

Independent Contractors, Employees and Temporary Workers: Understanding the Differences

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Randy Thompson and Elena Minkin Parker¹

I. Introduction

Recognizing the legal distinctions between “employees” and “independent contractors” can be difficult. Misclassification, however, can result in serious consequences to an organization, including tax penalties and awards of back-pay, overtime and benefits. To complicate matters, the various federal and state agencies that govern the employment relationship each have their own tests to determine where the lines between employee and independent contractor should be drawn.

The risks of misclassification have never been higher. The IRS recently implemented a new “research project” under which it will audit the records of thousands of employers to enforce correct classification. This paper describes the state of the law today regarding the classification of workers and discusses practical steps that companies can take to determine the correct classification.

II. Background

According to the most recent reports by the U.S. Bureau of Labor Statistics, four out of five organizations in the United States use non-employee, contract workers. These workers account for at least one quarter of the country’s workforce and, as a portion of the workforce, will experience 54% growth through 2012, double the rate of the overall workforce.² Given the recent economic downturn, this trend is likely to accelerate as companies look for additional flexibility in hiring.

Benefits. Companies seek to use independent contractors instead of hiring full-time employees for a number of reasons. Independent contractors provide practical benefits such as the ability to staff up or staff down quickly without a lengthy employment process or raising expectations of long-term employment. Contract workers allow a company to budget wage costs only for what is needed. Independent contractors can provide specialty services that a company may not need on a full time or long term basis.

Some workers also prefer the independent contractor status. A worker may be able to earn more in cash compensation than an employee if she does not need benefits such as health insurance. The independent contractor, theoretically in business for herself, also may be able to write off expenses and achieve greater financial flexibility than she could under full-time

¹ Randy Thompson and Elena Minkin Parker are St. Louis attorneys in the Labor & Employment Department at Husch Blackwell LLP.

² HUMAN CAPITAL INSTITUTE, WHITE PAPER, THE STATE OF CONTRACT TALENT MANAGEMENT AND THE ROLE OF HR (Jan. 2009) (citing to ANGELA CLINTON, U.S. BUREAU OF LABOR STATISTICS: “CONTINGENT WORK, THE WAVE OF THE FUTURE” (1997)).

employment. Contract work also provides flexibility in time and location to the individual and may offer a variety of opportunities in the kind of work available.

Some of the beneficial reasons for using independent contractors, however, are the very reasons government agencies look so critically at the practice. Many of the laws governing the employer-employee relationship do not apply to independent contractors. For example, using independent contractors might avoid the need for employment eligibility checks and collection of I-9 forms. Companies do not withhold or pay taxes (including FICA (Medicare and Social Security) or FUTA (unemployment)) on independent contractors. Additionally, federal anti-discrimination laws such as Title VII, the Age Discrimination in Employment Act or the Equal Pay Act protect only employees, not independent contractors. Independent contractors who lose their jobs do not qualify for unemployment benefits.

The decision to classify a worker as an independent contractor carries significant risks. The decision cannot rest simply on a desire to avoid “increasing headcount.” Merely labeling an individual who would otherwise be considered an employee an “independent contractor” will not make it so. Similarly, both parties’ agreeing in writing that the worker is an independent contractor will not make it so. Rather, the conduct and actual relationship of the parties determines the status; an employee is an independent contractor only if she is treated like an independent contractor.

Consequences of Misclassification. The consequences of incorrectly classifying a worker as an independent contractor are manifold, but typically they will involve having to pay back taxes and wages, including overtime and other benefits, and penalties under both federal and state laws.

In 2009, the IRS announced a new “National Research Project” aimed at obtaining data regarding worker misclassification and its effect on the “tax gap.”³ The IRS announced that this year it will investigate 1,500 to 2,000 separate employers for potential misclassifications relating to returns filed for the 2008 calendar year.⁴ The IRS will target a range of businesses, both large and small and for-profit and not-for-profit.⁵

The IRS reports an annual \$15 billion payroll “tax gap,” \$14 billion of which is attributable to unpaid FICA and FUTA taxes.⁶ In 2006, the IRS estimated that \$1.6 billion a year in lost taxes is attributable to worker misclassification. Since it is easier to collect these taxes from a company or single employer rather than from the individual workers themselves, and because employers pay these taxes more reliably than individuals, the IRS understandably has a bias toward considering workers “employees.”⁷

³Joseph E. Bender, *New IRS Initiative Giving Rise to More Employment Tax Audits this Fall* (June 18, 2009), available at <http://wildman.com/index.cf?fa=news.bulletinPrint&aid=F4344DDA-AA23-C4E9>.

⁴ “IRS Takes Aim at Employment Tax Returns (Forms 941),” Douglas W. Charnas, July 29, 2009, available at <http://www.martindale.com>.

⁵ *Id.*

⁶ Douglas W. Charnas, *IRS Takes Aim at Employment Tax Returns (Forms 941)* (July 22, 2009), available at <http://www.martindale.com/print.aspx>.

⁷ See TREASURY INSPECTOR GENERAL FOR TAX ADMIN., MEMORANDUM FOR DEPUTY COMMISSION FOR SERVICES AND ENFORCEMENT, ref. 2009-30-035 (Feb. 4, 2009).

A business that erroneously classifies its workers may be liable for a host of fees and back taxes. The IRS may require the organization to pay (1) the employer's one-half of the employee's FICA taxes, (2) either 20% or 40% of the employee's share of the FICA tax, and (3) in lieu of the employee's federal income tax withholding, either 1.5% or 3% of the compensation paid to the reclassified employee. The higher amounts are triggered if the employer failed to file IRS Form 1099 for the worker.⁸ If the IRS finds the employer's misclassification intentional, the company will be liable for the full amount of the reclassified worker's income taxes, offset by what the employee actually did pay the IRS.⁹

Individual and class action lawsuits also pose significant risks. The leading, but not lone, example of these risks is the fate that befell Microsoft following its misuse of the "independent contractor" label back in the late 1980s and 1990s. What started as a dispute between the IRS and Microsoft led to a major class action settlement in favor of Microsoft workers incorrectly classified as either independent contractors or temporary non-employees.

Microsoft had added a pool of workers to its base of permanent employees that it classified as "freelancers." Microsoft had them sign agreements saying they were independent contractors and paid them cash compensation, but no fringe benefits. Microsoft did not withhold or pay any taxes for these individuals.

Instead of treating the workers as individuals running their own businesses, however, Microsoft treated the freelancers as employees. They were integrated into the daily operations, working alongside regular employees and sharing the same supervisors and hours. Microsoft also required them to work on-site and provided them access badges, office equipment and supplies.

Following an audit in 1989 and 1990, the IRS determined that since Microsoft retained the right to control the means and manner of the freelancers' employment, they were indeed employees. Microsoft admitted to the IRS that the individuals should have been treated as employees for tax purposes and agreed to pay back FICA, FUTA and withholding taxes.

After learning of Microsoft's settlement with the IRS, several misclassified employees demanded back employee benefits, including benefits associated with the company's 401(k) plan. When Microsoft refused, the employees sued Microsoft in a case that three times ended up before the Ninth Circuit Court of Appeals. Each time, the court sided with the workers, the end result being that the employees were owed back fringe benefits, including retirement benefits. Particularly relevant was the fact that Microsoft's benefit plans were ambiguous as to which "employees" were entitled to receive benefits.¹⁰ The case, which affected at least 8,000 Microsoft workers, settled in 2000 for \$97 million.

⁸ 26 U.S.C. § 3509(a) & (b).

⁹ 26 U.S.C. § 3509(c).

¹⁰ *Vizcaino v. Microsoft Corp.*, 97 F.3d 1187 (9th Cir. 1996); *Vizcaino v. Microsoft Corp.*, 120 F.3d 1006 (9th Cir. 1997), *cert. denied*, 522 U.S. 1098 (1998); *Vizcaino v. Microsoft Corp.*, 173 F.3d 713 (9th Cir. 1999).

FedEx's 2010 annual report stated that FedEx Ground is currently involved in fifty class action lawsuits, several individual lawsuits and forty state tax and other administrative proceedings over the independent contractor issue. FedEx drivers claim they are treated like full-time employees since the company mandates job uniforms, sets their hours of work, and determines what prices to charge. The drivers sought about \$1 billion in damages for back pay, truck purchases, overtime and other contract-related costs.¹¹

Most of the class actions were recently consolidated for administration into the U.S. District Court for the Northern District of Indiana where FedEx won. The court found that the drivers were independent contractors because FedEx did not control the means and methods of their drivers' performance.¹² For example, the contractors were allowed to "choose the best way to manage their routes as long as they [were] meeting the customer service obligations" imposed by FedEx.¹³

Even though FedEx won this battle, the war is far from over. There are still several ongoing cases in other jurisdictions, and FedEx will not likely win them all. In fact, just twenty-seven days before FedEx's win in federal court, the corporation paid out \$3 million to Massachusetts to settle another misclassification claim.

III. Making the Determination: Independent Contractor or Employee?

Unfortunately, no single, official worker-classification checklist exists. Instead, numerous tests exist depending on the particular law under scrutiny. Generally, however, the various tests fall into one of two general categories: the common law "control" test or the "economic realities" test.

Under the common law "control" test, an individual worker is an independent contractor if the company has the right to control or direct only the *result* of the work and not the means or methods of *how* the worker accomplishes the result. Courts follow this test in one form or another in interpreting most federal anti-discrimination laws, as does the Internal Revenue Service (IRS). Under the broader and more recent economic realities test, applied by courts interpreting the Fair Labor Standards Act (FLSA) and the Family Medical Leave Act (FMLA), "control" is just one factor to consider. The economic realities test also focuses on the financial relationship between the worker and the organization. A worker who is economically dependent on the organization is, as a matter of economic reality, not in business for herself and is an employee.

A. Common Law "Control" Test

Nearly all of the relevant federal and state laws governing the employment relationship apply some form of the control test announced in two U.S. Supreme Court cases, *Nationwide*

¹¹ *In re FedEx Ground Package System, Inc., Employment Practices Litigation*, Cause No. 3:05-MD-527 RM (MDL-1700), Case 3:05-cv-005961-RLM-CAN (Jul. 27, 2009).

¹² *In re FedEx Ground Package Sys., Inc.*, No. 3:05-CV-530 RM, 2010 WL 3239363, at *31 (N.D. Ind. Aug. 11, 2010).

¹³ *Id.* at *45.

Mut. Ins. Co. v. Darden,¹⁴ and *Clackamas Gastroenterology Assocs. v. Wells*.¹⁵ While the specifics of various agencies' and entities' tests will differ, there is significant overlap and a general, common thread among them: the worker will be considered an *employee* if the company hiring her services retains behavioral or financial control over the worker and control over their relationship. The common law test is best exemplified by the analysis used by the IRS, discussed below. In many cases, the company need not *exert* control over the worker; it is enough that the company has the *right* to control these aspects of the working conditions.

The common law control test governs three key areas of the employer-employee relationship: (1) the employer's federal tax liability; (2) liability under federal employment statutes, including anti-discrimination laws; and (3) Missouri laws governing employment security and workers' compensation. Each of these three areas is discussed in turn.

1. Federal Tax Liability and the IRS Test

If a worker is an "employee," the company must take certain tax-related actions for the individual. These actions include withholding federal and state income taxes,¹⁶ paying federal and state unemployment taxes,¹⁷ and withholding the employee's "FICA" taxes from employee paychecks (Medicare and Social Security).¹⁸ Companies are not required to collect or withhold these taxes for independent contractors, who are responsible for paying these taxes themselves.

To determine whether a worker is an employee or an independent contractor, the IRS follows a variation on the common law control test that focuses on three broad categories of evidence: (1) behavioral control over the worker; (2) financial control over the worker; and (3) the nature of their relationship.¹⁹ Under each of these rubrics, the IRS considers a number of factors, many of which are described in Revenue Ruling 87-4,²⁰ which lists twenty common-law based indicia of employment status. These original twenty factors, along with additional factors identified since 1987, persist as examples of the kinds of control that may lead to a finding of "employee" status. These factors are listed below and grouped according to the three main "control" categories. What is key to remember is that no one factor is conclusive and the inquiry will turn not on whether the company actually exercises these forms of control, but whether the company retains the *right* to exercise control.

(1) Behavioral Control

Instructions: If the company has the right to require the worker to complete a job according to certain instructions, the worker is likely to be considered an employee. The more detailed the instruction, the more control the business

¹⁴ 503 U.S. 318 (1992).

¹⁵ 538 U.S. 440 (2003).

¹⁶ 26 U.S.C. § 3401(c).

¹⁷ 26 U.S.C. § 3306(i); *see, e.g., Da-Raef Corp. v. U.S.*, 70 F. Supp. 264 (Ct. Cl. 1947).

¹⁸ 26 U.S.C. § 3121(d).

¹⁹ STAFF OF THE JOINT COMMITTEE ON TAXATION, PRESENT LAW AND BACKGROUND RELATING TO WORKER CLASSIFICATION FOR FEDERAL TAX PURPOSES (May 7, 2007); *see also* <http://www.irs.gov/businesses/small/article>.

²⁰ Rev. Rul. 87-41, 1987-1 C.B. 296.

exercises over the worker and the more likely the IRS is to consider the worker to be an employee. Independent contractors usually use their own methods.

Training: The less training provided, the more likely the worker will be considered an independent contractor. Independent contractors are often highly skilled at what they do.

Services Rendered Personally: If the company requires that the worker personally perform services, and preclude her from delegating work or hiring assistants, the worker is probably an employee.

Hiring, Supervision, and Paying Assistants: If engaging assistants is up to the worker, she is probably an independent contractor. If this process requires approval, this factor will tend toward a finding of employment.

Set Hours of Work: If there are no set hours under which the worker must perform work, this factor will weigh toward a finding of independent contractor status.

Full-Time Required: If full-time engagement is required, the worker is probably an employee. If hours are discretionary, this will weigh toward a finding of independent contractor status.

Work Performed on Employer's Premises: If the worker must perform the job at the company's place of business and his or her work is incorporated into the company's daily operations, the worker is probably an employee.

Order or Sequence of Work: If the alleged employer sets the order or sequence of work, the worker is probably an employee.

Oral or Written Reports: If the alleged employer requires oral or written reports and updates during the worker's performance, this will weigh in favor of finding employment.

Right to Discharge: If the company can discharge the worker "at will," without running afoul of a contract, the worker is probably an employee.

Evaluation System: If an evaluation system measures the details of how the work is performed (and not just the end result), the more likely the worker is an employee.

(2) *Financial Control*

Payment by Hour/Week/Month: If the worker is paid according to time increments as opposed to jobs completed, the more likely the worker is an employee.

Payment of Business/Travel Expenses: Employees are more likely than independent contractors to have their expenses reimbursed. An independent contractor will usually consider expenses to be part of her overhead.

Furnishing of Tools/Materials: A true independent contractor will provide her own materials with which to complete a job.

Significant Investment: If the worker has a lot of capital at risk (the worker owns the major equipment used for the job, for instance), the more likely the worker will be considered an independent contractor. There are no dollar limits or minimums, however, and a significant investment is not a prerequisite for a finding of independent contractor status since some occupations will not require large expenditures.

Realization of Profit/Loss: If the worker has a significant investment in the tools used to complete a job and has a significant amount of unreimbursed expenses, the worker has a greater opportunity to lose money (i.e., expenses will exceed income). This possibility usually leads to a finding of independent contractor status.

Working for Multiple Firms At Same Time: Independent contractors are generally free to seek out other business opportunities. Having multiple customers indicates independent contractor status.

Services Available to General Public: Independent contractors often advertise, maintain a visible business location and are generally available for work in the relevant market.

(3) *Type of Relationship*

Permanency of the Relationship: If the expectation is that the worker will continue his or her services indefinitely, rather than for a set period or for a set project, this will likely lead to a finding of employee status.

Employee Benefits: Workers receiving fringe benefits like insurance, retirement benefits, and paid time off, are usually employees. An absence of such benefits, however, is not dispositive.

Right to Terminate: If the worker can end the relationship at any time without liability to the organization, the more likely the worker is an at-will employee than an independent contractor.

Integration: If the worker is integrated into the business operations, the worker is more likely to be an employee. For instance, a worker who is called in to fix a broken machine is probably an independent contractor. A worker who runs the machine on-site is likely subject to more control and, thus, more likely to be an employee.

Services Provided as Key Activity of Business: If the worker's services are a key aspect of the company's business, the worker is probably an employee. For instance, an attorney working at a law firm is likely an employee because the work will be represented as the firm's work and, thus, is subject to the firm's control.

In Revenue Ruling 75-41,²¹ the IRS determined that workers of a physician's professional service corporation were employees of the corporation.²² The corporation was in the business of providing "secretaries, nurses, dental hygienists, and other similarly trained personnel" to professionals and firms.²³ Using the control test, the IRS determined that the workers were employees because the corporation recruited the workers in question, paid them directly (as opposed to going through a third party), provided them with benefits, assigned them to jobs, and retained the right to discharge them.²⁴

In Revenue Ruling 70-309,²⁵ the IRS also determined that workers were employees.²⁶ Using the control test, the IRS determined that the oil well pumpers were employees even though they performed services away from the company's main operations and received no day-to-day instructions.²⁷ The IRS decided these workers should be classified as employees because they performed services pursuant to an arrangement that gave the company the right to exercise whatever control was necessary to assure proper performance of their services.²⁸

In some cases, the IRS has drawn clear-cut lines by statute, classifying certain workers as either employees or non-employees. Non-employees include "real estate agents" and "direct sellers."²⁹ In contrast, other provisions make the following workers "employees," provided that the relevant contract for services contemplates that "substantially all" of the work must be performed by the individual personally (as opposed to the individual's being able to delegate out the work or hire assistants): corporate officers; life-insurance sales persons; individuals who deliver meat, vegetables, fruit, baked goods, beverages (other than milk), or laundry or dry-cleaning; "home workers" who perform work according to the alleged employer's specifications; and traveling or "city salesmen" who sell business supplies to wholesalers, retailers, or hotels and restaurants (or similar establishments). These workers, however, are not "employees" if the individual has made a "substantial investment in the facilities used in connection the performance of such services" or "if the services are in the nature of a single transaction not part of a continuing relationship."³⁰

²¹ Rev. Rul. 75-41.

²² *Id.*

²³ *Id.*

²⁴ *Id.*

²⁵ Rev. Rul. 70-309.

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ 26 U.S.C. § 3508. A "direct seller," broadly stated, is someone who re-sells consumer products out of the home or other non-retail location, or someone who delivers or distributes newspapers or "shopping news." 26 U.S.C. § 3508(b)(2).

³⁰ 26 U.S.C. § 3121(d)(1)-(3).

A company may obtain a written determination from the IRS regarding the status of a particular worker for purposes of determining the correct employment taxes and income tax withholding by submitting IRS Form SS-8 to the IRS.³¹ A determination pursuant to this request applies to existing employees only, not prospective employees. While it can take up to six months to get a written determination from the IRS, the IRS advises companies that continually hire the same types of workers for particular services to consider filing the Form SS-8.³²

2. *Liability under Federal Anti-Discrimination Laws*

As a general rule, federal anti-discrimination laws like Title VII of the 1964 Civil Rights Act, the Americans with Disabilities Act and the Age Discrimination in Employment Act, among others, protect employees, but not independent contractors.³³ To determine whether an individual is an independent contractor or an employee, the Eighth Circuit applies the common-law test.³⁴

The Eighth Circuit follows Supreme Court precedent and considers the employer's "right to control the manner and means" of the work, "the skill required; the source of the instrumentalities and tools; the location of the work; the duration of the relationship between the parties; whether the hiring party has the right to assign additional projects to the hired party; the extent of the hired party's discretion over when and how long to work; the method of payment; the hired party's role in hiring and paying assistants; whether the work is part of the regular business of the hiring party; whether the hiring party is in business; the provision of employee benefits; and the tax treatment of the hired party."³⁵ The Supreme Court has emphasized that this list is nonexhaustive and each aspect of the relationship "must be assessed and weighed with no one factor being decisive."³⁶

3. *Temporary Workers and Joint Employment*

Disputes over a company's status as employer often involve their "temporary" workers. Where a worker works for the company but is employed by an outsourcing or staffing agency, the workers typically qualify as "employees" of the staffing firm and are thus protected by federal and state anti-discrimination laws and other laws relating to employment, such as workers' compensation.³⁷

The staffing company's client, however, or the "special employer" may also be liable under federal and state laws as the worker's employer under the "joint employment" theory of liability, provided the special employer meets the relevant statutory "employer" criteria (e.g., threshold fifteen-employees).

³¹ IRS Form SS-8 (Rev. 11-2006); Rev Proc. 2007-3, 2007-1 I.R.B. 108.

³² <http://www.irs.gov/businesses/small/article/0,,id+99921,00.html>.

³³ See, e.g., *Shah v. Deaconess Hosp.*, 355 F.3d 496, 499 (6th Cir. 2004).

³⁴ See *Ernster v. Luxco, Inc.*, 596 F.3d 1000, 1004 (8th Cir. 2010).

³⁵ *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 323–24 (1992).

³⁶ *Id.* at 324.

³⁷ See Enforcement Guidance on Contingent Workers, EEOC Notice No. 915.002 (Dec. 3, 1997); *Evans v. Webster*, 832 P.2d 951, 955-56 (Colo. App. 1992).

Under Missouri state law, which of course will govern state tax, unemployment, and workers' compensation liability, joint employment exists whenever (1) the employee consents to work for the special employer; (2) the employee actually enters upon the work for the special employer pursuant to an express or implied contract to do so; and (3) the special employer has the power to control the details of the work to be performed, to determine how the work shall be done, and whether it shall stop or continue.³⁸ With respect to the special employer's federal liability, the Eighth Circuit Court of Appeals has held a special employer qualifies as the worker's employer, along with the staffing agency, when the special employer exercises significant supervisory control over the worker.³⁹ Indeed, the special employer, must pass the "control" test regardless of the worker's relationship to the staffing agency.⁴⁰

4. *Missouri Employment Laws*

Generally, Missouri courts follow the common law control test when determining whether a worker is an employee or independent contractor. The determination is most important in the context of employment security laws and workers' compensation.

Employment Security Law. The Missouri Department of Employment Security (DES) determines whether a worker is an employee or an independent contractor pursuant to 8 CSR 10-4.150(1) and Section 288.034.5. It considers twenty factors derived from federal law to determine whether an individual should be classified as an employee or an independent contractor for purposes of unemployment tax liability.⁴¹ These factors include: (1) instructions; (2) training; (3) integration (whether a business could continue without the worker's contribution to the business); (4) services rendered personally; (5) hiring, supervising, and paying assistants; (6) continuing relationship; (7) set hours of work; (8) full time required; (9) doing work on employer's premises; (10) order or sequence set; (11) oral or written reports; (12) payment by hour, week, month; (13) payment of business and/or traveling expenses; (14) furnishing of tools and materials; (15) significant investment; (16) realization of profit or loss; (17) working for more than one firm at a time; (18) making service available to general public; (19) right to discharge; and (20) right to terminate.⁴² Importantly, "[t]he factors are not intended to serve as a bright-line rule with no flexibility, but rather they are indices of control to assist the employer in ... determin[ing] the common law employment status of its workers."⁴³ "Not every factor will be applicable in every situation," and each case will be decided on its unique set of facts.⁴⁴

A Missouri court applying these factors to tow truck drivers found the drivers were employees, not independent contractors.⁴⁵ The court examined each factor in turn and determined whether the factor favored employee status, independent contractor status, or was neutral. The court's decision did not hinge on any one factor in particular; however,

³⁸ *Schepp v. Mid City Trucking Co.*, 291 S.W.2d 633, (Mo. App. 1956).

³⁹ *EEOC Enforcement Guidance on Contingent Workers*, FEPM 405:7551, n. 14 (collecting cases). ; *see also* *Beaver v. Jacuzzi Bros., Inc.*, 454 F.2d 284, 285 (8th Cir. 1972).

⁴⁰ *EEOC Enforcement Guidance on Contingent Workers*, n. 13 & 14 (collecting cases).

⁴¹ *Quality Medical Transcription, Inc. v. Woods*, 91 S.W.3d 181, 185 (Mo. App. W.D. 2002).

⁴² *Haggard v. Division of Employment Sec.* 238 S.W.3d 151, 156 (Mo.,2007)

⁴³ *K & D Auto Body, Inc. v. Division of Employment Sec.* 171 S.W.3d 100, 106 (Mo. App. W.D. 2005)

⁴⁴ *Id.*

⁴⁵ *Id.* at 114.

considerable weight was given to the fact that the employer supplied the workers with expensive equipment.⁴⁶ Specifically, the employer furnished the workers with trucks and chains worth approximately \$60,000 to \$120,000 per vehicle.⁴⁷ The court found that this factor heavily favored employee status.⁴⁸

Workers' Compensation. In Missouri, courts use the right to control test to determine whether a worker's compensation claimant is an independent contractor or an employee.⁴⁹ Eight factors are relevant to the determination, but no one factor is dispositive (1) extent of control; (2) actual exercise of control; (3) duration of employment; (4) right to discharge; (5) method of payment; (6) degree to which alleged employer furnished equipment; (7) the extent to which the work is the regular business of the employer; and (8) the employment contract.⁵⁰ The most important question is "whether the employer had the right to control the means and manner of the service, instead of just controlling the ultimate results of the service."⁵¹

B. The "Economic Realities" Test

In determining whether an employer-employee relationship exists for purposes of the Fair Labor Standards Act (FLSA) and the Family Medical Leave Act (FMLA), courts apply the "economic realities" test. While the "economic realities" test considers factors within the common law and IRS control tests (including factors relating to behavioral and relationship control), courts interpreting the FLSA and FMLA place greater emphasis on the alleged employer's *financial* control over the employee than under those more prevalent tests.

1. The Six-Factor FLSA Test

The Fair Labor Standards Act ("FLSA")⁵² establishes minimum wage, overtime pay, recordkeeping, and youth employment standards affecting employees in the private sector as well as government employees. The FLSA applies only to employees, not independent contractors.⁵³ For purposes of FLSA coverage and the economic realities test, courts interpret the term "employee" broadly assessing the "totality of the circumstances." The focal point is whether the individual is economically dependent on the business to which she provides services or whether she is in reality in business for herself.⁵⁴ The alleged employer's "control" over the individual's services is just one factor that courts consider in determining whether the individual is economically independent.⁵⁵

⁴⁶ *Id.*

⁴⁷ *Id.* at 110.

⁴⁸ *Id.*

⁴⁹ *Nunn v. C.C. Midwest*, 151 S.W.3d 388, 399 (Mo. App. W.D. 2004).

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² 29 U.S.C. 201, *et seq.*

⁵³ *See, e.g.*, 29 U.S.C. § 206-07.

⁵⁴ *Dole v. Snell*, 875 F.2d 802, 804 (10th Cir. 1989).

⁵⁵ *Id.*

In general, the FLSA provides four different mechanisms to enforce an employer's minimum wage and overtime obligations. First, the FLSA authorizes criminal proceedings for willful violations with potential sanctions ranging from a \$10,000 fine to up to 6 months' jail time (although no jail time can be imposed for a first offense).⁵⁶ A criminal proceeding by the Department of Justice may be in addition to or in lieu of civil proceedings. Second, the FLSA provides that workers may bring a suit, including a class action, for damages for unpaid minimum wages or overtime and for retaliation.⁵⁷ Third, the Secretary of Labor may seek injunctive relief against an employer.⁵⁸ Fourth, the Secretary of Labor may seek damages for unpaid minimum wages or overtime.

Most courts, including courts in the Eighth Circuit, apply a six-factor test to determine whether an individual is a company's "employee" and, therefore, entitled to FLSA protection. Those six factors are: (1) the degree of control exercised by the alleged employer; (2) the extent of the worker's investment in facilities and equipment; (3) the degree to which the worker's opportunity for profit or loss are determined by the worker or the "employer;" (4) the skill and initiative required to do the job; (5) the permanency of the relationship; and (6) the extent to which a worker's services are integrated into the company's regular business.⁵⁹ It is important to note that an employment relationship can be found under a broad range of work, and at all times the focus is on the "economic reality" of the worker's situation - no one factor should control.⁶⁰

(1) Control

The following evidence of "control" will more often than not lead to a finding of an employer-employee relationship:

- Frequent supervision and oversight, as well as a requirement that the worker report to a superior;⁶¹
- The worker is not free to provide the same services to other entities;⁶²
- Paying the worker's taxes on real and personal property;⁶³

⁵⁶ 29 U.S.C. § 216(a).

⁵⁷ 29 U.S.C. § 216(b).

⁵⁸ 29 U.S.C. § 217.

⁵⁹ *Tobin v. Anthony-Williams Mfg. Co.*, 196 F.2d 547, 549 (8th Cir. 1952).

⁶⁰ *See, e.g., Brock v. Mr. W. Fireworks*, 814 F.2d 1042, 1053-54 (5th Cir. 1987).

⁶¹ *Martin v. Selker Bros., Inc.*, 949 F.2d 1286, 1288 (3d Cir. 1991) (required daily sales reports and regular visits to gas station, among other things, indicated gas station operators were employees of gas station owner); *cf. Johnson*, 371 F.3d at 729 (upholding jury verdict that found off-duty police officers working as security guards for public housing project were independent contractors due to near complete lack of control over when individuals worked and how many hours).

⁶² *Henderson v. Inter-Chem Coal Co.*, 41 F.3d 567, 570-71 (10th Cir. 1994) (mechanic worked exclusively for company for more than three years, working on various projects, indicating he was economically dependent on employer).

⁶³ *Donovan v. Sureway Cleaners*, 656 F.2d 1368 (9th Cir. 1981) (dry cleaning store operators were employees since, among other factors, store owners controlled nearly all facets of how the stores were run); *Cromwell v. Driftwood Elec. Contractors, Inc.*, No. 09-60212 (5th Cir. Oct. 12, 2009) (cable splicers were highly skilled, largely unsupervised, owned their own tools and equipment, but were employees as a matter of "economic reality" because they worked full time and exclusively for company); *cf. Freund v. Hi-Tech Satellite, Inc.*, 185 F. App'x 782 (11th Cir. 2006) (satellite installer was independent contractor where he was highly skilled, details of installation left to

- Setting prices for products or services;⁶⁴
- Controlling the advertising.⁶⁵

Because, however, the determination of employment under the FLSA is multi-factored, simply offering the worker a flexible schedule and minimal supervision will not automatically make the worker an independent contractor.⁶⁶

(2) Investment

This factor refers to “risk capital,” not items such as tools that have a small capital value. Where the company’s risk capital is significantly greater than the worker’s, the relationship is more likely to be one of employer-employee.⁶⁷

(3) Profit and Loss

Where the factors determining profit and loss, such as advertising, location, and prices, are within the company’s sole control, an employer-employee relationship is more likely.⁶⁸

(4) Permanency

The determination of “permanency” is very case-by-case, but the longer the engagement, the more likely a court will find that an employment relationship exists. The mere transitory nature of an engagement is not dispositive where the nature of the work itself makes it transitory, such as seasonal work, as opposed to the relationship being transitory because of the worker’s successful marketing skills.⁶⁹

his discretion, paid by the job, not by the hour, was free to accept jobs from other companies, and could accept as few or as many install jobs from the alleged employer as he wanted).

⁶⁴ *Usery v. Pilgrim Equip. Co., Inc.*, 527 F.2d 1308, 1312 (5th Cir. 1976) (dry cleaning store operators were employees since dry cleaning business controlled all aspects by which profit or loss could be achieved, including location, price-setting and advertising); *Reich v. Circle Invs.*, 998 F.2d 324 (5th Cir. 1993) (despite impermanent relationship, topless dancers were employees where the club set prices for dances, compiled work schedules, and approved costumes and exercised significant control over profit).

⁶⁵ *Sureway Cleaners*, 656 F.2d at 1371-72.

⁶⁶ *Doty v. Elias*, 733 F.2d 720 (10th Cir. 1984) (wait staff could set own hours, but they had to work during restaurant’s business hours - not independent contractors).

⁶⁷ *Tobin v. Anthony-Williams Mfg. Co.*, 196 F.2d 547, 550 (8th Cir. 1952) (holding lumber haulers were employees when they had no investment in company trucks and nominal ownership); *Carrell v. Sunland Constr.*, 998 F.2d 330 (5th Cir. 1993) (welders bought trucks and welding machines and assumed equipment-related liability costs - independent contractors); *Freund*, 185 F. App’x 782 (satellite installer was independent contractor where he drove own vehicle, provided own tools and similarly situated workers were permitted to hire assistants); *cf. McLaughlin v. Seafood, Inc.*, 867 F.2d 875, 876-77 (5th Cir. 1989) (crab and crawfish pickers were employees even though they provided their own garments and knives - the sole “real investment” in the facilities was made by employer, who also exercised significant day-to-day control over workers).

⁶⁸ *Martin*, 949 F.2d 1286 (gas station operators had no choice over location, which drove business volume, and were thus employees).

⁶⁹ *E.g., Dole v. Snell*, 875 F.2d 802, 804 (10th Cir. 1989) (cake decorator was employee where she was at bakery for 4.5 years and expected to work there indefinitely); *Brock*, 814 F.2d at 1053-54 (correct test for seasonal employment is not whether worker works for company year-round, but whether the engagement is exclusive or continuous during the relevant season).

(5) Skill & Initiative

Where a worker achieves success based on her own special skills and her own initiative, she is more likely to be found to be an independent contractor.⁷⁰ Routine work that requires little training or skill and that is incorporated into the company's daily operations is likely to be considered employment.⁷¹

(6) Integral Part of Operation

If the work performed is a primary part of the alleged employer's main operations, the worker is more likely to be found to be an "employee."⁷²

2. The FMLA

The Family Medical Leave Act of 1993 (FMLA) employs the same definitions of "employee" and "employer" as the FLSA.⁷³ Accordingly, whether a worker is an employee or employer for purposes of the FLMA will be determined according to the "economic realities" test of the FLSA. If a business is found to be a worker's employer for purposes of the FMLA, it may not interfere with or discriminate against an employee who exercises FMLA rights.⁷⁴

3. Temporary Workers and Joint Employment under the FLSA/FMLA

The Department of Labor also applies its own test to determine whether there is joint employment between a staffing agency and its clients for purposes of determining whether temporary workers are the "employees" of a company. The factors considered in making the determination include: (1) the power to fire the worker; (2) the right to supervise and direct work schedules and other employment conditions; (3) the rate and method of payment; and (4) whether the alleged employer maintained employment records for the worker.⁷⁵ Department of Labor regulations describe the instances in which a joint employment relationship will generally be found:

- where there is an arrangement between the employers to share the employee's services;

⁷⁰ *Donovan v. DialAmerica Mktg.*, 757 F.2d 1376, 1384-87 (3d Cir. 1985) (fact that distributors in home research business used "business-like initiative" to recruit other home workers weighed in favor of finding independent contractor status).

⁷¹ *Hodgson v. Taylor*, 439 F.2d 288, 290 (8th Cir. 1971) (men loading cars at night did not have special skills and therefore were considered employees); *Mitchell v. John R. Crowley & Bros., Inc.*, 292 F.2d 105, 107 (5th Cir. 1961) (night security guards were not specially skilled and, thus, were employees).

⁷² *Hodgson*, 439 F.2d at 290 (loading cars was an integral part of the employer's business and was a typical responsibility of employees); *Snell*, 875 F.2d at 811 (cake decorator's work was integral to cake company).

⁷³ 29 U.S.C. § 2611(3).

⁷⁴ 29 C.F.R. § 825.106(e).

⁷⁵ *E.g., Hodgon v. Griffin & Brand of McAllen, Inc.*, 471 F.2d 235, 237-38 (5th Cir. 1973) (day laborers on a crew paid by an independent contractor also employees of the independent contractor's).

- where one employer is acting directly or indirectly in the interest of the other employer regarding the employee; or
- where the employers are not completely disassociated with respect to the employment of a particular employee and may be deemed to share control of the employee, due to one employer's control of the other employee or by reason of the fact that both employers are under common control.⁷⁶

The same test applies in determining joint employment for both the FLSA and the FMLA.⁷⁷

4. *The Department of Labor's Increased Focus*

The Department of Labor (DOL) has announced that it plans to increase its focus on Wage and Hour violations involving misclassifications. In its 2011 budget request, the DOL projected that the number of Wage and Hour Division compliance actions in 2010 will increase more than 20% over the 2009 levels. In addition, the DOL projected that the number of compliance actions in 2011 will increase more than 41% over the 2010 levels. Thus, the DOL's goal represents a more than 70% increase in the agency's workload in just two years.

In order to reach this goal, the DOL has requested a \$25 million budget for 2011. The DOL justifies this budget request based on its findings that worker misclassification results in substantial losses not only to the Treasury and the Social Security, but also to Medicare and Unemployment Insurance Trust Funds. The DOL believes that \$25 million will help form a joint Labor-Treasury initiative to strengthen and coordinate Federal and State efforts in reducing misclassification.

More specifically, the budget seeks \$12 million to fund ninety new full-time positions for the Wage and Hour Division to focus on misclassification; \$11.25 million for the Employment and Training Administration for grants to states to increase their ability to focus on misclassification and reward the states that are most successful at detecting and prosecuting employers who misclassify; \$1.6 million and ten full-time positions for the Solicitor General's office to pursue misclassification litigation, including joining efforts with the states to pursue multi-state litigation; and \$150,000 for the Occupational Safety and Health Administration (OSHA) to modify training to allow inspectors to identify potential employee misclassification during safety inspections and share that information with the Wage and Hour Division.

IV. Classifications Under Fire

More and more workers who have been traditionally classified as independent contractors are alleging misclassification, including: delivery drivers (express package delivery, restaurant meal-delivery, home appliance delivery and installation, home improvement delivery, uniform delivery); warehousing workers; instructors for a military consulting company; exotic dancers; cable television installers; restaurant security guards; temporary health care workers; home

⁷⁶ 29 C.F.R. § 791.2.

⁷⁷ 29 C.F.R. § 825.106(b).

health care workers; janitors; workers providing professional and personnel services; real estate agents; taxicab drivers; insurance agents; web content editors for a travel website; construction workers; child care providers; and meat and poultry processing workers.

In a recent case out the Fifth Circuit Court of Appeals, insurance sales leaders claimed they were misclassified under the FLSA and sought unpaid overtime wages.⁷⁸ The court agreed and found that the sales leaders were employees because even though the workers supervised more junior agents, the company controlled the hiring, firing, assignment, and promotion of those junior agents.⁷⁹ Furthermore, the company paid for and controlled the sales leaders' advertising, set prices and policies, and determined the geographic territory of each sales leader and junior agent.⁸⁰ The sales leaders could not sell other companies' products, could not acquire leads unless provided by the company, could not own or operate other businesses, had no specialized skills, and were not economically dependent.⁸¹ Based on all these factors, the court concluded that the sales leaders were employees, and as a matter of economic reality, could not be considered "in business for [themselves]."⁸²

Importantly, not all courts reviewing independent contractor insurance agents find they are misclassified. In a recent case out of Illinois, the court decertified the class of agents based on significant variations in testimony regarding control over sales techniques, working hours, training, and client generation.⁸³

Other recent cases target drivers and temporary health care workers. For instance, in 2008 Friendly Cab Company refused to collectively bargain with a drivers' union arguing that its drivers were independent contractors and therefore were not protected by the National Labor Relations Act (NLRA).⁸⁴ The National Labor Relations Board (NLRB) concluded that the drivers were employees and that Friendly Cab violated the NLRA by refusing to meet and collectively bargain with the union.⁸⁵ The Ninth Circuit affirmed the drivers' employee status based on the fact that company policies dictated the details of the drivers' work, drivers were only allowed to pursue passengers provided by the company's dispatch process, and drivers could not sublease their taxis.⁸⁶ The court concluded that Friendly Cab exercised a considerable amount of control over the drivers such that the drivers could only be classified as employees.⁸⁷

In another recent case, temporary health care workers alleged misclassification and sought damages for overtime compensation under the FLSA and for benefits under the Employee Retirement Income Security Act (ERISA).⁸⁸ The employer, a temporary staffing agency, maintained a registry of health care workers and placed them in health care facilities when those

⁷⁸ *Hopkins v. Cornerstone Am.*, 545 F.3d 338 (5th Cir. 2008).

⁷⁹ *Id.* at 343.

⁸⁰ *Id.* at 343-44.

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Walker v. Bankers Life & Cas. Co.*, No. 06 C 6906, 2008 WL 2883614, at *7 (ND. Ill. July 28, 2008).

⁸⁴ *N.L.R.B. v. Friendly Cab Co., Inc.*, 512 F.3d 1090, 1093 (9th Cir. 2008).

⁸⁵ *Id.*

⁸⁶ *Id.* 1093-94.

⁸⁷ *Id.* at 1093.

⁸⁸ *Bamgbose v. Delta-T Group, Inc.*, 684 F. Supp. 2d 660, (E.D. Pa. 2010).

facilities needed staffing.⁸⁹ The workers who registered with the agency had a variety of educational backgrounds and skill sets, making them qualified for various placement opportunities.⁹⁰ After noting the differences between the various health care workers and their interactions with the agency, the court refused to certify a class finding that there were too many individualized issues bearing on status.⁹¹

V. Solutions

As the discussion above suggests, it can be difficult to make an independent contractor classification that satisfies all of the tests that courts and government agencies may apply. Before proceeding to classify a worker as an independent contractor, a company must *at a minimum* assess its business goals to determine why it seeks to retain independent contractors and it must consider every relevant legal factor identified by courts in determining a worker's status.

A. **First Step: Identify Business Goals**

As discussed above, the decision to classify a worker as an independent contractor carries with it certain risks that may not be justified under the circumstances. Additionally, some jobs simply may not realistically be filled by independent contractors. Jobs that must be performed on site, that are routine and unskilled and that are integrated into a company's main operations are far less likely to be filled by independent contractors than are jobs filled by persons of great skill and education, who use their own judgment and discretion to complete tasks, who are minimally supervised, who are hired on a project basis, and who are paid by the project and not in time increments. A company must thoroughly and realistically analyze its needs. While independent contractors may appear to meet a cost-saving need in the short term, the long term costs may outweigh that benefit.

A goal of avoiding logistical hassles such as managing tax withholdings, processing I-9 forms, avoiding potential liability under federal and state laws, and avoiding payment of expensive benefits will not meet any of the tests. Hiring and maintaining employees can be much less convenient than hiring independent contractors, but inconvenience is no defense for misclassification. If the starting point is a need for short-term or intermitting assistance in a specialized area, an independent contractor relationship, however, can be established.

B. **Independent Contractor Checklist**

The following is a checklist of the factors the company must consider, followed by additional steps a company should take, before classifying any worker as an independent contractor. The factors are broken down according to the three areas of control that should be avoided. It is important to remember that some kinds of work, routine, unskilled work that is integral to an organization's main operations, for instance, may simply not lend themselves to independent contractor status. At a minimum, all factors must be considered and the weight of any one factor will depend on the particular circumstances of each case.

⁸⁹ *Id.* at 664.

⁹⁰ *Id.* at 665.

⁹¹ *Id.* at 669.

1. Avoid Control of the Worker's Behavior.

- No unnecessary instructions or required methods of getting the job done (control only the results, not the means).
- No unnecessary training (independent contractors are usually skilled and require little training).
- Do not prohibit the worker from delegating her services to others or hiring assistants.
- Allow the worker to set her own hours - a timetable for completion is fine, but the less control over when she works, the better.
- Allow the worker to complete the job at the location of her choosing, if possible - integrating the worker into your business indicates employment.
- Avoid unnecessary reporting or evaluation requirements.
- Avoid a contract that is terminable at-will (this is too much like at-will employment, not a business arrangement).

2. Avoid Financial Control.

- Pay the worker by project or in a lump sum, not in time increments.
- Require the worker to cover her own expenses and to provide her own tools and equipment - remember, independent contractors are running their own businesses.
- Allow the worker to realize profit and loss, if possible, by letting her set prices and control advertising.
- No fringe benefits.
- If the company believes it is truly using the services of an independent contractor, it must assess the need to withhold income taxes and pay payroll taxes - doing so indicates employment.
- Avoid making checks payable to the worker personally - payments, if possible, should be made to a business, not an individual.

3. Avoid Relationship Control.

- Allow the worker to provide services to other companies or clients - no exclusive engagements.
- No open-ended engagements or promises of continued work - this is too much like employment at-will.
- Avoid contracts that are terminable at-will by either party.
- Avoid integrating the worker into the company's main operations - *see Microsoft*.
- No paid leave (remember, the time is the worker's to control).

V. Conclusion

Using independent contractors in lieu of employees cannot be viewed as simply a means of cutting or saving costs. Workers will be viewed as independent contractors and not subject to the myriad of employment laws and regulations only if they meet the requirements of providing services not under the direct supervision and control of the company. Misclassifying workers can expose company to serious liability from government agencies and private lawsuits.