

Misclassification of Independent Contractors

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A common and potentially costly mistake made by employers is the misclassification of employees as independent contractors. Employers may wish to retain workers as independent contractors as opposed to employees on short-term projects, to avoid the payment of cash compensation or benefits, or to accommodate a worker's request. However, state and federal laws narrowly define the circumstances under which independent contractor status is available, and employers have certain duties to their employees under state and federal law. For example, employers must pay minimum wage, make appropriate withholdings and payments on behalf of employees (*e.g.*, taxes, FICA, workers' compensation, etc.), and employers that maintain benefit plans must provide benefits to those individuals (usually defined as "employees") who meet the stated requirements for plan participation.

While the definition of "employee" and "independent contractor" may differ under different statutes,¹ the tests used to distinguish between the two overlap significantly. The most important factor generally considered is the extent of the control exercised by the employer/organization over the worker. Courts may also consider the nature of the work and the way the work relates to the employer's overall business.²

Some of the varying contexts include the following:

- For federal tax purposes, the IRS uses a multi-factor test to determine whether an individual is an employee or independent contractor. The IRS test focuses on the behavioral and financial control the employer exerts over the worker, as well as key characteristics of the relationship to which the parties have agreed.³

¹ For example, to determine if an individual worker qualifies as an "employee" for purposes of the Americans with Disabilities Act, ERISA, Age Discrimination in Employment Act (ADEA), and other statutes that do not provide a meaningful definition of employee, the common-law touchstone of control is the most important consideration. *Clackamas Gastroenterology Assoc. v. Wells*, 538 US 440 (2003). On the other hand, to determine the relationship between the parties for purposes of the Fair Labor Standards Act (FLSA), courts do not use this common-law test of master and servant, and rely instead on an economic realities test. *See* Department of Labor Fact Sheet No. 013, <http://www.dol.gov/esa/regs/compliance/whd/whdfs13.htm>; *see also infra* note 9 and accompanying text.

² *Rubalcaba v. Nabaki Farms, Inc.*, 333 Or 614, 619 n.2, 43 P3d 1106 (2002).

³ *See* IRS Publication 15-A. The elements of behavioral control include: (a) the instructions the business gives the worker, and (b) the training the business gives the worker. Financial control includes: (a) the extent to which the worker has unreimbursed business expenses, (b) the extent of the worker's investment, (c) the extent to which the worker makes services available to the relevant market, (d) how the business pays the worker, and (e) the extent to which the worker can realize a profit or loss. The issues related to the type of relationship between the parties includes: (a) definitions in written contracts describing the

- For Oregon income and unemployment tax, contractor licensing and other purposes, the individual must satisfy each of five requirements for an individual to qualify as an independent contractor. Among other things, (1) the individual must be free from direction and control over the means and manner of performing the work (subject only to the company's right to specify the desired results); (2) the individual must be customarily engaged in independently established business; and (3) the individual must be responsible for obtaining any licenses or certificates necessary to provide the services.⁴
- For purposes of Oregon's workers compensation laws, a court will first consider the employer's right to control the employee's performance.⁵ If the court finds some evidence of control, the court may then consider factors relevant to the nature of the work, including "whether the work is integral to the employer's business, and whether the individual, in relation to the employer's business, is in a business or profession of his or her own."⁶
- For purposes of a wage claim, ORS 652.210(2) defines an employee as an individual, *other than a copartner or an independent contractor*, who renders service to an employer for a fixed salary or rate.⁷ In this context, the terms and conditions of the employment relationship, as defined by contract or agreement, are relevant.⁸

Although no one factor is conclusive, any of the following circumstances would suggest employee, as opposed to independent contractor, status:

- (1) The individual is hired to perform duties that are currently being performed by employees working for the employer;

relationship the parties intended to create, (b) whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay, (c) the permanency of the relationship, and (d) the extent to which services performed by the worker are a key aspect of the regular business of the company. For a further explanation, see IRS Publication 15-A, <http://www.irs.gov/pub/irs-pdf/p15a.pdf>; see also <http://www.irs.gov/govt/fslg/article/0,,id=110344,00.html>.

⁴ ORS 670.600, as revised in 2005 (copy attached), becomes effective on January 1, 2006. The Oregon Department of Revenue recently took the position that corporate directors who do not meet the definition of "independent contractor" under ORS Chapter 670 must be treated as employees for state tax purposes. "Advisors" will come under the same scrutiny. See also, *Pacificab Co. v. Employment Dept.*, 187 Or App 693, 69 P3d 774 (2003) (for purpose of unemployment compensation eligibility, cab driver was employee and not an independent contractor because she did not represent to the public that her services were provided by an independently established business).

⁵ ORS 656.005(30) (defining worker as any person who furnishes services for remuneration subject to the direction and control of an employer); see also, *S-W Floor Cover Shop v. Natl. Council on Comp. Ins.*, 318 Or 614, 621-22, 872 P2d 1 (1994) (if court finds some evidence of employer's right to control performance of work, it may consider other factors relevant to the nature of the work, including "whether the work is integral to the employer's business, and whether the individual, in relation to the employer's business, is in a business or profession of his or her own.").

⁶ *Rubalcaba v. Nabaki Farms, Inc.*, 333 Or 614, 619 n.2, 627, 43 P3d 1106 (2002).

⁷ *Thompson v. Bolliger, Hampton & Tarlow*, 118 Or App 700, 849 P2d 526 (1993).

⁸ *Id.*, 118 Or App at 701-702.

- (2) The individual will be supervised by an employee of the employer;
- (3) The individual will work exclusively for the employer;
- (4) The individual will be paid a consistent, periodic payment regardless of the quality or quantity of work performed during the period;
- (5) The individual will be reimbursed for business/travel expenses;
- (6) The individual will work on the employer's premises, use the employer's equipment, and/or be integrated into the employer's business (*e.g.*, have a telephone extension, attend meetings, receive training, regularly interact with the employer's employees in connection with performance of his/her duties);
- (7) The individual works for the employer for an extended period of time;
- (8) The individual does not maintain his/her own business.⁹

The failure to properly characterize those individuals who meet the definition of "employee" could have serious consequences. Both federal and state laws require payment of minimum wage and overtime to non-exempt employees, and a minimum salary to exempt employees (subject to certain limited exceptions).¹⁰ In addition, employers must maintain accurate records of all hours worked by non-exempt employees.¹¹ The minimum wage, overtime, and salary requirements applicable to employees **cannot** be satisfied by stock or other forms of non-cash compensation that may be paid to independent contractors. In addition to exposure for minimum wage and overtime, the failure to pay cash compensation may subject a non-complying employer to claims for final pay violations.¹²

Non-complying employers may also be required to pay amounts that should have been withheld or paid on the employees' behalf (*e.g.*, taxes, FICA, minimum wages, overtime pay, benefit contributions, the value of lost benefits), plus penalties, interest, other damages, and/or attorney fees.¹³ Workers sustaining work-related injuries, who would otherwise be required to rely on solely on workers compensation benefits, may be able to assert a negligence claim against the employer. The worker may also assert claims for harassment or discrimination, which are otherwise unavailable to an independent contractor.

⁹ See attached checklist for meeting statutory criteria in Oregon.

¹⁰ See 29 USC § 206(a) (establishing federal minimum wage at \$5.15 for non-exempt employees); 29 USC § 207(a) (requiring payment of overtime to non-exempt employees for hours worked in excess of 40 in one work week); ORS 653.261(1) (requiring payment of overtime to non-exempt employees for hours worked in excess of 40 in one work week); 29 CFR § 541.600 (establishing a minimum salary of \$455 per week for exempt employees, subject to limited exceptions); ORS 653.025 (establishing the minimum wage in Oregon); ORS 653.010(9) (defining "salary" under Oregon law as no less than the state minimum wage multiplied by 2,080 hours per year, then divided by 12 months). The current minimum wage under federal law is \$5.15. The minimum wage in Oregon is \$7.50, effective January 1, 2006.

¹¹ 29 USC §211(c); ORS 653.045(1)(b).

¹² See ORS 652.140.

¹³ See, *e.g.*, *Vizcaino v. Microsoft*, 173 F3d 713, *amended*, 184 F3d 1070 (9th Cir 1999), *cert. denied*, 528 US 1105 (2000).

Oregon limits the circumstances under which an employer may impose restrictions on competition by employees, but does not similarly limit the ability to restrict competition by independent contractors.¹⁴ The failure to properly classify a worker for purposes of imposing a noncompete may render such an agreement unenforceable.

In light of the potential risks, it is important to properly characterize the employment relationship at its inception, and to confirm that the characterization is consistent with the employer's definitions and intent as set forth in any contracts and company benefit plans. Prior to entering into a consulting or independent contractor relationship with anyone, the employer should, at a minimum, confirm the following:

- (1) Whether or not the individual maintains a business;
- (2) Whether the individual holds a business license;
- (3) Whether or not the individual maintains a business location;
- (4) Whether or not the individual works for any other individual or entity and, if so, in what capacity;
- (5) Whether the individual owns or has rights to the information, equipment and services to be provided;
- (6) Whether the individual carries business insurance.

It is important to remember that the foregoing factors and considerations are not exhaustive. In each case, the employer must make a determination based on the particular facts.

¹⁴ See ORS 653.295.

**CHECKLIST REGARDING
INDEPENDENT CONTRACTORS IN OREGON**

Effective January 1, 2006, an individual must meet the following criteria to be considered an independent contractor for purposes of ORS 670.600.	Yes	No
1. Is the Individual free from direction and control of the company in means and manner of work (subject only to company's right to specify desired results)?		
2. Does the individual meet at least <u>three</u> of the following criteria (showing that the individual is customarily engaged in an independently established business)? <ul style="list-style-type: none"> a. The individual maintains a business location that is: (1) separate from the business or work location of the person for whom the services are provided, or (2) that is in a portion of the individual's residence that is used primarily for business. b. The individual bears the risk of loss related to the business or the provision of services as shown by factors such as: (1) entering into fixed price contracts; (2) being required to correct defective work; (3) providing service warranties; or (4) maintaining indemnification agreements, liability insurance, bonds or E&O liability insurance. c. The individual provides contracted services for two or more different persons within a 12-month period, or routinely engages in business advertising, solicitation or other marketing efforts reasonably calculated to obtain new contracts to provide similar services. d. The individual makes significant investment in his/her business through means such as: (1) purchasing tools or equipment; (2) paying for the premises or facilities where services are provided; or (3) paying for licenses, certificates or specialized training required to perform the services. e. The individual has the authority to hire and fire other persons to provide or assist in providing the services. <p>____ Total</p>		
3. Is the individual is licensed under ORS chapter 671 (applicable to architects and landscape architects and contractors) or 701 (applicable to construction contractors), as applicable, or responsible for obtaining any licenses or certificates necessary to provide the services?		

INDEPENDENT CONTRACTOR STANDARDS IN OREGON

ORS 670.600:

- (1) As used in this section:
 - (a) 'Individual' means a natural person.
 - (b) 'Person' has the meaning given that term in ORS 174.100.
 - (c) 'Services' means labor or services.
- (2) As used in ORS chapters 316, 656, 657, 671 and 701, 'independent contractor' means a person who provides services for remuneration and who, in the provision of the services:
 - (a) Is free from direction and control over the means and manner of providing the services, subject only to the right of the person for whom the services are provided to specify the desired results;
 - (b) Except as provided in subsection (4) of this section, is customarily engaged in an independently established business;
 - (c) Is licensed under ORS chapter 671 or 701 if the person provides services for which a license is required under ORS chapter 671 or 701; and
 - (d) Is responsible for obtaining other licenses or certificates necessary to provide the services.
- (3) For purposes of subsection (2)(b) of this section, a person is considered to be customarily engaged in an independently established business if any three of the following requirements are met:
 - (a) The person maintains a business location:
 - (A) That is separate from the business or work location of the person for whom the services are provided; or
 - (B) That is in a portion of the person's residence and that portion is used primarily for the business.
 - (b) The person bears the risk of loss related to the business or the provision of services as shown by factors such as:
 - (A) The person enters into fixed-price contracts;
 - (B) The person is required to correct defective work;
 - (C) The person warrants the services provided; or
 - (D) The person negotiates indemnification agreements or purchases liability insurance, performance bonds or errors and omissions insurance.
 - (c) The person provides contracted services for two or more different persons within a 12-month period, or the person routinely engages in business advertising, solicitation or other marketing efforts reasonably calculated to obtain new contracts to provide similar services.
 - (d) The person makes a significant investment in the business, through means such as:
 - (A) Purchasing tools or equipment necessary to provide the services;
 - (B) Paying for the premises or facilities where the services are provided; or
 - (C) Paying for licenses, certificates or specialized training required to provide the

services.

- (e) The person has the authority to hire other persons to provide or to assist in providing the services and has the authority to fire those persons.
- (4) Subsection (2)(b) of this section does not apply if the person files a Schedule F as part of an income tax return and the person provides farm labor or farm services that are reportable on Schedule C of an income tax return.
- (5) For purposes of determining whether an individual provides services as an independent contractor:
 - (a) The creation or use of a business entity, such as a corporation or a limited liability company, by an individual for the purpose of providing services does not, by itself, establish that the individual provides services as an independent contractor.
 - (b) When the individual provides services through a business entity, such as a corporation or a limited liability company, the provisions in subsection (2), (3) or (4) of this section may be satisfied by the individual or the business entity.

ORS 670.605

- (1) In accordance with ORS chapter 183, those agencies responsible for the administration of ORS 671.510 to 671.710 and ORS chapters 316, 656, 657 and 701 jointly shall adopt rules to carry out the provisions of ORS 670.600.
- (2) The agencies responsible for the administration of ORS 671.510 to 671.710 and ORS chapters 316, 656, 657 and 701 shall cooperate as necessary in their compliance and enforcement activities to ensure among the agencies the consistent interpretation and application of ORS 670.600.