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## Employee v. Independent Contractor: A Critical Distinction

It is not uncommon for employers to enter into written contracts with their employees, which establish important terms such as the length of employment, job duties and responsibilities, and salary and benefits. Indeed, park districts often have contracts with their executive directors. Where such an employment contract exists, the subject individual is sometimes referred to as a contract employee.

However, I have also heard organizations use the term contract employee to refer to a worker who is actually an independent contractor. Independent contractors are not contract employees of the organization. By definition, they are not employees at all.

The difference in terminology is not semantics, and using the incorrect term can be indicative of a larger problem for the organization. In fact, failing to properly distinguish between employees and independent contractors can have serious financial consequences. Therefore, understanding the characteristics of each of these classifications is critical to an agency's operations.

### When the Problem Occurs

The pitfalls to be avoided typically arise when an entity wants to engage an individual as an independent contractor and avoid an employment relationship. Organizations retain independent contractors all the time. But when the independent contractor is a sole proprietor and is not another organization, there is a greater risk of misclassification.

There are numerous reasons organizations sometimes wish to utilize the services of an independent contractor rather than hire an employee. For instance, the services may only be needed on a short-term basis. The agency may be unable to afford the extra costs associated with employees such as pension payments, increased insurance premiums and personnel benefits. The requisite services may be so specialized that it is cost prohibitive for an organization to hire, train and maintain an employee to perform those services. Whatever the reason, if an organization wants to avoid certain financial obligations associated with employees that are not incurred with independent contractors, it is imperative that it take proper steps to establish the appropriate relationship with the worker being retained. It is not enough to merely call a worker an independent contractor.

### Treatment, Not Terminology, Is Key

Simply using the wrong term to refer to a worker does not create the issue. The problem arises when there is a difference between the way an organization classifies a worker and the way the organization treats that worker. In other words, if a worker is properly classified as an independent contractor based upon the way the organization treats him or her, just referring to the worker as a "contract employee" may be of little consequence. By the same token, if the organization classifies the worker as an independent contractor but treats the worker like an employee, there is an issue.

Contrary to the belief of many, establishing an independent contractor relationship is not as easy as entering into a contract stating

that the worker is performing the services as an independent contractor and not as an employee. While such language should be included in a contract when appropriate, courts and regulatory agencies such as the IRS have made it clear that stating that an individual is an independent contractor is insufficient to avoid an employer-employee relationship if it otherwise exists based upon the worker's treatment. Therefore, both the organization and the worker must understand the different characteristics between these two classifications to avoid unintentionally triggering an employment relationship.

### Why the Distinction Matters

As discussed above, organizations sometimes enter into independent contracts to avoid financial obligations associated with employees. Consequently, if the entity classifies a worker as an independent contractor with the intention of saving these costs but ends up treating the worker like an employee, the entity remains legally responsible.

These financial responsibilities are well known to employers. They include items that are withheld from an employee's paycheck such as income tax and employment taxes, i.e., Social Security and Medicare. Conversely, the worker, not the organization, is generally responsible for these payments if he or she is an independent contractor. For local government agencies, IMRF contributions are withheld from an employee's paycheck but not an independent contractor's.

Payroll deductions are not the only obligations an organization has for employees that it does not have for independent contractors. Illinois law also requires employers to pay workers' compensation and unemployment insurance for their employees. In the case of Social Security, Medicare and IMRF, the organization must also make employer contributions. Again, an organization would not have these obligations for independent contractors.

Failure to properly classify a worker can have consequences reaching back to the start of the relationship. For example, if the IRS uncovers a misclassification for which there is no reasonable basis during an audit, the organization will ultimately be liable for back payments of past due amounts that it failed to withhold or contribute. Similarly, if the IMRF discovers that one of its member-employers has misclassified an employee as an independent contractor, the IMRF will assess that member-employer for all retroactive employer contributions.<sup>1</sup> The employee would be assessed for his or her unpaid employee contributions and would also be required to reimburse the IMRF for any retirement benefit overpayments.

The consequences of a worker's misclassification are not limited to back payments for tax and pension liabilities. The applicability of labor laws relating to overtime and minimum wage depend on whether a worker is an employee or independent contractor, as does eligibility for unemployment benefits and both the benefits and protections of workers' compensation laws. For these reasons, it is imperative that an organization properly classifies the worker from the beginning of the relationship.

## Factors Used to Make the Determination

Unfortunately, there is no single rule that applies to every case, and the criteria used can vary based upon the relevant statute. In the absence of a uniform test, arguably the best guidance on this matter comes from the IRS, which applies the common law and will actually make a determination of worker status for purposes of federal employment and income taxes upon request. Because the IRS' decision is binding, organizations and workers may be hesitant to make a formal request. Nevertheless, the published criteria the IRS uses to determine whether a worker is an independent contractor or an employee provide insight that can be used to avoid misclassification.<sup>2</sup>

The following common law factors the IRS uses are taken from judicial and administrative decisions and fall within three broad categories.

### 1. Behavioral Control

The behavioral aspects of a worker's relationship to the organization are important to every regulating agency's analysis. This evaluation deals with whether the organization or the worker has the right to direct or control how the worker will perform the work. If the organization has the right to direct or control how the work will be done, then the worker is an employee.

For example, if the agency gives extensive instructions on how, when and where to do the work, the worker is likely an employee. Similarly, if the organization trains the worker on required procedures and methods to perform work in a certain way, the worker is likely an employee. However, if the worker sets his or her own hours, hires his or her own assistants and uses his or her own methods to perform the services, he or she may well be an independent contractor. Note that for purposes of this evaluation the organization does not actually have to direct or control the manner in which the work is performed if it has the right to do so.

### 2. Financial Control

This category examines whether the worker or the organization has the right to direct or control financial aspects related to the services being performed. If a worker has a significant investment in his or her work, he or she is more likely an independent contractor according to the IRS. So, if the worker provides all the supplies, equipment, tools and materials to perform the services and is not reimbursed for any of his or her expenses, he or she is more likely an independent contractor. On the other hand, if the worker is paid by the hour, has no financial risk beyond loss of salary and is paid regardless of performance, he or she is more likely an employee.

### 3. Worker and Firm Relationship

The IRS also considers how the worker and organization perceive their relationship. Oftentimes, contract terms are suggestive of one

classification over the other. If the contract guarantees benefits such as insurance and paid leave, the worker is probably an employee. Provisions allowing either party to terminate the relationship without penalty suggest an employment relationship. Although the terminology used to refer to a worker in a contract is not dispositive of the relationship, the IRS has indicated that it can be "very significant" if it is difficult or impossible to determine the worker's status based on other factors.

The permanency of the relationship between the parties and whether the services provided are a key component of an organization's regular business are also relevant. A temporary relationship for services ancillary to an organization's core functions favor classification as an independent contractor.

An individual's activities when not working for the organization can indicate the type of relationship a worker has with an organization. If a worker advertises his or her services and has an established business, the worker is likely a sole proprietorship with independent contractor status. Likewise, if the worker does not work exclusively for the organization but has similar contracts with other entities, he or she may well be an independent contractor. This is particularly true if the worker is not required to get permission from the organization to perform outside services to others.

## Criteria Used by Other Regulators

Although there is no uniform test for making the determination under every law, other regulators also appear to apply factors similar to the IRS. For example, the IMRF and the Illinois Worker's Compensation Act appear to follow common law guidelines for determining worker status.<sup>3</sup> On the other hand, the Illinois Unemployment Insurance Act presumes that an individual is an employee unless specific facts set forth in the statute are proven.<sup>4</sup> Another set of statutory criteria for making the determination under Illinois law was recently established for construction industry workers.<sup>5</sup> Again, while inconsistency in these standards adds to the confusion, the consequences for misclassification are no less severe.

## Summary

Misclassifying a worker as an independent contractor can have serious financial consequences that reach back to the beginning of the relationship. Because each determination must be made on a case-by-case basis and the criteria used vary, this column is necessarily limited to providing background on the issue to highlight its importance to IAPD members. As with any matter requiring legal or accounting advice, your agency should consult its local counsel and accounting professional for guidance if there is any doubt about whether a worker is an employee or independent contractor.

<sup>1</sup> See e.g., General Memorandum Number 604 (October 15, 2010)

<sup>2</sup> See Form SS-8 and Instructions (Rev. 12-2009); IRS Publication 1779: Independent Contractor or Employee . . . (Rev. 8-2008); Publication 15-A: Employer's Supplemental Tax Guide 2011; Topic 762 Independent Contractor v. Employee

<sup>3</sup> See 820 ILCS 305/1 *et seq.*

<sup>4</sup> 820 ILCS 405/212

<sup>5</sup> See 820 ILCS 185/10

## EMPLOYEE OR INDEPENDENT CONTRACTOR? Factors Suggesting . . .

### Independent Contractor

Worker uses own methods to perform services  
[Worker is paid a flat fee based on project](#)  
Worker provides similar services to others  
[Worker hires assistants to help with services](#)  
Project or services are to be completed by a certain date  
[Worker has ongoing unreimbursable expenses](#)  
Worker decides where to purchase supplies and materials  
[Worker sets his or her own hours](#)  
Work performed at worker's location  
[Worker supplies own tools and equipment](#)

### Employee

Organization trains worker to perform services in a particular manner  
[Worker is guaranteed regular hourly wage with benefits/paid leave](#)  
Worker provides services exclusively to organization  
[Organization hires additional assistants](#)  
Term of relationship is indefinite  
[All expenses are reimbursed](#)  
Organization provides all supplies and materials  
[Organization sets worker's hours](#)  
Work performed at organization's location  
[Organization provides tools and equipment](#)