

# Employee vs. Independent Contractor

## Protect Your Business from the Costs of Misclassification

### Possible Advantages of Working with an Independent Contractor

**Costs.** There are several ways you'll save by hiring independent contractors. You won't have to contribute to state or federal unemployment tax, social security, or workers' compensation coverage for an independent contractor. Contractors are generally responsible for their own benefits (such as medical, dental, or life insurance, vacation, and sick time, etc...). And without the need for bookkeeping, accounting, and payroll systems to track, report, and withhold tax and other payments applicable to employees, you'll also save in administrative costs.

**More Nimble.** Employers often find that hiring independent contractors affords greater flexibility to expand or contract their workforce according to business needs. Hiring independent contractors also enables them to more quickly take advantage of new markets and opportunities without being limited to their in-house knowledge or experience.

**Less Restrictive Regulatory Climate.** Another potential benefit is that many regulatory schemes at the state and federal levels apply only to employees and not to contractors. Some examples of such regulations include federal wage and hour laws and immigration laws.

**Less Potential for Litigation.** Litigation decreases where there are fewer grounds on which to bring suit. Discrimination claims are a good example. Most anti-discrimination statutes protect "employees," or reference rights and obligations stemming from the "employment" relationship—a relationship that does not exist between a business and a contractor.

### Possible Disadvantages of Using Independent Contractors

**Monitoring.** The principal must take the time to monitor the legal relationship between the business and the contractor to ensure continuing qualification as a contractor (and not as an employee).

**Control over Termination.** The principal in an independent contractor relationship will often have less ability to terminate the relationship. In most cases, an employee can be terminated without cause in California. "Terminating" a contractor relationship may constitute a breach of the contractor's agreement.

**Control over Services.** The principal has less control over how services are to be performed.

**Penalties.** With the independent contractor relationship, a principal runs a greater risk of penalties for misclassification.

The last disadvantage puts an absolute premium on the need for business owners—from sole proprietors to multi-national corporations—to make absolutely certain that they appropriately classify their workers as either employees or independent contractors.

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### Know the Laws

If you have decided you wish to classify a worker an independent contractor (as opposed to a W-2 employee), please read on. This document will help you decide whether or not the Internal Revenue Service (IRS) or Employment Development Department (EDD) is likely to agree with your classification. Knowing you're on the same page as state and federal authorities is the best way to avoid very costly mistakes.

You need to clearly understand the difference between an independent contractor and an employee, and how the IRS and EDD differentiate the two. The consequences for not doing so can be quite costly. In fact, if you misclassify a worker these agencies could require you to pay fines, penalties, unpaid taxes, and interest—sometimes going back as far as three or more years.

### Federal Law

To help business owners accurately classify their workers—and avoid the perils of misclassification—the IRS has developed a list of 20 common law (i.e., developed by courts over time) factors intended to help employers determine whether or not an employer-employee relationship exists. The 20 factors are applied on a case-by-case basis. For a worker to be classified as an employee, it is not necessary to satisfy more than half of the 20 factors; a strong showing in several factors may outweigh a poor showing in others. Though the factors can be seen as weights on a balance, no two factors necessarily have the same weight.

The IRS 20 Factors are broadly grouped into three categories: behavioral control, financial control, and type of relationship.

#### BEHAVIORAL CONTROL

Factor	Indicia of Independent Contractor Status (IC)	Indicia of Employee Status (EE)	Notes
<b>1. Instructions</b>	An IC is not generally required follow specific instructions; rather, he or she decides how to accomplish the task. A business may lack the expertise to instruct certain trained professionals.	An EE can, and often does, receive instructions on the means and methods of achieving a desired result. But even where no instructions are given, there could be other strong indications the employer has the right to control how the work results are achieved.	This factor –often referred to as the "control" factor - is one of the most important in this analysis. The strongest indication of employment is in a company's <i>right</i> to give instructions, or control the means and methods of performance. It is the <i>right</i> to control which matters, not the actual giving of instructions.

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<b>2. Training</b>	ICs generally possess the skills required to perform a given task with no additional training. They typically perform services using their own methods.	Employees, on the other hand, are often trained by the employer to perform services in a particular manner.	Training addresses the worker's <i>need</i> for additional training; whereas, the instruction factor addresses the principal's <i>right</i> to tell the worker what to do. Training also indicates the company is concerned with the method of achieving the task, and not just the end result.
<b>3. Services Personally Performed</b>	An IC should be able to subcontract all or a portion of the work to others.	An EE cannot delegate his or her work responsibilities.	Although this factor is on the list, a principal may want the IC to personally perform all work.
<b>4. Hiring, Supervising, and Paying Assistants</b>	An IC can hire/supervise its own employees, but does not supervise, and is not supervised by, the principal's employees.	An EE deals with the principal's contractors or other employees only at the employer's direction, or otherwise within the framework of the employer's policies.	Principal-provided assistants working with a worker suggests the principal is in control of the manner of work performed.
<b>5. Hours of Work</b>	An IC sets his or her own hours –whatever is necessary to complete the task within the agreed-upon time-frame.	The employer generally determines what hours an EE will work, and when.	Dictation of work hours may constitute control of method of performing services, not just of the end result. However, it may not be significant if good reasons exist for an IC's hours to be dictated.
<b>6. Full Time Required</b>	An IC may usually work for more than one principal, as long as he or she achieves the end result.	An EE, on the other hand, must usually make a specific time commitment to the employer.	Ask yourself what impact full-time work has on the ability of an IC to remain an independent business person.
<b>7. Job Location</b>	The IC can generally dictate where he or she will perform the services.	An EE must generally perform the services at the location chosen by the employer.	If work is performed on principal's premises, is it to coordinate with staff, or to use special equipment? Can work be taken off-site? Of course, EEs are working from home frequently as well now.

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<b>8. Order or Sequence of Work</b>	ICs generally control the manner and method of performing the services.	The EE is generally subject to the employer's control over the sequence of tasks.	The more control the principal exercises over the process, the more control he or she has over the manner and means of performance—which leans toward a finding of IC status.
<b>9. Whether Reports Are Required</b>	Because ICs are generally responsible for the end result, they are not usually obligated to submit interim reports.	An employer can, and often does, require interim reports.	If the report can be used to change how the worker performs, the relationship begins to look a lot more like an employer-employee relationship.
<b>10. Tools and Equipment</b>	The IC usually has the necessary tools and equipment to perform the services independently.	An employer usually provides the EE with the tools and equipment necessary to perform the required services.	If all the equipment and resources necessary to fulfill the requirements of the job are provided by the company, this situation argues in favor of the worker being an employee.

### FINANCIAL CONTROL

Factor	Indicia of Independent Contractor Status (IC)	Indicia of Employee Status (EE)	Notes
<b>11. Method of Payment</b>	ICs are often paid a flat fee on a per project basis. Nevertheless, there are contractors to whom it is customary to pay an hourly or other "time" rate (such as attorneys).	EEs are most often guaranteed a regular wage amount for an hourly, weekly, or other period of time. Even where supplemented by a commission, this method usually indicates the worker is an EE.	ICs are usually paid for results versus their time; and, as a result, their profit or loss is affected by their own efficiency. Commission work is generally not strongly indicative of either status.
<b>12. Payment of Expenses</b>	An IC usually assumes the burden of his or her own expenses. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important.	An EE, on the other hand, is usually reimbursed for his or her expenses.	This factor is almost always considered by an auditor. Contract price can be adjusted to accommodate expected expenses if IC status is desired.

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<b>13. Significant Investment in Business</b>	The IC makes an investment in tools, business equipment, publications, and supplies appropriate for his or her business.	An EE is not required to make an investment in his or her employer's business.	The investment of an IC will vary depending upon the industry (and, the more spent, the more defensible the IC relationship). A significant investment is not necessary for independent contractor status.
<b>14. Realization of Profit or Loss</b>	An IC accepts the economic benefits and risks of a business transaction. He or she can profit from the project and risks loss if the end result is unacceptable or costs exceed the project price.	An EE bears no economic risk; rather, he or she is paid regardless of whether the employer's product or service is profitable.	An IC sharing in the profits or risk of nonpayment is not generally considered significant; whereas a bid for a fixed price <i>and</i> risk of not recouping out-of-pocket costs <i>is</i> significant.
<b>15. Working for Multiple Companies</b>	The IC can and generally does work for more than one company simultaneously. ICs are generally free to seek out other business opportunities.	An EE is usually beholden to one employer.	Just because the IC does not, in fact, have other clients, is not dispositive; rather, it is the right to perform such outside services that is dispositive.
<b>16. Services Available to the Public</b>	An IC offers his or her services to the general public. ICs often advertise and maintain a visible business location.	An EE generally performs services only for his or her employer.	Ask yourself whether the worker is actively marketing his or her services to the general public (or target market segment of the general public).

### TYPE OF RELATIONSHIP

Factor	Indicia of Independent Contractor Status (IC)	Indicia of Employee Status (EE)	Notes
<b>17. Integration into Principal's Business</b>	An IC's services are frequently not essential to the principal's core business, and are not incorporated into the product or service sold by the principal.	An EE's services are essential to bringing the employer's product or service to the marketplace. The more integral a service is to the business, the more likely it is that the employer will have the right to control the manner and means of performance.	Ask yourself whether the IC is doing the work an EE would typically do.

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<b>18. Continuing Relationship</b>	An IC generally works on one project and then moves on, accepting additional projects when and if he or she is available.	EEs, on the other hand, have a continuing relationship with the Employer for an indefinite period of time.	Does the IC accept multiple projects from the same principal? For ICs, multiple projects can affect other factors, such as the IC's availability for other work, whether the IC has other clients, and for how long the IC will be performing services.
<b>19. Right to Discharge</b>	The IC can only terminate according to the agreement with the principal. If the principal wrongly terminates, the IC is entitled to contract damages.	Employees can generally be discharged "at will."	This factor is very important, as a company's ability to dismiss at will demonstrates the ultimate in control.
<b>20. Right to Quit</b>	The IC is obligated to complete the work called for under the contract.	An at-will EE may generally quit his or her job, without recourse or continuing obligation (with the exception, of course, of protection of trade secrets, etc...).	When a worker may leave the job without additional liability to the employer, this strongly suggests EE status.

### THE SAFE HARBOR PROVISION

The IRS substantially stepped up enforcement of the employment tax laws in the 1970s. In response to the IRS's increasingly aggressive tactics, Congress provided relief by enacting section 530 of the Revenue Act of 1978. Under this section, a business may classify a worker as an independent contractor for IRS/payroll purposes regardless of whether the 20-factor test criteria are passed, if they meet the requirements of section 530 of the Act. Under this section, a worker may be classified as an independent contractor if the following conditions apply:

- The taxpayer business did not treat the service provider as an employee for any period
- The business filed an IRS Form 1099 for the worker in a timely manner
- The business has not treated workers in substantially similar situations as employees
- The business has a "reasonable basis" for treating the service provider as an independent contractor

### California Law

California employs a number of different statutory and judicial (i.e., tests derived by the courts) tests to determine if you have properly classified a worker. Which test applies can depend upon the type of employment tax or insurance at issue (e.g., income tax withholding, unemployment and disability insurance, or worker's compensation). We don't cover these tests in detail in this document because they are all described—to various degrees—in the section

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above covering the federal test used by the IRS. For information about specific variances, resort to the individual agency involved, most of which are linked to on our website.

### Right of Control

In California, the most important factor in determining a worker's status is the right of the employer to control how the worker accomplishes a given task. If the employer has that right of control, then an employer-employee relationship exists—even if the employer does not exercise that right. The single most compelling factor is the employer's right to discharge the worker at will and without cause. If you're still uncertain, consider the following additional factors that may indicate an employer-employee relationship:

**Distinct occupation or business:** Does the service provider have a separately established occupation or business?

**Industry custom:** Is it typical for similar service providers to work without supervision or under the direction of an employer?

**Skill:** What level of skill is required to perform the required services?

**Tools and place of work:** Does the employer provide the tools and place of work for the worker? This factor may be less significant when the worker is providing intellectual services.

**Length of time of service:** How long will the worker provide services? Is the work ongoing or intermittent?

**Method of payment:** Does the employer pay the worker by time, piece rate, or completed job?

**Regular business:** Is the work to be performed a part of the employer's regular business?

**Intent of the parties:** Do the parties believe that they are creating an employer-employee relationship?

**Employer's actual exercise of control:** The extent of the employer's actual control over the manner and means of performing the services may have a bearing on classification.

**Benefit to employer:** Is the employer engaged in a business enterprise or are the services for the benefit or convenience of the employer as an individual?

California common law also stipulates very specific ways to apply these factors to the following industries: real estate, professional home health care, computer services, art, and newspaper distribution.

### Economic Realities

California courts have also recognized that the "economic realities" of a work relationship can sometimes indicate the existence of an employer-employee relationship even if specific language in a contract states otherwise. Again, the most important factor is the extent to which the employer can exercise control over the "means and manner" of the worker's performance.

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In particular, if an employer can control both the desired result and the means by which the worker achieves it, then an employer-employee relationship probably exists.

When applying the "economic realities" test, consider the following factors:

- Whether work in this type of occupation is typically done under the direction of a supervisor or by a specialist without supervision.
- The skill required in the particular occupation.
- Whether the alleged employer or the individual in question furnishes the equipment used and the place of work.
- The length of time the individual has worked for the alleged employer.
- The method of payment, whether by time or by the job.
- The manner in which the work relationship can be terminated, *i.e.*, by one or both parties, with or without notice and explanation.
- Whether annual leave is offered.
- Whether the work is an integral part of the business of the alleged employer.
- Whether the worker accumulates retirement benefits.
- Whether the alleged employer pays Social Security taxes on behalf of the worker.
- The intention of the parties.

### Conclusion

Still have questions? Don't take your chances—the costs of a misclassified worker are too great. Get in touch with Buchanan Law Group to protect your business and get the most out of your working relationships.

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