



MISCLASSIFICATION OF EMPLOYEES



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The misclassification of employees as independent contractors continues to draw significant attention from agencies responsible for enforcing federal and state employment and tax laws. Misclassification occurs when an employer intentionally or unintentionally classifies a worker as an independent contractor rather than an employee. In fiscal year 2014, the U.S. Department of Labor (DOL) stepped up its efforts against worker misclassification, providing nearly \$14 million to help identify misclassifications, recover unpaid taxes, and investigate violations, including \$10 million in grants to states and \$3.8 million for Wage and Hour Division (WHD) personnel ([FY 2014 Department of Labor Budget in Brief](#)).

Misclassification of employees results in significant loss of revenues to federal, state, and local tax departments, Social Security, Medicare, unemployment insurance trust funds, and workers' compensation funds. Misclassified employees are often denied rights and benefits to which they would be entitled under federal and state employment laws (i.e., overtime, protection under anti-discrimination laws, family and medical leave, health insurance coverage, etc.).

For employers that understand the consequences of misclassifying an employee, the process of determining whether a worker is an independent contractor or an employee is often a confusing and frustrating experience. This is largely because federal agencies and courts use different tests for determining a worker's status, under different laws. For example, the Internal Revenue Service (IRS) uses a common law test, sometimes referred to as the "Right to Control" test, for determining an individual's status for federal tax purposes (Social Security, Medicare, and income tax). On the other hand, the WHD and courts use the [Economic Realities Test](#) to determine an individual's status under the Fair Labor Standards Act (FLSA). To complicate matters, states have also adopted their own tests (primarily for workers' compensation and unemployment tax purposes) which are often hybrids of the other tests. In this white paper, we focus on the "Right to Control" test.

Right to Control and the 20-Factor Test

Under the Internal Revenue Code, an employer/employee relationship exists when the person or persons for whom services are performed has the **right to control** and direct the individual who performs the services, not only as to the result to be accomplished by the work but also the details and means by which that result is accomplished. As an aide to determine whether the right to control is sufficient to establish an employer/employee relationship, the IRS in Revenue Ruling 87-41 set forth 20 common law factors that may be examined. This is commonly referred to as the "20-Factor Test."

The 20 factors identified by the IRS are:

- 1. Instructions:** If the person for whom the services are performed has the right to require compliance with instructions, this indicates employee status.
- 2. Training:** Worker training (e.g., by requiring attendance at training sessions) indicates that the person for whom services are performed wants the services performed in a particular manner, which indicates employee status.

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3. **Integration:** Integration of the worker's services into the business operations of the person for whom services are performed is an indication of employee status.
4. **Services rendered personally:** If the services are required to be performed personally, this is an indication that the person for whom services are performed is interested in the methods used to accomplish the work, which indicates employee status.
5. **Hiring, supervising, and paying assistants:** If the person for whom services are performed hires, supervises, or pays assistants, this generally indicates employee status. However, if the worker hires and supervises others under a contract pursuant to which the worker agrees to provide material and labor and is only responsible for the result, this indicates independent contractor status.
6. **Continuing relationship:** A continuing relationship between the worker and the person for whom the services are performed indicates employee status.
7. **Set hours of work:** The establishment of set hours for the worker indicates employee status.
8. **Full time required:** If the worker must devote substantially full time to the business of the person for whom services are performed, this indicates employee status. An independent contractor is free to work when and for whom he or she chooses.
9. **Doing work on employer's premises:** If the work is performed on the premises of the person for whom the services are performed, this indicates employee status, especially if the work could be done elsewhere.
10. **Order or sequence test:** If a worker must perform services in the order or sequence set by the person for whom services are performed, that shows the worker is not free to follow his or her own pattern of work, and indicates employee status.
11. **Oral or written reports:** A requirement that the worker submit regular reports indicates employee status.
12. **Payment by the hour, week, or month:** Payment by the hour, week, or month generally points to employment status; payment by the job or a commission indicates independent contractor status.
13. **Payment of business and/or traveling expenses:** If the person for whom the services are performed pays expenses, this indicates employee status. An employer, to control expenses, generally retains the right to direct the worker.
14. **Furnishing tools and materials:** The provision of significant tools and materials to the worker indicates employee status.
15. **Significant investment:** A worker's own investment in facilities he or she uses indicates independent contractor status.
16. **Realization of profit or loss:** A worker who can realize a profit or suffer a loss as a result of the services (in addition to profit or loss ordinarily realized by employees) is generally an independent contractor.
17. **Working for more than one firm at a time:** If a worker performs more than de minimis services for multiple firms at the same time, that generally indicates independent contractor status.
18. **Making service available to the general public:** If a worker makes his or her services available to the public on a regular and consistent basis, that indicates independent contractor status.
19. **Right to discharge:** The right to discharge a worker is a factor indicating that the worker is an employee.

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- 20. Right to terminate:** If a worker has the right to terminate the relationship with the person for whom services are performed at any time he or she wishes without incurring liability, that indicates employee status.

Note that the degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed.

Evolution of the Test

Although Revenue Ruling 87-41 is still valid today, the IRS has attempted to simplify the test by taking the more relevant factors and grouping them into three main categories of evidence, which establish degree of control and independence. The three categories are:

- **Behavioral:** Does the company control or have the right to control what the worker does and how the worker does his or her job?
- **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.)?
- **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?

Behavioral Control

Behavioral control refers to facts that show whether there is a right to direct or control how the worker does the work. A worker is an employee when the business has the right to direct and control the worker. The business does not have to actually direct or control the way the work is done — as long as the employer has the right to direct and control the work.

The behavioral control factors fall into the categories of:

- Type of instructions given.
- Degree of instruction.
- Evaluation systems.
- Training.

Type of Instructions Given

An employee is generally subject to the business's instructions about when, where, and how to work. All of the following are examples of types of instructions about how to do work:

- When and where to do the work.
- What tools or equipment to use.
- What workers to hire or to assist with the work.

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- › Where to purchase supplies and services.
- › What work must be performed by a specified individual.
- › What order or sequence to follow when performing the work.

Degree of Instruction

Degree of instruction means that the more detailed the instructions, the more control the business exercises over the worker. More detailed instructions indicate that the worker is an employee. Less detailed instructions reflect less control, indicating that the worker is more likely an independent contractor.

Note: The amount of instruction needed varies among different jobs. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. A business may lack the knowledge to instruct some highly specialized professionals; in other cases, the task may require little or no instruction. The key consideration is whether the business has retained the right to control the details of a worker's performance or instead has given up that right.

Evaluation System

If an evaluation system measures the details of how the work is performed, then these factors would point to an employee. If the evaluation system measures just the end result, then this can point to either an independent contractor or an employee.

Training

If the business provides the worker with training on how to do the job, this indicates that the business wants the job done in a particular way, and is strong evidence that the worker is an employee. Periodic or ongoing training about procedures and methods is even stronger evidence of an employer-employee relationship. Conversely, independent contractors ordinarily use their own methods.

Financial Control

Financial control refers to facts that show whether or not the business has the right to control the economic aspects of the worker's job.

The financial control factors fall into the categories of:

- › Significant investment.
- › Unreimbursed expenses.
- › Opportunity for profit or loss.
- › Services available to the market.
- › Method of payment.

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Significant Investment

An independent contractor often has a significant investment in the equipment he or she uses in working for someone else. However, in many occupations, such as construction, workers spend thousands of dollars on the tools and equipment they use and are still considered to be employees. There are no precise dollar limits that must be met in order to have a significant investment. Furthermore, a significant investment is not necessary for independent contractor status as some types of work simply do not require large expenditures.

Unreimbursed Expenses

Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services that they perform for their business.

Opportunity for Profit or Loss

The opportunity to make a profit or loss is another important factor. If a worker has a significant investment in the tools and equipment used and if the worker has unreimbursed expenses, the worker has a greater opportunity to lose money (i.e., their expenses will exceed their income from the work). Having the possibility of incurring a loss indicates that the worker is an independent contractor.

Services Available to the Market

An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.

Method of Payment

An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is often paid by a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.

Type of Relationship

Type of relationship refers to facts that show how the worker and business perceive their relationship to each other.

The factors for the type of relationship between two parties generally fall into the categories of:

- Written contracts.
- Employee benefits.
- Permanency of the relationship.
- Services provided as key activity of the business.

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Written Contracts

Although a contract may state that the worker is an employee or an independent contractor, this is not sufficient to determine the worker's status. The IRS is not required to follow a contract stating that the worker is an independent contractor, responsible for paying his or her own self-employment tax. How the parties work together determines whether the worker is an employee or an independent contractor.

Employee Benefits

Employee benefits include things like insurance, pension plans, paid vacation, sick days, and disability insurance. Businesses generally do not grant these benefits to independent contractors. However, the lack of these types of benefits does not necessarily mean the worker is an independent contractor.

Permanency of the Relationship

If you hire a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that the intent was to create an employer-employee relationship.

Services Provided as Key Activity of the Business

If a worker provides services that are a key aspect of the business, it is more likely that the business will have the right to direct and control his or her activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

Summary

When determining whether a worker is an employee or independent contractor, employers must consider and weigh all factors. 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. Further, factors which are relevant in one situation may not be relevant in another. Employers must carefully consider all factors and err on the side of caution when categorizing workers as independent contractors.

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