# Independent Contractor or Employee?

## Mitigating Legal Risk Associated With the Classification of Workers

*by Tara Stingley and Sydney Huss*

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Employers and workers continue to navigate their obligations, preferences, and business needs in the aftermath of the COVID-19 pandemic. Workers' demands for flexibility and alternative work arrangements remain strong.[1] In some contexts, independent contractor status may work well for both workers and employers. When using workers properly classified as independent contractors, companies generally are not required to comply with minimum wage or overtime pay requirements under the Fair Labor Standards Act; to pay unemployment tax, state or federal income tax, Social Security, or Medicare taxes for independent contractors; or to include independent contractors in retirement and benefits plans.[2]


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However, employers—and the attorneys advising them—should be aware of increasing government scrutiny of independent contractor classifications, the legal standards governing classification of workers, and the penalties and risks associated with misclassification. This article will discuss each of these issues in turn.

## I. Properly Classifying the Working Relationship

Currently, there is no universal definition to determine whether a worker is an employee or an independent contractor. Rather, this determination requires consideration of several factors. While such grey areas can be frustrating to companies looking for clear guidance in their business practices, the rel-

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evant factors may grant flexibility in organizing a workforce. In properly classifying working relationships, Nebraska employers and their attorneys should be aware of three distinct, but interrelated, legal tests.

## A. The Common Law Test

The U.S. Supreme Court, the 8th Circuit Court of Appeals, and the Nebraska Supreme Court all have adopted a non-exhaustive list of factors derived primarily from the Restatement (Second) of Agency.[3] The Nebraska Supreme Court in particular uses these factors in evaluating working relationships under the Nebraska workers' compensation statutes.[4] In determining whether a worker is an employee or an independent contractor under a "common law" test, the following factors are considered:[5]

1. Extent of control which the business exercises over the worker
2. Whether the worker is engaged in a distinct occupation or business
3. The kind of occupation, with focus on whether work is usually done with or without supervision and direction
4. The skill required in the particular occupation
5. Who supplied the instrumentalities, tools, and place of work
6. Length of time for which the worker is engaged
7. Method of payment—whether by the time or by the job
8. Whether the work is part of the regular business of the employer
9. Whether the parties believed they were creating an agency relationship
10. Whether the worker is or is not in the same business

In weighing these factors, one must consider all characteristics of the working relationship, with no one factor being decisive or conclusive.[6] Such an inquiry "requires more than simply tallying factors on each side and selecting the winner on the basis of a point score."[7]

Notably, while not determinative in itself, the "right to control" is generally the most important factor to be considered in determining whether a worker is more properly classified as an employee.[8] "However, even the employer of an independent contractor may, without changing the status, exercise such control as is necessary to assure performance of the contract in accordance with its terms."[9]

## B. The Internal Revenue Service

The Internal Revenue Service ("IRS") uses a three-factor test that considers those facts providing evidence of the degree of control over and independence of the worker:

1. *Behavioral*: Does the company control or have the right to control what the worker does and how the worker does their job?
2. *Financial*: Are the business aspects of the worker's job controlled by the payer, such as how the worker is paid, whether expenses are reimbursed, and who provides the tools and supplies?
3. *Type of Relationship*: Are there written contracts or employee type benefits (i.e., pension plan, insurance, vacation pay, etc.)? Will the relationship continue, and is the work performed a key aspect of the business?[10]

Like the common law test, the IRS test focuses primarily on the "right to control" and recognizes there is no "magic" number of factors that makes a worker an employee.[11]

If worker status is unclear, the IRS authorizes filing of a "Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding."[12] This form can be filed by either the business or the worker. Following the filing of a Form SS-8 and review of the facts and circumstances surrounding the employment relationship, the IRS will issue an official determination of the worker's status.

## C. The Employment Security Law, Neb. Rev. Stat. § 48-604(5)

Finally, for purposes of determining whether an individual is an "employee" entitled to unemployment compensation, Nebraska employers must utilize the statutory analysis set forth under Nebraska's Employment Security Law, codified at Neb Rev. Stat. § 48-604(5) (Reissue 2021). The Employment Security Law is not (and was never intended to be) a codification of common law.[13] Furthermore, unlike the common law and IRS tests, the Employment Security Law does not adopt a "totality of the circumstances" analysis. Rather, under this statute, services performed by an individual for wages, including wages received under a contract of hire, *shall* be deemed to be "employment" *unless* the hiring party satisfies each of the following three factors:

1. The individual has been and will continue to be free from control or direction over the performance of services—both under the contract of service and in fact;
2. The individual's service is outside the usual course of the business for which such service is performed, or such service is performed outside

of all the places of business of the enterprise for which such service is performed; and

3. The individual is customarily engaged in an independently established trade, occupation, profession, or business.[14]

## D. Common Elements of Classification Inquiries

Notwithstanding their somewhat distinct nature, these tests share several common elements. Businesses seeking compliance with these various legal and regulatory requirements should focus on the following factors to properly classify the working relationship:

- *Nature, degree, and extent of control over the worker*: Consider whether, and to what extent, the business actually controls or has a right to control the worker and the performance of the job. What kind and amount of instruction or commands does the business give the worker? Greater control suggests an employment relationship, whereas little or no control leans in favor of an independent contractor relationship.
- *Duration or permanency of the relationship*: How long will the company engage the worker? The longer or more permanent the relationship, the more likely the worker is an employee.
- *Financial considerations*: Consider who bears the risk of loss in the working relationship. Does the worker face opportunity for profit, with no corresponding potential for loss? If so, the worker is more likely to be an employee. Also consider the method of payment. While independent contractors are usually paid a flat fee or paid by the job, as opposed to by the hour, this may vary among industries, professions, and jobs.
- *Level of skill required*: Consider the level of skill and independent judgment utilized by the worker. The greater the amount of initiative, independent judgment, or skill required or used by the worker, and the less training required by the worker, the more likely the worker is an independent contractor.
- *Integration of business and worker*: Consider how closely the businesses and work of the principal and worker are integrated. If the worker is dependent on this work or business for their continued livelihood, the worker is more likely to be an employee. In contrast, if the worker performs work for several companies and is less dependent on any single company or job, the worker is more likely to be an independent contractor.

- *Training*: Consider whether the worker required training from the company before they could perform their work. The more training required or necessitated, the more likely they are an employee. In contrast, independent contractors generally require little or no training.
- *The parties' intent*: Finally, what kind of relationship did the parties intend to create? Written contracts describing the relationship generally provide the best evidence of the parties' intent. However, consideration should also be paid to the types of benefits provided to the worker, the supplier of the worker's "tools" and place of work, the location of the worker, and the subjective intent of the parties themselves.

## II. Recent Action by the Federal Government

As previously noted, governmental agencies have indicated their intent to more closely monitor companies to ensure proper classification of workers. Among these agencies is the U.S. Department of Labor ("DOL"), charged with enforcing the FLSA.

The DOL has traditionally used an "economic realities" test to determine the degree to which the worker is economically dependent on the employer. In October of 2022, the DOL issued a notice of proposed rule entitled *Employee or Independent Contractor Classification Under the Fair Labor Standards Act*.[15] As justification for the rule, the DOL argues that "the misclassification of employees as independent contractors remains one of the most serious problems facing workers, businesses, and the broader economy." The DOL further asserts that a clarified rule is necessary to reduce confusion and accommodate changing work arrangements.[16]

The rule broadly proposes utilizing a totality of the circumstances factor test similar to the common law test, with a "focus on whether each factor shows the worker is economically dependent upon the employer for work versus being in business for themself . . ."[17] These factors include:

1. *Opportunity for profit or loss depending on managerial skill*: whether the individual can exercise their own "exercise of initiative (such as managerial skill or business acumen or judgment)."
2. *Investments by the worker and the employer*: whether the worker makes investments particular to a specific job, or otherwise makes investments that support an independent business.
3. *Degree of permanence of the work relationship*: whether the relationship is "definite in duration or sporadic" which favors independent contractor status, or "by design indefinite in duration or continuous" which favors an employee status.
4. *Nature and degree of control*: whether the employer or worker retains substantial control of their own projects, schedule, and workload.
5. *Extent to which the work performed is integral to the employer's business*: whether the work the worker performs is central to the employer's production processes.
6. *Skill and initiative*: whether the work requires specialized training or skill that is not normally provided by the employer.[18]

The comment period for the proposed rule closed in December of 2022, and as of this writing, a final rule has not yet been issued. A prior refinement of the rule was issued, delayed, and ultimately withdrawn, all while being subject to litigation in federal court.[19] Early indications suggest that the new rule could make it more difficult for workers in certain industries to be classified as independent contractors. Accordingly, the DOL's final rule is likely to be challenged as well.[20]

## III. Penalties and Risks Associated with Misclassification of Workers

The importance of properly classifying the working relationship is bolstered by the significant penalties and risks associated with misclassification. Misclassifying workers can lead to numerous violations of federal, state, and local laws and regulations impacted by the employment relationship.[21] In addition, workers can generally bring suit for any rights of which they were deprived by the improper classification. Practitioners should be aware of the following risks and penalties associated with misclassification:

- *Vicarious liability*: Generally, employers are subject to vicarious liability for all torts committed by their employees acting within the scope of their employment.[22]
- *Liability for unpaid wages and overtime payments*
- *Liability for failure to withhold taxes*: This includes payment of back taxes for taxes not withheld or paid, as well as related federal and state penalties. The federal government may impose substantial penalties for misclassifications based upon "reasonable cause"[23] and "willful neglect."[24]
- *Unpaid state unemployment insurance contributions*
- *Workers' compensation benefit payments*
- *Contributions to employee benefit plans for reclassified individuals*

- *Potential liability under anti-discrimination and other federal statutes such as Title VII,*[25] *ADA,*[26] *ADEA,*[27] *and ERISA.*[28]
- *Exposure in the franchise arena*: Franchisors should proceed with caution to ensure proper classification of franchisees as independent contractors and to avoid the significant financial penalties associated with misclassification. For example, in *Roman v. Jan-Pro Franchising International, Inc.*,[29] a putative class of janitors alleged that the franchisor, Jan-Pro, had misclassified them as independent contractors. The court agreed, using a retroactive application of California's narrow test for independent contractor status then approving the certification of the class as misclassified workers with claims for wages, overtime, and various business-related deductions and fees.[30]

## IV. Mitigating Risks Associated with Misclassification

To minimize the legal risks associated with misclassification of workers, businesses should assess each situation individually, considering their organization's needs, the services to be provided, and the extent of control over the proposed worker. Following consideration of these issues, steps should be taken to ensure that the relationship fits the desired classification under all applicable tests. In doing so, however, it is important to remember that actual facts trump mere labels. Simply because a worker is dubbed an "independent contractor" does not make them so.

For those businesses wishing to create an independent contractor relationship, the following safeguards should be considered and implemented.

**First**, businesses should draft and execute a written agreement with the independent contractor. Written agreements are instrumental in articulating the parties' intent and in defending against a misclassification claim. The agreement should: (a) define the relationship as one between businesses, (b) reinforce the independence and separateness between the business and the contractor, (c) state with reasonable particularity the services to be performed, (d) identify the fee to be paid to the contractor, and (e) define the length of the parties' relationship and the manner in which the relationship can be terminated by either party.

**Second**, independent contractors should have their own workers' compensation coverage and be responsible for their own income tax obligations. The business should consider requiring proof of compliance on these points.

**Third**, independent contractors should invoice the business for their work. If practicable, depending upon the nature of the profession and work performed, independent contractors should provide their own transportation, supplies, and tools necessary to perform the work.

**Finally**, the independent contractor's independence should be respected. Specifically, businesses should not attempt to prohibit independent contractors from working for or with others through the use of non-competition clauses. Simply put, if workers are truly "independent" contractors, they should be treated as such.

## V. Conclusion

In light of increased government monitoring of the workforce to ensure proper classification of workers, practitioners should apply increased scrutiny to arrangements whereby businesses engage individuals as independent contractors. In these circumstances, practitioners must be particularly cognizant of the rules governing proper classification of workers, the legal risks associated with misclassification, and the steps necessary to minimize risks associated with misclassification.

## Endnotes

1 *Americans Are Embracing Flexible Work—And They Want More of It*, McKinsey & Co. (June 23, 2022), *available at* https://www.mckinsey.com/industries/real-estate/our-insights/americans-are-embracing-flexible-work-and-they-want-more-of-it.

2 *See* 48B AM. JUR. 2d Labor & Labor Relations § 2768 (2023).

3 *See* Restatement (Second) of Agency, § 220(2) (2023).

4 *Aboytes-Mosqueda v. LFA Inc.*, 306 Neb. 277, 285, 944 N.W.2d 765, 771-72 (2020).

5 *See Cmty. for Creative Non-Violence v. Reid*, 490 U.S. 730, 751-52 (1989); *Gray v. FedEx Package Sys. Inc.*, 799 F.3d 995, 1000 (8th Cir. 2015); *Aboytes-Mosqueda*, at 285, 944 N.W.2d at 771-72.

6 *See Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 324 (1992); *Harris v. Velichkov*, 860 F. Supp. 2d 970, 981-82 (D. Neb. 2012).

7 *Ernster v. Luxco, Inc.*, 596 F.3d 1000, 1005 (8th Cir. 2010) (internal citations omitted).

8 *See Larson v. Hometown Comm'ns, Inc.*, 248 Neb. 942, 954, 540 N.W.2d 339, 358 (1995); *see also Wright v. H & S Contracting, Inc.*, 29 Neb. App. 581, 586, 956 N.W.2d. 329, 334 (2021).

9 *Larson*, at 954, 540 N.W.2d at 358 (quoting *Stephens v. Celeryvale Transport, Inc.*, 205 Neb. 12, 20, 286 N.W.2d 420, 425 (1979)).

10 *See* https://www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee.

11 *See id.*

12 *See* http://www.irs.gov/pub/irs-pdf/fss8.pdf.

13 Neb. Rev. Stat. § 48-604(5) (West 2022).

14 *Id.*

15 *Employee or Independent Contractor Classification Under the Fair Labor Standards Act*, 87 Fed. Reg. 62218 (proposed Oct. 13, 2022) (to be codified at 29 C.F.R. 780, 788, 795).

16 *Id.* at § 3.

17 *Id.* at § 5.

18 *See generally id.*

19 *Id.* at § 2.D.

20 *See e.g.*, *ABC Opposes DOL's Independent Contractor Proposed Rule, Associated Builders and Contractors* | Newsline (Dec. 14, 2022), *available at* https://www.abc.org/News-Media/Newsline/entryid/19729/abc-opposes-dols-independent-contractor-proposed-rule.

21 For example, the Employee Classification Act ("ECA") applies to contractors in the construction and delivery service industries. *See* Neb. Rev. Stat. §§ 48-2901 to 48-2912 (West 2022). Penalties under the ECA may include: (1) collection of unpaid taxes (plus interest), (2) potential referrals to civil and criminal prosecutors, and (3) fines of $500 per misclassified employee for a first offense, and a $5,000 fine per misclassified employee for subsequent offenses. *See* Neb. Rev. Stat. §§ 48-2908 through 48-2909, and 48-2911.

22 *See* Restatement (Third) of Agency § 7.07(1) (2006).

23 Businesses that misclassify individuals based on "reasonable cause" may be liable for the amounts not withheld, interest on those amounts, and penalty payments of 1.5% of the income tax not withheld and 20% of the social security due. *See* I.R.C. § 3509(a).

24 If the misclassification and failure to withhold are based upon "willful neglect," the business is liable for the amounts not withheld, interest on those amounts, and penalty payments of 3% of the income tax not withheld and 40% of the social security due. *See* I.R.C. § 3509(b).

25 Only "employers" can be liable under Title VII of the Civil Rights Act of 1964. *See* 42 U.S.C. §§ 2000e-2(a), 2000e(f). *See, e.g., Schwieger v. Farm Bureau Ins. Co. of NE*, 207 F. 3d 480, 483 (8th Cir. 2000) (denying an insurance agent's Title VII claims against her affiliated insurer where agent was only an independent contractor, and not an employee). Because Title VII contains no specific definition of "employer," courts generally apply the common law test. *See Darden*, 503 U.S. at 323-25 and n. 3.

26 *See* 42 U.S.C. § 12111(4); *see also Wojewski v. Rapid City Regional Hosp. Inc.*, 450 F.3d 338, 342 (8th Cir. 2006) (holding that "while the ADA protects 'employees,' the Act does not protect independent contractors").

27 *See Alexander v. Avera St. Luke's Hosp.*, 768 F.3d 756, 761-62 (8th Cir. 2014) ("We have consistently applied this principle in determining whether a plaintiff asserting claims under the ADA or the ADEA was a protected employee or an unprotected independent contractor.").

28 *See Jammal v. Am. Family Ins. Co.*, 914 F.3d 449 (6th Cir. 2019).

29 *Roman v. Jan-Pro Franchising Int'l Inc.*, 342 F.R.D. 274 (2022).

30 *Id.* at 313.