

Independent Contractor (Self-Employed) or Employee?

What exactly is an independent contractor? Isn't a freelancer always an independent contractor? We regularly get these questions and unfortunately the answers are not as simple as we or clients would like. For instance, some freelancers are indeed independent contractors and some are not. Ultimately the employer must evaluate their relationship with the individual worker in order to determine their appropriate status. The misclassification of employees as independent contractors is of significant concern of both federal and state governments, as it potentially results in under reporting and collection of taxes. This under reporting and collection has been estimate to be over \$2 billion per year. As a result, many states have imposed significant penalties on such misclassification.

At its most basic level what distinguishes an independent contractor from an employee is that the IC is in business for themselves. A company hires them for the end result of providing a service or product. As such the IC typically has control of how the service or product will be delivered, pays their own expenses and has the potential to gain or lose based on how well they manage their business.

Complicating the situation is the fact that the IRS and various state agencies use similar, but somewhat different definitions of independent contractor.

The following information from the IRS is a realistic starting point:

Determining Whether the Individuals Providing Services are Employees or Independent Contractors

Before you can determine how to treat payments you make for services, you must first know the business relationship that exists between you and the person performing the services. The person performing the services may be -

- An [independent contractor](#)
- An [employee](#) (common-law employee)
- A [statutory employee](#)
- A [statutory nonemployee](#)

In determining whether the person providing service is an employee or an independent contractor, all information that provides evidence of the degree of control and independence must be considered.

Common Law Rules

Facts that provide evidence of the degree of control and independence fall into three categories:

1. **Behavioral:** Does the company control or have the right to control what the worker does and how the worker does his or her job?
2. **Financial:** Are the business aspects of the worker's job controlled by the payer? (these include things like how worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)
3. **Type of Relationship:** Are there written contracts or employee type benefits (i.e. pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?

Businesses must weigh all these factors when determining whether a worker is an employee or independent contractor. Some factors may indicate that the worker is an employee, while other factors indicate that the worker is an independent contractor. There is no "magic" or set number of factors that "makes" the worker an

employee or an independent contractor, and no one factor stands alone in making this determination. Also, factors which are relevant in one situation may not be relevant in another.

The keys are to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally, to document each of the factors used in coming up with the determination

From: <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Independent-Contractor-%28Self-Employed%29-or-Employee%3F>

As mentioned above, some states and agencies use variations on the IRS tests. These include the Common Law Test, the FLSA Economic Realities Test and the ABC test. While generally consistent with the IRS test they do add things like: Whether or not the work is part of the regular business of the "employer" and whether a high level of skill is required by the occupation.

As a result, it is possible that a worker could be considered to be an Independent Contractor in regard to the IRS, but an employee as far as a state agency is concerned.

Employee Benefits and Affordable Health Care Act Issues

ERISA regulations, which govern retirement plans, such as 401ks and the Affordable Care Act both define "Employer", as the Common Law Employer. The Common Law Employer is generally defined as the employer the employer who has the authority to direct and control the manner in which services will be performed, whether exercised or not. Paymaster Services such as The TEAM Companies are considered the Statutory Employer.

As such, utilizing a paymaster service or even paying freelancers as Independent Contractors may not relieve employers of obligations of employee retirement and health insurance regulations, if they otherwise meet the plan qualifications. This should be of particular concern if freelancers are working full time. Employee benefit consultants are best able to evaluate and address these issues.

Consequences of Misclassification of Employees as Independent Contractors

What are the risks?

If you misclassify an employee as an independent contractor and are challenged by the government, there are a wide range of potential liabilities.

Federal IRS: Penalties include: Employer and employee share of FICA taxes, income taxes plus penalties and interest totaling over 40% of their pay and going back up to three years. There are additional penalties if the misclassification is determined to be intentional.

Federal DOL: The pay of IC reclassified as an employee may be subject to unpaid overtime. This means that their pay/hours would be recalculated to determine if they are due overtime pay. Per the DOL: "Willful violators may be prosecuted criminally and fined up to \$10,000. A second conviction may result in imprisonment. Employers who willfully or repeatedly violate the minimum wage or overtime pay requirements are subject to civil money penalties of up to \$1,100 per violation."

It should be noted that the DOL Administrator recently issued an interpretation expressing the DOL's belief that "most workers (classified as independent contractors) are employees under the FLSA's (Fair Labor Standards Act) broad definitions."

State Liabilities: These vary by state and are in addition to the Federal penalties. There are currently 24 states developing or having passed laws addressing independent contractor misclassification: Arizona, California, Colorado, Connecticut, Delaware, Florida, Illinois, Indiana, Kansas, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, Utah, Vermont, Washington, and Wisconsin.

California: Has the most aggressive state level laws. Effective January 1, 2012 California's Independent Contractor Misclassification Law, imposes penalties of a minimum of \$5,000 and a maximum of \$15,000 for each misclassified 1099 issued, and \$25,000 for each violation of the law if the business has engaged in a "pattern or practice" of willful misclassification. These penalties are in addition to state taxes not remitted and related penalties.

Further CA Labor laws potentially require the calculation of overtime on a daily, work over 8 hours, basis. If overtime is due for a non-exempt employee, having not paid it with original payments makes it subject to "Waiting Time" penalties. By example, a worker who was paid \$500 for a week's work as an independent contractor, but worked 50 hours could be due an additional \$187.50 for the ten hours of overtime, but Waiting Time penalties could increase the payment due to \$5625! (187.50 x Maximum 30 days waiting time)

Audits happen randomly, but are most often triggered by an "independent contractor" applying for unemployment benefits.

Workers' Compensation Insurance: This insurance is designed to limit an employer's liability if an employee is injured on the job. Unless your policy extends coverage to Independent Contractors, you will not have this protection and any claims would fall under general liability insurance likely becoming far more expensive.

How to protect your company?

Obviously, decisions to hire Independent Contractors should be carefully considered. Seeking legal advice on establishing internal policies would be wise. Further, documenting your decision making process on a case by case basis is an often recommended best practice.

If in your determination a freelancer does not qualify as an Independent Contractor, The TEAM Companies can help. We specialize in paying freelancers as W-2 employees of The TEAM Companies, thus relieving clients of the administrative burdens of temporarily adding them to their internal staff payroll.

Independent Contractor Evaluation

Unfortunately there are no bright line tests. Different government agencies have slightly different tests. Other than the ABC test, all require looking at the totality of the relationship. Yes or no to any single or even most questions is not determinative. This list is a guide to assist you in making these overall evaluations. It is always safe to pay them as a W-2 employee.

Common Law Tests - Used all or in part by most states

	Yes	No	
Company has actual or right to control how worker does the job?	Emp	IC	
Distinct occupation or business?	IC	Emp	
High level of skill required?	IC	Emp	
Short length of time the services are provided?	IC	Emp	
Paid by the job/Project, not Day/Hour?	IC	Emp	
Is the work part of company's regular business?	Emp	IC	

IRS Three Factor Test -Used by the IRS

Behavioral control

	Yes	No	
•Company instructs and/or trains	Emp	IC	
•Personal service required	Emp	IC	
•Services integrated into company business	Emp	IC	
•Continuing relationship	Emp	IC	
•Work performed on company site	Emp	IC	
•Company sets hours	Emp	IC	
•Company hires assistants	Emp	IC	

Financial control

	Yes	No	
•Worker risk of profit and loss	IC	Emp	
•Worker paid by hour/day not for deliverables	Emp	IC	
•Company reimburses expenses	Emp	IC	
•Company provides tools	Emp	IC	
•Worker has significant investment in their business	IC	Emp	

Relationship of the parties

	Yes	No	
•Can company terminate worker without notice or penalty for reasons other than non-performance? ("At Will" employment)	Emp	IC	
•Can the worker terminate without notice or penalty?	Emp	IC	
•Are the services made available to more than one company and to the public?	IC	Emp	

Economic Reality Test - Used by US Dept. of Labor - Wage & Hour claims

	Yes	No	
Are the services rendered an integral part of the "employer's" business?	Emp	IC	
Is there a permanent relationship?	Emp	IC	
Does the worker have an opportunity for profit and loss?	IC	Emp	
Does the worker have an investment in facilities and equipment?	IC	Emp	

"ABC" Test - Used all or in part by some states

Presumes employee status unless the ABC Factors are true:

	Yes	No	
A: Working under contract free from employer's control	IC	Emp	
B: Service is outside employer's usual business	IC	Emp	
C: Worker is customarily engaged in an independent trade providing these services	IC	Emp	

This is an educational guide provided by The TEAM Companies. All determinations are situationally specific and are the responsibility of the user. Contact: Carl Zucker, VP Production Business Affairs with any questions: (646) 358-1408, czucker@theteamcompanies.com

