

# Guide to Defining Employees vs. Independent Contractors

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## Overview

The purpose of this guide is to give employers an overview of who is an employee and who is an independent contractor. The importance of this distinction is that the two groups are treated much differently when it comes to employment law, benefits and taxes. The employer who is not aware of the difference, or chooses to ignore it, may be setting themselves up for costly legal issues down the road.

## Who is an Employee?

By definition, an employee is a person who works for another in return for compensation, where the employer has the power or right to control and direct the employee in the material details of how the work is performed.

## Who is an Independent Contractor?

An independent contractor is one who, in the exercise of an independent employment, contracts to do a piece of work according to his own methods and is subject to his employer's control only as to the end product or final result of his work.

## Why Use Independent Contractors?

Employers use independent contractors to reduce the cost of benefits and employment taxes and increase their flexibility. Independent contractors are not covered under many labor laws such as minimum wage, overtime and unemployment coverage. In addition, independent contractors can bring a specific expertise to a project that is critical, but not needed on a full-time basis.

## How This Can Cause a Problem

If the employer has wrongly determined that an employee is really an independent contractor, then there can be severe consequences.

The IRS can pursue the employer to collect back taxes and other contributions that should have been paid by the employer on the employee's behalf. The employee can

also seek compensation for job benefits that were denied to them. This can quickly add up to substantial sums of money.

## **How to Determine a Worker's Status**

The test of who is an employee and who is an independent contractor is not clear-cut. The very definition of "employee" is not clearly defined in various laws. Generally, the "totality of the circumstances under which a person is working" determines their status. Just calling someone an "employee" or an "independent contractor" does not make it so.

Here is how we can get to that determination, based on court case decisions. There are three possible tests, called "the common-law test," "the economic realities test," and a hybrid test combining some of both common-law and economic realities.

### **Common-Law Test**

Under the common-law test, the question is who can control the employee's work process and product. An employee is a worker whose work process and work product are controlled by the employer. An independent contractor controls their own work process and product.

#### **Worker is an employee if:**

- Employer controls details of the work
- Worker is engaged in a business that is not distinct from employer's business
- Employer supervises worker
- Skill level need not be high or unique
- Employer provides Worker instrumentalities, tools, and workplace
- Worker is employed for extended period of time
- Worker is paid by the hour, or other computation based on time worked is used to determine pay
- Work is part of employer's regular business
- Employer and worker intend to create employer-employee relationship
- Worker provides services only to the employer

#### **Worker is an independent contractor if:**

- Worker controls details of the work
- Worker operates in business that is distinct from employer's business
- Work is done without supervision
- Skill level is specialized, is unique, or requires substantial training
- Worker provides instrumentalities and tools of workplace and works at a site other than the location of workplace employer

- Worker is employed for specific project or for limited time
- Worker is paid by the project
- Work is not part of employer's regular business
- Employer and worker do not intend to create an employer and employee relationship
- Worker provides services to more than one business

The IRS uses a variation of the common-law test in its own 20-factor test.

### **Economic Realities Test**

The economic realities test is similar to the common-law test, but focuses on whether a worker depends on someone else's business for their continued employment. If so, they are an employee. If the worker operates an independent business, the worker is an independent contractor. This test is often used in minimum wage and overtime cases.

### **Hybrid Test**

The hybrid test combines elements of the common-law test and the economic realities test. It considers the economic realities of the work relationship as a critical factor, but also focuses on the employer's right to control the work process. Each and every aspect of the work relationship is examined. This test is often used in discrimination cases under Title VII of the Civil Rights Act.

### **Conclusion**

Employers must take care to properly classify a worker as an employee or an independent contractor at the very beginning of the relationship, in order to avoid costly legal problems later. The key factor is who has the right to control the work process, in all aspects. Just because the employer calls a worker an employee or an independent contractor does not mean that it is correct. The legal standards must be applied.

### **Disclaimer**

Aspire HR Consulting LLC is providing this Guide solely as general information and should not be considered as legal advice. Any legal issues should be reviewed by your legal counsel to apply the laws to the particular facts of your situation.

## About Aspire HR Consulting LLC



Aspire HR Consulting LLC was founded in 2004 by Bill Gottlin.

Bill Gottlin has helped many small and mid-sized companies with their HR challenges. Bill understands the needs and issues of business owners to hire the right people, set company rules and policies and train managers to get the best results from their employees.

Prior to founding Aspire HR Consulting, Bill worked for over 20 years with companies in senior HR positions. He has handled every HR issue that companies face and is able to apply the “best practices” of large corporations to create solutions for smaller companies.

At Aspire, we are experts in developing HR solutions. We understand your HR challenges, give you personal attention and use best practices.

### How We Help You

- Outsourced HR Department
- Employee Handbooks
- Company Policy Development
- Job Descriptions and Organizational Structure
- Training Managers to Interview, Hire, Discipline and Terminate Employees
- Mentoring Key Managers and Performance Evaluation
- Downloadable HR Publications to instantly give you the information you need to manage your staff

### How We Work

We listen to your needs and issues and then develop an action plan to address your challenges. We assist you in three ways:

#### Outsourced HR Department

For an affordable monthly fee, Aspire becomes your HR Department. We handle recruiting, training, policy development, mentoring, employee evaluations, compensation and benefits consulting.

### **Stand-Alone Projects**

On a project basis, Aspire provides advice and guidance on HR concerns such as hiring, terminating and managing sensitive issues, a fully customized employee handbook, company policies, training seminar, project, or recruiting.

### **Do-It-Yourself HR Publications**

For those who need quick and useful HR information, Aspire HR Consulting provides downloadable guides and templates so you can take action fast. These include:

- Employee Handbook
- How to Find and Hire Great Employees for Your Business
- Effective Discipline and Termination Guide for Managers

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