

Employee or Independent Contractor?

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Why independent contractor and not employee?

Employer avoids the following expenses:

The employer's share of SS and Medicare taxes

Possible overtime pay

FMLA Leave and other "employee benefits"

Unemployment Compensation tax/claims

Worker's Compensation insurance premiums

Proper worker classification - why does it matter?

IRS

FLSA

State Unemployment Compensation

Worker's Compensation

ERISA

Liability issues

IRS

\$50 fine for each W-2 not filed.

Penalty of 1.5% of the wages, plus 40% of the FICA taxes (social security and Medicare) that were not withheld from the employee and 100% of the matching FICA taxes the employer should have paid. Interest is also accrued on these penalties daily from the date they should have been deposited.

A monthly “Failure to Pay Taxes” penalty equal to 0.5% of the unpaid tax up to 25% of the total tax liability.

If the IRS suspects fraud or intentional misconduct, it may assess additional fines and penalties such as a penalty based upon 20% of all of the wages paid, plus 100% of the FICA taxes, both the employee's and employer's share. If extremely egregious, the IRS could pursue Criminal penalties of up to \$1,000 per misclassified worker; 1 year in prison can be imposed as well.

DOL/FLSA

Comprehensive audit (could go back as many as three years)

Payment of back wages/overtime *to all affected employees*

Substantial fines and penalties

Referral to state agencies/IRS

Other agency issues.....

State UC and Worker's Compensation agencies:

- Retroactive payment of unemployment base amount
- Substantial "Per Diem" type fines and assessments

ERISA:

- Potential disqualification of a retirement plan

Tort Liability:

- Respondeat Superior

Proper classification: analysis

Each federal and state agency uses different “tests”

IRS: Eleven Factors Test

DOL: Economic Realities Test

State UC Agencies/Worker’s Compensation: ABC
Test

Eleven Factors Test

Behavioral control

Financial control

Relationship

Behavioral Control

Instructions the business gives the worker. An employee is generally subject to the business' 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.

Financial control

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 they perform for their business.

The extent of the worker's investment. An employee usually has no investment in the work other than his or her own time. 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 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.

Financial control (cont.)

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. Since an employer usually provides employees a workplace, tools, materials, equipment and supplies needed for the work, and generally pays the costs of doing business, employees do not have an opportunity to make a profit or loss. An independent contractor can make a profit or loss.

Relationship

Facts that show the parties' type of relationship include:

Written contracts describing the relationship the parties intended to create.

Whether 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.

The extent to which services performed by the worker are a key aspect of the regular business of the company.

Relationship (cont.)

Facts that show the parties' type of relationship include:

Written contracts describing the relationship the parties intended to create. This is probably the least important of the criteria, since what really matters is the nature of the underlying work relationship, not what the parties choose to call it. However, in close cases, the written contract can make a difference.

Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay. The power to grant benefits carries with it the power to take them away, which is a power generally exercised by employers over employees. A true independent contractor will finance his or her own benefits out of the overall profits of the enterprise.

The permanency of the relationship. If the company engages 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 the intent was to create an employer-employee relationship.

Section 530 Safe Harbor

Section 530 states in part that an individual will not be considered an employee if a taxpayer treated him or her and other workers performing similar tasks as nonemployees for all periods, had a reasonable basis for doing so, and filed required information and other returns (such as Form 1099-MISC) consistently with that status.

DOL: Economic Realities Test

“Suffered or Permitted” to Work

“A worker is an employee if he or she is economically dependent on the employer, whereas a worker is an independent contractor if he or she is in business for himself or herself.”

Thus the DOL looks behind the form of the relationship and to the “economic realities” surrounding it.

Economic Realities Test: Factors to Consider

Is the worker an integral part of your business?

Does the worker's managerial skill affect his or her opportunity for profit/loss?

Comparison of relative employer/worker investments.

Permanency of the relationship.

Employer control.

State Worker Classification Tests

The “ABC” Test asks:

- To what extent is the worker free from control by the principal?
- If the work performed by the contractor is the same work performed by the contracting business; and
- Whether the worker has an *independent* trade, occupation, profession or business outside of their work for the contracting company.

Case Study: something doesn't smell quite right.....

St. Croix Sensory, Inc. vs. Dept. of Employment and Economic Development
Court of Appeals of Minnesota

The Facts:

- St. Croix ran a sensory laboratory specializing in “odor testing”. The company hired, as independent contractors “sensory assessors” to perform certain “odor evaluations” on materials, products and air quality samples.
- The assessors perform their evaluations at the company’s facility, most often using the company’s “olfactometer” which is owned and located on the company’s premises.
- The parties enter into a written contract whereby it states the workers are ICs. Under the terms of the contract the assessors are paid per each scheduled session, regardless of if the session is cancelled or ends prematurely. They are not paid hourly.

Case Study: something doesn't smell quite right.....(cont.)

Minnesota DEED conducted an audit and found that the workers were misclassified as ICs and should have been classified as employees. Accordingly, the company was ordered to pay back unemployment taxes on all wages of present and past assessors.

The law judge reasoned that the company “substantially possessed the right to control the means and manner of the assessor’s performance.”

On appeal, the court cited the controlling statute which defines an employee as an “individual who is performing or has performed services for an employer in employment.”

The state argued that because the workers had to use the company’s equipment and premises and also had to follow detailed instructions as to how to “evaluate” smells, this constituted the necessary control over the means and the manner of the work to be done.

How did the court rule?

The court first looked to the contract, which contained a provision reserving in the company the right to “inspect the assessor’s work, to stop work, to prescribe alterations and generally conform to the needs of the clients.”

Next, the court made the following observation:

“It appears the assessors control the manner in which they perform the tests - how long to sniff, how many sniffs to take, and what reactions to record.”

Based upon this control as one of the main determining factors the court overturned the DEED’s decision and found in favor of the independent contractor status of the workers.

Ah, the sweet smell of victory!

Concluding Remarks

Perform a proper analysis of your workers before hiring them to perform work for your company.

EmployShare's "Classification Tool".

Remember, different agencies employ different tests.

Err to the side of caution—it is always safer to classify a worker as an employee!

Proceed with caution when "restructuring workers." End of year/VCSP Program.

If you do choose to classify the worker as an Independent Contractor, a well drafted and comprehensive Independent Contractor Agreement is your first line of defense.

Contact Information



A single source solution to manage and protect your practice.

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