

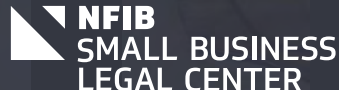
**NFIB GUIDE TO**  
**INDEPENDENT**  
**CONTRACTORS**

- »The Common Law Test
- »The Totality-of-the-Circumstances Test
- »The ABC Test

»Statutory Employees

# HOW TO DETERMINE A WORKER'S CLASSIFICATION

DEVELOPED BY



Every business that hires workers must determine whether a worker is an employee or an independent contractor. This may seem like an easy determination to make. After all, employees work for you—but then again, so do independent contractors. Needless to say, correctly classifying your workers can be a challenge.

More importantly, misclassifying your workers can result in an avalanche of expensive legal and tax problems with federal agencies such as the IRS, the Department of Labor and the National Labor Relations Board, just to name a few. That's why we compiled the

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Inside you'll find the answers to your most basic questions, such as how the two categories of workers are defined and the three most common tests used by government agencies for determining who is an independent contractor. The guide also explores more complex issues, including legal and financial obligations based on classification and liability associated with worker status. Finally, we'll give you tips on avoiding misclassification problems.

Developed by the NFIB Small Business Legal Center, the

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will help you stay on the right

side of employment law.

This guide is just one of the many compliance guides developed by our Legal Center to make your job just a little bit easier. To find out about all of the guides available in this series, call 1-800-NFIB-NOW or visit [www.NFIB.com/legal](http://www.NFIB.com/legal).



**Elizabeth**

Executive Director, NFIB Small Business Legal Center

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## Appendix one

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## Appendix two

The *NFIB Guide to Independent Contractors* has been compiled to assist you in determining whether your workers should be considered employees or independent contractors.

This document is not legal advice. The information in this guide is intended for informational purposes only. Some of the information may be dated and may not reflect the most current legal developments. Readers of this guide should contact their attorney to obtain advice with respect to any particular legal matter.

The National Federation of Independent Business is the leading small business association representing the consensus views of its members in Washington and all 50 state capitals. NFIB's mission is to promote and protect the right of our members to own, operate and grow their businesses.

The NFIB Small Business Legal Center is the voice for small business in the nation's courts and the legal resource for small business owners nationwide. A 501(c)(3) public interest law firm, the center litigates and educates for small businesses. Founded in 2000, the Legal Center has become a critical component of NFIB's influence.

Is a worker an employee or an independent contractor? This question has long caused headaches for businesses. Proper classification of a worker as an independent contractor can help a business save time and money. Conversely, if that worker is an employee who is misclassified as an independent contractor, then the consequences to your business can be severe.

This guide helps explain the differences between employees and independent contractors, offers some guidance on how to ensure proper classification, and informs you of the impact that misclassification can have on your business. Though the federal government and the individual states may vary in their methods of classification, as a business owner you will need to make sure you have all of your bases covered on both the federal and state levels. By systematically adopting a step-by-step method to classify your workers under all the applicable federal and state tests, you can prevent some future administrative headaches and save your business money in the long run.

UNDER UNITED STATES LAW, a worker is either an employee or an independent contractor. Each worker must be given only one classification; there can be no ambiguity as to which category you have selected. The main thing to

# THE RISKS OF MISCLASSIFICATION

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## BASED ON CLASSIFICATION

The Immigration Reform and Control Act requires businesses to complete I-9 forms verifying that employees are authorized to work in the United States. A business is not required to go through this process for independent contractors.

In states that impose an income tax, employers are responsible for withholding state income taxes on wages paid to employees. Businesses do not have to withhold taxes for independent contractors.

Businesses are responsible for providing workers' compensation coverage for employees but not for independent contractors. This can result in substantial savings; however, unlike employees who are covered by workers' compensation, independent contractors can sue you for work-related injuries.

. Businesses must pay an unemployment tax on the wages of employees, but not on the wages of independent contractors. In the event of loss of job, only those classified as employees are eligible to obtain unemployment compensation benefits.

It is important to determine the proper worker status in order to handle any intellectual property disputes between you and your workers. Intellectual property covers the various legal entitlements that attach to the tangible products created by the human mind. These legal rights are determined by the status of the worker who created the product in question. Independent contractors generally have greater ownership rights over the intellectual property they create for their hiring company, while employees usually sacrifice any claims to the intellectual property created for the company that employs them.

Misclassification of a worker's status can lead to costly litigation for the business. Employees misclassified as independent contractors have successfully sued for unemployment insurance, stock options, overtime pay, retirement benefits, profit sharing, disability payments, workers' compensation and more, in so-called "permatemps" (workers who are classified as long-term temporary workers) and related lawsuits. These types of lawsuits can cost a business valuable time and resources in addition to any civil monetary awards that may have to be paid to the misclassified workers.

# ADMINISTRATIVE BURDENS

Along with the financial and legal obligations associated with worker classification, businesses must also consider the administrative tasks associated with each category of worker.

Employers control the details of an employee's daily assigned work tasks.

Employees are paid a salary or hourly wages, generally in periodic set intervals such as biweekly or bimonthly.

The rate paid to an employee is often less than the higher rate charged by independent contractors for the same work.

*fi* Employers often provide benefits such as health insurance, retirement plans, sick leave, and paid vacations for their employees.

Employees are limited to workers' compensation benefits when injured on the job and may not sue the employer for negligence.

A new employee may lack the requisite skill necessary to perform the job, leaving the employer to provide training.

Employers must usually furnish employees with workspace and tools to perform their duties.

Various state laws regulate the termination of employees without an employment contract. Generally, an employee is terminable at will.

Independent contractors generally control the details of the tasks they are contracted to perform.

Independent contractors are paid by the job, at intervals determined by the contract.

The rate charged by an independent contractor is often higher than the rate at which an employee could be paid for the same work.

*fi* By hiring an independent contractor, a business is able to save on fringe benefits such as health insurance, retirement plans, sick leave, and paid vacations.

Independent contractors are not covered by workers' compensation, but they can sue the business for negligence if there is a work-related injury.

Businesses do not have to provide training to independent contractors for general skills.

The independent contractor is usually hired for his/her prior knowledge or skill required for the position.

Businesses generally do not provide work space or the tools necessary for independent contractors.

If a business is unsatisfied with the independent contractor's work, it can terminate the relationship, subject to the agreement with the contractor.

The administrative burden associated with employees is typically higher and more long-term than it is with independent contractors. However, there are several risks associated with hiring an independent contractor. Which of these burdens and risks your business is ready to take on should help you in deciding which category of worker to hire.

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**Businesses generally are not liable for the negligence of independent contractors except in certain situations.**

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Whether a business will be liable for the wrongful actions of a worker depends on the classification of that worker. Employers may be held liable for the negligent acts of employees, since the employer was presumably controlling the actions of the employee. There is much less risk of liability for a business regarding the actions of independent contractors. Businesses generally are not liable for the negligence of independent contractors except in certain situations. For example, if the activity is ultra-hazardous, non-delegable, or the business holds the contractor out to be an employee, then the independent contractor will likely be considered an employee for liability purposes.

Whether or not your business is ready to assume liability for the actions of your workers should also inform your decision on how to classify them. The principal concept is that liability, like other financial obligations, will depend on the business establishing clear and separate categories of workers, as either employees or independent contractors.





## The Common Law Test

The IRS<sup>1</sup>, some state unemployment compensation insurance agencies, and some state workers' compensation agencies.

An employer-employee relationship exists when the business controls or has the right to control the worker performing the services, the result of the work, and also the means by which the result is accomplished. A business-independent contractor relationship exists when the worker independently performs services outside of the business's control.

The Common Law Test consists of twenty factors. Not all of the factors need to be present in every case in order to make a determination about classification. The test merely weighs the existence of factors indicating a level of control against those factors showing independence.

provided with instructions from the business regarding when, where, and how to perform the work.

decides when, where, and how to accomplish the services he or she is providing.

receives training directly from the employer, demonstrating that the business wants the services performed in a particular manner.

receives little or no training from the business, but rather, hiring is based on pre-existing proficiency or expertise in a particular line of work.

personally performs any assigned duties.

free to hire employees or subcontract tasks.

works hours established by the employer.

retains the ability to set own hours.

receives pay for time and labor only without realizing any additional gain or sharing in the risk of loss realized by the company based on the worker's services.

personally stands to gain or to lose economically based on performance of his/her services.

usually devotes his/her employment to the business; full-time employment could prevent the worker from engaging in other gainful employment.

does not necessarily work solely for one business and remains free to pursue other projects.

performs services on the premises of the employer to the extent which the nature of the services requires the work to be done on the employer's premises. If the business has the right to compel the worker to perform services at an alternative specified location, then the level of control remains the same.

chooses where to perform the services.

required to perform services in the order set by the employer.

retains the option of deciding the sequence in which the work is performed.

<sup>1</sup> In 2006, the IRS issued a revised test that consolidated the 20 factors into 11 factors, divided into three groups: (1) behavioral control, (2) financial control, and (3) the type of relationship between the parties. Functionally, this new test is very similar to the 20-factor test. IRS Publication 15-A lists the factors and is available at [www.irs.gov/publications/p15a/ar02.html#d0e346](http://www.irs.gov/publications/p15a/ar02.html#d0e346).



Qualifying as an independent contractor under the safe harbor does not guarantee that another agency, such as the state workers' compensation board, will come to the same conclusion.

In the event that the IRS determines that a worker has been inappropriately classified as an independent contractor despite the business's conscientious application of the IRS Common Law Test, there is a safe harbor that can prevent penalties from being imposed. This safe harbor, Section 530, essentially excuses a business for its misclassification of a worker if the business has a "reasonable basis" for its classification. A reasonable basis may arise from one of the following:

• sufficient similarity between a court case or revenue ruling to classification used by the business.

• when the IRS has previously reviewed the business's treatment of similar workers and did not challenge the decision nor assess a tax.

• where there is a long-standing, widespread industry practice of labeling a certain type of worker as an independent contractor.

• where the business reasonably relied upon the advice of a business lawyer or accountant who knew the facts about the business.

One of the most important aspects of the safe harbor is the notion of similar circumstances. A business must treat all similarly situated workers alike as inconsistencies will preclude safe harbor protections. So long as the business is classifying all of its workers the same way, then there may be room for the safe harbor to protect the business from IRS penalties.

However, businesses should keep in mind that the IRS extends this safe harbor protection only to cover penalties for employment tax purposes. Qualifying as an independent contractor under the safe harbor does not guarantee that another agency, such as the state workers' compensation board, will come to the same conclusion.

The Department of Labor.

There is an employer-employee relationship when a worker is economically dependent on the business for which services are rendered.

The Totality-of-the-Circumstances Test is made up of six factors. All of the factors are examined in this analysis, with no one factor being determinative.

- a. **Employee:** may not negotiate pay, cannot decline work, does not hire own workers, does not purchase materials or equipment, and/or does not engage in marketing or advertising.
- b. **Independent Contractor:** negotiates his or her pay, decides to accept or decline work, hires his or her own workers, purchases materials and equipment, or engages in marketing or advertising.

- a. **Employee:** Worker does not make investments (aside from tools/equipment) to grow his or her business.
- b. **Independent Contractor:** Worker makes investments to grow his or her business.

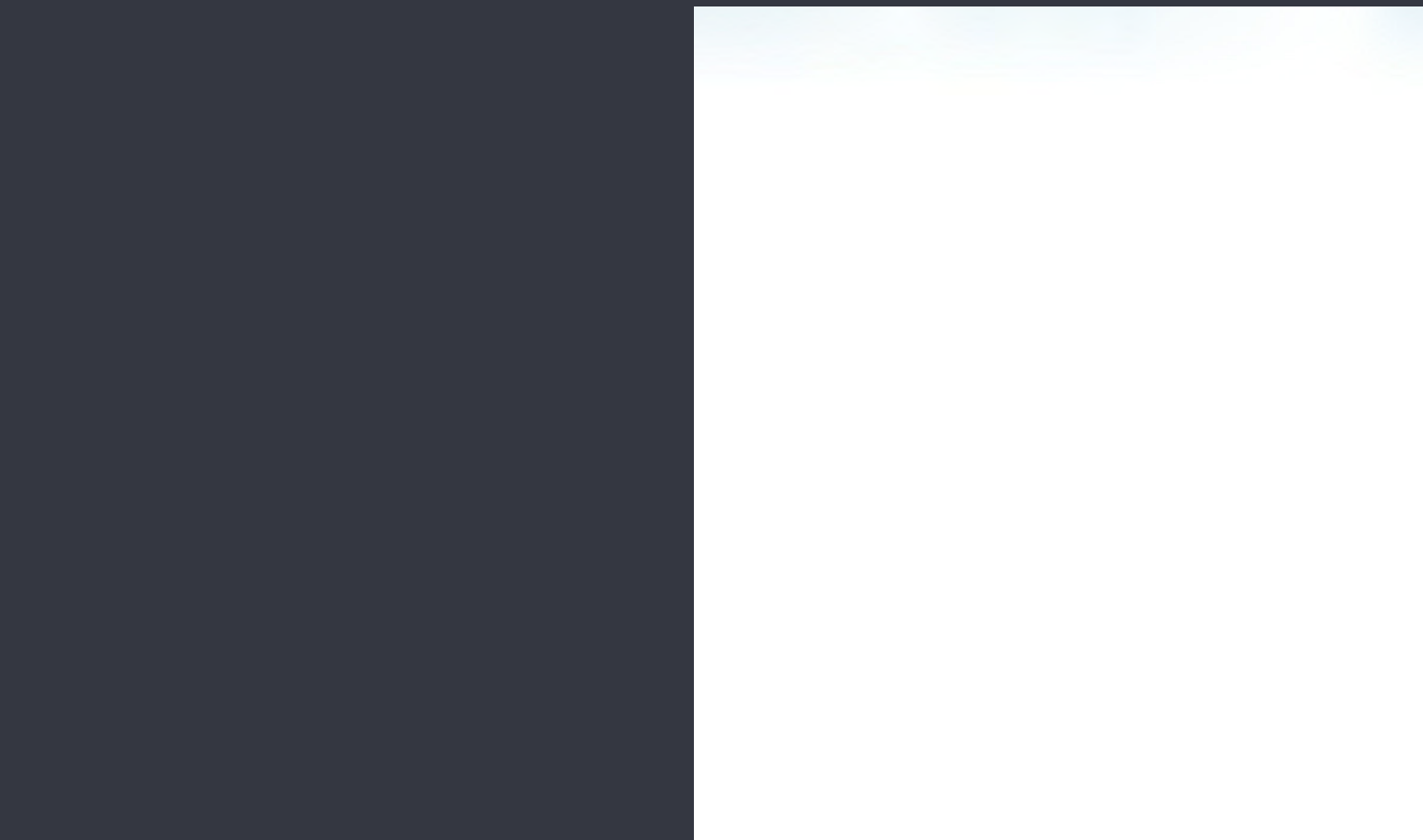
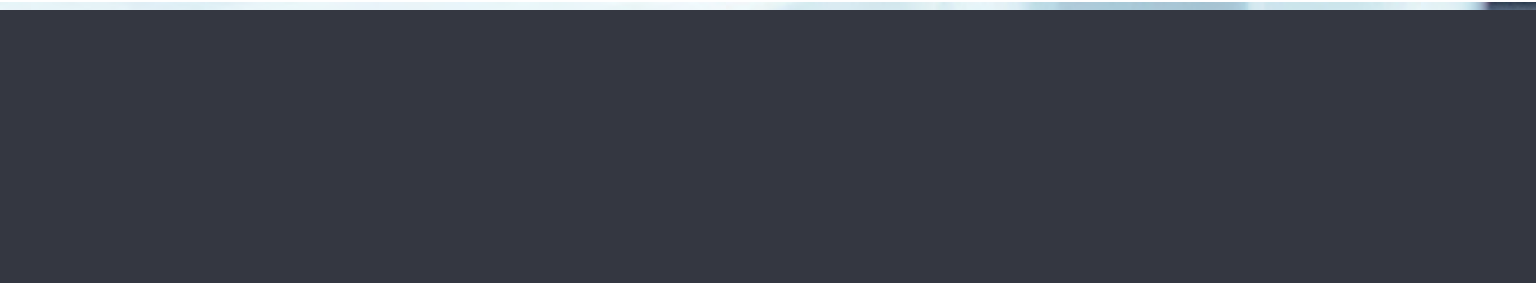
- a. **Employee:** The work relationship is continuous, lacks a fixed ending date, or is the worker's only client.
- b. **Independent Contractor:** The work relationship is periodic, sporadic, or the worker has other clients.

- a. **Employee:** The potential employer supervises the worker and controls hiring, firing, scheduling, prices, and/or pay.
- b. **Independent Contractor:** The potential employer does not supervise the worker nor control hiring, firing, scheduling, prices, or pay.

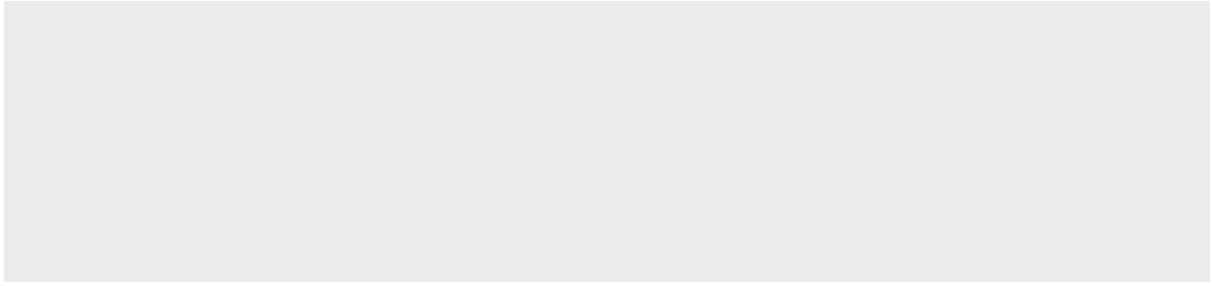
- a. **Employee:** The worker performs a role that is considered central to the business.
- b. **Independent Contractor:** The worker does not perform a role that is considered central to the business.

- a. **Employee:** The worker does not market his or her skill to generate outside business.
- b. **Independent Contractor:** The worker shows a business-like initiative and effectively markets his or her skill to generate outside business.

Additional factors may be considered if they assist in assessing whether the worker is economically dependent on the employer for work.







# APPLICATION OF THE TESTS

Mary runs a housecleaning service out of her basement. She owns a truck, vacuums, mops, buckets, and cleaning supplies. She advertises to generate business through local mailings and in newspapers. Mary has a schedule of charges based on how many rooms are to be cleaned, square footage, and how much time is required for cleaning. If Mary needs help, she enlists her daughter's services and pays her out of Mary's earnings. Mary is an independent contractor.

- This fact pattern is characterized by a lack of control by looking at the strong presence of independent contractor factors #3, #6, #10, #13, #14, #15, #17, and #18. Weighed against the weak presence of the remaining factors, the lack of control leads to the determination that a business that hires Mary would be able to classify her as an independent contractor.

- Factors #1 and #4 indicate independent contractor status.

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In connection with the performance of the Services contained in this Agreement, the Contractor may be exposed to confidential and proprietary information of the Company, whether or not so identified. All such information shall be subject to the terms and conditions of the Non-Disclosure Agreement as set forth in Exhibit C.

- i) The Contractor represents and warrants that the Services will be performed in accordance with and not violate applicable laws, rules or regulations, and standards prevailing in the industry. The Contractor shall be solely responsible for obtaining all permits, permissions or licenses required to comply with such laws, rules or regulations.
  - ii) The Contractor has full power and authority to enter into and perform its obligations under this Agreement. The Agreement is a legal, valid and binding obligation of the Contractor. The Contractor represents that this Agreement does not violate the terms of any agreement between the Contractor and a third party. So long as the Contractor shall devote as much productive time and energy as is necessary to perform the required Services under this Agreement, the Contractor is expressly free to perform services for other parties while performing services for the Company.
- 
- i) The Company represents that it has full power and authority to enter into and perform its obligations under this Agreement. The Agreement is a legal, valid and binding obligation of the Company.
  - ii) The Company shall not be liable for injury or death occurring to the Contractor's employees or other assistants in the course of performing.

This Agreement may be terminated by either party if the other party breaches or is in default on any obligation contained in this Agreement. The party terminating the Agreement shall provide 15 days' written notice to the other party. Upon termination by either party, Contractor shall provide to Company a final invoice and return to Company any materials or other tangible items provided by the Company to Contractor in connection with this Agreement. Unless otherwise terminated, this Agreement will continue in force until the Services have been fully and completely performed.

This Agreement will be governed and construed in accordance with the laws of the State of ..... that are applicable to contracts made and performed therein. Both parties submit to the jurisdiction of the federal and state courts in the named state for purposes of any suit or proceeding arising from this Agreement.

This document and any exhibit attached constitute the entire understanding and agreement between the parties. This Agreement supersedes any and all agreements, either oral or in writing, between the parties not embodied herein.

If any provision of this Agreement is held by a court of competent jurisdiction to be invalid, void or unenforceable, then the remaining provisions will continue in full force without being impaired in any way.

[COMPANY NAME]

[CONTRACTOR]

\_\_\_\_\_  
\_\_\_\_\_

\_\_\_\_\_  
\_\_\_\_\_

By: \_\_\_\_\_

By: \_\_\_\_\_

EXHIBIT A  
EXHIBIT B  
EXHIBIT C

