Independent Contractor or Employee? Worker Classification Checklist

Few issues in employment law compliance are as thorny as making the determination of whether to classify a worker as an employee or as an independent contractor. The stakes are high. Classifying workers as independent contractors can result in tremendous savings for employers – independent contractors are not eligible for:

- Overtime
- Workers' compensation coverage
- Health insurance
- Pensions
- Other contractual benefits typically available to company workers

Moreover, with respect to independent contractors, employers:

- Do not withhold income tax
- Do not pay Social Security
- Do not pay unemployment taxes

Thus, designating workers as independent contractors is potentially quite lucrative for employers.

Misclassification, however, can be costly as Department of Labor ("DOL") and Internal Revenue Service ("IRS") penalties can be steep. There is no bright line rule to help employers make the call. Instead, the DOL and the IRS each apply different tests to determine a worker’s classification. The DOL uses the “economic reality test” to determine worker eligibility for minimum wages and overtime under its laws; the IRS applies a set of factors to determine independent contractor status for tax law purposes.

This checklist and the information contained herein are not intended to be an exhaustive or detailed list of requirements, do not constitute legal advice, and do not serve as a substitute for the advice of knowledgeable legal counsel. Its objective is to alert HR professionals to the worker classification requirements of which they should be aware for compliance and planning purposes.

✓ Worker Classification Checklist

The Department of Labor’s “Economic Realities” Test

Under this test, the circumstances of the entire work situation are evaluated, including the underlying economic reality of the relationship. In general, for purposes of the Fair Labor Standards Act, employees will be dependent on the business that they serve, as distinguished from independent contractors, who are engaged in their own business.

Factors Considered Significant (With No Single One Controlling) Include:

- The extent to which the services rendered are an integral part of the principal’s business
- The permanency of the relationship
- The amount of the alleged contractor’s investment in facilities and equipment
- The nature and degree of control by the principal
- The alleged contractor’s opportunities for profit and loss
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- The amount of initiative, judgment, or foresight in open market competition with others required for the success of the claimed independent contractor
- The degree of independent business organization and operation

Factors Not Considered Significant Include:
- Where the work is performed
- The absence of a formal employment agreement; licensure by state or local government
- How the person is paid

The IRS Guidelines

To determine whether an individual is an employee or an independent contractor for business tax purposes under the common law, the IRS consolidated its 20 factor test into three broad categories:
- Behavioral control
- Financial control
- The type of relationship of the parties

Behavioral Control

Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired 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, 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

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 ordinarily use their own methods.
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 for 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. Independent contractors 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 by 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.

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 you engage a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that your intent was to create an employer-employee relationship

- The extent to which services performed by the worker are a key aspect of the regular business of the company – if a worker provides services that are a key aspect of your regular business activity, it is more likely that you will have the right to direct and control his or her activities

The Future

- The IRS has stepped up enforcement and will conduct employment tax compliance audits on 2,000 randomly selected employers per year over the next three years.

- In addition, a pending bill, The Employee Misclassification Prevention Act, would amend the Fair Labor Standards Act to strengthen enforcement and penalties for misclassification of employees as independent contractors.

- Now is the time to ensure that your worker classification house is in order.