

Independent Contractor Classification Guide

Why do I need a guide? Can't anyone be an independent contractor if they agree to it?

Only certain types of workers can be properly classified—by law—as independent contractors (ICs) (sometimes called 1099 employees). What the worker wants is irrelevant, even if they sign something! They can't sign away their rights to employee protections under the Fair Labor Standards Act, nor can they (or you) forgo payroll taxes unless the IC classification is valid.

What happens if someone is misclassified?

There are many potential liabilities resulting from misclassification and they come from several sources, namely, the IRS, unemployment insurance, workers' compensation, federal wage and hour law, and state wage and hour law.

An employer will owe up to three years of back taxes on the misclassified employee's wages, in addition to fines and interest. They will also owe back unemployment and workers' compensation insurance. And they may also owe premiums on other state-run insurance programs, such as paid family leave.

In addition to money owed to government entities, employers will also owe misclassified workers two to three years of back pay for any work they did that was not compensated at applicable minimum wage and overtime rates, as well as liquidated (extra) damages equal to that amount. Finally, in states that have their own minimum wage, overtime, or employee classification laws, the employee will likely be able to sue and recover under both state and federal law. There may also be hefty attorney fees on top of the costs described above.

Does it matter if I misclassified someone by accident?

Not much. Under certain laws willfulness will increase the potential damages from two years of back pay to three, and lead to higher statutory penalties. But most of the laws at play in misclassification and wage and hour cases are strict liability statutes, meaning it makes no difference that the employer didn't mean to do it incorrectly.

What if I discover I've had someone misclassified?

If you believe you have workers misclassified as ICs, you should convert them to employees. However, you should strongly consider consulting with an attorney first, to determine whether it would be beneficial to negotiate a release of claims at the time of reclassification. Reclassifying a worker as an employee will likely tip them off that they were previously

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misclassified and may lead them to investigate wage and hour claims either through an attorney or a state agency. A well-drafted release of claims (accompanied by back pay owed), however, may prevent a future investigation or lawsuit. This might sound like a reason to leave things as they are, but every extra day of misclassification increases your potential liability, so we don't recommend ignoring a misclassification and hoping the worker won't notice.

So how do I figure out who can be an independent contractor?

Welcome to the rest of this guide! When determining who can be an IC, we recommend that you review both tests included in this guide. The IRS test will be applied if review of your classifications stem from a tax issue or audit, whereas the Department of Labor (DOL) test will apply in the case of wage and hour claims. The tests are very similar, and if a worker passes one, they will almost certainly pass the other, but out of an abundance of caution, we encourage employers to look at both.

Given the potential outcome of a misclassification, **when in doubt, classify the worker as an employee.**

The IRS Right to Control Test

We recommend starting with this test since it has more examples and explanations to think through. By the time you get to the DOL test, you will have the answers to the questions it asks.

According to the IRS, facts that show a degree of control and independence fall into three categories—behavioral, financial, and type of relationship. This a *balancing or factors test*. Businesses must weigh all these factors when determining whether a worker is an employee or an independent contractor. Some factors may indicate that the worker is an employee, while other factors indicate that the worker is an IC. There is no magic or set number of factors that makes the worker an employee or IC, and no one factor stands alone in making this determination.

Factors which are relevant in one situation may not be relevant in another. The keys are to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally, to document each of the factors used in coming up with the determination.

Behavioral

Behavioral control refers to whether there is a right to direct or control how the worker does the work. A worker is an employee when the business has the right to direct and control the

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worker. The business does not have to actually direct or control the way the work is done, as long as the employer has the right to direct and control the work.

The behavioral control factors fall into the following categories:

Types of Instructions Given

An employee is generally subject to the business's instructions about when, where, and how to work. 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 when performing the work

Degree of Instruction

Degree of Instruction means that the more detailed the instructions, the more control the business exercises over the worker. More detailed instructions indicate that the worker is an employee. Less detailed instructions show less control, indicating that the worker is more likely an independent contractor.

Note: 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, and 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.

Evaluation System

If an evaluation system measures the details of how the work is performed, then these factors would point to an employee. If the evaluation system measures just the end result, then this can point to either an independent contractor or an employee.

Training

If the business provides the worker with training on how to do the job, this indicates that the business wants the job done in a particular way. This is strong evidence that the worker is an employee. Periodic or ongoing training about procedures and methods is even stronger evidence of an employer-employee relationship. ICs ordinarily use their own methods.

Financial

Financial control refers to facts that show whether or not the business has the right to control the economic aspects of the worker's job. The financial control factors fall into the following categories:

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Significant investment

An IC often has a significant investment in the equipment they use in working for someone else. However, in many occupations, such as construction, workers spend thousands of dollars on the tools and equipment they use and are still considered to be employees. There are no precise dollar limits that must be met in order to have a significant investment. Furthermore, a significant investment is not necessary for independent contractor status as some types of work simply do not require large expenditures.

Unreimbursed 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, such as office rental, licensing fees, professional liability insurance, and software subscriptions. However, employees may also incur unreimbursed expenses in connection with the services that they perform for their business, though these should be less significant and ongoing.

Opportunity for profit or loss

The opportunity to make a profit or loss is another important factor. If a worker has a significant investment in the tools and equipment used and if the worker has unreimbursed expenses, the worker has a greater opportunity to lose money (i.e., their expenses will exceed their income from the work). Having the possibility of incurring a loss indicates that the worker is an independent contractor.

Services available to the 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. If an employer wants an IC to work for them exclusively, this is strong evidence of an employer-employee relationship.

Method of payment

An employee is generally guaranteed a regular wage based on hours worked or a fixed salary. 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 a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.

Type of Relationship

Type of relationship refers to facts that show how the worker and business perceive their relationship to each other. The factors, for the type of relationship between two parties, generally fall into the following categories:

Written Contracts

Although a contract may state that the worker is an employee or an independent contractor,

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this is not enough to determine the worker's status. The IRS is not required to follow a contract stating that the worker is an independent contractor, responsible for paying their own self-employment tax. How the parties work together determines whether the worker is an employee or an independent contractor.

Employee Benefits

Employee benefits include things like insurance, pension plans, paid vacation, sick days, and disability insurance. Businesses generally do not grant these benefits to independent contractors. However, a lack of these benefits does not necessarily mean the worker is an independent contractor.

Permanency of the Relationship

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

Services Provided as Key Activity of the Business

If a worker provides services that are a key aspect of the business, it is more likely that the business will have the right to direct and control its activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. Likewise, a restaurant that hires a chef or server is hiring someone who offers the services that are key to their business and would no doubt maintain the right to control the behavior and work of the chef or server. This would indicate an employer-employee relationship.

The Department of Labor Economic Realities Test

The goal of this test is to determine the underlying economic reality of the situation and whether the individual is economically dependent on the supposed employer. The factors below are each significant, though no single factor or answer will tip the scales one way or another. Like the IRS test, this is a factors or balancing test, meaning the employer must weigh the answers as a whole and see if they indicate that a worker operates more like an employee or more like an independent contractor.

Nature of Services

The extent to which the **worker's services are an integral part of the employer's business**. The more integral the role, the more likely they are an employee.

- Does the worker play an integral role in the business by performing the primary type of work that the employer performs for his customers or clients?

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- Does the worker perform a discrete job that is one part of the business' overall process of production?
- Does the worker supervise any of the company's employees?

Permanency

The **permanency of the relationship**. The more permanent, the more likely they are an employee.

- Were they hired for an indefinite period of time or a project or short-term basis?
- How long has the worker worked for the same company?

Investment

The amount of the **worker's investment in facilities and equipment**. The less investment, the more likely they are an employee.

- Is the worker reimbursed for any purchases of materials, supplies, etc.?
- Does the worker use their own tools or equipment?

Control

The **nature and degree of control** by the employer. The more control, the more likely they are an employee.

- Who decides on what hours to be worked?
- Must the work be done in a specific location?
- Must the work be done in a certain order?
- Who is responsible for quality control?
- Who sets the pay rate?

Profit and Loss

The **worker's opportunities for profit and loss**. The less opportunity, the more likely they are an employee.

- Did the worker make any investments such as insurance or bonding?
- Can the worker earn a profit by performing the job more efficiently?
- Can the worker increase their profit by hiring out certain portions of the assignment?
- Could the worker suffer a loss of capital investment?

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Skill

The **level of skill** required in performing the job and the amount of initiative, judgment, or foresight in **open market competition** with others required for the success of the independent enterprise. The less special skill required, the more likely the worker is an employee.

- Does the worker have a unique skill, or do they perform routine tasks requiring little training?
- Would most people be able to do the task the worker was hired for?
- Does the worker advertise their services through a website, internet marketing, business cards, etc.?

Legitimate Business

The degree of independent business organization and operation.

- Does the worker have a registered business?
- Does the worker do work for other companies?
- Does the worker have a separate business location?