

Employee or Independent Contractor? Why the distinction between the two is so important

By Scott W. Meier

Over the past six months, I have received several requests to either discuss the independent contractor designation or draft independent contractor agreements. The issues associated with these requests include not only the legal aspects of independent contractor arrangements but also the tax aspects as well. In a time of increasing demand for workers and workforce development, employers often use independent contractors and temporary employees to bolster their workforces. Use of such individuals, however, can be risky if the employer has not properly classified them.

Classifying workers as independent contractors and temporary employees may allow employers to avoid certain payroll taxes and costly employee benefits. Nevertheless, if employers have misclassified workers, the potential damages can include huge amounts for unpaid benefits, taxes and penalties. The simple fact remains that it is not the choice of the person doing the hiring nor the person being hired that determines an individual's status as an employee or an independent contractor, but the factual nature of the relationship between the parties. The financial consequences of incorrectly categorizing workers who are employees as if they were independent contractors can be devastating to the employer.

THE DISTINCTION BETWEEN AN EMPLOYEE AND AN INDEPENDENT CONTRACTOR

The distinction between an "employee" and an "independent contractor" is often blurry. Moreover, the definition of an employee differs by statute. The determination of a person's status is important and has additional implications concerning employer liability for workers' wrongs. This liability depends on the worker's status.

It is helpful to first know who an *employee* is. Sometimes, employers have obligations to employees they do not have to other people; sometimes, employers have obligations to all those the employer engages to work for them, whether or not they are employees.

Several different approaches provide legal definitions of an employee versus a contractor. According to Black's Law Dictionary, an "employee" is "[a] person who works in the service of another person (the employer) under an express or implied contract of hire, under which the employer has a right to control the details of the work performed." BLACK'S LAW DICTIONARY 543 (7th Ed. 1999). Wyoming case law does not define an employee but by reference to the Wyoming statutes. In *SOS Staffing Service, Inc. v. Fields*,¹ the Wyoming Supreme Court stated that for wage claims, the term "employee" ". . . means any person engaged in any extrahazardous employment under any appointment, contract of hire or apprenticeship, express or implied, oral or written, and includes legally employed minors and aliens authorized to work by the United States department of justice, immigration and naturalization service."²

In *Diamond B Services, Inc. v. Rohde*,³ for purposes of wage claims, citing Wyo. Stat. §7-4-501(a)(ii) (LexisNexis 2003), the Wyoming Supreme Court defined “employee” as “any person who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.”⁴

An independent contractor, on the other hand, is one whom someone hires to undertake a specific project, but is generally free to do the assigned work and to choose the method of accomplishing it. The Wyoming Supreme Court in *Diamond B Services* defined an independent contractor as “. . . one who, exercising an independent employment, contracts to do a piece of work according to his own methods and without being subject to the control of his employer except as to the result of the work.”⁵

WHY DOES IT MATTER?

Because employers have different obligations toward employees than independent contractors, properly categorizing those hired becomes extremely important. From a lawyer’s standpoint, probably the most immediate thought that comes to mind with respect to independent contractor/employee issues is the concept of *respondeat superior*. As a matter of public policy and economic requirement, a master is liable for damages caused by the negligence of his servant while acting within the scope of the servant’s employment.⁶ Under this principle, an employer is liable for an employee’s wrongful acts committed within the scope of the employment.⁷

Employers of independent contractors, although potentially responsible for injuries to employees of the contractor, must assume a controlling and pervasive role in work being done to generate any duty of care sufficient to establish vicarious liability for negligence of the independent contractor.⁸ *Respondeat superior* will not operate to impute the tort of an independent contractor to his employer. Nor are employees of an independent contractor entitled to recover from an owner for injuries suffered while doing inherently dangerous work required under a contract with the owner.⁹

While many lawyers can appreciate the doctrine of *respondeat superior*, they may not appreciate the significance of tax related issues associated with the distinction between independent contractors and employees. More important, many lawyers do not realize the significant penalties associated with tax related issues when employers incorrectly categorize those they hire.

From a payroll standpoint, the law does not require employers to make unemployment contributions or pay workers’ compensation assessments for independent contractors. Nor are they required to withhold federal or state incomes taxes, FICA, and Medicare contributions for independent contractors. If, however, the Internal Revenue Service reclassifies a worker as an employee, the employer becomes liable for employment taxes that should have been withheld from the worker’s pay, such as FICA taxes. The employer also becomes liable for the employer’s share of FICA taxes and federal unemployment taxes. Finally, the employer becomes liable for penalties and interest for failure to pay these taxes and file payroll tax returns.

Additionally, the state may assess penalties under its unemployment compensation fund, such as the Wyoming Employment Security Act,¹⁰ its workers’ compensation act, such as the Wyoming Workers’ Compensation Act¹¹ or state income tax withholding if working in other states. Other penalties also include the possibilities of having retirement plans retroactively disqualified,

which could cause all vested accrued benefits to become fully taxable for all employees enrolled in such a plan.¹²

HOW DOES ONE DETERMINE IF SOMEONE IS AN EMPLOYEE OR AN INDEPENDENT CONTRACTOR?

In *Fox Park Timber Co. v. Baker*,¹³ the Wyoming Supreme Court set down a set of guidelines or tests for determining whether one being hired is an employee or an independent contractor. Summarized, they are as follows:

1. Retention of the right of control whether the work is done by the piece or done for a fixed lump sum.
2. Control of the premises where the work is done.

Another test is whether either of the employers possess the right to terminate the services at will without incurring liability to the workers. This test embraces, of course, the right of an employer at any time to discharge the party performing the work, an affirmative answer establishing the status of master and servant.

In 1978, the Wyoming Supreme Court, in *Combined Insurance Company of America v. Sinclair*,¹⁴ held that “[t]he overriding consideration in determining whether one is an employee or an independent contractor lies in ascertaining whether or not the employer has the *right to control* the details of the work whereby liability is sought to be established.”¹⁵

In a more recent decision, the Wyoming Supreme Court in *Cline v. State, Dept. of Family Services* held that “[t]he control of the work reserved in the employer which effects a master-servant relationship is control of the means and manner of performance of the work, as well as of the result[.]”¹⁶ Again in 2004, the Court in *Coates v. Anderson* stated:

Such a right to control is a prerequisite of the master-servant relationship. Conversely, the absence of such a right of control is a prerequisite of an independent contractor relationship. Master-servant and independent contractor are thus opposite sides of the same coin; one cannot be both at the same time with respect to the same activity; the one necessarily negatives the other, each depending on opposite answers to the same right of control inquiry.¹⁷

Finally, in October 2005, the Court in *Diamond B Services, Inc.* reiterated that the overriding consideration in Wyoming in determining whether one is an employee or an independent contractor is whether the employer has a right to control the details of the work whereby liability is sought to be established.¹⁸

The question of right to control, however, does not hinge on whether the employer exercised that control. In *Combined Insurance*, the Court stated that in determining whether one is an employee or an independent contractor, “[t]he base determining factor is whether [the employer] retained *the right of control . . . and not whether such control was in fact exercised.*”¹⁹

A *specific agreement* alone does not make an employee out of a contractor because it affects only the basic contractual relationship itself. In *Diamond B Services, Inc.*, the Court stated that “[w]hen an express contract exists between the parties, it is important evidence in defining the relationship, although it is not conclusive of the issue.”²⁰ Other factors that are important in determining the status of the worker include the method of payment, the right to terminate the

relationship without incurring liability, the furnishing of tools and equipment, the scope of the work and the control of the premises where the work is to be done.²¹ Another factor to be considered is whether the worker devotes all of his efforts to the position or if he does work for others.²²

Regarding the “method of payment” criterion, an independent contractor usually determines the price of his services and bills for his services on a regular basis.²³ In an employer-employee relationship, on the other hand, the employer determines the employee’s rate of pay and takes deductions out of his paychecks for federal income taxes, Social Security, and Medicare.²⁴

The Court in *Combined Insurance* pointed out another indicia of the retention of the right to control and the exercise of control is whether the purported employer had the authority to fire the alleged employee without incurring liability.²⁵ The Court, quoting *Fox Park Timber Company v. Baker*²⁶ and *Brubaker v. Glenrock Lodge*²⁷, stated:

. . . Another test is whether either of the parties possesses the right to terminate the services at will without incurring liability to the other, this embracing, of course, the right of the employer at any time to discharge the party performing the work, an affirmative answer establishing the status of master and servant. . . .

Finally, the Wyoming Supreme Court has stated that the payment of workers’ compensation and unemployment insurance premiums by an employer suggests a worker is an employee rather than an independent contractor.²⁸ Similarly, when a worker is eligible to participate in benefit programs such as retirement or insurance plans, because of his association with the employer, it suggests a master-servant relationship exists.²⁹

IRS DETERMINATION OF INDEPENDENT CONTRACTOR STATUS

The Internal Revenue Service also has defined an independent contractor in Internal Revenue Service Ruling 87-41 (1987-1). The Revenue Ruling essentially encompasses the same principles of Wyoming common law.³⁰ According to the Treasury Department, an “individual is an independent contractor if . . . the employer [has] the right to control or direct only the result of the work and the means and methods of accomplishing the result”³¹ (unless specific agreements dictate special terms). In other words, an independent contractor is one with whom the employer makes special arrangements to have a specific job done, usually by a specific deadline, and the contractor then determines the how and where the job is done.

The IRS has recognized the common law direction and control test and, in doing so, has identified twenty factors or elements that indicate whether sufficient control exists to establish an employer-employee relationship. An IRS training manual³² organizes the 20 factors into the following four groups:

1. **Behavior Control Factor.** An employer has the right to control how an employee does the work. An independent contractor usually retains control over how the work is done. Common factors that suggest employee status include:
 - Employers require workers to follow instructions about when, where and how to work, such as obtaining prior approval before proceeding with the job.
 - The worker must render services personally.
 - The employer provides training to do a job in a particular manner (other than orientation and safety training).

2. **Financial Control Factor.** An employer has the right to control how an employee conducts his or her business aspects. An independent contractor has the right to control his or her own business activities. Common factors that suggest employee status include:
 - Workers do not realize a profit or suffer a loss from services done (other than agreed-upon compensation for work completed).
 - Workers depend on the employer to provide the facilities, tools, equipment and materials needed to do a particular job. Employers generally reimburse employees for business and incurred travel expenses.
 - Workers do not work for more than one company at a time and do not make their services available to the public.
 - Employers pay employees either by the hour or on a salary. Employers usually pay independent contractors by the job or the contractor receives a commission.

3. **Relationship Factor.** The following factors illustrate how the worker and the business perceive the relationship.
 - The contract must have substance (method of payment, handling of expenses, how work is done) designating the worker as an independent contractor.
 - Employers only pay health insurance, pension plans, vacation and sick pay benefits to employees.
 - A temporary relationship is more likely to suggest independent contractor status (even if long term).
 - If the worker's services are an integral part of the business operations, the worker is generally an employee.

4. **Less Important Factors**
 - The employer's right to discharge the worker
 - The worker's right to terminate their relationship
 - Part-time or full-time work requirement
 - Work required to be done on the employer's premises
 - Setting of hours to do work
 - Setting of an order or sequence of the work
 - Interim oral or written reports requirement

Other items included in the IRS training manual include incorporated workers generally will not be recharacterized as employees, W-2 forms do not necessarily suggest employee status and state law or any other government or industry standard regulation is not a relevant factor.

WHAT SHOULD YOU, THE LAWYER, CONSIDER?

First, you as counsel, should have a detailed interview with your client. Determine all of the facts and circumstances surrounding the work to be done. To determine whether a worker is an employee or independent contractor, question your client on both the common law factors and the IRS factors regarding those being hired. Make sure you have a complete and accurate understanding of all facts and circumstances surrounding the relationship.

Second, when drafting an independent contractor agreement, remember that while the terms of a written agreement are certainly relevant to the determination of the worker's status, they are not determinative. Even if the written agreement declares the worker to be an independent contractor, if the facts suggest otherwise (*e.g.*, employer directs or controls the worker, determines how and when work is to be done), the worker will be considered an employee. Furthermore, the written agreement for an independent contractor should not describe, in detail, how the worker is to do his or her job and consequences of failing to meet those standards.

In drafting the independent contractor agreement, make sure the employer does not:

- govern when, where and how the worker will complete the job;
- require the worker to obtain prior approval before proceeding with the job;
- pay the worker on a salary or hourly basis, but rather, by the job or contract/commission rate;
- pay the worker directly as opposed to his or her trade name or business;
- give the worker benefits such as health insurance, pension plans, vacation and sick pay benefits;
- provide more than minimal training (*i.e.*, orientation and safety training);
- give the worker the tools he or she will need to complete the job; and
- require the worker to work exclusively for the employer.

CONCLUSION

Changes in the landscape of the workplace are blurring the definitions of an employee and independent contractor even more. Temporary employees flood the market, and personnel suppliers rent out employees in ever-increasing numbers. Virtual companies employ more and more home-based (or telecommuting) employees. Under these conditions, where do employer rights and responsibilities begin and end?

Generally speaking, a person is an employee if he or she performs services subject to the will and control of an employer, what must be done, how it must be done, where and when; the employer has the legal right to control both the method and the result of services. An employer-independent contractor relationship is one in which a party with a *specialized* calling is employed to *accomplish an end result, without the control or supervision* of the employer.

At times, it is difficult to determine whether a relationship is one of master-servant or employer-independent contractor. The overriding consideration in determining whether a person is an employee or an independent contractor is whether the employer has the right to control the person's work. A second consideration is whether the employer can terminate the individual without incurring liability.

When advising clients or drafting agreements, make sure you have a complete understanding of the facts surrounding the relationship, so they can meaningfully apply the various tests used to differentiate the employee from the independent contractor.

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- ¹ *SOS Staffing Service, Inc. v. Fields*, 2002 WY 141 ¶ 15, 54 P.3d 761 (Wyo.2002).
- ² *Id.* at ¶27, citing Wyo. Stat. § 27-14-102(a)(vii) of the Wyoming Workers' Compensation Act.
- ³ *Diamond B Services, Inc. v. Rohde*, 2005 WY 130, ¶ 27, 120 P.3d 1031 (Wyo.2005).
- ⁴ *Id.* at ¶27.
- ⁵ *Diamond B Services*, ¶ 27, citing *Combined Insurance Company of America v. Sinclair*, 584 P.2d 1034, 1043 (Wyo.1978) quoting *Lichty v. Model Homes*, 66 Wyo. 347, 211 P.2d 958, 967 (Wyo.1949).
- ⁶ *Blessing v. Pittman*, 70 Wyo. 416, 251 P.2d 243, 246 (Wyo.1952).
- ⁷ *Austin v. Kaness*, 950 P.2d 561, 563 (Wyo. 1997); *Hamilton v. Natrona County Education Association*, 901 P.2d 381, 385 (Wyo.1995); *see also, Miller v. Reiman-Wuerth Company*, 598 P.2d 20, 22-23 (Wyo.1979); and *Combined Insurance Company of America v. Sinclair*, 584 P.2d 1034, 1041 (Wyo.1978).
- ⁸ *Natural Gas Processing Co. v. Hull*, 886 P.2d 1181 (Wyo. 1994).
- ⁹ *Jones v. Chevron U.S.A., Inc.*, 718 P.2d 890 (Wyo. 1986); *Holdaway v. Gustanson*, 632 F. Supp. 393 (D. Wyo. 1986).
- ¹⁰ Wyo. Stat. § 27-3-101, *et. seq.*
- ¹¹ Wyo. Stat. § 27-14-101, *et. seq.*
- ¹² *Kenney*, TC Memo 1995-431.
- ¹³ *Fox Park Timber Company v. Baker*, 53 Wyo. 467, 84 P.2d 736, 743, (Wyo.1938) 84 P.2d 736, 743; *see also* 120 A.L.R. 1020.
- ¹⁴ *Combined Insurance Company of America v. Sinclair*, 584 P.2d 1034 (Wyo. 1978).
- ¹⁵ *Id.* at 1042, citing *Stockwell v. Morris*, 46 Wyo. 1, 22 P.2d 189 (emphasis added). The Court went on to state that the issue of control is ordinarily a question of fact for the jury and becomes a question of law only when but one reasonable inference can be drawn. *Combined Insurance Company of America*, 584 P.2d at 1042, citing *Barnes v. Fernandez*, 526 P.2d 983 (Wyo. 1974); and *Tyler v. Jensen*, 75 Wyo. 249, 295 P.2d 742, 749 (1956). More particularly, according to the Court in *Combined Insurance*, the extent to which an employee has the 'right to control' is primarily a jury question. *Combined Insurance*, 584 P.2d at 1042, citing *Holly Sugar Corporation v. Perez*, 508 P.2d 595, 598 (Wyo. 1973).
- ¹⁶ *Cline v. State, Dept. of Family Services*, 927, P.2d 261 (Wyo. 1996) (citing 41 AM. JUR. 2D *Independent Contractors* § 12 (1995)); *see also, Natural Gas Processing Co. v. Hull*, 886 P.2d 1181, 1185 (Wyo.1994).
- ¹⁷ *Coates v. Anderson*, 2004 WY 11, ¶7, 84 P.3d 953, 957 (Wyo. 2004), *see also Diamond B Services, Inc.*, 2005 WY 130, ¶29, 120 P.3d 1031, 1041.

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- ¹⁸ *Diamond B Services, Inc.*, 2005 WY 130, ¶28, 120 P.3d 1031, 1041. *See also* *Krier v. Safeway Stores 46, Inc.*, 943 P.2d 405 (Wyo. 1997); *Stephenson v. Pacific Power & Light Co.*, 779 P.2d 1169, 1176 (Wyo.1989); *Holliday v. Bannister*, 741 P.2d 89, 95 (Wyo.1987); *Noonan v. Texaco, Inc.*, Wyo., 713 P.2d 160 (1986).
- ¹⁹ *Combined Insurance Company of America*, 584 P.2d at 1042 (emphasis added).
- ²⁰ *Diamond B Services, Inc.*, 2005 WY 130, ¶29, 120 P.3d 1031, 1041, citing *Coates*, ¶14; *Noonan v. Texaco, Inc.*, 713 P.2d 160, 164 (Wyo. 1986).
- ²¹ *Diamond B Services, Inc.*, 2005 WY 130, ¶ 29, 120 P.3d 1031, 1041, citing *Stratman v. Admiral Beverage Corp.*, 760 P.2d, 974, 980 (Wyo. 1988); *Combined Insurance Company of America v. Sinclair*, 584 P.2d 1034, 1043 (Wyo. 1978).
- ²² *Id.*
- ²³ *Diamond B Services, Inc.* 2005 WY 130, ¶ 30, 120 P.3d 1031, 1042, citing *Noonan*, 713 P.2d at 166; *Combined Insurance*, 584 P.2d at 1043.
- ²⁴ *Id.*
- ²⁵ *Combined Insurance*, 584 P.2d at 1043, quoting *Lichty v. Model Homes*, 66 Wyo. 347, 211 P.2d 958, 967 (1949).
- ²⁶ *Fox Park Timber Co. v. Baker*, 53 Wyo. 467, 84 P.2d 736 (1938).
- ²⁷ *Brubaker v. Glenrock Lodge Intern. Order of Odd Fellows*, 526 P.2d 52 (Wyo. 1974).
- ²⁸ *Diamond B Services, Inc.*, 2005 WY 130, ¶ 30, 120 P.3d 1031, 1042, citing *In re: Claims of Naylor*, 723 P.2d 1237, 1240-41 (Wyo.1986); *In re Reed*, 444 P.2d 329, 330 (Wyo.1968).
- ²⁹ *Diamond B Services, Inc.*, 2005 WY 130, ¶ 30, 120 P.3d 1031, 1042, citing *Combined Insurance*, 584 P.2d at 1043.
- ³⁰ *See Diamond B Services, Inc.*, 2005 WY 130, ¶ 27, 120 P.3d 1031, 1041, footnote 4.
- ³¹ Internal Revenue Service No. 937, *Business Reporting: Employment Taxes, Information Returns, 1989*.
- ³² IRS Training Materials Course 3320-102, *Independent Contractor or Employee?* *See also* Revenue Ruling 87-41 (1987).