

Independent contractor vs. employee: avoiding misclassification

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It is critical that employers correctly determine whether to classify the individuals providing services as independent contractors or employees. Failure to correctly classify an individual can result in fines and penalties with the IRS and denial of critical benefits and protections, such as family and medical leave, overtime, minimum wage, and unemployment insurance. Additionally, employers that misclassify their employees may not be paying the proper overtime compensation or minimum wage under the Fair Labor Standards Act, FICA and Unemployment Insurance taxes, or workers' compensation premiums.

The general rule is that an individual is an independent contractor if you, the person for whom the services are performed, have the right to control or direct only the result of the work and not the means and methods of accomplishing the result. Anyone who performs services for you is generally your employee if you have the right to control what will be done and how it will be done. Classification as an employee generally requires the business to withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee.

To determine whether an individual is an independent contractor or employee, there are two main tests: 1) the Economic Reality Test: The FLSA, and 2) the Federal Common-Law Test.

Federal courts applying the FLSA consider an "economic reality test." This test focuses on "whether the individual is economically dependent on the business to which he renders service or is, as a matter of economic fact, in business for himself" and applies factors similar to the common law tests (*Doty v. Elias*, 733 F.2d 720, 723 (10th Cir. 1984)). Courts generally focus on five factors: 1) the degree of control exerted by the alleged employer over the worker, 2) the worker's opportunity for profit or loss, 3) the worker's investment in the business, 4) the permanence of the working relationship, and 5) the degree of skill required to perform the work. The U.S. Court of Appeals for the Eighth Circuit (whose decisions apply to Arkansas) applies a variation of this test called

the "hybrid test," defining employee under the FLSA "in light of general common-law concepts, taking into account the economic realities of the situation" (*Wilde v. County of Kandiyohi*, 15 F.3d 103, 105 (8th Cir. 1994)).

Under the Federal Common-Law Test, or "right to control test," the relationship of the worker and the business must be examined. All information that provides evidence of the degree of control and the degree of independence must be considered. Facts that provide evidence of the degree of control and independence fall into three categories: behavioral control, financial control, and type of relationship. The courts have applied this test in Arkansas worker's compensation cases as well. See *Woodmancy v. Framco*, 2011 Ark. App. 785.

If after reviewing the three categories of evidence, it is still unclear whether a worker is an independent contractor or employee, **Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding**, can be filed with the IRS. The IRS will review the facts and circumstances and officially determine the worker's status.

Misclassifying employees as independent contractors can result in **significant fines and penalties**. The IRS has a "reasonable basis" or "safe harbor" provision that allows employers to escape certain penalties for a misclassification. If you classify an employee as an independent contractor and you have no reasonable basis for doing so, you may be held liable for employment taxes for that worker. If you have a reasonable basis for not treating a worker as an employee, you may be relieved from having to pay employment taxes for that worker. To get this relief, you must file all required federal information returns on a basis consistent with your treatment of the worker. The FLSA provides a defense to liquidated damages to employers who prove that they had a good faith belief that their practices complied with the FLSA. An employer must demonstrate that it actually believed that its practices complied with FLSA and that its actual belief was reasonable when compared to other employers.

Federal Common-Law Test: Facts Showing Degree of Control

	Independent Contractor	Employee
Behavioral	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.	
Instructions	Business has given up the right to control the details of a worker's performance and little or no instruction has been given about when, where, and how to work.	Subject to business's instructions about when, where, and how to work (what tools or equipment to use, what workers to hire, where to purchase supplies, what work must be performed by a specific individual, what sequence to follow). Even if no instructions are given, sufficient behavioral control may exist if employer has right to control how work results are achieved.
Training	Ordinarily use their own methods to perform their services.	May be trained to perform services in a particular manner.
Financial	Facts that show whether the business has a right to control the business aspects of the worker's job.	
Expense Reimbursement	More likely to have unreimbursed expenses. Company is not liable for any expenses paid or incurred.	Company reimburses worker for business or traveling expenses.
Investment	Usually has a significant investment in the facilities or tools used in performing services. Furnishes their own tools and materials.	Company usually provides worker's tools and materials.
Service Availability	Regularly makes services available to the general public and is free to seek out business opportunities (advertise, maintain visible business location)	Does not regularly make services available to the general public.
Payment Method	Often paid a flat fee, on commission, or on a time and materials basis for the job.	Guaranteed a regular wage amount for an hourly, weekly, monthly, or other period of time.
Profit or Loss	Can realize a profit or loss.	Cannot make a profit or loss.
Type of Relationship	Facts that show the parties' type of relationship.	
Written Contract	A written contract describing the relationship the parties intend to create.	
Benefits	Employee-type benefits are generally not provided.	Provides worker with employee-type benefits (insurance, pension plan, vacation pay, sick pay)
Permanency of relationship	Expectation that the relationship is for a specific project or period of time.	Expectation that the relationship will continue indefinitely.
Regular business of company	Worker performs services that are separate and distinct from work done by regular full-time employees. Services are not a key aspect of the business.	Worker provides services that are a key aspect of your regular business activity and parallels work done by regular full-time employees.