Independent Contractor Myths versus Reality

Dangerous Assumptions Employers Make When They Engage Independent Contractors... and How You Can Avoid Them!

Compliance HR

Simplifying the Complexity of Employment Law

Table of Contents

Independent Contractor Myths versus Reality

Introduction

In today's dynamic economy, many workers prefer to work as independent contractors, as they seek the greater freedom and income potential that model can offer. By extension, many organizations prefer to engage independent contractors for the flexibility, potential cost savings, and greater access to talent.

This alignment of interests seems perfect, until you recognize that numerous federal and state regulatory agencies have established guidelines, which presume that workers should be classified as employees unless they meet very specific, and often differing, requirements to qualify as independent contractors. These strict regulations create significant misclassification risk for organizations that engage independent contractors.

Employee misclassification is defined as the practice of engaging workers as independent contractors when they should be considered employees. In addition to denying workers of important employee benefits and protections, worker misclassification allows businesses to avoid their share of employment and tax laws, such as workers' compensation, unemployment insurance and payroll taxes.

In this ComplianceHR whitepaper, we will share some of the most common myths about engaging independent contractors and worker misclassification, along with insights on how employers can avoid them.

What is an independent contractor?

Employee misclassification is defined as the practice of engaging workers as independent contractors when they should be considered employees.

In the United States, workers are often classified as either an employee (an individual to whom statutory wage payment and other legal protections apply) or an independent contractor (to whom such protections *generally* do not apply).

Typically, companies engage independent contractors for a discrete period of time to perform a task or produce a deliverable outside the scope of expertise or capability of the company's employee-workforce. Contractors are not engaged like employees, for example they are not asked to complete employment applications or W-4 forms, are not paid a salary, do not receive benefits, or receive a copy of the company's employee handbook.

In addition, independent contractors usually remain free from direct supervision and control, can negotiate their own pay rates, have latitude to perform their assigned task(s) in any manner and on any schedule they choose (so long as their work product is delivered by company-required deadlines), provide their own tools and equipment to do the job, and are not prevented from simultaneously performing work for multiple businesses, **including competitors.**

If properly implemented, an independent contractor relationship can be beneficial to the worker and the company. For the independent contractor, the relationship offers greater flexibility and control over one's work, along with tax benefits. In addition to flexibility for the engaging company and greater access to talent, another benefit is that the costs of independent contractor engagement generally pale in comparison with those associated with employee hiring and retention. For instance, the company is not required to contribute to unemployment insurance funds, provide expensive employee benefits, or allow participation in retirement, profit sharing, and similar plans.

Independent contractors usually remain free from direct supervision, negotiate their own pay rates, have latitude to perform assigned task(s) in any manner and on any schedule they choose, provide their own tools and equipment, and are not prevented from simultaneously performing work for multiple businesses, including competitors.

The Risks for Independent Contractors

If a worker is misclassified as an independent contractor, they may be denied benefits and protections to which employees are legally entitled.

Typically, only workers who are "employees" have access to important benefits and protections under certain federal, state, and local laws. Among others, these benefits and protections may include:

- The right to minimum wage, overtime pay
- The right to unpaid, job-protected family and medical leave
- Certain anti-discrimination and anti-retaliation protections
- The availability of workers' compensation if you are injured on the job
- The availability of unemployment insurance (UI)
- Employer payment of half of the Social Security and Medicare Taxes

In addition to these employee-centric benefits, a worker who has been mistakenly operating as an independent contractor also may be exposed to risks.

The Risks for Employers

The U.S Department of Labor (DOL) estimates that 10% to 30% of audited employers misclassify some workers.

Using independent contractors has become a vital component of modern workforce strategy. However, misclassification of workers as independent contractors can expose organizations to significant risk.

Even though the majority of the U.S. workforce falls into the former (employee) category, independent contractors serve an increasingly important function in the economy and offer businesses greater flexibility, cost savings, and other benefits.

To take advantage of these benefits without risking the downsides – including potential misclassification fines and penalties, litigation and other pitfalls – companies must understand the differences between employees and independent contractors from a legal standpoint, and make the correct determination before any work commences.

The pervasive practice of misclassification can also hurt law-abiding businesses who are prevented from competing on a level playing field when some employers wrongly classify their workers as independent contractors and thereby lower their costs unlawfully.

The pervasive practice of misclassification can also hurt law-abiding businesses who are prevented from competing on a level playing field when some employers wrongly classify their workers as independent contractors and thereby lower their costs unlawfully. In addition, federal and state governments lose billions of dollars each year in tax revenue as a result of worker misclassification.

To help you navigate through this potential legal minefield the rest of this whitepaper presents the most dangerous assumptions businesses make about independent contractors, and how to avoid them.

Myths vs. Reality

Myth:

A short IC project poses no misclassification risk.

Reality:

It is the work and how it will be performed, not the length of time, that will determine if someone is an employee or an independent contractor.

Many project sponsors mistakenly believe that short duration projects pose no misclassification risk, and therefore the consultant can safely be classified as an independent contractor for their engagement.

There are numerous court decisions stating that the length of time personal services are provided does not alone determine if an individual is an employee or an independent contractor. In fact, it is possible to work less than a day and still be considered an employee. Conversely, it is possible to work for longer than a year and still be a valid independent contractor. For the IRS, DOL, and other state agencies, the length of time is never the sole determining factor.

Myth:

If a worker has been engaged by other companies as an independent contractor for many years, it is safe to engage them as an independent contractor.

Reality:

Just because a worker has been considered a bona fide independent contractor in the past does not mean a worker will always be an independent contractor.

Even if a worker has been a legitimate independent contractor for a long time, they could become an employee in the future if the nature of their work relationship changes. The worker is an employee if their work falls within a law's definition of employment. On the other hand, the worker may be an independent contractor if their work does not fall within a law's definition of employment.

The present nature of their work relationship (and not their previous status) will determine whether they are an employee or not.

Myth:

A signed independent contractor agreement substantiates the classification.

Reality:

A contract by itself, even one willingly signed by both parties, does not determine the true worker status in the relationship.

This is one of the most common myths shrouding the independent contractor relationship. Just because there is a contract, signed by the contractor and the project sponsor, stating that the consultant is an independent contractor responsible for their own taxes and benefits, does not mean that the IRS, DOL, or a state agency will not dispute the contractor's status.

For example, under the FLSA, FMLA, and MSPA, you are an employee if, as a matter of economic reality, your work indicates that you are economically dependent on an employer, and you are an independent contractor if you are in business for yourself. Any label that worker or the employer give to the relationship, even in an agreement signed by both parties, is irrelevant.

Instead, what matters is whether the reality of the situation indicates that the worker is economically dependent on the employer (an employee), or in business for themselves (an independent contractor).

Similarly, for federal tax purposes, signing an independent contractor agreement does not make the worker an independent contractor. It may be just one relevant fact in determining the relationship of the parties.

The bottom line is that a contract does not supersede employment law. Federal and state courts across the country have consistently held that a written contract only helps to show the intent of the two parties – a contract by itself will not determine the true status of the relationship. Indeed, it is not the contractual label, but rather the actual working relationship between the worker and the engaging entity, that controls the determination.

Government agencies have full authority to scrutinize any contract. Courts have concluded that a "contract cannot affect the true relationship of the parties to it. Nor can it place an employee in a different position from that which he actually held." It is also interesting to note that during training many auditors are instructed that since the government did not sign the contract, it is not a party to it, and therefore it is not bound by it.

Myth:

Consultants with their own corporations are automatically independent contractors.

Reality:

Courts have ruled that an individual who forms a corporation technically becomes an employee of that company. However, it is possible for an individual to form a corporation and still perform work in a manner that makes them an employee of their client. This is because the elements of direction and control between the individual and the client company are what actually determine the status of the relationship.

This is another common, and dangerous, assumption. Many client companies mistakenly believe that any consultant who has incorporated their consulting business is exempt from the usual common law factors because consultants with their own corporations are automatically considered as independent contractors to the client company.

Despite the fact that a worker provides "proof" such as their own Employer Identification Number (EIN), or paperwork demonstrating they perform services as a Limited Liability Corporation (LLC), sole proprietorship, or other type of business entity, does not by itself make them an independent contractor.

The worker is an employee if their work falls within a law's definition of employment, regardless of how the relationship is characterized on paper. Under the FLSA, FMLA, and MSPA, how the worker or the employer characterizes the relationship is irrelevant to determining whether they are an employee; what matters is whether the reality of the situation indicates the worker is economically dependent on the employer (an employee) or in business for themselves (an independent contractor). For federal tax purposes, how the worker and the employer characterize the relationship is only one fact considered among many in determining whether the employer has the right to control how the worker performs their work.

Myth:

A consultant with a business license and liability insurance poses no risk to the client company.

Reality:

A business license or liability insurance alone will not determine the actual relationship between the two parties, therefore their existence will not eliminate the risk from using the consultant's services.

This myth is closely related to the prior one. While a business license and professional liability insurance are generally viewed as "indicators" of an independent business, they alone will not determine the actual relationship between the two parties. The total picture of the working relationship must be considered.

There have been numerous cases where the individual contractor had both a business license and professional liability insurance yet was still found to be an employee of the company. This finding can result in back pay and benefits, and in the case of a tax audit, in an assessment for additional taxes, penalties and interest for the company that incorrectly classified the employee as an independent contractor.

A number of other factors, such as the right to direct and control the details of the work, are more important than a business license or insurance when determining the status of a consultant.

Myth:

Contractors who telework or perform the work off-site are independent contractors.

Reality:

Workers are not considered as independent contractors simply because they work off-site or from home.

This is another common myth. Just because a worker is out of sight, and not around a company's employee workforce, does not mean they could still be your employee. Here's why...

Working away from the client company's worksite, such as from home, does not necessarily make a worker an independent contractor. Both employees and independent contractors may telework or work off-site. Similarly, both employees and independent contractors may work at a company's work site.

A worker is an employee if their work falls within a law's definition of employment. On the other hand, a worker may be an independent contractor if their work does not fall within a law's definition of employment. The client company, or the project sponsor, may still control or have the right to control how the work is done under the relevant law even if the worker works off-site and is not subject to constant supervision.

Myth:

Documenting an independent contractor's project is a waste of time.

Reality:

Unfortunately, this is less of a myth and more of a common practice by time-starved managers who just want to get the work done as soon as possible. The reality is that documentation of independent contractor projects is critically important. This is a best practice not only to ensure projects are delivered on time and within scope, but also to provide important supporting documentation should an agency challenge your independent contractor's classification at some point in the future.

It is a best practice to create a Statement of Work (SOW) for every independent contractor's project. This important document provides a description of a given project's requirements, and often includes:

- Purpose of the project
- The scope of work to be performed
- Location of the project, project length, and any work requirements
- Expected deliverables and associated deadlines
- Any hardware and software required
- Performance-based standards to be met
- Acceptance criteria
- Payment terms and conditions.

In addition to providing supporting evidence of an independent contractor relationship, creating a thorough SOW can help to eliminate any risk that might arise from misunderstandings or disputes between parties on any of the above elements.

Myth:

It is safe to follow established industry practice when classifying certain workers as independent contractors.

Reality:

Following "common industry practice" is not a defense to misclassify a worker under the FLSA, or any other statute.

Regardless of the industry practice, if the contractor's work falls within a law's definition of employment, they cannot be classified as an independent contractor and denied their rights as an employee under that law.

Under the FLSA, FMLA, MSPA, and many states' regulations, what matters is whether the reality of the situation indicates that the worker is economically dependent on the employer (an employee) or in business for themselves (an independent contractor). For federal tax purposes, what matters is whether the employer has the right to control how the worker does their taxes (however, there is a special relief provision for federal employment tax purposes under which industry practices may be relevant).

Myth:

If one agency considers the worker an independent contractor, then all others will also.

Reality:

As we saw with the previous myth, different agencies can have different standards for determining independent contractor status. Therefore, it is dangerous to assume that satisfying one test will satisfy the requirements for all others.

For example, workers may be considered employees and have protections under a certain state's law, even if they are determined not to be employees under federal law. As we saw in the previous myth, this is because many of the tests used to determine employee status under state law often differ from the tests used under federal law, such as the federal Fair Labor Standards Act (FLSA).

Myth:

A company issuing a 1099 tax form to the contractor automatically makes them an independent contractor.

Reality:

Issuing a 1099 (or the contractor receiving one from a client) does not automatically make the worker an independent contractor. The reality is a worker may be an independent contractor if their work does not fall within a law's definition of employment. Inversely, a worker might be an employee if their work falls within a law's definition of employment.

1099 forms are intended to document and report different types of payments made by a business during the tax year, and they are sent to the payment recipient and the IRS. Receiving a 1099 tax form is simply the result of how the client company classified the worker for federal tax purposes, but the form itself does not mean the worker was correctly classified as an independent contractor for federal tax purposes. Furthermore, receipt of a 1099 is irrelevant to determining whether the worker is an employee under federal statutes like the FLSA, FMLA, or MSPA.

Example: Taxes

Under federal tax laws, a worker is not an independent contractor for tax purposes just because they receive a 1099. What matters is whether the organization receiving the worker's services has the right to control how they perform the work. To learn more about whether a worker is an independent contractor or employee for federal tax purposes, please visit the IRS' website.

Example: Minimum Wage, Overtime, and other FLSA Protections

Receiving a 1099 does not make a worker an independent contractor under the FLSA. In fact, whether a worker receives a 1099 is irrelevant. Under the FLSA, a worker is an employee if their work indicates they are economically dependent on an employer. On the other hand, a worker is an independent contractor if, as a matter of economic reality, they are in business for themselves. It is important to remember that a worker can be an employee under the FLSA even if the IRS considers them an independent contractor. To learn more about whether a worker is an employee or independent contractor under the FLSA, please visit the DOL Misclassification Initiative page.

Myth:

Independent contractors are not entitled to any of the benefits and protections provided to people who meet the definition of an “employee”.

Reality:

This is a tricky one, since it depends on whether a proper classification evaluation was performed prior to the engagement. Even if a worker is determined to be a legitimate independent contractor under one law, they may still be an employee under other, more stringent, laws.

Most of the protections available under federal and state employment laws are generally available only to “employees,” and are not available to independent contractors. Federal laws have differing definitions of employment. For example, under the Fair Labor Standards Act (FLSA), the Migrant and Seasonal Agricultural Worker Protection Act (MSPA), and the Family and Medical Leave Act (FMLA) most workers are employees, but the definitions in other laws may be a little less broad. Therefore, it is possible to not be an employee but rather an independent contractor under one law, and be an employee under a different law (especially the FLSA, FMLA, or MSPA).

To illustrate how different laws define employment as well as the benefits and protections these laws provide to employees, please see the table on the following page.

Law:	Benefits, Protections and Employer Requirements:	More Information:
Fair Labor Standards Act (FLSA)	• Minimum wage • Overtime pay The FLSA also requires employers to keep employment records.	The FLSA's definition of employment was designed to be broad and provide expansive coverage for workers. As a result, most workers are employees under the FLSA. For more information, visit the FLSA Overview page and the DOL Misclassification Initiative page.
Migrant and Seasonal Agricultural Worker Protection Act (MSPA)	• Wages • Safe housing and transportation • Disclosure about the employment	MSPA uses the same broad definition of employment as the FLSA. For more information, visit the MSPA website and the DOL Misclassification Initiative page.
Family and Medical Leave Act (FMLA)	• Up to 12 weeks of unpaid, job-protected leave for family and medical reasons • Continuation of health insurance when employees take FMLA leave	The FMLA uses the same broad definition of employment as the FLSA but has additional eligibility requirements in order for employees to be entitled to job-protected leave. For more information about FMLA, visit the FMLA Overview page and the DOL Misclassification Initiative page.
State Workers' Compensation Laws	Workers' compensation if you are injured on the job	The employment status of workers who are injured while employed by private companies or by state and local governments is determined by each state's workers' compensation board.
Internal Revenue Code	• Income tax withholding • Withholding and payment of Social Security taxes and Medicare taxes	The federal tax rules generally focus on the work relationship that exists between the worker and employer and whether the employer has the right to control how work is done, looking at many facts and circumstances. Please visit the Internal Revenue Service's "Independent Contractor versus Employee" page to learn more.
State Unemployment Insurance Laws	Unemployment insurance (UI) if you are laid off or otherwise separated due to non-disqualifying reasons and meet other eligibility requirements.	Most state laws contain strict tests to determine whether there is sufficient absence of control by an employer that the worker is not an employee but an independent contractor. Information and contacts for state UI agencies are available at: http://www.ows.doleta.gov/unemploy/agencies.asp.

Myth:

Government agencies hold everyone to be an employee because they want to capture the tax revenue and guarantee worker protections, therefore there is no such thing as a valid independent contractor.

Reality:

This is a myth where the truth is somewhere in the middle. Both federal and state agencies have stated that using independent contractors is a proper and legitimate business strategy. Court cases and audit findings confirm that position every day. However, there is a strong agency bias that all workers are employees of the entity receiving the benefit of their work product, unless proven otherwise.

Organizations can safely use consultants as independent contractors, so long as they classify them correctly *and* have the proof to support their decision.

The only fail-safe way an organization can mitigate worker misclassification risk is if they never engage a service provider as an independent contractor. This strategy is always an option but it can be severely limiting for organizations who want flexibility and the best access to talent.

The truth is that organizations can safely use consultants as independent contractors, so long as they classify them correctly ***and*** have the proof to support their decision. All of the factors must be considered and documented for each independent contractor classification.

In the unfortunate (but increasingly common) event where a company is audited, the best protection is a properly documented decision that will help prove to the agency that the rules were followed. It is dangerous to guess incorrectly, just as it is dangerous to ignore the issue. The prudent business decision is always to mitigate risks.

Myth:

There is one standard test in the U.S. to determine whether someone qualifies as an independent contractor.

Reality:

As illustrated throughout this whitepaper, there are many federal and state statutes governing independent contractor status. These government regulations are often complex and sometimes contradictory. Even if a worker qualifies as an independent contractor under one regulatory agency's test, they are not automatically qualified under any other agency's test. Organizations must take a broad view to mitigate risk.

Conclusion

In addition to not falling victim to any of the myths shared in this whitepaper, the best way to mitigate your risk of worker misclassification is to identify all the applicable tests at play. It is important to know what factors will be considered in the event a worker's independent contractor status is scrutinized by a court or regulatory body.

It is also important to evaluate any independent contractor relationship against the strictest test possible in the applicable jurisdiction. Human resources and legal leaders want to ensure that as many factors are satisfied as possible (or all of them for cases like the ABC test, under which the factors are more like requirements).

Finally, businesses should also be mindful that the employment law landscape is dynamic, particularly around worker misclassification. Federal, state, and local regulations are constantly changing, so they may need to adjust relationships as dictated by changes to the law or attendant regulations.

NOTE: See the back page for details on an expert system that empowers HR and legal teams to make the right work classification determination, based on the most stringent and applicable federal and state regulations.

ComplianceHR – Simplifying the complexity of employment law

ComplianceHR offers the only on-demand, intelligent suite of HR compliance solutions focused on helping companies of all sizes address the ever-changing federal and state employment law requirements on employee handbooks, leave, onboarding, minimum wage, overtime, independent contracting, and more. All our solutions are powered by the subject matter expertise of Littler, the world's largest employment law firm and built on Neota's AI-powered platform. ComplianceHR solutions empower HR professionals, compliance teams, and attorneys to treat their workforce fairly while minimizing associated costs and risks. A great example of this is Navigator IC.

ComplianceHR's IC Compliance Solution

Independent contractor misclassification is perhaps the most difficult employment law compliance issue that companies face today. With Congress, state legislators, federal and state agencies, unions, plaintiff's attorneys and other groups all focused on regulating independent contracting, the legal updates and risks are seemingly endless.

If your organization engages independent contracts to get work done, you are most likely exposing your organization to significant compliance risk.

Different federal and state laws apply different tests for IC status – three, four or even six different tests may apply to a single contractor under wage-hour, unemployment, workers' compensation, employment tax, safety and equal opportunity laws. With this complexity, how is an employer supposed to know if a worker is an independent contractor or an employee?

Navigator IC

Navigator IC helps you take the guesswork out of this complex decision in a matter of minutes. And because we update all of our tools in real-time, you can be confident that the results and guidance you receive are accurate and up-to-date. This easy-to-use solution provides you with:

- An easy-to-use questionnaire for inputting individual fact patterns
- Risk assessments driven by expert analysis of applicable federal and state regulations and the outcomes of over 1,700 court cases
- Instant, actionable guidance and a customized report on how to lower the risk of misclassification
- A summary of applicable laws
- A complete questionnaire transcript

See a Demo

To learn more about ComplianceHR and Navigator IC, register for a no obligation consultation with a compliance expert. After you've met with our compliance consultant, you will receive a free, 14-day trial to use all of the Navigator Suite applications.

ComplianceHR

Simplifying the Complexity of Employment Law