



Independent Contractor Or Employee?



The issue of whether an individual may be classified as an independent contractor or employee is increasingly becoming a challenge. Some States are pressuring employers to justify classifications, as legislators look for additional payroll tax revenue and respond to complaints indicating that some employers are identifying their employees as an independent contractors in an effort to avoid their obligations to employees (such as Unemployment, Social Security, and Medicare taxes, overtime and minimum wage, workers' compensation and so forth.) This data sheet is intended to provide assistance with understanding the variables to be considered for the proper clarification of a worker as an employee or independent contractor.



While determining whether an individual should be classified as an employee or independent contractor can be difficult, there are some "tests" and tools that you can reference to help ease the process. Contrary to popular belief, companies cannot just "declare" an individual as an independent contractor. Instead, they must meet certain legal tests. There are several tests that can be used to determine if an individual qualifies as an independent contractor or employee for the purposes of state or federal laws. Five of the most common tests are:



1. IRS Factor Control Test ("20 Factor Test")
2. Economic Reality Test
3. Relative Nature of Work Test
4. ABC Test
5. Common Law Test

Which test is used depends upon the particular statutes or government agencies involved, as well as the subject matter at hand. The result may be that a worker is an "employee" under one statute, but may be considered an independent contractor under another. As you might expect, the tests are not clear-cut and are open to interpretation. However, the tests do have some significant similarities, with the main questions being:

Does the company control how the work will be performed (in which case you've likely got an employee) or does the company simply oversee the result (which would be more favorable to a finding of an independent contractor relationship)?

Below is a general reference regarding which test is commonly used to determine employment status as it relates to the areas outlined:



Area/Statute	Test Commonly Used
IRS Withholding.....	IRS Factor Control Test ("20 Factor Test")
Fair Labor Standards Act (FLSA) (i.e. overtime & minimum wage).....	Economic Reality Test
Workers' Compensation	Economic Reality Test
Unemployment Benefits	ABC Test
Discrimination (Title VII, Age Act, ADA) & Affirmative Action.....	Common Law ("Right to Control") Test plus the Economic Reality Test
Immigration (I-9's).....	IRS Factor Control Test ("20 Factor Test")
ERISA	Common Law ("Right to Control") Test
Worker Adjustment & Retraining Notification Act	Common Law ("Right to Control") Test
National Labor Relations Act & Labor Management Relations Act.....	Common Law ("Right to Control") Test

The Economic Reality Test and IRS Factor Control Test (i.e. the "20 Factor Test") are included with this data sheet. Please note that the tests are only guidelines and are not all applicable in every situation. No one test is decisive, rather the entire situation must be considered. The IRS Factor Control Test includes most of the elements of the other tests and was based on the Common Law test.

Several factors in addition to the IRS Factor Control Test and Economic Reality test may also be looked at. For example, if the position requires a very high level or specialized skills, this may support an independent contractor status. Also, if the individual in question bills his own invoices, carries his own Workers' Compensation, retains an accountant for his business' bookkeeping and makes his services available to other clients, then he may qualify as an independent contractor.

An additional tool you can use to determine whether an individual is an independent contractor or employee for tax purposes is IRS Form SS-8, which can be submitted to the IRS in order to gain their direction. For a copy of the SS-8 form visit <http://www.irs.gov/pub/irs-pdf/fss8.pdf>

Please remember that the information contained here is not intended to provide specific answers to your situation. Rather, it is a reference point from which to start to determine if the individuals in question qualify as employees or as independent contractors. It must also be noted that Federal laws and State laws may vary, so it is important to check on the requirements for your State as well.

Finally, please remember the financial risks associated with misclassifying employees as independent contractors. In addition to penalties and fees, you may also find you will be charged with liabilities, including back taxes and overtime. Also, by misclassifying an individual you may open yourself up to lawsuits related to the following:

- 1.) Denial of ERISA and other benefits
- 2.) Denial of Workers' Compensation
- 3.) Denial of Family Medical Leave Act
- 4.) Discrimination for failure to accommodate for a disability
- 5.) Failure to include the individual in your employee count which resulted in your company appearing not to be required to comply with Title VII, ADA, ADEA, FMLA, WARN Act, Affirmative Action and other State and Federal employment laws
- 6.) Failure to retain proper tax forms for employees
- 7.) Confusion as to who owns the rights to the work completed

In conclusion, even after you have completed one of the tests outlined above and determined that the individual is indeed an independent contractor, an independent auditor may still find that the individual is in fact an employee. However, by having a completed contract in hand (which includes the name of the individual's business), compensating the individual for completed projects rather than ongoing work and pre-auditing the individual using the IRS Form SS-8 in addition to referencing the tests outlined above, you may be able to support your claim that the individual is an independent contractor prior to being challenged by the government, an individual, an insurance company or in a court of law.

Economic Reality Test On Employment Status

The Economic Reality Test is based on decisions by the U.S. Supreme Court and uses the following seven factors to determine if an individual is an employee or independent contractor:

1. The extent to which services rendered are an integral part of the principal's business;
2. The permanency of the relationship;
3. The amount of alleged contractor's investment in facilities and equipment;
4. The nature and degree of control by the principal;
5. The alleged contractor's opportunities for profit and loss;
6. The amount of initiative, judgment, or foresight in open market competition with others required for success of the alleged independent contractor; and
7. The degree of independent business organization and structure.

IRS 20 Factor Test on Employment Status

As an aid to determining whether an individual is an employee under the common law rules, twenty factors or elements have been identified as indicating whether sufficient control is present to establish an employer-employee relationship. The twenty factors have been developed based on an examination of cases and rulings considering whether an individual is an employee. The degree of importance of each factor varies depending upon the occupation and the factual context in which the services are performed. The twenty factors are designed only as guides for determining whether an individual is an employee; special scrutiny is required in applying the twenty factors to assure that formalistic aspects of an arrangement designed to achieve a particular status do not obscure the substance of the arrangement (that is, whether the person or persons for whom the services are performed exercise sufficient control over the individual for the individual to be classified as an employee). The twenty factors are described below:

1. **INSTRUCTIONS:** A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed have the **RIGHT** to require compliance with instructions. See, for example, Rev. Rul. 68-598, 1968-2 C.B. 464, and Rev. Rul. 66-381, 1966-2 C.B. 449.
2. **TRAINING:** Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner. See Rev. Rul. 70-630, 1970-2 C.B. 229.
3. **INTEGRATION:** Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must necessarily be subject to a certain amount of control by the owner of the business. See *United States v. Silk*, 331 U.S. 704 (1947), 1947-2 C.B. 167.
4. **SERVICES RENDERED PERSONALLY:** If the Services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results. See Rev. Rul. 55-695, 1955-2 C.B. 410.
5. **HIRING, SUPERVISING, AND PAYING ASSISTANTS:** If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor status. Compare Rev. Rul. 63-115, 1963-1 C.B. 178, with Rev. Rul. 55-593 1955-2 C.B. 610.

IRS 20 Factor Test on Employment Status (continued)

6. CONTINUING RELATIONSHIP: A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals. See *United States v. Silk*.
7. SET HOURS OF WORK: The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control. See Rev. Rul. 73-591, 1973-2 C.B. 337.
8. FULL TIME REQUIRED: If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor on the other hand, is free to work when and for whom he or she chooses. See Rev. Rul. 56-694, 1956-2 C.B. 694.
9. DOING WORK ON EMPLOYER'S PREMISES: If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere. Rev. Rul. 56-660, 1956-2 C.B. 693. Work done off the premises of the person or persons receiving the services, such as at the office of the worker, indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee. The importance of this factor depends on the nature of the service involved and the extent to which an employer generally would require that employees perform such services on the employer's premises. Control over the place of work is indicated when the person or persons for whom the services are performed have the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required. See Rev. Rul. 56-694.
10. ORDER OR SEQUENCE SET: If a worker must perform services in the order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker's own pattern of work but must follow the established routines and schedules of the person or persons for whom the services are performed. Often, because of the nature of an occupation, the person or persons for whom the services are performed do not set the order of the services or set the order infrequently. It is sufficient to show control, however, if such person or persons retain the right to do so. See Rev. Rul. 56-694.
11. ORAL OR WRITTEN REPORTS: A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control. See Rev. Rul. 70-309, 1970-1 C.B. 199, and Rev. Rul. 68-248, 1968-1 C.B. 431.
12. PAYMENT BY HOUR, WEEK, MONTH: Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on straight commission generally indicates that the worker is an independent contractor. See Rev. Rul. 74-389, 1974-2 C.B. 330.
13. PAYMENT OF BUSINESS AND/OR TRAVELING EXPENSES: If the person or persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities. See Rev. Rul. 55-144, 1955-1 C.B. 483.
14. FURNISHING OF TOOLS AND MATERIALS: The fact that the person or persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employer-employee relationship. See Rev. Rul. 71-524, 1971-2 C.B. 346.
15. SIGNIFICANT INVESTMENT: If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor.

IRS 20 Factor Test on Employment Status (continued)

On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed for such facilities and, accordingly, the existence of an employer-employee relationship. See Rev. Rul. 71-524. Special scrutiny is required with respect to certain types of facilities, such as home offices.

16. **REALIZATION OF PROFIT OR LOSS:** A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but the worker who cannot is an employee. See Rev. Rul. 70-309. For example, if the worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.

17. **WORKING FOR MORE THAN ONE FIRM AT A TIME:** If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. See Rev. Rul. 70-572, 1970-2 C.B. 221. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.

18. **MAKING SERVICE AVAILABLE TO GENERAL PUBLIC:** The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship. See Rev. Rul. 56-660.

19. **RIGHT TO DISCHARGE:** The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications. Rev. Rul. 75-41, 1975-1 C.B. 323.

20. **RIGHT TO TERMINATE:** If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship. See Rev. Rul. 70-309.



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