INFORMATION MEMO
Employee or Independent Contractor: Legal Implications and Ramifications

Find out the factors to look at in making the determination of whether a worker you hire should be treated as an employee or an independent contractor. Your decision can have far-reaching financial consequences for the city, including workers compensation liability, unemployment insurance penalties, Fair Labor Standards Act obligations, and more.

Alert: Significant changes have occurred related to the federal Department of Labor’s guidance on classification of workers in recent years. The federal Department of Labor (DOL) is charged with overseeing the laws and regulations discussed in this memo. The DOL often provides guidance to employers in the form of letters called Administrator’s Interpretations (AIs). It is important to know that these AIs are not binding law – but rather suggest how the DOL will interpret and enforce the law. In layman’s terms these AIs serve as warnings to employers about practices the DOL frowns upon.

In 2015 and 2016 the Department of Labor issued two AIs on independent contractor status that were very favorable to employees. These AIs indicated that the DOL – as the enforcing agency – was ready to challenge employers over some independent contractor classifications it viewed as too broad or exploitative. The AIs warned employers that under the DOL’s interpretation of the law most workers should be considered employees rather than independent contractors. Employers can face significant penalties when they misclassify an employee as an independent contractor.

However, in 2017, a new DOL administration withdrew the 2015 and 2016 AIs. The new DOL administration has not offered any new replacement guidance. Again – it is important to remember that these AIs only provided guidance on interpreting the law - but did not themselves have the strength of law or regulation. The withdrawal of the AIs seems to indicate that the new DOL administration will not choose to enforce the law in the same manner as the old administration. Their failure to issue any additional guidance seems to indicate that we have returned to the pre-2015 status quo. This standard is discussed in the following memo.

However, private litigants, who believe they were wrongly misclassified, may still use the withdrawn letters in court to establish an interpretation of the law most favorable to them. It is, at this point, unclear, how the courts will treat withdrawn guidance letters in interpreting the law. This all means, that for the average employer, an already complex area of the law has become more difficult. Cities who work with independent contractors should discuss these classifications with their city attorney.
I. Effects of designation

It’s important to note that in the event of an audit, the Department of Labor or Internal Revenue Service (IRS) will give little regard to how the city titles the position, labels the position as full-time or part-time status, or classifies the position as “employee” or “independent contractor.” Instead, the agencies will review several factors described in this memo for designating a position as an employee or independent contractor. The legal determination of whether a worker is deemed an employee or independent contractor can have far-reaching financial ramifications for the city, including, but not limited to, workers compensation liability, unemployment insurance penalties, Fair Labor Standards Act obligations, pension and insurance benefits, wrongful termination lawsuits, and vicarious liability to the city for these worker’s negligent actions.

II. How to determine

In the DOL Administrator’s Interpretation No. 2015-1, employers are to use the Fair Labor Standard Act’s definition of employer as “to suffer and permit to work” in applying an “economic realities test” when determining whether workers are employees or independent contractors.

Previously, you may have read or heard about a “common law” test developed by the courts to help determine whether a worker is an employee for federal tax purposes. Generally, under the common law test, the more control the employer exerts over a worker, the more likely the worker would be deemed an employee rather than an independent contractor. The Administrator’s 2015 Interpretation specifically noted, “Indeed, although the common law control test was the prevalent test for determining whether an employment relationship existed at the time that the FLSA was enacted, Congress rejected the common law control test in drafting the FLSA.”

The DOL 2015 guidance directs employers to follow what courts now use when determining whether a worker is an employee or independent contractor under the FLSA: a multi-factorial “economic realities” test which focuses on whether the worker is economically dependent on the employer or is in business for him or herself.

Factors to be considered under this “economic realities” test include the following questions for analysis:
A. **Is the work an integral part of the city?**

The 2015 Administrator’s Interpretation stated, “if the work performed by a worker is integral to the employer’s business, it is more likely that the worker is economically dependent on the employer.” On the other hand, “a true independent contractor’s work, is unlikely to be integral to the employer’s business.”

When evaluating this question, the Administrator’s Interpretation stated work can be integral to a business even if the work is just one component of the business and/or is performed by hundreds or thousands of other workers. An example provided relates to a worker answering calls at a call center. The guidance stated that call center worker is an employee performing work integral to the call center’s business even though there may be hundreds of other employees performing the same work. The guidance also notes work can be integral to an employer even if it is performed away from the employer’s premises.

B. **Does the worker’s managerial skill affect the worker’s opportunity for profit or loss?**

The guidance notes an independent contractor is “a worker in business for him or herself [and] faces the possibility to not only make a profit, but also to experience a loss.” Examples of managerial skills include a worker’s decision to hire others, purchase materials and equipment, advertise, rent space, and manage time tables that will affect his or her opportunity for profit or loss beyond a current job.

A worker’s ability to work more hours has nothing to do with the worker’s managerial skill, so the ability to take on overtime would demonstrate worker status, rather than independent contractor status.

C. **How does the worker’s relative investment compare to the employer’s investment?**

An independent contractor will make some investment, but also undertake some risk for a loss. A city’s analysis will need to include not only the nature of the worker’s investment, but also compare the worker’s investment to the employer’s investment. The guidance stated “investing in tools and equipment is not necessarily a business investment or a capital expenditure that indicates that the worker is an independent contractor.”
For an independent contractor, the worker’s investment should not be relatively minor compared with that of the employer. The guidance offers if “the worker’s investment is relatively minor, that suggests that the worker and the employer are not on similar footings and that the worker may be economically dependent on the employer.” In other words, this type of arrangement would be determined to be an employee/employer arrangement. Two examples are provided in the guidance illustrating this concept:

- A worker providing cleaning services for a cleaning company is issued a Form 1099-MISC each year and signs a contract stating that he/she is an independent contractor. The company provides insurance, a vehicle to use and all equipment and supplies of the worker. The company invests in advertising and finding clients. The worker occasionally brings his/her own preferred cleaning supplies to certain jobs. In this scenario, the relative investment of the worker as compared to the employer’s investment is indicative of an employment relationship between the worker and the cleaning company. The worker’s investment in cleaning supplies does little to further a business beyond that particular job.

- A worker providing cleaning services receives referrals and sometimes works for a local cleaning company. The worker invests in a vehicle that is not suitable for personal use and uses it to travel to various worksites. The worker rents his/her own space to store the vehicle and materials. The worker also advertises and markets his/her services and hires a helper for larger jobs. She regularly (as opposed to on a job-by-job basis) purchases material and equipment to provide cleaning services and brings his/her own equipment (vacuum, mop, broom, etc.) and cleaning supplies to each worksite. His/Her level of investments is similar to the investments of the local cleaning company for who she sometimes works. These types of investments may be indicative of an independent contractor.

D. Does the work performed require special skill and initiative?

The guidance notes, “a worker’s business skills, judgment, and initiative, not his or her technical skills, will aid in determining whether the worker is economically independent.” For skills to be indicative of independent contractor status, they should be used in some independent way, such as demonstrating business-like initiative. The DOL notes, a highly skilled carpenter providing carpentry services for a construction firm would not meet the independent contractor status unless the carpenter markets his services, determines when to order materials, and the quantity of materials to order, and determines which orders to fill.
E. **Is the relationship between the worker “permanent” or indefinite?**

“Permanency” or indefiniteness in the worker’s relationship with the employer is reflective of an employee relationship. An independent contractor, on the other hand, typically works one project for an employer and does not necessarily work continuously or repeatedly for an employer.

F. **What is the nature and degree of the employer’s control?**

The more control an employer has over the meaningful aspects of the work the more an employee relationship is established.

The city will want to consider all of these factors when analyzing whether the worker is economically dependent on the employer or truly an independent contractor. Misclassifying an employee as an independent contractor can come at a high price. Penalties for treating an employee as an independent contractor may include, but are not limited to, exposure to additional taxes, penalties and interest, additional wage and overtime obligations under the Fair Labor Standards Act, workers’ compensation and unemployment liabilities, and the possibility of wrongful termination suits. Thus, it is very important that cities make well-informed decisions when classifying workers. Be sure to work with the League and your city attorney before making an independent contractor classification.

If the city is confident the worker is an independent contractor, then the city must also ensure that the worker/contractor be properly licensed to perform the work and that he or she has the necessary insurance coverage in case of a lawsuit.

Proper insurance coverage is typically evidenced through a certificate of liability insurance that includes the city as an insured, and proof of workers’ compensation insurance or an exemption certificate. It can be a good practice to request these documents periodically during the course of the contract to ensure they stay in force.

G. **What about classifying a city manager, treasurer, or clerk as an independent contractor?**

1. **IRS and Social Security regulations**

   From time to time, the League is asked whether the entire positions of city manager, clerk, or treasurer can be classified as an independent contractor.
The answer is no, based on IRS and Social Security regulations, which do not allow a public official whose position is established by statute to be classified as an independent contractor. Treasury regulations covering the application of self-employment tax state the performance of the functions of a public office does not constitute a trade or business. Further, for IRS purposes, persons holding public office are excepted from self-employment tax and are recognized as employees for income tax withholding purposes. A city classifying its manager, clerk, or treasurer as an independent contractor may be violating IRS and Social Security regulations for which there are also likely sanctions. For these reasons, the state auditor’s legal compliance manual requires these positions be treated as employee positions.

2. PERA definitions of city manager, clerk, and treasurer

Also according to the state auditor, individuals in these positions should be regarded as employees for purposes the Public Employees Retirement Act (PERA). State law defines “employee,” for purposes of PERA, to include a city manager (who does not opt out of PERA), a town or city clerk, or treasurer. The law goes on to state that persons performing the duties of these defined “public officer” positions will not be considered to be an “independent contractor” for PERA purposes. Under this law, it is important to remember that a city manager (again, who does not opt out of PERA) is broadly defined to include:

- An appointed manager in a Plan B statutory city or in a home rule city operating under the “council-manager” form of government.
- An appointed person holding the position of chief administrative officer of a home rule charter city or a statutory city under a charter provision, ordinance, or resolution establishing the position and prescribing its duties and responsibilities.

However, some duties could be separated out and performed by a contractor. For example, payroll might be contracted out. Best practice suggests working with the city attorney on all of these classifications.

III. PERA factors

The Public Employees Retirement Association, with some variations, uses the factors as noted above to qualify someone as an employee. In most cases, if the IRS determines an individual is an employee, that person is an employee under PERA as well.
IV. Further assistance

Since each independent contractor analysis is unique to the position responsibilities, it’s important for cities to consult with their city attorney. League of Minnesota Cities Human Resources and Benefits Department staff are also available to provide assistance with independent contractor questions.