

# COMPLIANCE OVERVIEW

Provided by Eaton Insurance Services

## 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 to 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 relationship with their workers. This Compliance Overview provides information for employers on classifying workers correctly.

### LINKS AND RESOURCES

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

### HIGHLIGHTS

#### 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 TESTS & USAGE

- Common law agency (copyrights, ERISA, NLRA)
- Economic realities test (FLSA, FMLA)
- Hybrid test (Civil Rights Act, ADEA, ADA)
- IRS test (taxation)

This Compliance Overview is not intended to be exhaustive nor should any discussion or opinions be construed as legal advice. Readers should contact legal counsel for legal advice.



## WORKER CLASSIFICATION

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 American with Disabilities Act and the Family and Medical Leave Act 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.

## WORKER CLASSIFICATION TESTS

The most common tests are the common law test, the economic realities test, the hybrid test and the IRS 20-point test.

### *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 the terms “employee,” “employer” and “scope of employment,” these terms are best understood under the context of the laws of agency. Several courts in the United States have favored this test for issues related to the Copyright Act, Employee Retirement Income Security Act (ERISA) and the National Labor Relations Act (NLRA).

The Common Law Agency Test requires an intense consideration of 13 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. These 13 factors, also known as the *Reid* factors, evaluate the following:

1. The duration of the relationship between the parties;
2. How much discretion the worker has over when and how long to work;
3. The worker's role in hiring and paying assistants;
4. The employer's right to control the manner and means by which the product is accomplished;
5. The location of the work;
6. The method of payment;
7. The skill level required to complete the job or services;
8. Who provides the tools and equipment to complete the job;
9. How the employer reports payment of workers' compensation for tax purposes;
10. Whether the employer is in business;
11. Whether the employer provides employee benefits to the worker;
12. Whether the employer has the right to assign additional projects to the worker; and
13. Whether the work is part of the employer's regular business.

## ***The Economic Realities Test***

The economic 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 realities 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 Family and Medical Leave Act (FMLA).

The economic realities 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 insufficient to establish dependency, but as a whole, enables 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 from the common law agency and the economic realities 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:

1. 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?);
2. Whether a termination procedure exists for terminating the work relationship and whether it resembles the procedure used for terminating employees;
3. Whether the worker accrues time off; and
4. 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 Americans with Disabilities Act (ADA), the Supreme Court has criticized this approach and is leaning more toward using the common law test for similar issues.

## ***The Internal Revenue Service Test***

The Internal Revenue Service (IRS) has also developed its own test to determine whether an employment relationship exists between a worker and an employer. The IRS developed this test to determine 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 the three categories mentioned above:

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

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

## **CONSTANT RE-EVALUATION**

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 expensive fines and litigation procedures.