

HR COMPLIANCE OVERVIEW



Determining Worker Classification: Independent Contractor vs. Employee

Whether a worker is covered by a particular law or is entitled to receive a particular benefit often depends on whether the worker is an employee or an independent contractor. In general, employment laws, labor laws and related tax laws do not apply to independent contractors.

Some employers prefer to hire independent contractors to avoid the costs of employee benefits, unemployment compensation contributions and workers' compensation liability. This preference can lead employers to misclassify employees as independent contractors. Misclassifying employees has become an increasing concern for governments, courts and regulatory agencies. Employers that misclassify employees can be liable for expensive fines and litigation if a worker should have been classified as an employee and did not receive a benefit or protection he or she was entitled to receive by law.

Employers should make sure to determine the true nature of their relationships with their workers. This Compliance Overview provides information for employers on classifying workers correctly.

LINKS AND RESOURCES

- [IRS Guidance](#)—Independent Contractor or Employee?
- U.S. [Department of Labor Fact Sheet](#)—Am I an employee? Employee Relationship Under the Fair Labor Standards Act (FLSA)

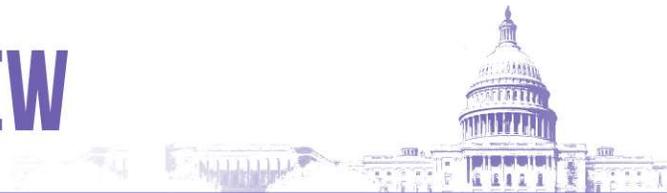
Worker Classification

- ✓ Classification determines eligibility for employment benefits and legal protections.
- ✓ Misclassification exposes employers to expensive fines and litigation.
- ✓ Whether an individual is an employee or independent contractor will depend on the facts and circumstances of the situation, not the label used by the employer.

Common Workers Classification Tests

- The common law agency test
- The economic reality test
- The hybrid test
- The IRS test
- The ABC test

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Classifying an individual as either an employee or an independent contractor is not a simple task. No standard test has emerged to determine the true character of an independent contractor relationship. In fact, employers may have to apply various tests to determine how issues of employment benefits, workers' compensation, unemployment compensation, wage and hour laws, taxes or protection under Title VII of the Civil Rights Act, the Americans with Disabilities Act (ADA) and the Family and Medical Leave Act (FMLA) affect their workforces. In addition, employers should be aware that state and local variations of these tests may also apply in certain situations.

The recurring theme in these tests is control. In different ways, these tests seek to determine the amount of control that an employer exerts over a particular worker or set of workers. Employer control can be classified into three categories: behavioral control, financial control and the overall relationship between the parties.

The Common Law Agency Test

The common law test is also known as the agency test because it assumes that, unless there is a definition for "employee," "employer" and "scope of employment," these terms are best understood in the context of agency laws. Several courts have favored this test for issues related to the Copyright Act, Employee Retirement Income Security Act (ERISA) and National Labor Relations Act (NLRA).

The common law agency test applies a multifactor approach approved by the U.S. Supreme Court and found in the Restatement (Second) of Agency. The common law agency test requires an intense consideration of different factors that individually may not determine the character of the relationship between the employer and the worker but, as a whole, allow for an understanding of how much control an employer exerts over a particular individual. This test's analysis evaluates the following factors:

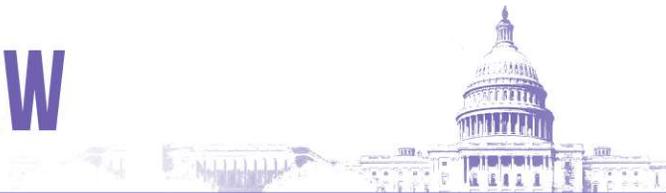
- Extent of control by the employer;
- Whether or not the individual is engaged in a distinct occupation or business;
- Whether the work is usually done under the direction of the employer or by a specialist without supervision;
- The skill required in the occupation;
- Whether the employer or individual supplies instrumentalities, tools and place of work;
- The length of time for which the individual is employed;
- The method of payment;
- Whether or not the work is part of the regular business of the employer;
- Whether or not the parties believe they are creating an independent contractor relationship;
- Whether the principal is or is not in business; and
- Whether the evidence tends to show that the individual is, in fact, rendering services as an independent business

The Economic Reality Test

The economic reality test also requires a thorough analysis of the relationship between the parties and evaluates the level of financial dependency that the worker has on an employer. Generally, under the economic reality test, the more an individual depends on an employer, the more likely it is that the individual should be categorized as an employee. The courts have favored this test when the term "employee" is used in a very broad sense; for example, in issues related to the Fair Labor Standards Act (FLSA) and the FMLA.

The economic reality test outlines several factors an employer may consider to determine the level of financial dependency. As with the common law agency test, one factor standing alone is not sufficient to establish dependency,

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but as a whole, these factors enable the employer to evaluate the nature of an employment relationship. These factors evaluate:

1. The degree of the employer's right to control the manner in which work is performed;
2. The degree of skill required to perform the work;
3. The worker's investment in the business;
4. The permanence of the working relationship;
5. The worker's opportunity for profit or loss; and
6. The extent to which the work is an integral part of the business.

The Hybrid Test

As the name suggests, the hybrid test combines elements of the common law agency and the economic reality tests. The factors under this test are a combination of the ones described above but consider special details in the relationship between an employer and a worker, such as:

- The kind of occupation the individual is performing (does it require the supervision of an expert or can it be done by a specialist working alone?);
- Whether a termination procedure exists for terminating the work relationship and whether it resembles the procedure used for terminating employees;
- Whether the worker accrues time off; and
- The parties' intentions.

Though some lower courts have used this test to deal with issues related to Title VII of the Civil Rights Act, the Age Discrimination in Employment Act (ADEA) and the ADA, the Supreme Court has criticized this approach and is leaning more toward using the common law test for similar issues.

The IRS Test

The IRS has also developed its own test regarding whether an employment relationship exists between a worker and an employer for purposes of determining the tax liability of employers and individuals. The IRS test is sometimes referred to as the control test, and it expands and classifies factors from the common law test into three categories:

1. A sphere of behavioral control;
2. A sphere of financial control; and
3. Factors that determine the type of relationship that exists between parties.

For more information, instructions and commentaries on this test, see the IRS publication on its [website](#).

The ABC Test

The ABC test is used by several states when determining a worker's status. This test is similar to the common-law rules used in the IRS test; however, this test presumes that a worker is an employee unless the facts and circumstances provide evidence of independent contractor status based on three criteria:

1. Whether there is an absence of control—The absence of control exists if the worker is free from the direction or control of the hiring organization by contract or agreement and in fact.

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2. Whether the business of the worker is unusual to and/or away from the hiring organization's facilities—The worker must perform work that is "unusual" in regard to the employing organization's business and/or off the hiring entity's premises to be considered an independent contractor.
3. Whether the worker is customarily engaged as an independent contractor in this trade or occupation—Many professions or trades are customarily performed by independent contractors who have their own business identity and engage in business for profit on the open market.

Although these criteria are similar to the IRS test, there are critical differences. These differences must be carefully examined because it's possible for a worker to be an independent contractor under the IRS test and an employee under the ABC test. For example, a worker may be classified as an independent contractor by the IRS; however, when trying to obtain unemployment benefits, the same individual may be classified as an employee by the state agency that handles unemployment benefits.

Some states use a slightly modified version of the ABC test that only requires workers to meet some of the test's elements to be classified as independent contractors.

Constant Reevaluation

Employers must evaluate current working relationships on a regular basis. Working relationships are dynamic, and the changes that occur over time may impact the nature of the relationship between a worker and an employer. Employers that do not review the nature of their relationships with independent contractors run the risk of incurring expensive fines and litigation.