



KNOWING THE
DIFFERENCE
BETWEEN **EMPLOYEE**
& **INDEPENDENT**
CONTRACTOR AND
WHY IT MATTERS

*How a few distinctions could impact
your business model*



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The pandemic greatly influenced the growth of the gig economy, upending the traditional 9 to 5 working experience and increasing social reliance on home delivery. Over the last five years, the gig economy grew from a \$204 billion industry to over \$455 billion in 2023.¹ It's estimated that about 50% of the U.S. workforce will be freelancing by 2027.²

At the same time, the U.S. Department of Labor (DOL) proposed a new rule in October 2022 to redefine who is considered an employee versus an independent contractor.³ After a more relaxed approach to classification under the previous White House administration, this change seeks to align the written law with how case law currently addresses employee classification.

This reversal is already impacting workers and employers across multiple industries, from health care to trucking, construction and delivery.

With this new rule, the DOL seeks to primarily protect workers from the harms of misclassification, but misclassification can also be a challenge to businesses. On top of back wages that may need to be paid if a DOL investigation is found in favor of the worker, federal and state penalties, tax and payroll fines, and even potential for jail time can cause additional challenges for the business and its leaders.

While a 6- to 12-month grace period is expected, businesses who currently incorporate independent contractors into their employment strategies or are considering that business model will need to take into account the revised classification process once it's approved in order to avoid such penalties.

DETERMINING EMPLOYMENT CLASSIFICATION: *Then vs. Now*

The definitions set forth by common law for employee and independent contractor are not crystal clear on the surface.

An employee is defined as “any individual employed by an employer,” where “employ” is defined to include the words “suffer or permit to work.”⁴

¹ Statista “Projected gross volume of the gig economy from 2018 to 2023 (in billion U.S. dollars),” September 30, 2022.
² Statista “Number of freelancers in the United States from 2017 to 2028 (in millions),” September 30, 2022.
³ U.S. Department of Labor “US Department of Labor Announces Proposed Rule on Classifying Employees, Independent Contractors: Seeks to Return to Longstanding Interpretation,” October 11, 2022.
⁴ U.S. Code “Title 29 - Labor,” 2021.



Under the current [Employee or Independent Contractor Classification Under the Fair Labor Standards Act](#), employers are generally required to provide nonexempt employees at least the federal minimum wage for all hours worked and at least one and one-half times the employee's regular rate of pay for every hour worked beyond the 40-hour workweek. Employees often receive health benefits and are protected against employment discrimination and retaliation.

These protections do not apply to independent contractors, who are also referred to as self-employed or freelancers. While the IRS does not explicitly define an independent contractor, they are recognized as workers who control “what will be done and how it will be done.”⁵

THEN: *The Control Test*

Determining whether an employer and employee relationship exists under common law cannot be done on definitions alone.

Traditionally, the IRS has used a series of tests known as the [common law or control test](#) to determine if workers are employees or independent contractors. These tests evaluate behavior control, financial control and the relationship between the parties involved.⁶ Sample considerations as per the IRS include:

BEHAVIORAL CONTROL: Does the company control or have the right to control how the worker accomplishes their tasks?

FINANCIAL CONTROL: Are the business aspects of the workers' job - such as how they are paid or who provides the tools and supplies - controlled by the payer?

TYPE OF RELATIONSHIP: Are there written contracts or the exchange of employee benefits such as a pension plan, insurance or paid vacation time? What is the length of the relationship and are the services considered a key activity of the business?

[Previous guidance from the DOL](#) on how to apply these control factors in the evaluation of a worker's status designated the level of control over the work and the opportunity for profit or loss as the “core factors,” which carried the most weight in the determination.

⁵ IRS “Independent Contractor Defined,” November 2, 2022.
⁶ IRS “Independent Contractor (Self-Employed) or Employee?” April 5, 2023.

NOW: Economic Dependency

In the courts, and drafted into the new rule, the control test is no longer the primary factor when evaluating worker classification. Instead, the focus is on economic dependency through an economic reality test.

The question is now primarily, “Is the worker economically dependent on the employer for work? Are they in business for them self?”

Being economically dependent from the employer includes multiple factors. Ask yourself:



Does the independent contractor’s income come solely from your company?



Does the independent contractor claim to be in business for themselves?



How is the independent contractor being compensated? Is it by project or time?



Does the independent contractor control when and where they complete the work?

For a business to classify a worker as an independent contractor, they must establish that the worker is operating as a separate independent business, provides services to other businesses, has their own insurance and operates like a subcontractor. While the economic dependency angle may not be enforced universally yet, once the final rule is issued, companies will need to have a tighter grip on their classification processes.



04

STEPS TO AVOIDING WORKER MISCLASSIFICATION

With the growing number of U.S. workers choosing gig work, and the fact that 29.5% of total employer compensation costs account for benefits,⁷ the appeal of using independent contractors is clear. Complications emerge when a company does not ensure their working relationships are clearly defined and adhere to classification requirements laid out by the DOL as well as their state.

Here are four steps to ensuring compliance with independent contractor classification.

1. AUDIT YOUR EMPLOYMENT PRACTICES.

Before making any moves, businesses who currently operate with independent contractors will want to work with an Employment Practices Liability attorney to perform a full audit of their current employment practices.

Neither the initial control test nor the economic reality test are fool-proof methods for classifying employees.

If only it could be as simple as scanning a bar code and receiving either an “employee” or “independent contractor” status. These tests are built with room for interpretation, and requirements may vary based on local and state laws.

TIP 1: Don’t give yourself grief for any mistakes or misunderstandings made in the past; instead, focus on identifying which laws and tests apply to your business, your current classification practices and whether your classification decisions are properly supported.

2. GET YOUR DOCUMENTATION IN ORDER.

One of the most important parts of both your audit and how you move forward will be documentation. It cannot be said enough: document, document, document.

Organizing the documentation you already have on current independent contractors will help support classification decisions if they are questioned. If you do not have this information already

on file, gather insurance, business license and payroll information for all workers currently providing services for your business.

If you’re in an industry that involves hazardous operations, ensure your policies and procedures are in compliance with Occupational Safety and Health Administration (OSHA) standards, and that all workers – both full-time employees and independent contractors – are properly trained, and establish proof of this training.

TIP 2: As you move forward, documentation will continue to be crucial. Establish employment practices that feed into a documentation system, and require proper documentation before any work is performed.

3. USE AN INDEPENDENT CONTRACTOR CONTRACT.

A written contract between your organization and the independent contractor you’re hiring is one of the crucial documents needed to prove independent contractor status since it clearly defines

the working relationship between the business and the independent contractor.

The information in each contract will indicate whether or not the worker is an employee eligible for benefits or an independent contractor. Contracts should include information regarding:

- Scope of work/services being provided
- Project duration and/or deadline for provided services
- Payment
- Tax payments and indemnity clauses
- A list of requirements of the contractor, including business insurance and any training needed for the job
- Confidentiality clauses, if they apply

Remember, it’s all about control and economic dependency. As a result, it’s essential to factor in the working conditions and relationship between the employer and person hired when determining if someone is actually an employee or independent contractor.

For example, a non-compete clause should never be present in an independent contractor’s contract – unless it’s narrowly written and allowed in the state where the independent

contractor would be working. States, such as Florida, allow employers to have non-compete agreements with their independent contractors.

In addition, it is recommended that organizations have a non-disclosure agreement with every independent contractor they use and stipulate that independent contractors should not be allowed to solicit clients or prospective clients – even if they will have access to those clients. By restricting who the worker can provide services to, the company makes them economically dependent on their relationship with it.

TIP 3: Similarly, the company cannot include the means and manner by which the work is accomplished within the contract’s scope. It can, however, include the expected quality and outcome of the work.

4. ESTABLISH A CYCLE OF DUE DILIGENCE AND REVIEW.

Like any other operating process within the business, employment practices for independent contractors should be consistent and followed by every member of the organization. This includes individuals with significant authority who may feel their power allows them

to dictate rules as they see fit. There are legal and financial consequences to inconsistency.

Training is a great example for businesses with hazardous operations. If independent contractors are not required to verify proper training for the tasks they will perform at your organization, OSHA can hold the business liable for any reported incident. You have to prove that you trained or collected proof of training before the contractor was put to work. The same can be said for proof of insurance.

For industries like health care, where independent contractors such as dentists may bring in their own staff of dental assistants, the contract and documentation requirements extend to each of these additional contractors.

TIP 4: If resources allow, dedicate staff to ensure proper adherence to and maintenance of your independent contractor employment practices. Steps are less likely to be missed or processes overlooked when it is clear who is responsible.

TALES OF MISCLASSIFICATION

Small to mid-size businesses often assume they can fly under the radar when it comes to claims of misclassification. But the reality is a claim that an independent contractor is really an employee can happen in just about any industry, to just about any business, with just about any scenario you can imagine. Here are three claims stories.

01

WHAT DOES EIGHT YEARS OF DRIVER MISCLASSIFICATION COST?

Joint logistics employers Parts Authority and Diligent Delivery Systems paid \$2.8 million each — totaling \$5.6 million — in back wages and liquidated damages, as determined by the U.S. District Court for the District of Arizona.⁸

From April 2012 to March 2020, it was determined that the companies misclassified almost 1,400 drivers as independent contractors and failed to meet minimum wage requirements, pay time-and-a-half for hours over 40 in the workweek, and keep required timekeeping records.

8 U.S. Department of Labor "News Release: Department of Labor Obtains Judgment Ordering Auto Parts Seller, Logistics Company to Pay \$5.6M to 1,398 Misclassified Drivers," January 12, 2023.



02

ARE GOLF CADDIES INDEPENDENT CONTRACTORS?

The sports and athletics industry is flush with misclassification court cases, from referees to security guards, cheerleaders to arena crew members. A few cases involving golf caddies in New York⁹ and New Jersey¹⁰ were filed in late 2022 and early 2023, bringing into question whether caddies are employees or independent contractors. Let's take a look.

CONTROL: At the clubs in these cases, the caddie master was responsible for assigning caddies to golfers, taking the control of their own schedule away from the caddies. At the same time, caddies were unable to reject any assignments.

ECONOMIC DEPENDENCY: While caddies are free to work at as many clubs as they like, caddies who demonstrate loyalty to a particular club have been known to benefit by having more golfers assigned to them, obtaining higher compensation as a result. Golf clubs also tend to set bag fees, which serves as the caddie's rate.

THE RELATIONSHIP: Most golf clubs require golfers to use caddies, and the service the caddies provide is directly related to the clubs' central business. This suggests an employee-employer relationship.

9 Bloomberg Law "NY Golf Club Misclassified Caddies, Owes Wages, Lawsuit Says," January 23, 2023.

10 Patch "Employee Sues Morristown Golf Club Over Labor Wage Dispute," October 13, 2022.

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KELLEY KRONENBERG

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WHO IS HELD LIABLE FOR MISCLASSIFICATION?

A complaint was filed against Wellfleet Communications on behalf of its sales telemarketers who claimed to receive less than minimum wage, and as little as \$3 for an entire work week.¹¹

The DOL investigation showed that over 1,300 call center workers, who worked a minimum of 32 hours per week for Wellfleet, were misclassified as independent contractors and therefore paid only when they made sales.

The company owners were held personally liable after the DOL investigation.¹² The ruling ordered the company to pay over \$1.4 million in back wages and liquidated damages.

11 Las Vegas Review-Journal "Las Vegas telemarketer sued for shorting workers' pay," October 20, 2016.

12 U.S. Department of Labor "Federal Court Finds Las Vegas Company, Management Employees Owe \$1.4M in Back Wages, Damages Paid to 1,328 Call Center Workers," November 2, 2021.



WHY THIS MATTERS NOW

The government's definitions for what is an employee and an independent contractor can be somewhat confusing and vague, but know that misclassification is receiving increased attention by both the current White House administration and at the state level as well.

Misclassification is not always an attempt at avoiding insurance coverage and other benefits to employees, like the government might fear. When the standards are unclear, employers are more likely to inadvertently misinterpret the guidelines.

The cost for this misinterpretation can be significant for employers. Engaging expertise and tightening up employment practices can save businesses from time consuming audits and expensive settlements.



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