

# Employing Independent Contractors

## Overview

In addition to hiring traditional employees, HR professionals can meet their organization's staffing needs through a variety of alternative arrangements. Such options are referred to collectively as the "contingent workforce."

The possibilities include the following types of workers:

- Independent contractors.
- Temporary employees.
- Seasonal employees.
- Leased workers.
- Interns.
- Volunteers.

This article focuses on the first of these—-independent contractors—although the categories may overlap, and some of the same principles may apply.

Perhaps the most basic question about the employment relationship is whether a worker is, in fact, an employee or an independent contractor. As with so many employment law issues, the answer is, "It depends." In this case, it depends in particular on who is asking: the U.S. Internal Revenue Service (IRS), the U.S. Department of Labor (DOL), a workers' compensation hearing officer and so on. Even courts have admitted that the distinction is not always clear.

Employee status triggers employer obligations under various federal and state laws that do not apply to independent contractors, and the responsibility for classifying a worker correctly falls squarely on the employer. Accordingly, HR professionals must understand the practical and legal differences between employees and independent contractors.

No bright-line test exists to determine when a worker should be classified as an employee rather than as an independent contractor. However, a wealth of information is readily available to help organizations make the necessary case-by-case determinations. Once the decision has been made to meet a staffing need through independent contractors, organizations can take a number of practical steps to manage independent contractors effectively.

## The Staffing Decision: Employees or Independent Contractors?

Organizations cannot use independent contractors indiscriminately to avoid the tax, equal employment opportunity and other legal requirements applicable to employees. Organizations face significant risks when they improperly classify a worker as an independent contractor when, under all the circumstances, that worker should be treated as an employee.

In general, engaging a regular employee when an independent contract might have been a better staffing solution poses fewer risks. However, if the organization does hire a regular employee for

a specific project, knowing additional work will not likely be available, the best practice is to inform the individual in writing that employment is for a limited duration. Keeping the employee in the dark on this subject could bring a claim against the organization for promissory estoppel, fraudulent nondisclosure or negligent misrepresentation.

Accordingly, an employer should consider a variety of factors—none of them in isolation—in deciding whether to meet a staffing need by means of independent contractors versus employees. Weighing the requirements of the job in combination with other factors will enable the employer to judge whether an independent contractor will both meet the employer’s staffing needs and withstand legal scrutiny.

### ***Duration***

If the staffing need relates to a specific project with no likelihood of continued employment, using an independent contractor as project manager would avoid the problem of having to lay off an employee when the project is done. Such a case would weigh in favor of independent contractor status.

### ***Exclusivity***

If the organization needs the worker’s full-time efforts over an extended or indefinite period, the situation would likely call for a traditional employee. Regulatory authorities will tend to view long-term independent contractors who have only one client as suspiciously similar to employees. If the organization needs the worker only part time, does not object to the individual having other clients or will be satisfied as long as the worker meets set deadlines, then the organization is on relatively solid footing in engaging an independent contractor.

### ***Control***

If the employer will rigidly prescribe the manner in which the work is performed, that weighs toward employee status. Hiring an employee would be the safer course of action. If the organization is concerned only about the final product and does not need to dictate how the worker gets from point A to point Z, an independent contractor may be the preferred approach.

### ***Independent judgment***

If the relevant job requires exercise of independent judgment, engaging an independent contractor may be a sound choice. An organization might choose to use an outside contractor to manage a specific complex project such as facilitating the transition after a merger or acquisition, for example.

### ***Specialized knowledge, training or experience***

Organizations routinely engage professionals such as lawyers and accountants as independent contractors. Information technology professionals also commonly serve on that basis.

Other situations requiring an independent contractor's specialized knowledge, training or experience might include:

- A defense contractor that needs specialized know-how to help win a particular contract.
- An organization that needs a trainer to deliver specialized programs.

### ***Stewardship of confidential matter***

It may seem inappropriate and risky for employers to entrust independent contractors with confidential information. Nevertheless, an argument can be made that some types of sensitive information are *more* safely lodged outside the organization than inside, where leaks and gossip predictably occur. Some organizations choose independent contractors to safeguard employees' medical privacy and family and medical leave records, for example.

### ***Personal services***

Individuals who provide clients with personal services will tend to be independent contractors rather than employees. A hair styling salon in a retirement community is more likely to be staffed with independent contractors than employees of the management company, for example. Similarly, an organization would be well justified in hiring an executive coach on an independent contractor basis.

### ***Importance of marketing***

Real estate agents, mortgage brokers, stock brokers and financial planners are often compensated on a commission basis that depends largely on their ability to bring in new business. A commission-based compensation arrangement makes meeting a staffing need through independent contractors particularly appropriate. This is especially true if the contractor's clients are deemed to be property of the contractor and not of the hiring organization.

### ***Exigent circumstances***

An urgent need may warrant engaging an independent contractor to perform work that a regular employee normally does. Meeting needs created when a worker goes on extended leave, for example, would weigh in favor of hiring an independent contractor even if the work required extensive controls over the worker's efforts and output. Generally, an organization can find a suitable independent contractor faster than it can find a suitable employee. (An organization may well want to pursue both avenues simultaneously, bringing in an independent contractor to deal with exigent circumstances, but taking its time to select a regular employee to assume the duties long term.)

### ***Business essentials***

Regulatory authorities will expect that truly independent contractors do not need organizations to provide them with an office, equipment or other basic necessities of doing business.

### ***Employees doing the same job***

Employees and independent contractors doing the same job is a big red flag for regulators. It is very risky for an organization to have two classes of workers—-independent contractors and employees—performing the same job. If challenged, the employer will be expected to offer a clear and convincing rationale that does not involve avoiding legal obligations.

### ***Industry standard***

The legality of a worker's classification as an independent contractor often boils down to the issue of reasonableness. In determining reasonableness, regulatory agencies often consider how other organizations in the same industry handle similar situations. Using independent contractors works better in certain industries such as computer programming, sales and the courier industry.

### ***Controlling administrative overhead***

Independent contractors normally are not eligible for employer-provided benefits and are responsible for their own income and employment taxes. If the organization is able to legitimately treat an entire class of workers as independent contractors, it may save substantially on administrative overhead.

The July 15, 2015, DOL Administrator's Interpretation 2015-1 Subject: The Application of the Fair Labor Standards Act's "Suffer or Permit" Standard in the Identification of Employees Who Are Misclassified as Independent Contractors provides additional clarification of the DOL's view on how employers and particularly courts should interpret the "economic realities" test used to determine whether a worker is an employee for purposes of the Fair Labor Standards Act (FLSA). The test includes the following six factors aimed at helping courts make this determination:

- Is the work an integral part of the employer's business?
- Does the worker's managerial skill affect the work opportunity for profit or loss?
- How does the worker's relative investment compare to the employer's investment?
- Does the work performed require special skill and initiative?
- Is the relationship between the worker and the employer permanent or indefinite?
- What is the nature and degree of the employer's control?

Companies that use independent contractors should re-examine their independent contractor relationships in light of the July 2015 Administrator's Interpretation to assess whether they are likely to withstand scrutiny under the DOL's new interpretation of the economic realities test.

### **Legal Ramifications of Misclassification**

Classifying a worker as an independent contractor should always be an informed and bona fide business decision, not a subterfuge to avoid the employer's obligations to employees. Independent contractor arrangements have drawn increasing scrutiny and significance with the proliferation of workplace laws covering employees and the growth of the contingent workforce.

Misclassification of an individual as an independent contractor can give rise to a variety of liabilities.

If the purported independent contractor arrangement is between two organizations, that is, between the organization receiving the services and the organization that actually engages the workers, there is a risk of being found a “joint employer”—a legal relationship in which *both* client and contractor can be liable for violations of employment laws.

### ***Tax consequences***

Employers are required to withhold income taxes on the basis of information employees provide on IRS Form W-4. If an employer fails to withhold income taxes on behalf of a worker improperly classified as an independent contractor, and the individual has failed to pay the taxes, the putative employer may be liable for federal or state taxes that were required to be withheld but were not.

In addition, independent contractors are not eligible to receive tax-free benefits from the organization. If the company chooses to offer health care benefits to an independent contractor, the contractor must pay income taxes on the value of the benefit. If the company includes an independent contractor in its defined benefit pension plan, it risks losing the tax-exempt status of the plan.

### ***Employee benefits obligations***

In an illustrative case, *Vizcaino v. Microsoft Corporation*, the court found that Microsoft had mischaracterized certain workers as independent contractors and freelancers. Although the workers had been hired for specific projects, some continued to work on successive projects for a number of years. They were fully integrated into Microsoft’s workforce, and worked onsite and on work teams along with Microsoft’s regular employees. They also shared the same supervisors, performed identical functions and worked the same core hours as regular employees. Microsoft provided them with admittance card keys, office equipment and supplies. However, as independent contractors, these workers were not eligible for the same employee benefits that Microsoft’s regular employees received. Microsoft reached a settlement for \$96,885 million and was subsequently assessed approximately \$27,128 million in attorneys’ fees and costs.

### ***Workers’ compensation***

A misclassified worker can result in the supposed employer being held liable for on-the-job injuries outside the protections of the workers’ compensation system, and for penalties as well.

### ***Unemployment compensation***

A worker may file a claim for unemployment compensation and be granted benefits if the unemployment agency believes that the worker was misclassified as an independent contractor. If the organization misclassified the worker, it may be liable for penalties and interest in addition to unpaid unemployment insurance premiums.

### ***Wage and hour liability***

The widespread use of independent contractors invites the scrutiny of plaintiffs' attorneys who may be eager to bring a class or collective action suit for unpaid overtime or minimum wage violations under the FLSA or state wage and hour laws.

### ***Vicarious liability***

An employer may incur liability for wrongful acts of a worker whom it has mistakenly classified as an independent contractor.

### **How to Classify Properly**

No legal test applies in every situation when deciding to classify a worker as an independent contractor. For example, the IRS and DOL use different, although similar, analytical frameworks. In fact, the multiplicity of tests defining independent contractor status applied across federal and state laws makes it possible for a worker to be classified as an independent contractor under one law but as an employee under another.

To minimize legal risk, employers are well advised to ensure that classification as an independent contractor would satisfy *every* test that may be applicable where the organization does business.

SHRM assisted Congress in attempting to draft better and more comprehensive legislation concerning the meaning of "independent contractor."

### ***Tests for independent contractor status***

Various federal government agencies and some states have their own tests to determine independent contractor status.

**U.S. IRS.** As reflected in Section 2 of its [Publication 15-A: Employer's Supplemental Tax Guide \(PDF\)](#), the IRS now looks at 11 factors (rather than the previous 20 factors) within three areas—behavioral control, financial control and the relationship between the parties. Organizations can obtain an official determination of a worker's status under the IRS test by filing [IRS Form SS-8](#). It takes about six months for the IRS to rule.

**Workers' compensation laws.** The test for independent contractor status under workers' compensation laws varies from state to state. To find out more about the workers' compensation test in a given state, employers may contact the state department of industrial relations or the [state labor department](#).

### ***Effective practices***

Organizations can take a number of proactive steps to ensure that they effectively use independent contractors within the bounds of the law:

- Involve HR up front in making a decision whether to meet a staffing need through independent contractors or employees and in making sure that the arrangement qualifies as a bona fide independent contractor relationship.
- Use written independent contractor agreements containing language that helps establish the bona fides of the classification as an independent contractor
- Organizations may ask the worker to indemnify the organization for any losses resulting from misclassification or to regularly provide the organization with proof that the independent contractor is timely in paying all employment taxes due.
- Adopt a formal policy concerning the use of independent contractors. Use a checklist to make sure all details regarding management of independent contractors are being handled.
- Do not treat independent contractors like regular employees, but do ensure that they understand and adhere to the organization's policies and procedures.

### *Agencies and organizations*

- U.S. Department of Labor
- U.S. Internal Revenue Service

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# Fair Labor Standards Act Advisor

## Independent Contractors

The Supreme Court has said that there is no definition that solves all problems relating to the employer-employee relationship under the Fair Labor Standards Act (FLSA). The Court has also said that determination of the relation cannot be based on isolated factors or upon a single characteristic, but depends upon the circumstances of the whole activity. The goal of the analysis is to determine the underlying economic reality of the situation and whether the individual is economically dependent on the supposed employer. In general, an employee, as distinguished from an independent contractor who is engaged in a business of his own, is one who "follows the usual path of an employee" and is dependent on the business that he serves. The factors that the Supreme Court has considered significant, although no single one is regarded as controlling are:

- (1) the extent to which the worker's services are an integral part of the employer's business (examples: 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? 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?);
- (2) the permanency of the relationship (example: How long has the worker worked for the same company?);
- (3) the amount of the worker's investment in facilities and equipment (examples: Is the worker reimbursed for any purchases or materials, supplies, etc.? Does the worker use his or her own tools or equipment?);
- (4) the nature and degree of control by the principal (examples: Who decides on what hours to be worked? Who is responsible for quality control? Does the worker work for any other company(s)? Who sets the pay rate?);
- (5) the worker's opportunities for profit and loss (examples: Did the worker make any investments such as insurance or bonding? Can the worker earn a profit by performing the job more efficiently or exercising managerial skill or suffer a loss of capital investment?); and
- (6) 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 claimed independent enterprise (examples: Does the worker perform routine tasks requiring little training? Does the worker advertise independently via yellow pages, business cards, etc.? Does the worker have a separate business site?).

For information about trainees (including School-to-Work programs) and volunteers or to find out whether you are covered by the FLSA, click on the underlined text.

Remember that some employees are exempt from various provisions of the law. To explore the broad categories of these exemptions or to obtain further information about the FLSA, click on the underlined text.

For more information, please contact your local Wage and Hour District Office.

Source: United States Department of Labor

<http://webapps.dol.gov/elaws/whd/flsa/docs/contractors.asp>