

Independent Contractor or Employee?

Why Getting It Right Matters

Treating workers as independent contractors has many benefits for employers, including avoiding the cost of payroll taxes and benefits and not having to deal with the administrative requirements associated with employees. These benefits make independent contractor status an attractive alternative to classifying a worker as an employee, if the worker meets the legal tests for independent contractor status. Unfortunately, many employers mistakenly believe that simply calling a worker an independent contractor or having the worker sign an “independent contractor agreement” satisfies the legal requirements for independent contractor status. Rather, whether a worker is properly classified as an independent contractor or employee depends on the nature of the relationship between the worker and the company as determined under applicable law. Employers who misclassify a worker as an independent contractor face significant federal and state monetary liabilities and penalties. These penalties can be imposed not only on the company but also on the individuals responsible for the misclassification. Therefore, an employer must conduct a careful analysis before classifying a worker as an independent contractor.

Independent Contractor v. Employee

Several federal and state laws apply in determining whether a worker is an employee or independent contractor. The most important are the federal Internal Revenue Code (IRC) enforced by the IRS, and the federal Fair Labor Standards Act (FLSA) enforced by the United States Department of Labor (DOL). The IRC applies what is called the “right to control” test to determine employee or independent contractor status. The “right to control” test looks at whether the company for which the worker is performing services has the right to control or direct the worker to such a degree that he or she is an employee. It consists of 20 factors that are analyzed to determine the company’s control over the worker’s behavior (e.g., where, when, and how the work is performed), the financial control the company has over the worker (e.g., whether the worker is paid by the hour or by the job, whether the worker can realize a profit or loss, and whether the worker makes his/her services available to others), and the nature of the relationship (e.g., is there a written independent contractor agreement, how integral are the worker’s services to the company and the permanency of the relationship). The FLSA uses what is called the “economic reality” test to determine whether a worker is economically dependent on the company for which he or she renders services so as to qualify as an employee. The “economic reality” test consists of only six enumerated factors but in actuality they incorporate all of the IRC’s “right to control” factors. Thus, both tests essentially use the same factors and a worker classified as an employee or independent contractor under one will in most cases be classified the same under the other statute. No one factor is controlling and the importance of a factor will depend on the position at issue and the circumstances under which the services are rendered. Even the existence of a written independent contractor agreement and both parties’ desire for independent contractor status will not be determinative of the issue as the agency or court will look behind any such arrangement to determine the parties’ actual relationship.

Legal Consequences of Misclassification

In addition to having to pay back payroll taxes, the employer’s share of FICA contributions and unemployment taxes, and accompanying civil penalties, companies that misclassify a worker as an independent contractor can be liable for unpaid overtime, retirement benefits, medical claims, stock options and any other economic benefit that the worker would have been entitled to if he or she had been properly classified. In addition, if this issue is determined in a lawsuit, the employer may be liable for the worker’s attorneys’ fees. That is why it matters to get it right when classifying a worker as an independent contractor.

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