depends on the facts of each case, application of the appropriate independent contractor tests, and differences in the judicial and administrative interpretation of those tests.

BENEFITS OF ENGAGING INDEPENDENT CONTRACTORS

Because independent contractors are not employees, entities contracting with them can avoid many of the financial and other obligations of using employees to perform work. However, penalties for misclassification are significant. An individual's status as an employee or independent contractor often determines whether the company is responsible for the following obligations.

BENEFITS OF ENGAGING INDEPENDENT CONTRACTORS

FEDERAL, STATE, AND LOCAL EMPLOYMENT LAW COMPLIANCE

Various federal, state, and local employment laws, including laws governing health and safety, wage and hour, and equal employment standards, protect employees but not independent contractors. Independent contractors are not counted for purposes of determining coverage under these statutes and they cannot pursue the statutory remedies available to employees. Federal employment laws that cover employees but generally not independent contractors include, for example:

- Fair Labor Standards Act (the “FLSA”). The FLSA includes minimum wage and overtime pay requirements for nonexempt employees generally. For example, while the FLSA generally requires companies to pay nonexempt employees overtime compensation for hours worked over 40 in a workweek, it does not require that companies do the same for independent contractors.
- Title VII of the Civil Rights Act (“Title VII”). (However, independent contractors do have some legal protections under 42 U.S.C. § 1981, prohibiting racial discrimination in contracts.)
- Equal Pay Act (the “EPA”).
- Age Discrimination in Employment (the “ADEA”).
- Americans with Disabilities (the “ADA”).
- Genetic Information Nondiscrimination Act (the “GINA”).
- Uniformed Services Employment Reemployment Rights Act (the “USERRA”).
- Occupational Safety and Health Act (the “OSH Act”). The OSH Act protects employees' right to complain about safety conditions.
- Worker Adjustment Retraining Notification Act (the “WARN”).

Family and Medical Leave Act (the “FMLA”).

BENEFITS OF ENGAGING INDEPENDENT CONTRACTORS

FEDERAL, STATE, AND LOCAL EMPLOYMENT LAW COMPLIANCE (CONT.)

- Employee Retirement Income Security Act (“ERISA”). In the retirement plans context, ERISA requires companies to make 401(k) and retirement benefits available to all employees on the same basis. In addition, retirement plans can lose their tax qualification if they cover non-employees, such as independent contractors. Regarding health plans, independent contractor issues may arise in the plan eligibility context. Also, the Affordable Care Act (the “ACA”) expanded ERISA to require large employers to either provide health coverage that is affordable and provides minimum value, or pay a penalty. Misclassification issues could affect whether employers are subject to this “play or pay” requirement (also known as the employer mandate).
- National Labor Relations Act (the “NLRA”). Employees have the right to form or join labor organizations, to bargain collectively through their representatives, and to engage in other concerted activities. The NLRA's definition of employee expressly excludes independent contractors.

State and local employment laws may also condition coverage and obligations on a worker's status as an employee. In addition to employment law obligations, all employers are required to comply with the Immigration Reform and Control Act of 1986 (the “IRCA”) by completing Form I-9 for each employee hired after November 6, 1986. By contrast, companies are not required to verify that independent contractors are authorized to work in the United States.

BENEFITS OF ENGAGING INDEPENDENT CONTRACTORS

EMPLOYEE BENEFITS

Companies often provide benefits to their employees that are not provided to independent contractors, including, for example: health insurance, including in a cafeteria plan; retirement or pension plans; stock options; paid vacations; sick days; life insurance; disability insurance; and, fringe benefits (for example, adoption assistance benefits).

THE AFFORDABLE CARE ACT

Compliance with some ACA requirements depends on how many full-time employees an employer has. For example, effective beginning in 2015 (in most cases), the ACA requires large employers to either offer health coverage that is affordable and provides minimum value to its full-time employees and their dependents, or pay a penalty. This requirement is commonly referred to as the employer mandate. Large employers are those that employed an average of at least 50 full-time employees (including full-time equivalents) each business day during the previous calendar year. Full-time employees for ACA employer mandate purposes are those who average 30 or more hours of service per week.

Also, beginning in 2016 under the ACA, large employers and other entities must submit information reporting to the Internal Revenue Service (IRS) regarding the coverage that they do (or do not) offer, and furnish statements regarding the coverage to employees. The ACA uses the common law definition of employee. Workers such as independent contractors who do not satisfy that definition are not counted among a company's employees for purposes of its ACA coverage responsibilities and penalties.

BENEFITS OF ENGAGING INDEPENDENT CONTRACTORS

TAX AND INSURANCE OBLIGATIONS

Employers must pay taxes, make the appropriate withholdings, and obtain certain insurance coverage on behalf of employees. These requirements generally do not extend to independent contractors. Thus, while a company's specific tax and insurance obligations are complex and heavily fact-specific, by engaging independent contractors the company can generally avoid the payments and withholdings required on behalf of employees, including:

- Federal, state, and local income taxes. Independent contractors are generally issued a Form 1099-MISC at the end of each year that they were paid \$600 or more. (Employees are issued a W-2.)
- Social Security and Medicare taxes (owed under the Federal Insurance Contributions Act ("FICA")).
- Federal unemployment insurance taxes (owed under the Federal Unemployment Tax Act ("FUTA")).
- State unemployment insurance taxes. (Independent contractors are not entitled to unemployment compensation benefits.)
- Workers' compensation insurance. (However, unlike employees who may be limited to the exclusive remedy of workers' compensation, independent contractors are free to sue for work-related injuries.)

CONSEQUENCES OF MISCLASSIFICATION

The benefits of using independent contractors are often significant, but the financial costs and penalties of misclassification can be staggering. The DOL, the IRS, state government agencies and courts construe independent contractor status narrowly and impose large penalties for misclassification. A contributing factor to this narrow view is that companies using independent contractors have the advantage of avoiding many of the obligations of an employment relationship. In addition, exemptions and exclusions from the employee protections granted by employment statutes like the FLSA are construed narrowly to preserve the statute's intentionally broad reach.

In addition to ensuring compliance going forward, a company that misclassifies employees as independent contractors may be liable for: back wages and overtime pay; employee benefits, including stock options, retirement benefits, and health plan coverage (for example, penalties involving the ACA employer mandate and information reporting requirements); disability payments and workers' compensation; tax and insurance obligations; liquidated damages; and, civil monetary penalties.

CONSEQUENCES OF MISCLASSIFICATION

FEDERAL, STATE, AND LOCAL EMPLOYMENT LAW COMPLIANCE

A misclassified worker may be retroactively entitled to rights under state and federal employment statutes. For example, incorrectly classifying a worker as an independent contractor could lead to claims for: unpaid overtime compensation and reimbursement of work-related expenses; reasonable accommodation and return to work benefits under the ADA and its state equivalents; leaves of absence under the FMLA and its state equivalents; plant closure and mass layoff notice under WARN and its state equivalents; and, discrimination under Title VII, ADEA, and other federal, state, or local anti-discrimination laws.

In addition, employers that fail to complete Form I-9 for a worker who is an employee are subject to a wide variety of fines and penalties under IRCA.

EMPLOYEE BENEFITS

A company that has misclassified an employee as an independent contractor can be made to pay the benefits the employee would have otherwise been owed over the course of the working relationship. Thus, a company can be liable for benefits it intended to offer only to employees.

CONSEQUENCES OF MISCLASSIFICATION

THE AFFORDABLE CARE ACT

Misclassification of employees as independent contractors directly impacts both a company's compliance obligations under the ACA and its exposure to related penalties. Thus, under the ACA, reclassifying as employees those workers who were previously treated as independent contractors can mean:

- The company now has a sufficiently large population of full-time employees to qualify as a large employer for: employer mandate purposes; and additional requirements involving ACA information reporting.
- Non-compliance penalties under the ACA increase as the number of full-time employees used to calculate those penalties increases

TAX AND INSURANCE OBLIGATIONS

The tax and insurance liabilities for misclassification are significant and can include: years of unpaid federal, state, and local income tax withholdings; Social Security and Medicare contributions (owed under the FICA); workers' compensation and unemployment insurance premiums, including federal unemployment taxes owed under FUTA; and, interest and penalties.

TARGETS OF ENFORCEMENT AND LITIGATION

Regulatory agencies such as the DOL and the IRS and their state equivalents have identified industries subject to targeted enforcement of independent contractor misclassification. Those industries include: construction, transportation and trucking, cable companies, janitorial services, landscaping and nurseries, security services, nursing, child care, home health care, internet services, restaurants and catering services, staffing services, hotels and motels, and, oil and gas.

The DOL generally focuses its enforcement efforts on industries characterized by a fissured workplace. In other words, the DOL targets industries with a business model that relies on independent contractor or other contingent workforce arrangements where the relationship between the worker and the beneficiary of that work is increasingly attenuated and sometimes even obscured.

TESTS FOR INDEPENDENT CONTRACTOR STATUS

There is no single test to evaluate independent contractor status for all purposes and compliance is often complicated by the fact that different tests may apply. For example, the test to determine independent contractor status under federal tax law is not the same as the test applied under the FLSA. Different tests and interpretations can mean:

- A worker is an independent contractor for some purposes and an employee for others (such as under state and federal law, for example).
- A worker who provides two different services to the employer is an employee for one and an independent contractor for the other (for example, an employee in the company's shipping department who does graphic design outside of work and who occasionally provides graphic design services to the company as an independent contractor).
- Courts applying the same test to the same position may arrive at different results.

The tests for independent contractor status often share some common characteristics, however. For example, most: involve an analysis of the same or similar factors; are a balancing test and no single factor is determinative; analyze the degree of control the company has over the manner and means by which the worker accomplishes the work; and, afford little weight to the parties' characterization of the relationship, including in a written agreement.

Companies should be familiar with the different tests that may be applicable.

THE ECONOMIC REALITIES TEST: THE FLSA STANDARD

The FLSA's definition of employee is vague. An employee is "any individual employed by an employer" who is "suffered or permitted" to work. With little guidance from the statute, the DOL and the courts have developed the economic realities test to determine if an employment relationship exists under the FLSA. The focus of the test is whether the economic realities of the parties' relationship are such that the worker is dependent on the company to which he provides services.

The economic realities test is always used to assess independent contractor status under the FLSA. It is also sometimes used to assess independent contractor status under other federal employment statutes, including Title VII, the ADA, and the ADEA, depending on the jurisdiction. An individual's specific work circumstances determine his employment status under the FLSA. No single factor determines a worker's status as an employee or independent contractor. Contractual language, the worker's title or label, and common law factors evaluated in isolation do not define the relationship.

Courts analyze the totality of the parties' relationship and nearly all use a balancing test to evaluate various factors, including the five factors originally identified by the United States Supreme Court (sometimes referred to as the Silk factors): the degree of control; the relative investment in facilities; the worker's opportunity for profit and loss; the permanency of the parties' relationship; and, the skill required. Courts generally consider these five (or similar) factors and most have added a sixth: whether the worker's services are integral to the company's business.

THE DOL'S INTERPRETATION

The United States Department of Labor ("DOL") administers and enforces the FLSA. The agency generally relies on the six elements identified by the United States Supreme Court and subsequent case law. In addition, drawing from case law, the DOL takes the position that:

- The time and mode of payment are not conclusive of employee status.
- Whether the worker has signed an agreement stating that he is an independent contractor is not controlling because it is the parties' working relationship that is determinative, not the labels the parties choose.
- Whether the worker has incorporated a business or is licensed by a state or local agency "has little bearing" on the worker's status as an employee or independent contractor.

In July 2015, the DOL issued Administrator's Interpretation No. 2015-1, The Application of the Fair Labor Standards Acts "Suffer or Permit" Standard in the Identification of Employees Who are Misclassified as Independent Contractors. The 15-page interpretive guidance does not announce a new test or change the generally accepted list of six factors used to determine employment status. Rather, the DOL's guidance restates the six factors and emphasizes the importance of a worker's economic dependence on the company.

The DOL explains that the economic realities test focuses on whether the worker is economically dependent on the hiring entity or is in business for himself. Economic dependence is sufficient to find an employment relationship, according to the DOL.

THE DOL'S INTERPRETATION

The interpretive guidance discusses the six factors and explains the DOL's position on each, as follows:

- If the work performed is integral to the hiring entity's business. If so, it is more likely the worker is economically dependent on the employer and is an employee. According to the DOL, a true independent contractor's work is unlikely to be integral to the hiring entity's business.
- If the worker's managerial skill affects his opportunity for profit or loss. The DOL takes the position that this factor is not satisfied by a worker's ability or decision to work more hours, for example. To be properly classified as an independent contractor, the worker's managerial skills must include his decisions concerning: hiring others; purchasing materials and equipment; advertising; renting space; and managing time tables.
- If the worker's relative investment compares to that of the hiring entity. The DOL states that the worker's investment should not be relatively minor compared to that of the hiring entity. Also, the comparison should not be limited to the parties' investment in the particular job performed by the worker.
- Whether the work performed requires special skill and initiative. The DOL explains that the worker's business skills, judgment and initiative are at issue, not his technical skills. Technical skills alone are not sufficient to demonstrate independence or business initiative.
- If the working relationship is permanent or indefinite. If so, the DOL is likely to find an employment relationship. However, the DOL notes that simply because the relationship lacks permanency or is of a specified duration, the worker is not necessarily an independent contractor.
- The nature and degree of the hiring entity's control over the worker. Generally courts (and historically the DOL) distinguish between control only over the outcome of the work (supporting an independent contractor relationship) and control over how the work is performed (supporting an employment relationship). Control factors may include: setting the rate of pay and working hours; determining how the work is performed; and being free to work for others and hire helpers.

THE DOL'S INTERPRETATION

However, in its interpretive guidance, the DOL states that a worker must have "meaningful control" over certain aspects of his work. Simply having control over his hours of work or working remotely does not satisfy this requirement. In addition, the worker's control must actually be exercised, not simply theoretical, according to the DOL.

While the DOL acknowledges the United States Supreme Court's precedent that no single rule or test can determine if a worker is an employee or an independent contractor, and that the totality of the work circumstances must be considered, the DOL's interpretive guidance focuses on only the six factors. In addition, the DOL de-emphasizes the importance of the control factor, saying that control is just one consideration and should not play an oversized role in evaluating whether a worker is an independent contractor.

THE CONTROL TEST: THE IRS STANDARD

The IRS standard is used to determine whether a worker is an employee for federal tax purposes. Historically, the IRS Standard was the 20-Factor Test, but more recently, the IRS has grouped the 20 factors into three primary categories.

If a worker is an employee under the IRS test, he is an employee for all federal tax purposes. However, there are distinct statutory exemptions recognized in the definition of "employee" under FICA, FUTA, and other withholding rules.

The IRS standard takes a holistic approach to the independent contractor classification. It looks at three aspects of the worker's control or independence: behavioral control, financial control, and the type of relationship.

THE CONTROL TEST: THE IRS STANDARD

BEHAVIORAL CONTROL

A worker is an employee when the company (or other third party) has the right to direct and control the worker. The company need not actually exercise this control, but only have the right to do so. To test whether behavioral control exists in a particular situation, a company should ask, "does the company control or have the right to control, not only what the worker does, but also how the worker does it?"

Behavioral control falls into four categories: type of instructions given; degree of instruction; the way the work is evaluated; and, the training needed or given.

If the company instructs the worker about when, where, and how to work, this factor favors a finding that he is an employee, not an independent contractor. Similarly, if the worker is given fairly detailed instructions, the worker is more likely an employee, and less-detailed instructions reflect less control, suggesting that the worker is more likely an independent contractor.

An evaluation system for an independent contractor generally measures the end result only. If the company's evaluation system measures the details of how the work is performed, it suggests an employee relationship.

Finally, if the company provides the worker with substantial training (particularly ongoing training) about how tasks should be performed, the training is evidence that the worker is an employee. An independent contractor, by contrast, is free to use his own methods of performing the work.

The following types of instructions tend to support the finding of an employment relationship: when and where to do the work; which tools or equipment to use; which workers to hire or use to assist with the work; where to purchase supplies and services; what work must be performed by a particular individual; and, the order or sequence to follow when performing the work.

THE CONTROL TEST: THE IRS STANDARD

FINANCIAL CONTROL

Financial control refers to whether the company has the right to control the economic aspects of the worker's job. To test this factor, a company should ask, "are the business aspects of the worker's job controlled by the company or client (including, for example, how the worker is paid, whether expenses are reimbursed, who provides tools and supplies, and so on)?" The IRS expects that independent contractors will:

- Have a significant investment in tools, training, office space, and the like. A significant investment in these resources indicates independent contractor status. There is no dollar amount that must be achieved for an investment to be considered significant. A significant investment is not always necessary, however, particularly for work that does not require large expenditures.
- Pay their own expenses. While employees are generally reimbursed for work-related expenses, independent contractors are much more likely to have unreimbursed expenses in connection with their work. For example, an independent contractor is not reimbursed for the cost of operating their equipment to perform their service.
- Have the opportunity to make a profit or sustain a loss on the project. An independent contractor has an opportunity to experience a loss or a profit as a result of his investment in tools and other resources. An employee, by contrast, typically does not have an opportunity to do so.
- Offer their services to the general public. An independent contractor can generally market and offer his services to the general public as he chooses.
- Receive payment based on the task and not by the hour. An employee is generally paid on an hourly or salary basis and receives regular compensation regardless of the tasks he accomplishes. An independent contractor is generally paid by the job or on a flat-fee basis.

THE CONTROL TEST: THE IRS STANDARD

TYPE OF RELATIONSHIP

The type of relationship factor refers to how the relationship is perceived by the worker and company. It depends to a large extent on how the relationship is structured. To test this factor, a company should ask:

- Are there written contracts between the parties? A written contract is a starting point for the IRS to examine the nature of the relationship. However it is not conclusive. Even if an agreement states that the worker is an independent contractor, the IRS may still determine the worker is an employee based on the nature of the actual relationship.
- Does the worker receive employee-type benefits (for example, pension plan, insurance, or vacation pay)? Receipt of these benefits indicates an employment relationship.
- Will the relationship continue indefinitely? An independent contractor should be hired for a specific project or period of time, not indefinitely. An indefinite working relationship indicates that the intent was to create an employment relationship.

Are the services provided a key activity of the business? Provision of services that are key to the business indicate that the worker providing them is an employee and not an independent contractor, as businesses are more likely to direct and control the activities of a worker providing key services.

THE CONTROL TEST: THE IRS STANDARD

TYPE OF RELATIONSHIP (CONT.)

The IRS examines written agreements in addition to other information about the working relationship to determine whether the terms clearly provide for an independent contractor relationship (although statements characterizing the worker as an independent contractor in a contract do not suffice as proof of that status). Some facts suggesting an employment relationship include: employee-type benefits are provided under the agreement; the service the worker provides is integral to the company's business; the service the worker provides is similar to services employees provide; and, the contract is at-will.

In contrast, an independent contractor agreement generally contains terms specifying the following: that the relationship is an independent contractor relationship and that the worker is not eligible to receive any employee-type benefits; a defined service or set of services the worker is being hired to perform; a fixed fee payable when those services are complete; and, that the company may terminate the contract in the event of a material breach.

THE CONTROL TEST: THE IRS STANDARD

REQUESTING A DETERMINATION OF WORKER STATUS FROM THE IRS

If after considering these factors the company is still unsure whether to classify a worker as an independent contractor or an employee, the company can request a determination from the IRS. This process is as follows: the company communicates to the IRS relevant facts about the working relationship; the IRS reviews the facts; and, the IRS makes a decision and communicates the decision to the company in the form of a Determination Ruling Letter.

To request a determination, companies submit a Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding. The IRS uses the form to collect relevant information about the working relationship and the three primary areas of control.

Although it can take six months or more to get a determination from the IRS, companies that frequently hire the same type of worker can benefit from an IRS determination. Going forward, the company can rely on the determination for all relationships of that category. However, if any significant element of the work relationship changes, the company should request a new determination.

COMMON LAW AND OTHER TESTS

THE COMMON LAW DARDEN TEST

The common law Darden test is regularly, but not exclusively, used in the context of Title VII, the ADA, the ADEA and ERISA because those statutes share the same definition of employee. The test focuses on the common law principles of agency law to determine the hiring party's right to control the manner and means by which the work is performed and, accordingly, the worker's status. The test considers the: skill required; source of supplies and tools; location of the work; duration of the relationship between the parties; hiring party's right to assign additional projects to the hired party; extent of the hired party's discretion over when and how long to work; method of payment; hired party's role in hiring and paying assistants; regular business of the hiring party and if the work performed is part of that business; hiring party's status as "in business"; provision of employee benefits; and, tax treatment of the hired party.

THE COMMON LAW 20-FACTOR TEST

THE COMMON LAW DARDEN TEST

Although the IRS now uses the more holistic approach outlined above, at one time it employed a 20-factor common law test to determine independent contractor status. It is still instructive to review the 20 factors because many of them were incorporated into the IRS's new approach. In addition, the 20 factors are cited frequently by state agencies making independent contractor determinations. The 20 factors are:

- **Instructions:** The hallmark of an independent contractor is that only the end result is measured. The independent contractor should not be given instructions or procedures regarding details or methods from the engaging entity and should not be supervised.
- **Training:** An independent contractor should not need training and ideally should have previous expertise in performing the work.
- **Integration with the company's operations:** If the worker provides services similar to those provided by employees or if the success of the company's operations depends on the independent contractor's successful performance, this factor indicates that the worker is subject to direction and control, suggesting an employment relationship. An independent contractor's services are usually separate from the client's business and are not integrated or merged into it.
- **Services rendered personally:** An independent contractor usually has the right to employ others and assign them to perform the services in his place.
- **Hiring, supervising, and paying helpers:** If the company supervises or directs the work of the independent contractor's employees or assistants, this supports a finding of an employment relationship. A true independent contractor selects, hires, and reimburses his own assistants.
- **Continuing relationship:** An independent contractor tends to be hired for a finite project and the relationship ends when the project is complete. An indefinite or continuing relationship is indicative of an employment relationship.

Set hours of work: Requiring a worker to work during set hours is a clear indication of control and indicates an employment relationship.

THE COMMON LAW 20-FACTOR TEST

THE COMMON LAW DARDEN TEST (CONT.)

- Full time or exclusive work: An independent contractor is free to perform work for many companies simultaneously. Requiring the worker to work full time or exclusively for the company is a strong indicator that the worker is an employee.
- Location where services are performed: Requiring work to be done on company premises implies a degree of control over the work, indicating an employment relationship. Independent contractors ordinarily work wherever they choose.
- Specifying the order or sequence of work: A company generally has control over the worker if it specifies, by contract or in practice, the order or sequence of work.
- Oral or written reports: Oral or written progress reports suggest an employment relationship. Companies should use caution when requiring status reports from independent contractors. Infrequent progress reports to document major milestones, for example, may be treated as consistent with an independent contractor relationship. However, detailed time records or daily status updates likely are not.
- Payments: An employee is typically paid at regular intervals, while an independent contractor is more likely to be paid a negotiated flat fee or to submit a bid and then be paid by the job. In general, lump sum, fixed fee, or by-the-job payments are consistent with independent contractor status. Pay that is tied to hours worked, such as hourly, weekly, or monthly wages are more consistent with employment. Further, paying the worker through payroll suggests an employment relationship while paying through accounts payable on receipt of an invoice suggests an independent contractor relationship.
- Business or travel expenses: Few expenses are reimbursable to an independent contractor and those that are should be extraordinary. All normal office expenses should be paid for by the independent contractor.
- Tools and materials: An independent contractor should have the tools and materials necessary to achieve the agreed on results.

THE COMMON LAW 20-FACTOR TEST

THE COMMON LAW DARDEN TEST (CONT.)

- Investment: Like tools and materials, independent contractors are expected to invest in their own business. If the contractor's investment is relatively minor compared to the company, it tends to undermine an independent contractor arrangement.
- Profit and loss: Because their pay tends to remain constant, employees are generally shielded from profit and loss. Independent contractors however risk the investment of their time and money and may sustain losses as a result of a downturn in business, for example. On the other hand, independent contractors may also benefit from their own efforts to increase business and grow their investment.
- Number of companies with whom the independent contractor works: The best situation for a finding of independent contractor status is one where the worker can choose between competing assignments. The more dependent the worker is on a single company for income, the more the relationship tends to indicate employment.
- Advertises services to the general public: Business cards, letterhead, and advertising may be indicators of independent contractor status.
- Right to fire: The contract should only allow for termination if the results do not meet the contractual requirements. On the other hand, the ability to terminate the relationship at-will, especially before the task is complete and without any liability, suggests an employment relationship.
- Right to quit: An independent contractor is usually contractually bound to complete the assignment and liable for any failure to deliver the specified result.

THE COMMON LAW 20-FACTOR TEST

THE HYBRID TEST

The hybrid test is a hybrid of the common law Darden factors and the economic realities test. The test is used by some courts to determine independent contractor status under employment statutes like Title VII and the ADEA.

STATE LAW TESTS

Tests for independent contractor status can also vary under state employment statutes. State independent contractor tests can impose a more narrow definition than the federal equivalent.

MINIMIZING THE RISK OF MISCLASSIFICATION

To minimize the risk of potentially significant misclassification liability, companies should implement these best practices:

- Conduct an audit. Counsel should review existing worker classifications to determine if they comply with applicable federal, state, and local laws. Companies should promptly correct any misclassifications to cut off future exposure. Counsel should be engaged in the reclassification process to minimize the risk of litigation. Companies should also consider taking advantage of the VCSP.
- Train personnel on classification issues. Training managers and employees, including those who interact directly with independent contractors, to ensure proper classification at the time the contractor is engaged and to reduce the possibility that the independent contractor status will subsequently be undermined by changes in company policies or practice.
- Obtain a ruling from the IRS. A company can file a Form SS-8 Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding with the IRS. It can take six months or more to get a determination from the IRS, but the company can rely on the ruling as a reasonable basis under the Section 530 safe harbor. Companies should be aware that an IRS ruling that the worker is actually an employee is also conclusive, however.
- Draft agreements that document the independent contractor distinction.

MITIGATING MISCLASSIFICATION PROBLEMS

Employers have several options for mitigating the consequences of misclassification.

SECTION 530 SAFE HARBOR

A safe harbor from the tax consequences of misclassification is available in some instances where a company can show it meets certain relief requirements. The safe harbor under Section 530 of the Revenue Act of 1978 applies where the company: had a reasonable basis for the misclassification; treated the worker and all similarly situated workers consistently as independent contractors; and, reported all federal tax returns in a manner substantially consistent with the independent contractor classification (for example, by using Form 1099-MISC). This criterion cannot be met for a particular year if the company did not file the required returns for that year.

The IRS provides a few justifications that constitute a reasonable basis for a misclassification, including, for example, that the company: reasonably relied on a court case or IRS ruling; relied on a past IRS audit that: began before January 1, 1997; or included an examination of whether the relevant individual (or an individual in a substantially similar position) should be treated as an employee; knew that a significant segment of the relevant industry practices the same misclassification; and, relied on some other reasonable basis (for example, on advice from a lawyer or an accountant who knew about the company's business).

The requirement of substantial consistency would not be met, for example, where the company withheld FICA or income tax on behalf of the worker, but treated the worker as an independent contractor for other purposes.

The Section 530 safe harbor only applies to employer-owed taxes. Qualifying workers are judged as employees for other federal tax purposes, including for payment of their own income taxes. If the safe harbor rules do not apply, no presumption of employment status is made and status must be analyzed using the IRS standard to determine whether the worker is properly classified as an independent contractor.

MITIGATING MISCLASSIFICATION PROBLEMS

Employers have several options for mitigating the consequences of misclassification.

SECTION 530 SAFE HARBOR (CONT.)

Companies will not be penalized as having treated a worker as an employee (and therefore inconsistently) if either: they file an amended or delayed tax return treating the worker as an employee because of an IRS audit; or, the IRS files a return on behalf of the company treating the worker as an employee.

Companies that fulfill the requirements of the Section 530 safe harbor can obtain tax relief through the Classification Settlement Program ("CSP"), which offers a settlement agreement to companies eligible for the Section 530 safe harbor. The program gives some measure of tax relief, the amount of which depends on the strength of a company's safe harbor position. Generally, a company can obtain terms allowing it to avoid tax assessments over one year. If a company meets the reporting requirements, and likely can meet the remaining safe harbor requirements, the settlement offer may be an adjustment of 25%.

MITIGATING MISCLASSIFICATION PROBLEMS

IRC SECTION 3509 LIABILITY REDUCTION

For companies that do not satisfy the Section 530 safe harbor requirements, IRC Section 3509 Liability Reduction assistance may be available. Under IRC Section 3509, companies are eligible to pay smaller income tax withholdings along with smaller employee shares of FICA. This option does not reduce a company's employer-paid FICA costs.

VOLUNTARY CLASSIFICATION SETTLEMENT PROGRAM

Since September 2011, the IRS has offered a Voluntary Classification Settlement Program ("VCSP") authorizing companies to voluntarily reclassify independent contractors (and other nonemployees) as employees. Companies in the program pay a nominal fee to cover missed payroll taxes (10% of the company's tax liability in the most recent tax year). To qualify, employers must: have consistently treated in the past, and currently treat, the workers as nonemployees; have filed the required tax forms for the workers in the previous three years; not be currently involved in an employment tax audit by the IRS or any other audit by a government agency regarding the classification; and, have complied with any past audits.

Employers can reclassify workers by filing Form 8952, Application for Voluntary Classification Settlement Program at least 60 days before the date the worker will be treated as an employee.

MITIGATING MISCLASSIFICATION PROBLEMS

RECORDKEEPING REQUIREMENTS

Company recordkeeping requirements for workers are most often found in applicable federal, state, and local employment laws. For example, the FLSA imposes specific requirements about the information and records employers must keep for each nonexempt employee, but does not require those records for independent contractors. Because independent contractors are generally not covered by employment law statutes, companies engaging them are subject to fewer recordkeeping obligations. However, companies should maintain records that evidence a worker's independent contractor status and document compliance. For example, companies are required to provide Form 1099-MISC to any independent contractor paid \$600 or more in the previous year. Companies issuing Forms 1099-MISC should retain a copy.

In addition, companies may be liable for failing to maintain adequate records of employment during periods in which employees were misclassified as independent contractors.

Companies should consider retaining the following records and information for each independent contractor:

- The parties' written agreement, including expired and revised agreements.
- The contractor's federal Employer Identification Number (EIN or FEIN) and its state equivalent. Federal EINs are the corporate equivalent of a Social Security number and are issued to every organization by the IRS. State governments issue similar unique numbers to identify the organization for tax and other purposes. (Sole proprietorships generally use the owner's Social Security number.) Companies are responsible for backup withholding for any independent contractor that does not provide an EIN or provides an incorrect EIN.
- Payments made to the independent contractor, including the amounts and dates paid. (Companies should require invoices and payments to independent contractors should be made from accounts payable, not payroll.)

MITIGATING MISCLASSIFICATION PROBLEMS

RECORDKEEPING REQUIREMENTS

- Copies of Forms 1099-MISC, including any that are returned by the post office as undeliverable. Companies must provide a completed Form 1099-MISC to independent contractors for each year in which the contractor was paid \$600 or more.
- Contact information, including name, address and dates of engagement.
- Documents that may evidence the worker's independent contractor status, including: certifications of the contractor's insurance coverage, such as general liability coverage; and business cards, letterhead, invoices, and other indicia of the contractor's business.

Independent contractor records should be maintained in vendor files, not in employee personnel files. Companies should ensure that independent contractor documentation is standardized and used consistently.