

# PUBLIC EMPLOYMENT LAW

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## INDEPENDENT CONTRACTOR OR EMPLOYEE? THE LEGAL DISTINCTION AND ITS CONSEQUENCES

■ Diane M. Juffras

Government employers sometimes turn to independent contractors (occasionally referred to as “contract employees”) to perform work traditionally done by regular employees. Some of the advantages that employers see include:

- *No overtime pay.* Under the Fair Labor Standards Act (FLSA), many employees must be paid overtime (one-and-one-half times their regular rate of pay) for hours worked over 40 in a given week. Independent contractors are not subject to the FLSA and may be paid at the agreed-upon rate regardless of the number of hours worked.
- *No benefits.* Employees are generally entitled to participate in the fringe benefit plans that the employer offers. In North Carolina, this includes participation in the Local Government Employee Retirement System or the Teachers and State Employees Retirement System, as well as in the employer’s health insurance benefit plan. Independent contractors are not generally eligible for participation in benefit plans.
- *No withholding, no FICA contribution.* Employers must withhold federal, state and local income taxes, as well as social security and Medicare taxes (FICA taxes) from their employees’ wages. They must make an employer FICA contribution for each employee. Independent contractors are not subject to income tax or FICA withholding. Employers are also not responsible for making FICA contributions on independent contractors.
- *No workers’ comp.* Employees must be covered by the employer’s workers’ compensation insurance plan. Independent contractors are not covered by the North Carolina Workers’ Compensation Act.

The difference between the amount of total compensation paid to an employee and that paid to an independent contractor doing the same work can be substantial. Classifying a group of workers as independent contractors, rather than as employees, can result in significant savings for an employer. But it also involves significant risk. Misclassifying an employee as an independent contractor can prove very expensive to the employer who makes that mistake.

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*Paradise County needs an additional sanitation worker in the public works department, an additional visiting nurse in the health department, and an additional accounts payable clerk in the finance department. In each case, the new position would have the same job duties as already existing positions. The county commissioners do not think it possible to fund all three requests, but rather than choose among them, they allocate enough money for each of the three departments to add an additional worker on what the commissioners call an "independent contractor" basis: the workers are to be paid at an hourly rate, but will not receive any benefits from the town. The public works, health, and finance departments advertise for and hire workers, who sign agreements stating that they understand that they are hired as independent contractors and that, as such, they will not receive benefits. The payroll office, seeing that the workers are not receiving benefits, does not withhold income or FICA taxes or make FICA contributions.*

*After the new workers have been on the job for several months, one of them approaches the payroll office and complains that she often works more than 40 hours per week, but she does not receive overtime. She also complains that the county has not withheld social security and Medicare (FICA) taxes from her paycheck. The worker is concerned that she is not receiving credit with the Social Security Administration for her time working for Paradise County and that she will not receive all of the social security benefits to which she would otherwise be entitled at retirement.*

*The payroll office tells the worker that because she was classified as an independent contractor (a) she is not covered by the FLSA and is not entitled to overtime, and (b) the county is not required to withhold FICA taxes. Dissatisfied with this answer, the worker complains to her supervisor. The supervisor reminds her that she agreed to work as an independent contractor and tells her that if she doesn't like it, she can quit.*

*The worker files complaints with the United States Department of Labor and the Internal Revenue Service. They each begin an investigation into Paradise County's worker classifications.*

### **Agreement to Work as an Independent Contractor Has No Legal Significance**

The Paradise County hypothetical illustrates one of the most common misconceptions about who is and is not an independent contractor. Many employers

believe that so long as a worker wants or agrees to be paid as an independent contractor, the employer is not responsible for paying overtime or for withholding taxes for that worker. That simply is not so. All of the workers that Paradise County has hired as "independent contractors" are – as far as the law is concerned -- employees.

"Independent contractor" is a distinct legal status determined by factors that go beyond the employer and employee's mutual desire to contract for work on this basis. Both the United States Department of Labor (which administers the Fair Labor Standards Act) and the Internal Revenue Service (which oversees not only the withholding of federal income taxes but of social security and Medicare contributions, as well) have tests for determining whether a worker is an employee or an independent contractor for FLSA and tax purposes. Other statutes, such as anti-discrimination laws or state statutes governing who qualifies for unemployment benefits, use still other tests for determining a worker's status.

Although the various tests for determining whether a worker is an employee or independent contractor go by different names, they differ only slightly: all are variants of the common-law test for determining whether or not someone is an "employee." Thus, the tests share common principles. Under all of the tests, the essence of the relationship between a hiring organization and an *independent contractor* is the agreement by the independent contractor to do a discrete job according to the independent contractor's own judgment and methods, without supervision by the hiring organization. The hiring organization retains approval only as to the results of the work. In contrast, an employer may require an *employee* to perform his or her duties in particular ways using particular methods at particular times even if, in fact, the employer gives assignments only occasionally. An employee may be disciplined – even discharged – for failing to follow the employer's instructions about how to perform a task.

### **A Price to Pay**

An organization that misclassifies workers as independent contractors when those workers do not meet the legal test for independent contractor status may be subject to significant penalties under both the Fair Labor Standards Act and the Internal Revenue Code (IRC). Penalties include:

- liability for overtime compensation going back for a period of two years (FLSA);

- liquidated damages in an amount equal to the amount of overtime owed (FLSA);
- liability for 1.5% of each worker's federal income tax liability where the misclassification was unintentional (IRC);
- liability for both the employer's share of FICA contributions and up to 20% of the employee's missing FICA contribution (IRC); and
- interest on the underwithheld amounts and other IRS penalties (IRC).

These penalties make illusory those projected savings that caused the organization to engage workers as independent contractors in the first place.

This Bulletin discusses in detail the tests applied by the U.S. Department of Labor and the Internal Revenue Service in determining whether a worker is an employee or an independent contractor. The Bulletin also discusses more briefly those versions of the common-law test that the courts apply in determining whether a worker has standing to bring a claim as an employee under Title VII and other anti-discrimination statutes, the North Carolina Workers' Compensation Act, and the statutes governing the North Carolina public employees' retirement systems. It concludes with a discussion of a misclassified worker's rights to health insurance benefits.

## The Fair Labor Standards Act Test

The FLSA defines "employee" broadly as "any individual employed by an employer."<sup>1</sup> It defines "employer" as "any person acting directly or indirectly in the interest of an employer in relation to an employee,"<sup>2</sup> while to "employ" someone is "to suffer or permit [them] to work."<sup>3</sup> On its face, it is hard to see what sort of worker would be not fall within the FLSA's definition of employee – it would seem to cover everybody.

The U.S. Department of Labor and the courts nevertheless recognize that there are people who perform work who simply cannot be called employees of the organization. To determine whether or not a worker is an employee for FLSA purposes, courts have developed what is called an "economic reality" test.

1. See 29 U.S.C. § 203(e)(1).

2. See 29 U.S.C. § 203(d).

3. See 29 U.S.C. § 203(g).

## The Economic Reality Test

The economic reality test looks at whether a worker is economically dependent upon the organization for which he or she renders services.<sup>4</sup> To put it another way, the courts ask whether a worker depends upon an "employer" for the opportunity to render service or whether the worker is in business for himself or herself. To make this determination, the courts use a six-factor test that asks:

- What is the nature and degree of control that the hiring organization has over the way in which the worker is to perform the work? The more control that the hiring organization has over the worker, the more likely it is that the worker is an employee.
- Does the worker have an opportunity to make a profit or a loss? The ability to make a profit or sustain a loss on a job is the hallmark of an independent contractor.
- Does the worker have an investment in the materials, equipment or other personnel required to perform the work? When a worker supplies the materials or equipment needed for the job or directly hires others to assist in him or her in performing the work, this factor will weigh heavily in favor of independent contractor status.
- Does the work require skill and independent initiative? Independent contractors usually have a special skill and exercise initiative in seeking out assignments or clients.
- What is the expected duration of the working relationship? The independent contractor relationship is usually for a limited duration. Where a hiring organization engages a worker indefinitely, or where the worker has performed services for the hiring organization for a long period of time, the courts are more likely to find that the worker is an employee.
- To what extent is the work an integral part of the hiring organization's operations? Independent contractors usually perform work that is peripheral to the hiring organization's operations. Where a worker is doing a job that is essential to the organization's operations, this factor will weigh in favor of employee status.

4. See *Rutherford Food Corp. v. McComb*, 331 U.S. 722, 726-28, 730 (1947).

No single factor is dispositive in making the determination of worker status, and some of them overlap. Each situation is evaluated in light of all of the circumstances of the hiring organization-worker relationship.<sup>5</sup>

## The Internal Revenue Code Test

The Internal Revenue Service also has an interest in seeing that employers who classify workers as independent contractors or “contract employees” are legally entitled to do so. Under the Internal Revenue Code (the “Code”), an employer is required to withhold estimated federal income taxes from an employee’s wage payments. In addition, the Code imposes social security and Medicare taxes on the wages of employees, both of which an employer must remit to the IRS through payroll deduction. Employers themselves also pay social security and Medicare taxes on each person they employ.

In contrast, an organization is not required to withhold income or FICA taxes from its payments to an independent contractor, nor does it pay any social security or Medicare taxes on the independent contractor’s fee. A hiring organization’s legal responsibilities end with the filing of annual information returns (the form 1099) with both the worker and the IRS that show the money paid to the contractor during the tax year. An independent contractor is responsible for directly paying both income and FICA taxes to the IRS.<sup>6</sup>

Thus, the federal government stands to lose potentially significant amounts of revenue when hiring organizations misclassify employees as independent contractors. Not only are employer

5. See *Chao v. Mid-Atlantic Installation Services, Inc.*, 16 Fed.Appx. 104, 106, 2001 WL 739243 \*\*1 (4<sup>th</sup> Cir. 2001); *Dubois v. Secretary of Defense*, 161 F.3d 2, 1998 WL 610863 \*\*1 (4<sup>th</sup> Cir. 1998) (unpublished disposition); *Donovan v. DialAmerica Marketing, Inc.*, 757 F.2d 1376, 1382-83 (3d Cir.), *cert. denied*, 474 U.S. 919 (1985); *Brock v. Superior Care, Inc.*, 840 F.2d 1054, 1059 (2d Cir. 1988).

6. The IRS has stepped up its efforts to identify employees incorrectly classified as independent contractors in recent years: independent contractors tend to understate their income -- sometimes erroneously, sometimes consciously -- resulting in revenue loss for the federal government from underpayment of both federal income and employment taxes. Thus, when an employer is both withholding an employee’s share and contributing its own share, federal tax revenues are both greater and more predictable.

contributions to social security and Medicare completely lost, but independent contractors may underreport income and remit less in the way of income tax and FICA contributions than they actually owe. This is true even where the hiring organization properly reports the amount paid to the independent contractor to the IRS.

## The Right to Control Test

The Code does not formally define the term “employee” for the purposes of determining federal income tax liability, but instead provides that the usual common-law rules apply in determining the employer-employee relationship.<sup>7</sup> The common-law test, sometimes known as the “right to control” test, looks at whether the organization for which the worker is performing services has the right to control or direct the worker. In a 1987 Revenue Ruling, the IRS compiled and set out a list of twenty factors that the courts had considered over the years in applying the right-to-control test. Those twenty factors are: 1) whether the worker must comply with another person’s instructions about the work; 2) whether the worker requires training in order to do the work; 3) whether the work performed by the worker is integrated into the hiring organization’s operations; 4) whether the worker must perform the services personally; 5) who hires, supervises and pays the worker’s assistants, if any; 6) whether the worker and hiring organization have a continuing relationship; 7) whether the work must be performed during set hours; 8) whether the worker must devote most of his or her time to the work for the hiring organization; 9) whether the work must be performed on the employer’s premises or can be done elsewhere; 10) whether the worker must perform services in an order or sequence set by the hiring organization; 11) whether a worker must submit reports; 12) whether the worker is paid by the hour, week or month; 13) whether the worker’s business or traveling expenses are paid by the hiring organization; 14) whether the worker furnished the tools, material and equipment

7. See 26 U.S.C. § 3121(d)(2). See also *Weber v. Commissioner*, 60 F.3d 1104, 1110 (4<sup>th</sup> Cir. 1995); *Eren v. Commissioner*, 180 F.3d 594, 596-97 (4<sup>th</sup> Cir. 1999) (because foreign earned income tax exclusion section of Internal Revenue Code does not define employee, common law rules apply in distinguishing employees and independent contractors under federal tax law), *citing* *Nationwide Mutual Ins. Co. v. Darden*, 503 U.S. 318, 322-23 (1992).

needed to perform the work; 15) whether the worker has a significant investment in facilities needed to do the work; 16) whether the worker can make a profit or suffer a loss as a result of performing the services for the hiring organization; 17) whether the worker can work for more than one firm at a time; 18) whether the worker makes his or her services available to the general public; 19) whether the hiring organization can discharge the worker; 20) whether the worker has the right to terminate the relationship with the hiring organization.<sup>8</sup>

As both the IRS and the courts emphasize, no single factor is controlling, and the importance of a factor will vary depending on both the occupation at issue and the circumstances under which the services are rendered.<sup>9</sup> In *Weber v. Commissioner*, for example, the Fourth Circuit looked at seven factors in determining whether a minister was an employee of his church: (1) the degree of control exercised by the church over the details of the work; (2) which party – church or minister -- had invested in the facilities used in the work; (3) the opportunity of the minister for profit or loss; (4) whether the church had the right to discharge the minister; (5) whether the work was part of the church’s regular business; (6) the

8. See Revenue Ruling 87-41 (1987), 1987-1 C.B. 296. Most of these factors appear in the summary of the common-law test set forth by the United States Supreme Court in *Darden*, 503 U.S. at 323-24 (applying common-law test to determine who qualifies as an employee under Employee Retirement Income Security Act [ERISA]) and *Community for Creative Non-Violence v. Reid*, 490 U.S. 730, 751-52 (1989)(applying common-law test to determine who is an employee for purposes of the Copyright Act). See also *Clackamas Gastroenterology Associates, P.C. v. Wells*, 538 U.S. 440 (2003) (EEOC focus on common-law test is appropriate for determining who is “employee” for purposes of Americans with Disabilities Act).

9. See Revenue Ruling 87-41 (1987), 1987-1 C.B. 296. See also *Weber*, 60 F.3d at 1110 (looking at seven of the twenty factors to determine whether minister was employee of church); *Hospital Resource Personnel, Inc. v. United States*, 68 F.3d 421, 427 (11<sup>th</sup> Cir. 1995) (“Although no one factor is definitive on its own, collectively the factors define the extent of an employer’s control over the time and manner in which a worker performs. This control test is fundamental in establishing a worker’s status.”); *General Inv. Corp. v. United States*, 823 F.2d 337, 341 (9<sup>th</sup> Cir. 1987); *REAG, Inc. v. United States*, 801 F.Supp. 494, 501 (W.D.Okla. 1992); *Critical Care Register Nursing, Inc. v. United States*, 776 F.Supp. 1025, 1028 -29 (E.D.Pa. 1991).

permanency of the relationship; and (7) the relationship the parties believed they are creating.<sup>10</sup> With respect to the first factor – the right to control -- the Fourth Circuit noted that it is not only *actual* control exercised by the hiring organization that is relevant, but the extent to which the organization has the *right* to intervene to assert control.<sup>11</sup>

Because the Department of Labor and the IRS use nominally different tests – the “economic reality” test versus the “right-to-control” test – to determine worker status, it is theoretically possible that in a particular case a worker could be found to be an employee under one test and an independent contractor under the other – that is, it is possible that the same worker could be an employee for FLSA purposes and an independent contractor for tax purposes, or vice-versa. But in fact, the two tests look to the same factors, and a worker whom a hiring organization has a right to control is also one who is economically dependent upon the hiring organization. Research for this Bulletin has uncovered no fact pattern set forth in case law, Department of Labor Wage and Hour Opinion Letters or IRS Revenue Rulings that would lead to different conclusions under the two tests. For that reason, the factors indicative of worker status under both the FLSA economic-reality test and the IRS right-to-control test will be discussed together in the following sections.

## Determining Worker Status

*Imagine that a city wants to build a swimming pool. Officials of the city have opinions about what features they want in a swimming pool, but they do not know how to construct a swimming pool, and no one in the city’s regular employ has experience in swimming pool construction. So the city engages a swimming pool contractor to construct the pool. This is a classic example of the independent contractor relationship.*

*The city will tell the swimming pool contractor what result it wants: a swimming pool of a particular size, in a particular layout, with specified depths, complete with certain accessories like diving boards, stairs and ladders. The city and contractor will agree upon a price for the final product. While the city may negotiate with the contractor – and even have a price above which it will not go – the city will not be able to set the price unilaterally. The contractor, who will*

10. See *Weber*, 60 F.3d at 1110.

11. See *Weber*, 60 F.3d at 1110.

*supply all of the materials, equipment and workers needed to construct the swimming pool, will estimate how much time it will take to construct the pool and how much it will cost. It will then determine how much or how little profit it is willing to make to take this job.*

Contrast this with the Paradise County hypothetical. In none of the three instances did the county set out to hire someone with specialized skills for a discrete job. What each department head had originally asked for was funding to hire one additional employee. What each got was permission to hire someone to perform the job functions of an employee under an alternate compensation arrangement.

Is there a way legally to classify the three new Paradise County workers as independent contractors? For FLSA purposes, the issue is whether the sanitation worker, the visiting nurse and the accounts payable clerk are each, as a matter of “economic reality,” workers dependent on the county with respect to the services they provide or whether they are in business for themselves. For Internal Revenue Code purposes, the issue is whether the county has the right to control the work of the sanitation worker, the visiting nurse and the accounts payable clerk. A close look at the factors that comprise the economic reality and right-to-control tests makes clear that these workers cannot be classified as independent contractors for either FLSA or Internal Revenue Code purposes. They must be classified as employees.

### **Nature and Degree of the Employer’s Control over the Worker**

The more control that the hiring party has over a worker, the more likely it is that the worker is an employee. A hiring party has control over a worker when it has *the right* unilaterally to assign the worker a task or to require something of the worker at any given time. The hiring party does not have to exercise that right to have control over the worker for that worker to be an employee as a matter of law.<sup>12</sup> Where a hiring party may change a given worker’s job duties or reassign duties among several workers, it has supervisory control over a worker.<sup>13</sup>

12. See 26 C.F.R. § 31.3401(c)-1(b) (employment tax regulations); *Weber*, 60 F.3d at 1110.

13. See *Mathis v. Housing Authority of Umatilla County*, 242 F.Supp.2d 777, 783 (D.Or. 2002)(section 8 housing coordinator was subject to housing authority’s

### **Training in Required Methods**

A hiring party makes clear that it wants services performed in a particular way when it provides training in the actual methods the worker is to use or, more generally, in the hiring party’s policies and procedures. Training of this kind is indicative of an employment relationship. In one Fourth Circuit case, where an architect (a) was required to follow the procedures and directives in the hiring organization’s handbook, (b) could not exceed budget, and (c) had his hours, leave and pay set by employer, the court found that (1) the hiring organization had right to control architect’s activities, and (2) the architect was an employee for tax purposes.<sup>14</sup> Similarly, the IRS held that a park attendant hired on a seasonal basis by a government agency was an employee, in part because the agency provided training and instructions on methods to be used and set specific hours.<sup>15</sup> Similarly, if the hiring party requires that the services must be performed personally by the named worker, the presumption is that the hiring party is interested in the methods used to accomplish the work, rather than in the results alone. Thus, a requirement that the services be performed personally by the worker indicates an employment, rather than an independent contractor relationship.<sup>16</sup>

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control where she worked at housing authority offices, was subject to direction of executive director and housing authority reserved right to change or reassign job duties).

14. See *Eren*, 180 F.3d at 597.

15. See Priv. Ltr. Rul. 200323023 (Feb. 24, 2003). See also Rev. Ruling 66-274 (1966), 1966-2 C.B. 446 (in the context of medical professionals, the right of the hiring organization to require compliance with its general policies is indicated by whether or not the physician is subject to the direction and control of a chief of staff, medical director or some other authority; physician director of hospital pathology department not subject to direction and control of any hospital representative such as chief of staff is independent contractor). See also Rev. Ruling 73-417, 1973-2 C.B. 332 (physician director of hospital laboratory is employee, in part because he must comply with all rules and regulations of hospital).

16. See Rev. Rul. 55-695, 1955-2 C.B. 410 (retired employee who is retained as a “consultant” by former employer on retainer-fee basis for purpose of training replacement is an employee). See also Priv. Ltr. Rul. 8937039 (Sept. 15, 1989) (psychologists required to perform services personally are employees); Priv. Ltr. Rul. 9326015 (March 31, 1993) (physician-employee in university-health clinic required to perform services personally).

Where the hiring party has rules governing the worker's personal conduct, it exercises control over the worker.<sup>17</sup>

### ***Monitoring Worker Performance***

A hiring party does not have to "check up" on a worker's performance or conduct on a daily basis in order to exercise control over the worker. Indeed, some workers perform their duties off-site where, as a practical matter, their performance cannot be monitored on a daily basis. Even in circumstances where a representative of a hiring organization visits a job site as infrequently as once or twice a month, however, the courts will deem the organization to be exercising control over the worker.<sup>18</sup>

Another way a hiring organization can track a worker's performance of services is by requiring that the worker submit written or oral reports. These may be reports of time spent on certain tasks or on the project as a whole. The worker may be required to give a detailed description of the work performed, or of clients or patients seen in a given time period. The requirement that a worker submit reports is evidence that the worker is an employee.<sup>19</sup>

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17. See *Richardson v. Genesee County Community Mental Health Services*, 45 F.Supp.2d 610, 614 (E.D.Mich. 1999) (employing agency that provided nurses with patient care guidelines, as well as with work rules governing "employee conduct" exercised supervisory control for purposes of determining whether nurses were "employees" within the meaning of the FLSA). See also United States Dep't of Labor Wage and Hour Opinion Letter dated Aug. 24, 1999, 1999 WL 1788146 (hospital is likely joint employer of private duty nurses with nurse registry).

18. See *Brock v. Superior Care, Inc.*, 840 F.2d 1054, 1057, 1060 (2d Cir. 1988) (where nurses work off-site with individual patients needing home or specialized care, the employer will still exercise control and supervision where it visits job sites even as infrequently as once or twice a month and requires nurses to keep and submit to it patient care notes required by federal and state law). See also *Donovan*, 757 F.2d at 1383-84; *Mathis*, 242 F.Supp.2d at 783. On the IRS side, cf. *Weber*, 60 F.3d at 1110.

19. See *Kentfield Medical Hospital Corp. v. United States*, 215 F.Supp.2d 1064, 1070 (N.D.Calif. 2002) (hospital psychologists required to submit daily reports of their work were employees); Rev. Rul. 73-591, 1973-2 C.B. 337 (beautician required to submit daily work reports to owner of salon is employee); Rev. Rul. 70-309, 1970-1 C.B. 199 (oil-well pumpers who work in field seldom see employing corporation's agents, but are employees in part because they must submit written reports on a regular

### ***Regular Wages***

Closely related to the requirement that a worker submit time reports to the hiring party is the practice of paying the worker a regular wage based on the amount of time spent performing services. Payment of any kind of regular wage – by the hour, week or month – even where the wage is not directly linked to the actual amount of time spent working during the pay period (as is the case with exempt salaried employees) generally indicates that the worker is an employee. In contrast, payment by the job or on a commission basis is evidence of an independent contractor relationship. However, if a worker is paid a regular wage merely as a convenience -- that is, as a way of spreading out the payment of a lump sum that has been agreed upon as the cost of a job -- then this practice would not weigh in favor of employee status.<sup>20</sup> Courts consider the fact that the hiring party has unilaterally set a worker's hourly wage as evidence that the hiring party controls the worker.<sup>21</sup>

Thus, in two Fourth Circuit Internal Revenue Code cases, the fact that an architect and a minister respectively were paid on a salaried basis weighed in favor of employee status for each.<sup>22</sup> In two contrasting Revenue Rulings, the IRS found that a

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basis). See also Priv. Ltr. Rul. 9326015 (March 31, 1993) (physician in university-health clinic); Priv. Ltr. Rul. 9320038 (Feb. 22, 1993) (department of corrections medical director required to submit time reports is employee); Priv. Ltr. Rul. 200323023 (Feb. 24, 2003) (seasonal park attendant required to keep logbook is employee).

20. See Priv. Ltr. Rul. 9320038 (Feb. 22, 1993) (dep't of corrections medical director paid hourly rate is employee). See also Priv. Ltr. Rul. 200339006 (June 9, 2003) (accounting technician paid hourly wage was employee); Priv. Ltr. Rul. 9728013 (April 9, 1997) (part-time lifeguard paid hourly wage is employee); Priv. Ltr. Rul. 9326015 (March 31, 1993) (physician in university-health clinic); Priv. Ltr. Rul. 8937039 (Sept. 15, 1989) (psychologists treating patients for professional firm are employees).

21. See *Brock*, 840 F.2d at 1060. See also U.S. Dep't of Labor Wage and Hour Opinion Letter dated Dec. 7, 2000, 2000 WL 33126542 (fact that company controlled rate at which package-delivery drivers were compensated factor leading to conclusion that drivers were employees, rather than independent contractors). See also *Eren*, 180 F.3d at 597 (architect whose pay and leave were set by hiring party is employee).

22. See *Eren*, 180 F.3d at 597; *Weber*, 60 F.3d at 1111.

hospital physician whose compensation consisted *solely* of a percentage of his department's gross receipts was an independent contractor, while a hospital physician whose compensation was also a percentage of charges attributable to his department, but who was also *guaranteed a minimum salary* was an employee.<sup>23</sup>

### ***Paradise County's Control Over Its New Workers***

Think again about the construction of the swimming pool. While the city will no doubt be curious about how the work is progressing and city officials may well visit the job site, the city will not be telling the contractor how to excavate the earth or what method to use in mixing the concrete. Nor does the city have the right to tell the contractor that when the contractor is done with this swimming pool, the city has another one for him to construct at the same price on the other side of town -- although the city and the contractor may well come to some agreement on a second job. The city may worry that the contractor is not working fast enough, but until the contractor misses a contractual deadline, the city must bite its tongue.

Now think about Paradise County's "independent contractors." The sanitation worker, visiting nurse and accounts payable clerk would each work under the supervision of another county employee. The sanitation worker will not choose his own routes, but will have route, truck and co-workers assigned to him by a supervisor. The visiting nurse will have to follow the health department's patient care guidelines, and be required by the county to adhere to applicable state and federal regulations governing the treatment and billing of patients -- all of which are indicia of employer control.<sup>24</sup> The accounts payable clerk will be told how the county tracks and records accounts payable and will have to use the software program already in place.<sup>25</sup>

23. See Rev. Ruling 66-274, 1966-2 C.B. 446 (independent contractor); Rev. Ruling 73-417, 1973-2 C.B. 332 (employee).

24. See U.S. Dep't of Labor Wage and Hour Opinion Letter dated Aug. 24, 1999 (hospital is likely joint employer of private duty nurses with nurse registry).

25. See Priv. Ltr. Rul. 200339006 (June 9, 2003) (accounting technician who was paid an hourly wage, given all necessary supplies, equipment and materials needed to perform her services, who received assignments from a supervisor who determined the methods by which the services were to be performed was employee rather than

All three workers will have to abide by county work rules governing personal behavior. All three will be expected to work scheduled hours. They will not be allowed to take care of personal or other business while working for Paradise County. They will be held to the same workplace standards for job performance and personal conduct as employees working for the county.

The conditions under which Paradise County's so-called independent contractors work make clear that in each case, the county has the right to control the performance of their work. Their working conditions are in marked contrast to those in *Chao v. Mid-Atlantic Installation Services, Inc.*, a Fourth Circuit FLSA case in which the court held that cable installers were independent contractors, rather than employees. In *Mid-Atlantic*, the fact that the defendant company assigned daily routes to cable installers and required them to report into a dispatcher on a regular basis did not establish employer control. The installers were free to complete the assigned jobs in whatever order they chose and were allowed to attend to personal affairs and to conduct other business during the day. They were also permitted to hire and manage other workers to help them complete their daily assigned installations. This freedom to complete their work whenever during the day and howsoever they chose weighed heavily in the court's determination that they were independent contractors.<sup>26</sup>

### ***Control over Professional Employees***

The degree of control necessary to find employee status varies in accordance with the nature of the services the worker provides. Professionals such as physicians, certified public accountants, lawyers, dentists, registered nurses and building and electrical contractors (to name just a few examples) require specialized skills to do their work. The methods that these skilled professionals use are frequently dictated by the standards of their individual professions, rather than by the hiring organization. The high level of knowledge and skill needed to perform their respective services often precludes direct supervision of their work. Nevertheless, when skilled workers such as these are hired under conditions in which

independent contractor); Priv. Ltr. Rul. 200222005 (Feb. 15, 2002) (clerical worker hired because she submitted lowest bid, but who worked under similar conditions to accounting technician above was employee).

26. See *Mid-Atlantic*, 16 Fed.Appx. at 106, 2001 WL 739243 \*\*2.



they are paid a set salary and follow prescribed routines during set hours, they lose some of the independence that characterizes the practice of their profession and their usual status as independent contractors and they become employees.<sup>27</sup>

Such is the situation of Paradise County's new visiting nurse. Registered nurses are considered skilled professionals and the IRS generally recognizes them as independent contractors when they perform private-duty nursing services for individual patients. In a private-duty nursing setting, nurses typically have full discretion in administering their professional services and are not subject to enough direction and control by the hiring party (usually the patient or the patient's family member) to establish an employment relationship. But when registered nurses are part of a medical staff of a hiring organization, they are usually subject to the control of a physician or another nurse. Under these conditions, the registered nurse is an employee. The IRS makes a distinction between registered nurses, on one hand, and licensed practical nurses (LPNs), nurse's aides, and home health aides, on the other: LPNs and aides who assist patients with personal and domestic care do not generally render professional care and are usually subject to almost complete direction and control regardless of the setting in which they perform their services; they are almost always employees.<sup>28</sup>

### The Right to Discharge the Worker

An employer exercises control over an employee through the threat of dismissal, which causes the employee to obey the employer's instructions. A true

27. See *Eren*, 180 F.3d at 596 (architect); *Weber*, 60 F.3d at 1111 (minister); *Kentfield Medical Hospital Corp.*, 215 F.Supp.2d at 1070 (psychologists). See also Rev. Rul. 87-41, 1987-1 C.B. 296 (the IRS' twenty-factor discussion); Rev. Rul. 58-268, 1958-1 C.B. 353 (dental hygienist); Priv. Ltr. Rul. 9323013 (March 11, 1993) (psychiatrist at state psychiatric facility who serves as court-appointed examiner charged with examining individuals who have been involuntarily committed to the facility is an employee); Priv. Ltr. Rul. 9201033 (Jan. 3, 1992) (x-ray technician).

28. See Rev. Rul. 61-196, 1961-2 C.B. 155. This is similar to the distinction made by the Department of Labor in its regulations governing the classification of exempt and nonexempt employees: RNs may be classified as exempt professionals, while LPNs may not. See 29 C.F.R. § 541.301(e)(2).

independent contractor, however, cannot be fired so long as the independent contractor produces a result that meets the hiring party's specifications. So when a hiring party has the right to fire the worker, it is usually treated as evidence that the worker is an employee, rather than an independent contractor. In one situation considered by the IRS, a medical staffing corporation argued that the workers it supplied to medical practices and hospitals were independent contractors, rather than employees of the staffing corporation. But, because the corporation had the right to direct the performance of workers' services for its clients and to fire the workers if they did not perform services to the satisfaction of the client, the IRS found the workers to be employees.<sup>29</sup>

The right of the *worker* to terminate his or her services at any time without incurring any liability is also characteristic of an employment relationship. In contrast, an independent contractor who quits without completing the job for which hired might have to forfeit some of the contract price. The hiring party could also sue the independent contractor either for specific performance (an order from the court to the worker to do the work agreed upon) or for breach of contract, provided that the hiring party can show damages resulting from the failure to complete the work as agreed.<sup>30</sup>

### Opportunity for Profit or Loss

Where a worker has the opportunity to make a profit or take a loss on a job – either by completing it faster or more slowly than the worker anticipated, or at greater or lesser cost than estimated – the courts are more likely to find that the worker is an independent contractor. Employees do not typically have the possibility of making a profit or loss: they are usually

29. See *Weber*, 60 F.3d at 1111, 1113 (although minister could not be fired at will, his failure to follow the Book of Discipline could have resulted in termination by fellow members of the clergy); Rev. Rul. 75-41, 1975-1 C.B. 323 (physicians working for physician services corp. who can be fired at will are employees); Priv. Ltr. Rul. 9320038 (Feb. 22, 1993) (medical director who can be fired with 30-days notice is employee).

30. See Rev. Rul. 70-309, 1970-1 C.B. 199 (oil-well pumpers can quit at any time); Priv. Ltr. Rul. 9320038 (Feb. 22, 1993) (dep't of corrections medical director who could be fired with 30-days notice and could quit at any time was employee); Priv. Ltr. Rul. 200339006 (June 9, 2003) (accounting tech who could quit without incurring liability or penalty was employee)

paid a straight salary or an hourly wage. Courts do not consider an increase in an hourly worker's take-home pay to be an instance of making a profit when that increase is merely the result of working a greater number of hours.<sup>31</sup> Conversely, the Fourth Circuit has made clear that for the purposes of determining independent contractor status, there is no opportunity for a worker to suffer a loss where the only possible loss is the failure of the hiring organization to pay the worker.<sup>32</sup>

In the *Mid-Atlantic* case, the cable installers' opportunity for profit or loss manifested itself in a number of ways. First, the hiring company could charge the installers if they failed to comply with either the technical requirements of an installation or with local ordinances regulating cable installation. Second, the fact that the installers supplied their own trucks and tools, and had responsibility for their own liability and automobile insurance showed that the installers incurred expenses of a type not normally borne by employees and which affected the amount they ultimately earned from a set of jobs. So too did the fact that the installers had responsibility for paying any assistants that they hired and for reporting payments made to the assistants to the IRS.<sup>33</sup>

In contrast, the compensation of Paradise County's new sanitation worker, visiting nurse and accounting clerk would be entirely a function of the number of hours worked. They have no opportunity for profit and loss. This factor weighs strongly in favor of employee status in each of their respective cases.<sup>34</sup>

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31. See *Richardson*, 45 F.Supp.2d at 614 (FLSA case; nurses at mental health crisis clinic who had no opportunity for profit or loss were employees); *Eren*, 180 F.3d at 597 (IRC case; salaried architect who was not paid commission or percentage of profits had no opportunity for profit or loss); *Weber*, 60 F.3d at 1111 (IRC case; minister paid a salary, provided with a parsonage, a utility expense allowance and a travel allowance had no opportunity for profit or loss).

32. See *Eren*, 180 F.3d at 597.

33. See *Mid-Atlantic*, 16 Fed.Appx. at 107, 2001 WL 739243 at \*\*3.

34. See Priv. Ltr. Rul. 200339006 (June 9, 2003) (accounting technician who was paid by the hour and could not hire assistants or substitutes had no opportunity for profit or loss).

## Worker Investment

The issue of whether or not a worker has made an investment in the materials, equipment or additional workers needed for a job is closely related to question of whether or not the worker has an opportunity for profit or loss. The two questions are sometimes analyzed as one, since the investment in supplies and equipment and the hiring of assistants are a form of investment, and a worker who has no investment in the work cannot incur a loss or make a profit.<sup>35</sup>

Where a worker supplies materials or equipment or directly hires others to assist in him or her in completing a job, the courts will weigh this factor in favor of independent contractor status. Where the hiring party supplies materials, equipment and personnel, it is evidence of an employment relationship.<sup>36</sup> For example, when a hospital provided psychologists with staff, office space and all of the supplies necessary for them to see patients, the court found that the psychologists were employees, not independent contractors. Similarly, when a church provided a minister with an office, this factor weighed in favor of employee status. The minister had argued that the fact that he used his home computer for church business gave him an investment in "the business," but the court rejected that argument, finding that he chose to work at home for his own convenience.<sup>37</sup>

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35. See Rev. Rul. 70-309, 1970-1 C.B. 199 (oil-well pumpers who work in field who assume no business risks are employees). See also Priv. Ltr. Rul. 9251032 (Sept. 21, 1992) (nurse in state tuberculosis outreach program who assumed no risk of profit or loss is employee).

36. See *Weber*, 60 F.3d at 1111 (fact that minister used his own computer at home for church work does not mean he had an investment in the equipment used for his work, when the church provided him with an office; he chose to work at home for his own convenience); *Kentfield Medical Hospital Corp.*, 215 F.Supp.2d at 1070 (where psychologists were provided with staff, office space and all tools and equipment necessary for their work and psychologists performed their work at hospital, this factor weighs in favor of employee status); Rev. Rul. 71-524, 1971-2 C.B. 346 (drivers of tractor-trailer rigs are employees of truck-leasing company that supplies rigs and drivers to a common carrier where truck-leasing company owns rigs, furnishes major repairs, tires and license plates, generates all jobs and bears major expenses and financial risks); IRS Priv. Ltr. Rul. 9320038 (Feb. 22, 1993) (dep't of corrections medical director provided with all necessary supplies and equipment was employee).

37. See *Weber*, 60 F.3d at 1111.

Consider again the construction of the swimming pool. The contractor will come to work having already purchased everything that is needed to do the job. The city is unlikely to supply anything. Since the construction of a pool usually requires more labor than a single worker, the contractor will typically supply and pay his (or her) own assistants. The contractor will factor the cost of the material, the equipment and the helpers into the price of the job. Whether the contractor accurately assesses these direct and indirect costs impacts whether he makes a profit or takes a loss on the job.

Similarly, in the *Mid-Atlantic* case, one of the factors weighing heavily in the court's conclusion that the cable installers were independent contractors was the fact that they invested in and brought with them to each job their own tools, trucks and assistants, and that they paid for the insurance that covered the various aspects of their work.<sup>38</sup> In contrast, in *Richardson v. Genesee County Community Mental Health Services*, nurses who worked at a crisis clinic at an hourly rate, but supplied nothing beyond their own expertise, were found not to have any investment in their work.<sup>39</sup>

In Paradise County, neither the sanitation worker, visiting nurse, nor accounts payable clerk will bring tools of their trade to work with them (notwithstanding that the nurse may bring her own stethoscope). They will each use the employer's supplies and equipment. To the extent that the work requires collaboration, they will each work with other workers hired by the employer, rather than going out and seeking assistants themselves. Their individual lack of investment in the resources needed to perform their respective jobs also weighs in favor of employee status for each of these workers.

### Work Requiring Special Skills and Initiative / Offering Services to Others

Independent contractors usually have a special skill and exercise initiative in seeking out assignments or clients. For example, electricians, carpenters, and construction workers, like swimming pool contractors, have special skills.<sup>40</sup> Registered nurses

are also skilled workers.<sup>41</sup> But the mere fact of having a special skill is not in and of itself indicative of independent contractor status. What counts is whether the worker exercises significant initiative in locating work opportunities or clients.<sup>42</sup> Thus, electricians and carpenters who service the needs of a single hiring organization over a long period of time will likely be employees, rather than independent contractors.<sup>43</sup> But when a worker advertises his or her services to the public on a regular and consistent basis, and performs services for a number of unrelated persons or businesses at the same time, that fact generally indicates that the worker is an independent contractor. Performing services for two or more persons or businesses simultaneously, however, is not dispositive evidence of independent contractor status: a person can work for two organizations or persons as an employee of each.<sup>44</sup>

Neither the job of sanitation worker or accounts payable clerk require any special skills or initiative. Individual sanitation workers do not generally offer their services to the public: trash collection is usually a municipal service or one provided by a company under contract. If an accounts payable clerk provided services to a variety of different clients at the same time, the clerk could be an independent contractor. Here, however, the fact that the clerk works a regular

41. See *Richardson*, 45 F.Supp.2d at 614.

42. See *Richardson*, 45 F.Supp.2d at 614 (nurse working after regularly scheduled hours at crisis clinic run by same employer do not locate clients independently), citing *Brock*, 840 F.2d at 1060 (where nurse are paid hourly rate by employing organization, rather than directly by patient, they are likely to be employees). See also *Mathis*, 242 F.Supp. 2d at 784 (special skills factor weighs toward employee status where section 8 housing coordinator's work and client contact took place at housing authority during regular business hours; coordinator did not use skills in any independent way).

43. Where a job does not require any special skills, but requires only initiative for success, this factor will not weigh strongly in either direction. See *Thomas v. Global Home Products, Inc.*, 617 F.Supp. 526, 535 (W.D.N.C. 1985), *aff'd in part, modified and remanded*, 810 F.2d 448 (4<sup>th</sup> Cir. 1987) (local distributor for cookie and candy company is employee).

44. See Rev. Rul. 70-572, 1970-2 C.B. 221 (race-horse jockey who offers services to the horse-racing public is independent contractor). Cf. Priv. Ltr. Rul. 9251032 (Sept. 21, 1992) (nurse for state tuberculosis outreach program did not represent herself as offering services to the public and was employee).

38. See *Mid-Atlantic*, 16 Fed.Appx. at 107, 2001 WL 739243 at \*\*3. See also DOL Wage and Hour Opinion Letter Sept. 5, 2002, 2002 WL 32406602.

39. See *Richardson*, 45 F.Supp.2d at 614.

40. See *Mid-Atlantic*, 16 Fed.Appx. at 107, 2001 WL 739243 at \*\*3.

40-hour week for the county under direct supervision argues against such status.

The visiting nurse does have a special skill. This factor will not weigh heavily in favor of independent contractor status, however, because the nurse does not seek out client service opportunities on her own, but is assigned patients by the health department and is paid by the county, rather than by the patient.

### Duration of the Relationship

Although it is possible for an independent contractor to have a long-term relationship with an employer, the typical independent contractor relationship is usually for a limited duration.<sup>45</sup> The swimming pool contractor is a case in point: the relationship between the city and the contractor lasts only as long as it takes to construct the pool; once payment is made for the finished product, the relationship ends.

A continuing relationship, on the other hand, is strong evidence of employee status. Employers should note that for FLSA and Internal Revenue Code purposes, a continuing relationship can exist where work is performed at frequently recurring, but nonetheless irregular intervals, such as when a person works on an on-call basis. One example of such a relationship would be that of a physician who sees patients at a clinic only when needed.<sup>46</sup>

45. See *Mid-Atlantic*, 16 Fed.Appx. at 107, 2001 WL 739243 at \*\*3 (fact that many cable installers had worked with dependent for a number of years was neutral factor in independent contractor analysis, since it is possible for independent contractors to have a long-term relationship with an employer. See also *Brock*, 840 F.2d at 1060 (nurses were employees even though most nurse received referrals from other sources and few had continuing relationships with the defendant).

46. See *U.S. v. Silk*, 331 U.S. 704 (1947); *Eren*, 180 F.3d at 597 (worker who had performed services for hiring party exclusively for over twenty years was employee rather than independent contractor); *Weber*, 60 F.3d at 1113 (minister's relationship with the church was clearly envisioned as permanent where church paid salaries to ministers even where there are no positions available locally); *Kentfield Medical Hospital Corp.*, 215 F.Supp.2d at 1070 (psychologists were required to work 48 weeks per year and had ongoing relationships with hospital); *Priv. Ltr. Rul. 9326015* (March 31, 1993) (physician in university health clinic had continuing relationship despite the fact that he only worked when needed). See also *Priv. Ltr. Rul. 9320038* (Feb. 22, 1993)(dep't of correction medical director was continuing position).

The projected continuing relationship of Paradise County with its three newest workers further indicates that these workers should be classified as employees.

### Integral Part of the Employer's Business

Where the work that an individual does is an integral part of the employer's operation, the worker is more likely to be an employee than an independent contractor.<sup>47</sup> How do the courts measure whether a specific job is integral to an organization? One measure is whether the worker provides services that the employing organization exists to provide. Workers who perform the mission work of an agency are an integral part of the employer's business. For example, nurses hired by a crisis clinic to provide mental health crisis intervention and referral services to the public were an integral part of the clinic's operation.<sup>48</sup> Similarly, a Section 8 housing coordinator who supervised one of three programs administered by the employer housing authority was an integral part of the housing authority's organization.<sup>49</sup> And a minister's work was clearly part of the regular work of the United Methodist Church, just as treating patients was an integral part of the professional practice of a group of psychologists.<sup>50</sup> None of the positions in these examples were entitled to independent contractor status; all of the workers were employees.

Another question that the court may ask includes whether the worker performs the same work as others who are classified as employees. Where "independent contractors" perform the same work as employees, they are considered integrated into the employer's hierarchy and more likely to be employees.<sup>51</sup> Similarly, where workers are independent contractors "afterhours" for their regular employers, but perform the same job duties as they do during "regular hours," they are most certainly going to be determined to be employees.<sup>52</sup> Indeed, for FLSA purposes, even where

47. See *Thomas*, 617 F.Supp. at 535.

48. See *Richardson*, 45 F.Supp.2d at 614. <sup>48</sup> See also U.S. Dep't of Labor Wage and Hour Opinion Letter dated Aug. 24, 1999, 1999 WL 1788146 (hospital is likely joint employer of private duty nurses with nurse registry).

49. See *Mathis*, 242 F.Supp. 2d at 785.

50. See *Weber*, 60 F.3d at 1112 (minister); *Priv. Ltr. Rul. 9320038* (Feb. 22 1993) (psychologists).

51. See *Brock*, 840 F.2d at 1057-58; *Mathis*, 242 F.Supp.2d at 785.

52. See *Richardson*, 45 F.Supp.2d at 614.

regular employees are hired to perform different jobs “afterhours,” they almost always must be treated as employees. As the U.S. Department of Labor advised one company that desired to hire an employee (the lead designer of its monthly magazine) as an independent contractor (to do the typesetting and laying out of books) through her private business:

[I]t is our opinion that the graphic designer when performing work for your company in her freelance graphic design capacity would also be an employee of your company and not an independent contractor. This is so even though the work that she would perform as a freelance artist would be different than her normal job responsibilities at the company. *It has long been the position of the Wage and Hour Division that it is unrealistic to assume that an employment and “independent contractor relationship” may exist concurrently between the same parties in the same workweek [emphasis added].*<sup>53</sup>

In the case of the swimming pool contractor, it is clear that the contractor does not provide services that are basic to the employer’s mission (because even if providing recreational services is basic to a city’s business, building swimming pools is not). Nor does the contractor do work similar to that done by employees – indeed, the whole point of bringing in the swimming pool contractor was to tap into expertise and experience that is both lacking in the city’s workforce and unlikely to be needed again.

The situation of the Paradise County workers is markedly different. Two perform some of the “mission work” of the county (sanitation work, provision of public health services); one performs work essential to the county’s business operations (paying its bills). All three perform the same work as others hired as employees. A court would likely find all three to be an integral part of the county’s operations. This factor also weighs heavily in favor of employee status.

### Summing Up: Paradise County Has Three New Employees

In engaging the services of the sanitation worker, visiting nurse and accounting clerk, Paradise County has taken on three new employees, notwithstanding how the county or the worker describe the relationship. Why is that the case? Because Paradise County

53. See U.S. Dep’t of Labor Wage and Hour Opinion Letter dated July 5, 2000, 2000 WL 33126569.

- has retained the right to control the work of the sanitation worker, visiting nurse and accounting clerk;
- has the right to fire each of them; and
- has not provided the workers with the opportunity to make a profit or suffer a loss.

The workers, for their part,

- individually have made no investment in the performance of their services for the county; and
- do not seek out client opportunities on their own.

Finally, with respect to each of the workers,

- both Paradise County and the worker envision a continuing relationship; and
- the work done is an integral part of the business of county government.

As a matter of law, the workers are employees, not independent contractors.

### What Happens When the Worker Desires to Be an Independent Contractor?

Sometimes a worker will want to be hired as an independent contractor, rather than as an employee. The worker may be willing to “waive” his or her rights as an employee to overtime, social security contributions and other benefits. It does not work. The worker’s desire to be classified as an independent contractor is irrelevant to a determination of the appropriate legal status since workers cannot waive their status as “employees” for either FLSA or IRC purposes. If a worker is, as a matter of economic reality, dependent upon the hiring party, or if the hiring party has the right to control the worker, the fact that the parties have called their relationship one of principal and independent contractor will not alter the worker’s legal status as employee.<sup>54</sup>

54. See *Thomas*, 617 F.Supp. at 534, citing *Robichaux v. Radcliff Material, Inc.*, 697 F.2d 662, 667 (5<sup>th</sup> Cir. 1983) and *Real v. Driscoll Strawberry Associates, Inc.*, 603 F.2d 748 (9<sup>th</sup> Cir. 1979) (FLSA cases). See also *Mathis*, 242 F.Supp.2d at 786 (section 8 housing coordinator’s request to be treated as independent contractor does not alter “economic reality” that she is housing authority employee)

## Some Hard Cases

### *Positions Funded Through Grants*

Almost all North Carolina government employers -- state agencies, local governments, community colleges and four-year colleges -- have positions whose salaries are funded through grants from federal or private sources. Because these positions are generally created outside of the organization's usual classification and budgeting process, employers may be tempted to engage the workers as independent contractors. An IRS Revenue Ruling on the status of a professor and a clerical worker whose salaries were funded through a grant to a college makes clear that for *all* grant-funded positions, employers should continue to do economic reality and right-to-control analyses. The ruling shows that most workers hired to fill grant funded positions will be employees rather than independent contractors.

In Revenue Ruling 55-583, the IRS found that a professor who was responsible for conducting research and supervising support staff under a grant from a private foundation to a state college was an employee of the college with respect to both that portion of his salary that was paid out of the college's budget *and* the portion paid out of grant funds. Although the professor had discretion with respect to the means and methods of performing the research, as well as over the hours during which research was performed, the college had broad general supervision over the way the grant money was spent and had a right to exercise direction and control. The professor had hired a clerical assistant to work with him exclusively on grant-related research and her salary was also paid from grant funds. The IRS found that she had been hired with the implied consent of the college and held that where one employee (here, the professor) hires other individuals in connection with the first employee's work with either the express or implied consent of the employer, those other individuals are also employees of the employer.<sup>55</sup>

Two points are worth emphasizing here. Except perhaps in the case of certain kinds of scientific research, most grants are made to the organization -- sometimes to the individual who will carry out the project *and* the organization, but rarely to the individual alone. This means that the hiring organization will usually have the right to exercise direction and control over the activities funded by the

(FLSA). See also *Weber*, 60 F.3d at 1113 (Internal Revenue Code).

55. See Rev. Ruling 55-583, 1955-2 C.B. 405.

grant. As explained above, the right to control a worker's activities weighs heavily in favor of employee status, even where the hiring organization does not exercise that right.

Second, the individual in charge of administering the grant may well prefer that workers hired under the grant not receive the benefits paid to other employees in the organization. This may be because the positions are for a defined, short-term duration or because the grant money is not sufficient to cover the cost of the benefits. Even if grant-funded workers do not receive benefits, they are likely to be employees if the organization or an employee of the organization is directing them in the performance of their duties. While the duration of the relationship is a distinct factor to be considered in determining worker status, the fact that a job is temporary will not turn the worker into an independent contractor where other factors weigh in favor of employee status.

### *Adjunct or Part-Time Instructors in Colleges, Recreation and Parks Departments or Employee Training and Development Programs*

While educational institutions make the greatest and most obvious use of adjunct or part-time instructors, local government recreation and parks departments also frequently hire part-time workers to teach physical education and activity classes and other subjects. Similarly, employers offering employee training and development programs are likely to make use of outside, adjunct workers to lead training sessions. Use of adjunct instructors such as these would, on its face, appear to be a textbook example of the proper classification of a worker as an independent contractor:

- adjunct instructors are engaged for a limited duration to do a defined job;
- adjunct instructors typically have a particular expertise for which they are hired and typically perform similar or related services for other organizations or individuals;
- for colleges and local government recreation programs, the hiring organization charges a fixed fee for the courses or sessions that adjunct instructors teach and typically pay the instructors some percentage of that as a fixed fee for their services.

The IRS, however, takes a different view. In a series of revenue rulings, private letter rulings and technical

advice memoranda, the IRS has held that part-time instructors are employees where the hiring organization

- determines the courses that are offered,
- determines the content and hours of each course,
- enrolls the students, and
- provides the facilities at which the instruction is offered, and

the instructor

- is required to perform his or her services personally;
- has no investment in the facilities;
- does not bear a risk of profit or loss (that is, the instructor is paid the same amount whether or not tuition and fee payments cover the hiring organization's expenses).

The IRS takes this position even if the instructor provides teaching services or services related to the subject of expertise to others and may devote only a small percentage of work time to the instruction performed for the hiring organization.<sup>56</sup> The IRS analysis focuses on the fact that the hiring organization controls everything about the way in which the "teaching services" are performed – that is, in each of the cases the IRS considered, the hiring organization controlled everything except the actual delivery of the material.

Would the FLSA economic reality test provide a different result? Probably not. As discussed above, the FLSA economic reality test and the IRS right-to-control test consider essentially the same factors. Research for this Bulletin has not revealed any cases that address the issue of an adjunct instructor's status as employee or independent contractor under the FLSA. This lack of cases is not surprising. Most instructors would have little reason to bring an FLSA claim. Many instructors would qualify as FLSA-exempt professionals and few nonexempt part-time instructors are likely to work in excess of 40 hours such that overtime is an issue.

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56. See Rev. Ruling 70-308, 1970-1 C.B. 199; Tech. Adv. Mem. 91-05-007 (February 1, 1991); Tech. Adv. Mem. 89-25-001 (June 23, 1989); Priv. Ltr. Rul. 8728022 (April 10, 1987).

### *Physicians*

Correctly classifying physicians hired to staff health clinics, on-site occupational health offices, or public hospitals presents some of the same challenges as classifying registered nurses, discussed above in the section on professionals. Given their very high level of specialized training, physicians generally exercise almost complete discretion in their treatment of patients and are subject to relatively little day-to-day supervision. Where there is such supervision, it is generally provided by another physician.

As discussed earlier, an important factor in determining whether a worker is an employee or independent contractor is the extent to which the services the worker performs are an integral part of the hiring organization's regular business. As the IRS has noted in Rev. Ruling 66-274, a hiring organization that engages a physician usually does so because providing medical services is necessary to its operation. More important than the question of whether the physician's services are integral to the organization, therefore, is the way the services of the physician are integrated into the hiring organization. Significant factors here are (1) the manner in which the physician is paid for his services -- that is, whether the physician is paid on a percentage basis, salary basis or a percentage basis with a guaranteed minimum; (2) whether the physician is permitted to employ associate physicians or to engage substitutes when he or she is absent from work; (3) if the physician is permitted to engage substitutes, whether the physician or the hiring organization is responsible for compensating them; and (4) whether the physician is permitted to engage in the private practice of medicine or to perform professional services for others.<sup>57</sup> In other words, in the case of physicians, the right to control is a less important set of factors for IRS purposes than is the extent to which the physician is economically independent of the hiring organization.

Applying these factors, the IRS found that a physician director of a hospital pathology department was an independent contractor where the physician received a percentage of the department's gross receipts as his only compensation, personally paid his

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57. See Rev. Rul. 66-274, 1966-2 C.B. 446. See also *Weber*, 60 F.3d at 1112 (minister's work clearly part of regular work of United Methodist Church); Priv. Ltr. Rul. 9320038 (Feb. 22, 1993) (dep't of corrections medical director paid hourly rate is employee); Priv. Ltr. Rul. 8937039 (Sept. 15, 1989) (psychologists treating patients for professional firm are employees).

associates or substitutes, was permitted to engage in the private practice of medicine, and was not subject to the direction and control of any hospital representative, such as a chief of staff.<sup>58</sup> But a physician director of a hospital laboratory was an employee where he was guaranteed a minimum salary in addition to a specified percentage of charges attributable to his department, and he could not pursue outside business or provide pathology services to others without written consent and is an employee.<sup>59</sup>

## Penalties

### FLSA

An employer may misclassify a worker as an independent contractor when the FLSA's economic reality test determines that the worker ought to be classified as an employee. If the worker is a nonexempt employee and has worked in excess of 40 hours in any workweek, the employer is in violation of the FLSA. In such an instance, the worker will have a claim to unpaid overtime compensation. Employer liability for violations of the FLSA's overtime provisions include the full amount of unpaid overtime going back for a period of two years and an additional amount equal to the amount of the unpaid overtime as liquidated damages.<sup>60</sup> This presumes that the violation was not willful. Where the violation is willful – that is, where the employing organization has been put on notice of its noncompliance with the FLSA by the U.S. Department of Labor or otherwise has reason to know that it is noncompliant, or where it shows a reckless disregard for the provisions of the FLSA – then, the employer's liability for unpaid overtime compensation extends back for a period of three years, and it will be responsible for an equal amount in liquidated damages.<sup>61</sup>

58. See Rev. Rul. 66-274, 1966-2 C.B. 446.

59. See Rev. Rul. 73-417, 1973-2 C.B. 332.

60. See 29 U.S.C. §§ 216(b) and 255(a).

61. See 29 U.S.C. § 255(a); *Brock*, 840 F.2d at 1061.

Note that conduct that is merely unreasonable or negligent with respect to ascertaining an employer's obligations under the FLSA is not considered to be willful. See *McLaughlin v. Richland Shoe Co.*, 486 U.S. 128, 131, 133-35 (1988), *overruling* *Donovan v. Bel-Loc Diner, Inc.*, 780 F.2d 1113 (4<sup>th</sup> Cir. 1985). See also *Troutt v. Stavola Brothers, Inc.*, 905 F.Supp. 295, 302 (M.D.N.C. 1995), *aff'd*, 107 F.3d 1104 (4<sup>th</sup> Cir. 1997) (mere failure to seek legal advice, stand alone, is insufficient to establish

## Internal Revenue Code

When the Internal Revenue Service determines that a worker previously classified as an independent contractor does not meet its right of control test and is legally an employee, the employer will be liable for a percentage of the worker's federal income tax liability, for both the employer's own share of the worker's FICA tax liability and a percentage of the worker's share, and potentially for interest on the underwithheld amounts and penalties. Where the employer has unintentionally misclassified the worker, but has at least filed Form 1099 showing the amounts paid to the worker each tax year, the employer will be liable for only 1.5 percent of the worker's federal income tax liability and up to 20 percent of the worker's missing FICA contribution. The employer's liability increases to 3% of the worker's income tax liability and up to 40% of the worker's missing FICA contribution if it has failed to file Form 1099. If the IRS finds that the employer intentionally misclassified the worker, the employer may be liable for the worker's entire federal income tax liability and for the worker's entire FICA contribution. The employer may not seek reimbursement from the worker for taxes, penalties or fines imposed by the IRS.<sup>62</sup>

### *Section 530: A Potential Safe Harbor?*

Private employers may avail themselves of the "safe harbor" defense against the tax and FICA consequences of the misclassification of workers

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willfulness where there is no pattern of complaints to employer or in the industry that could establish knowledge or recklessness on part of employer). But an employer's failure to investigate whether its policies violate the FLSA where employees have questioned those policies would be reckless. See *Davis v. Charoen Pokphand (USA), Inc.*, 302 F.Supp.2d 1314, 1327 (M.D.Ala. 2004); *LaPorte v. General Electric Plastics*, 838 F.Supp. 549, 558 (M.D.Ala. 1993). In the Fourth Circuit, the determination of whether a violation was willful or not under 29 U.S.C. § 255(a), and thus whether the employer's liability for back overtime extends back three or merely two years will be determined by a jury. See *Fowler v. Land Management Group, Inc.*, 978 F.2d 158, 162-63 (4<sup>th</sup> Cir. 1992); *Soto v. McLean*, 20 F.Supp.2d 901, 913 (E.D.N.C. 1998) (denying defendants' motion for summary judgment).

62. See 26 U.S.C. §§ 3509, 6601, 6651, 6662 and 6721.



offered by section 530 of the Revenue Act of 1978.<sup>63</sup> Whether public employers may successfully invoke this safe harbor is unclear.

Under section 530, an employer meeting the following conditions will not be held liable for failure to withhold employee federal income taxes or for past-due FICA taxes: (1) the employer has treated a worker as an independent contractor, (2) it has filed all required federal employment tax returns on a basis consistent with the classification as an independent contractor (that is, the employer has filed Form 1099), and (3) it had a reasonable basis for not treating the worker as an employee.<sup>64</sup> Section 530 relief is not available, however, where the employer has treated another worker holding a substantially similar position as an employee.<sup>65</sup>

Section 530 provides that a taxpayer had a reasonable basis for not treating an individual as an employee if it had relied on either (a) judicial precedent, published rulings, technical advice with respect to the employer, or a letter ruling to the employer; (b) a past IRS audit of the employer in which there was no assessment attributable to the employer's treatment as of individuals holding positions substantially similar to the position in question as independent contractors; or (c) long standing recognized practice of a significant segment of the industry in which such individual was engaged.<sup>66</sup> Courts have held that an employer can satisfy the reasonable basis requirement by establishing that it relied on the advice of an attorney in making the decision to treat a worker as an independent contractor.<sup>67</sup>

63. Section 530 of the Revenue Act of 1978 has never been codified, although it is valid law. It is found as a note to 26 U.S.C. § 3401.

64. See 26 U.S.C. § 3401 note (section 503(a)(1)(B)); *Ahmed v. United States*, 147 F.3d 791, 797 (8<sup>th</sup> Cir. 1998) ("Section 530 does not confer eternal immunity from employment tax liability . . . it merely eliminates liability for those discrete periods of time during which the employer erroneously but reasonably failed to treat an individual as an employee"); *Springfield v. United States*, 88 F.3d 750, 753 (9<sup>th</sup> Cir. 1996); *Reag, Inc.*, 801 F.Supp. at 502.

65. See *Kentfield Medical Hospital Corp.*, 215 F.Supp.2d at 1068; *Select Rehab, Inc., v. United States*, 205 F.Supp.2d 376, 380 (M.D.Pa. 2002); *Halfhill v. United States Internal Revenue Service*, 927 F.Supp. 171, 175 (W.D.Pa. 1996).

66. See Section 530(a)(2).

67. See *Hospital Resource Personnel, Inc.*, 68 F.3d at 426-27 (temporary nurses); *Select Rehab, Inc.*, 205

### *Section 530 and the Public Sector*

The extent to which public-sector employers may invoke section 530 as a defense against past improper classification of workers as independent contractors is unclear. Nothing in section 530 itself limits its applicability to private-sector employers. The IRS, however, has said that section 530 is available to government employers only as a defense against *federal income tax liability*, not for FICA tax liability. Unfortunately, the IRS has not formally set out its position in a revenue ruling. Thus, in training materials prepared by the IRS for its employees in 1996 and still available to the public on its website, the IRS instructs that section 530 relief is available for state and local governments *for federal income tax liability*, provided that they meet the requirements set forth above. But although the training manual strongly suggests that a government employer may invoke section 530 in defense of its misclassification of a worker for purposes of federal income tax withholding, the training materials cannot be cited as authority for any of the position set forth therein.<sup>68</sup>

The training material does not explicitly address the availability of section 530 to state and local governments as a defense against misclassification for FICA purposes. Indeed, in two Technical Advice Memoranda from 1991, the IRS took the position that government agencies and instrumentalities are not entitled to relief under section 530 for FICA tax liability. The IRS reasoned that Congress did not intend to include government employers among those to whom it was granting relief by enacting section 530 because neither federal, state or local governments nor their employees were subject to FICA taxes at that time.<sup>69</sup> Technical Advice Memoranda are not, however, intended to be relied upon by anyone other than the employer to whom they are issued and thus are not binding. Neither

F.Supp.2d at 383 (medical directors); *North Louisiana Rehabilitation Center, Inc., v. United States*, 179 F.Supp.2d 658, 669 (W.D.La. 2001) (physician medical and program directors); *Queensgate Dental Family Practice, Inc. v. United States*, 1991 WL 260452 (M.D.Pa. 1991), *aff'd*, 970 F.2d 899 (3d Cir. 1992) (dentists); *Déjà vu Entm't Enterp. Of Minn., Inc. v. United States*, 1 F.Supp.2d 964, 969 (adult-entertainment club performers) (D.Minn. 1998).

68. See "Independent Contractor or Employee?: Training Materials," Internal Revenue Service Training 3320-102 (10-96), p. 1-37, available at <http://www.irs.gov/pub/irs-utl/emporind.pdf>.

69. See IRS Tech. Adv. Mem. 91-05-007 (Feb. 1, 1991) and Tech. Adv. Mem. 91-51-004 (Dec. 20, 1991).

Technical Advice Memorandum provides any legal citations supporting the IRS position, and the author has been unable to find any federal district court, court of appeals or tax court case so holding.

Any public employer that finds itself liable under the Internal Revenue Code for failure to withhold wages and for failure to withhold employees' and pay their own FICA contributions should assert a section 530 safe harbor defense if it has a reasonable basis for doing so. It should probably be prepared, however, for the IRS to reject the defense with respect to its failure to withhold and contribute FICA taxes and to challenge that rejection in court.

## Determining Worker Status under Other Employment Statutes

The question of worker status as employee or independent contractor arises in contexts other than overtime and tax withholding.

- What happens when a worker suffers sexual harassment, for example? Sexual harassment is a form of gender discrimination prohibited by Title VII of the Civil Rights Act of 1964, but Title VII's protections extend only to "employees."
- What happens when a worker is injured on the job? Again, the North Carolina Workers' Compensation Act covers "employees," but not independent contractors.
- A worker who is dismissed from a job typically seek unemployment benefits, but similarly, the North Carolina Employment Security Act only makes benefits available to "employees."
- Finally, what of the worker who grows too old to work? A worker who has worked as an "independent contractor" for a single public employer for as many as ten or even twenty years would not be eligible to draw benefits from either the Teachers and State Employees Retirement System or the Local Government Employee Retirement Systems, both of whose participants must be "employees."

Employers should keep in mind that when things go unexpectedly wrong and workers suffer physical injury in the workplace, emotional distress from harassment or financial difficulties from layoff or retirement, they may challenge their status as "non-employees" and seek to enjoy the benefits and

remedies provided to employees under various employment statutes. This may happen even where workers have willingly performed services as "independent contractors" and have understood that this status excluded them from coverage under the employer's workers' compensation insurance, and from enjoying unemployment insurance and retirement system benefits.

Public employers should therefore understand how work status is determined under each of the statutory schemes governing these programs. As the following sections show, interpretation of each of these statutes requires use of the common-law test to determine whether or not a worker is an employee.

## Federal Anti-Discrimination Law: Title VII, the Americans with Disabilities Act and the Age Discrimination in Employment Act

Title VII of the Civil Rights Act of 1964, the Americans with Disabilities Act (ADA) and the Age Discrimination in Employment Act (ADEA) prohibit employers from discriminating against employees on the basis of race, color, gender, religion, and national origin, disability, and age. While all three of these anti-discrimination statutes nominally define employee, the definitions are circular: Title VII defines "employee" as "an individual employed by an employer," as do both ADA and the ADEA.<sup>70</sup> Title VII and the ADA each define "employer" as a "person . . . who has fifteen or more employees" during a specified period of time; the ADEA defines "employer" as including "a State or political subdivision of a State and any agency or instrumentality of a State or a political subdivision of a State."<sup>71</sup>

It is a general rule of federal statutory construction that when Congress uses the term "employee" in a statute without defining it further, the courts will presume that Congress intended to describe the typical employer-employee relationship as it is understood at common law.<sup>72</sup> Thus, for Title

70. See 42 U.S.C. § 2000e(f) (Title VII); 42 U.S.C. § 12111(4) (ADA); 29 U.S.C. § 630(f) (ADEA).

71. See 42 U.S.C. § 2000e(b) (Title VII); 42 U.S.C. § 12111(5) (ADA); 29 U.S.C. § 630(b) (ADEA).

72. See *Darden*, 503 U.S. at 322-23 (construing the undefined term "employee" under the Employee Retirement and Income Security Act); *Reid*, 490 U.S. at 739-40 (construing the undefined term "employee" under the Copyright Act of 1976).

VII, ADA and ADEA purposes, the degree of control exercised by the hiring party will determine whether the worker is an employee or independent contractor.<sup>73</sup> The relevant factors include most of those used in the Internal Revenue Code right-to-control test.<sup>74</sup> A worker who is an employee under the FLSA and Code test will almost certainly also be an employee for Title VII, ADA and ADEA purposes.

### **The North Carolina Workers' Compensation Act and the North Carolina Employment Security Act**

Under the North Carolina Workers' Compensation Act, "employees" are entitled to medical benefits and compensation for lost wages if they suffer an injury by accident while on the job or develop an occupational disease. The Workers' Compensation Act defines the term "employee" as "every person engaged in an employment under any appointment or contract of hire or apprenticeship, express or implied, oral or written . . ."<sup>75</sup> As is the case under the FLSA

73. See, e.g., *Farlow v. Wachovia Bank of North Carolina*, 259 F.3d 309, 313 (4<sup>th</sup> Cir. 2001) and *Cilecek v. Inova Health System Services*, 115 F.3d 256, 260 (4<sup>th</sup> Cir. 1997), cert. denied, 522 U.S. 1049 (1998) (Title VII); *Clackamas Gastroenterology Associates*, 538 U.S. at 449-50 (holding that common law test was appropriate standard by which to determine whether physician-shareholders were employees of professional corporation for ADA purposes); *Mangram v. General Motors Corp.*, 108 F.3d 61, 62-63 (4<sup>th</sup> Cir. 1997) and *Garrett v. Phillips Mills, Inc.*, 721 F.2d 979, 980 (4<sup>th</sup> Cir. 1983) (ADEA).

74. The factors, as set forth in *Reid* are: the hiring party's right to control the manner and means by which the product is accomplished; the skill required; the source of the instrumentalities and tools; the location of the work; the duration of the relationship between the parties; whether the hiring party has the right to assign additional projects to the hired party; the extent of the hired party's discretion over when and how long to work; the method of payment; the hired party's role in hiring and paying assistants; whether the work is part of the regular business of the hiring party; whether the hiring party is in business; the provision of employee benefits; and the tax treatment of the hiring party. See *Reid*, 490 U.S. at 751-52; *Darden*, 503 U.S. at 322-23. See also *Farlow*, 259 F.3d at 313; *Cilecek*, 115 F.3d at 260; *Clackamas Gastroenterology Associates*, 538 U.S. at 445, 449-50; *Mangram*, 108 F.3d at 62-63; *Garrett*, 721 F.2d at 982.

75. See N.C.G.S. § 97-2(2).

and the Internal Revenue Code, the definition is somewhat circular. Accordingly, the North Carolina Supreme Court has held the appropriate test to determine worker status is the traditional common law test.<sup>76</sup>

Under the North Carolina Employment Security Act, unemployment insurance benefits may be paid to workers who have been separated from employment. In addressing worker status, this act is as unenlightening as the Workers' Compensation Act. The Employment Security Act defines "employment" as services performed "for wage or under any contract of hire . . . in which the relationship of the individual performing such service and the employing unit for which such service is rendered is, as to such service, the legal relationship of employer and employee . . . The term 'employee' . . . does not include (i) any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an independent contractor . . ."<sup>77</sup> The North Carolina Court of Appeals has said that the appropriate test here as well is the common law test of the right-to-control.<sup>78</sup>

The common law right-of-control test as developed under North Carolina law and applicable to both the Workers' Compensation Act and the Employment Security Act is spelled out in the 1944 case of *Hayes v. Elon College*. The factors that are indicative of independent contractor status under the *Hayes* test mirror those found in the FLSA economic reality and Internal Revenue Code right-to-control tests, namely, whether the person employed (a) is engaged in an independent business, calling or occupation; (b) is to have the independent use of his special skill, knowledge or training in the execution of the work; (c) is doing a specified piece of work at a fixed price or for a lump sum or upon a quantitative basis; (d) is not subject to discharge because he adopts one method of doing the work rather than another; (e) is not in the regular employ of the other contracting party; (f) is free to use such assistants as he may think proper; (g) has full control over such assistants; and (h) selects his own time. As is the case under the FLSA and Internal Revenue Code tests, the presence or absence of no one factor is

76. See *McGown v. Hines*, 353 N.C. 683, 686 (2001); *Hughart v. Dasco Transportation, Inc.*, 606 S.E.2d 379, 385 (N.C.App. 2005).

77. See N.C.G.S. § 96-8(6)a.

78. See *Employment Security Commission v. Huckabee*, 120 N.C.App. 217, 219 (1995), aff'd, 343 N.C. 297.

determinative.<sup>79</sup> A worker who is an employee under the FLSA and Code tests is very likely to be an employee for workers' compensation and unemployment insurance purposes, as well, and vice-versa.

## Retirement Systems

Chapter 135 of the North Carolina General Statutes, which governs the Teachers and State Employees Retirement System (TSERS), requires that all teachers and State "employees" be enrolled in TSERS.<sup>80</sup> Chapter 135 goes on to define the term "employee" as meaning "all full-time employees, agents or officers of the State of North Carolina . . . provided that the term 'employee' shall not include . . . any part-time or temporary employees."<sup>81</sup> Chapter 128, which governs the Local Government Employee Retirement System (LGERS), defines the term "employee" as "any person who is regularly employed in the service of and whose salary or compensation is paid by the employer as defined [below] . . . whether employed or appointed for stated terms or otherwise."<sup>82</sup> No cases have arisen under either TSERS or LGERS in which the North Carolina courts have had to decide whether a worker was an employee or independent contractor for the purposes of determining eligibility for participation in one of the retirement systems. It seems likely, however, that the North Carolina Supreme Court would find that Chapters 135 and 128, like the Workers' Compensation Act and the Employment Security Act, refer to the common law meaning of "employee" and would apply the *Hayes* test to determine the status of workers for retirement systems purposes.

## Worker Classification and Employee Benefits

In several private-sector cases, workers engaged as independent contractors have sued their hiring organizations, claiming that they are common-law employees and that they are therefore entitled to participate in the hiring organization's employee

79. See *Hayes v. Elon College*, 224 N.C. 11, 15 (1944). See also *Hughart*, 606 S.E.2d at 385; *Huckabee*, 120 N.C.App. at 219-220.

80. See N.C.G.S. § 135-3(1).

81. See N.C.G.S. § 135-1(10).

82. See N.C.G.S. § 128-21(10).

benefit plans.<sup>83</sup> In some cases, the employees have sought the value of benefits retrospectively. Could such a suit be successful against a North Carolina public employer?

The answer to this question is unclear: there are no reported cases involving claims of this kind against a public employer from North Carolina state or federal courts. Nor has research for this Bulletin revealed any public-sector cases raising this issue in other jurisdictions. But consideration of North Carolina law governing public-sector employee benefits and of the Ninth Circuit Court of Appeals decision in *Vizcaino v. Microsoft Corp.*, the most widely publicized of the private-sector cases, suggests that public-sector workers who meet the test for common-law employee status may have a right to participate in the hiring organization's benefit plans on the same terms as those the organization has recognized as "employees" from the outset.

## The Law Governing Public-Employee Benefits

Federal law does not require employers – public or private --to provide their employees with retirement, health insurance, or any other kind of benefit. The North Carolina General Statutes require state, community college and local school board employees to participate either in the Teachers and State Employees Retirement System or in an alternative retirement program, and to have the opportunity to

83. See e.g., *Vizcaino v. Microsoft Corp.*, 120 F.3d 1006 (9<sup>th</sup> Cir. 1997), *cert. denied*, 522 U.S. 1098 (1998) (workers' status as common-law employees made them eligible for participation in employee benefit plans despite being labeled independent contractors in employment agreements). See also *Epright v. Environmental Resources Management, Inc. Health and Welfare Benefit Plan*, 81 F.3d 335 (3d Cir. 1996) (where employee benefit plan eligibility was predicated on "full-time employment," company could not exclude full-time temporary employees from participation); *Daughtry v. Honeywell, Inc.*, 3 F.3d 1488 (11<sup>th</sup> Cir. 1993) (if worker was common-law employee for period of consulting agreement, then she was entitled to participate in employer's ERISA benefit plans); *Henley v. Northwest Permanente P.C. Retirement Plan and Trust*, 1999 WL 658886 (D.Ore. Aug. 12, 1999) (employer illegally excluded eligible workers from ERISA benefit plan when it interpreted the term "employee" as referring to "W-2 employees;" proper test was common-law test of employee status set forth in *Darden*).

join the State Health Plan.<sup>84</sup> In contrast, the General Statutes do not require local government employers to offer retirement or health insurance benefits.<sup>85</sup> As a practical matter, however, most employers find that they must offer some kind of minimal benefits package in order to recruit and retain good employees.

In designing benefits packages, employers are generally free to create separate classes of employees, some of whom are eligible to participate in benefits plans, some of whom are not, some of whom receive more generous benefits, other less generous ones. The only limitation on an employer's ability to fashion benefits offerings as it sees fit is that any exclusion of an employee or group of employees from participation in a benefit plan may not be based on race, color, gender, religion, national origin, age, disability or any other category prohibited by law.<sup>86</sup>

Public employer retirement and welfare-benefit plans such as health insurance are governed by state contract law. This is in contrast to private-sector pension and welfare-benefit plans which are governed by the federal Employee Retirement Income Security Act (ERISA).<sup>87</sup>

Under North Carolina contract law, when an employer's personnel policy has promised employees certain benefits, the promise is enforceable and the employer must provide the benefits promised.<sup>88</sup> This is an exception to the general rule adopted by the

84. For retirement, *see* Chapter 135 of the N.C.G.S., esp. §§ 135-1(10) and (11); for health insurance, also *see* Chapter 135, esp. §§ 135-40 and following. For additional benefits, *see, e.g.*, N.C.G.S. §§ 115C-341, 115C-342, and 115C-343.

85. *See, e.g.*, N.C.G.S. § 160A-162(b), which grants to the municipal council the authority to "purchase life, health, and any other forms of insurance for the benefits of all or any class of city employees and their dependents."

G.S. § 153A-92(d) grants identical authority to county boards of commissioners with respect to county employees

86. *See, e.g.*, 42 U.S.C. § 2000e-2 (Title VII); 29 U.S.C. § 623 (ADEA); 42 U.S.C. § 12112 (ADA); 38 U.S.C. § 4311 (Uniformed Services Rights and Reemployment Act prohibiting employment discrimination against persons serving in the armed forces).

87. For the exclusion of government pension and welfare-benefit plans from ERISA's coverage, *see* 29 U.S.C. §§ 1002(32) and 1003(b)(1).

88. *See, e.g.*, *Brooks v. Carolina Telephone*, 56 N.C. App. 801 (1982); *Hamilton v. Memorex Telex Corp.*, 118 N.C. App. 1, *disc. rev. denied*, 340 N.C. 260 (1995); *White v. Hugh Chatham Memorial Hospital*, 97 N.C. App. 130, *disc. rev. denied*, 326 N.C. 601 (1990).

North Carolina courts that says that an employer's issuance of a personnel policy manual or handbook for employees does not create an implied contract of employment incorporating the document's terms.<sup>89</sup> The rule that makes a promise of benefits enforceable would likely be the linchpin of worker arguments that as common-law employees, they are entitled to employee benefits.

### The Argument: A Promise of Employee Benefits is Enforceable

In the hypothetical case set forth at the beginning of this article, Paradise County has hired three new workers as "independent contractors." Imagine now that there has been a ruling by a court that the workers satisfy both the FLSA economic-reality test and the Internal Revenue Code right-to-control test: the workers are common-law employees. Following that ruling, the workers assert that they have the right to participate in Paradise County's various benefit plans – most importantly, in the county's health insurance plan – and they make claims for the value of benefits that they did not receive while performing services for the county under the misapprehension that they were independent contractors.

Will their claims succeed? Probably yes. Paradise County has some arguments on its side, but it will most likely lose this case.

As noted above, under North Carolina law, when an employer's personnel policy has promised employees certain benefits, the promise is enforceable and the employer must provide the benefits promised. This means that employers must provide the benefits set forth in the personnel policy as long as the provision and the policy that contains it remain in effect.<sup>90</sup> The workers' argument, then, is

89. *See Rucker v. First Union Nat'l Bank*, 98 N.C. App. 100 (1990), *disc. rev. denied*, 326 N.C. 801 (1990); *Smith v. Monsanto Co.*, 71 N.C. App. 632 (1984); *Griffin v. Housing Auth.*, 62 N.C. App. 556 (1983).

90. *See, e.g., Brooks*, 56 N.C. App. 801 (1982) (where employee manual represented that certain management employees would be entitled to severance pay if their employment were terminated without cause, it was employer's burden to prove that it had in fact eliminated the benefit and communicated that change to employees prior to plaintiff's termination); *Hamilton*, 118 N.C. App. at 11 (1995); *White*, 97 N.C. App. 130 (where employer promised in handbook that employees could maintain coverage under the employer's group health plan in event that they became permanently disabled during the period of

that since they have been found to be employees, they were employees all along. As employees, they claim, they have an enforceable right to participate in the county's benefit plans – a right that the county has denied them.

If Paradise County's personnel policy is like that of most North Carolina public employers, it offers participation in its benefit plans to all full-time "employees," without defining the term "employee" any further. If asked to interpret the meaning of the term, a North Carolina court would most likely apply the common law right-of-control test set forth in *Hayes v. Elon College*, as it has done with respect to the Workers' Compensation Act and the Employment Security Act (and would likely do in interpreting the meaning of the term "employee" under Chapter 135, which governs participation in the Local Government Employees Retirement System). A court would likely find that the workers are employees within the meaning of the Paradise County personnel policy and were and are entitled to participate in its benefit plans.

### Counter-Argument #1: The Workers Are Not Employees for Benefit Purposes

Paradise County might be tempted to argue in response that although the three workers are employees, they are a special kind of employee not eligible for benefits – that they are, for example, "contract employees" (or some other term), as opposed to "regular employees." The federal Ninth Circuit Court of Appeals considered and rejected an argument of this kind in *Vizcaino v. Microsoft Corp.* Microsoft workers had signed written agreements when they were first engaged to work that said that they were independent contractors and not employees. The workers later claimed that they were in fact common-law employees and were entitled to participate in Microsoft's employee 401(k) plan and its employee stock purchase plan.

With respect to participation in both plans, the Ninth Circuit reasoned as follows: Microsoft could have employed these workers as a separate category of employees – that is, employees who did not receive the benefits that regular employees did. If Microsoft had been withholding taxes on these workers, that would have suggested that Microsoft

their employment, promise was enforceable even where changes in terms of employer's group health plan made cost of covering disabled employee much more expensive than anticipated).

had indeed set them up as a separate "species of employee."<sup>91</sup> But, since Microsoft failed to withhold income and FICA taxes, it clearly thought that the workers were not employees at all, but independent contractors. The court described Microsoft's conduct as consistently distinguishing "the Workers from other employees, both regular full-time and temporary. It did not say that the Workers were employees in some special category; rather, it said that they were not employees at all."<sup>92</sup>

The Microsoft case suggests that if Paradise County's personnel policy provided for different classes of employees -- for example, "permanent employees" or "regular employees," on one hand, and "contract employees," on the other (or, more starkly perhaps, "benefits employees" and "non-benefits employees") – the county's argument that the three new workers were different from other employees and not eligible for benefits might have a chance of success. N.C.G.S. § 153A-92(d) clearly grants to a board of county commissioners the authority to offer benefits to "all *or any class of county employees* and their dependents" (emphasis added) (N.C.G.S. § 160A-162(b) grants corresponding authority to municipal councils). What Paradise County will need to show is that it has indeed created classes of employees, and that its personnel policy provides that one class of employees ("permanent employees," for example) is eligible for benefits, while the other ("contract employees," for example) are not.

Imagine now that the Paradise County personnel policy created different classes of employees and excluded at least one class from participation in its benefit plans. Even if it were not clear to which category of employee the three new workers belonged (after all, when they were hired, the county did not think they were employees and so did not characterize them as such), the personnel policy would be evidence that the county regularly hired some employees on terms that did not include benefits. At a minimum, Paradise County would need to show the existence of a group of non-participating employees to persuade a judge that the three new workers were not entitled to benefits despite being common-law employees.

The likelihood is, however, that Paradise County did not have different classes of employees – "benefits employees" and "non-benefits employees." It simply mischaracterized these workers, and Counter-Argument #1 fails.

91. See *Microsoft*, 120 F.3d at 1011.

92. See *Microsoft*, 120 F.3d at 1011.

## Counter-Argument #2: The Workers Waived Their Right to Benefits

Suppose (as is most likely) that the Paradise County personnel policy does not distinguish among classes of employees and that all full-time employees are eligible to participate in its benefits program. In that case, the county might argue that even if the three new workers it has hired are common-law employees and eligible to participate in benefit plans, they have waived their right to do so.

This argument has intuitive, common-sense appeal. The argument would go like this: When the workers were hired, they agreed to terms that provided that they would not receive benefits. The agreement that each made with the county was that they would work as “independent contractors” and, more specifically, that (1) they would not be paid overtime, (2) the county would not withhold income or employment taxes from their earnings, (3) the county would not contribute an employer’s share of social security or FICA taxes, and (4) the workers would not receive health insurance or any other welfare-benefit provided to county employees. As it turned out, federal law did not permit the workers to waive their rights as employees under the FLSA and the Internal Revenue Code. Provisions (1), (2) and (3) of their agreements are therefore void. But what about the workers’ agreement to provide services without receiving health or other benefits? Can they not agree to work on such terms? Can they not waive their rights as common-law employees to participate in benefit plans?

It looks as if, for reasons set out below, the waivers are not effective. Counter-Argument #2 fails.

### *No Waiver Where There Is Mutual Mistake*

Generally speaking, employees can waive their rights to participate in benefit plans. But the Ninth Circuit’s opinion in the *Microsoft* case shows some of the problems inherent in making this argument when an employer hires employees under the legally incorrect premise that they are independent contractors.

First, the *Microsoft* court says that waiver is not at issue – the workers never really made a waiver of employee benefits rights because Microsoft did not consider them employees. The court found that “Microsoft mistakenly thought that the Workers were independent contractors and that all else simply seemed to flow from that status.”<sup>93</sup> The plaintiffs in the *Microsoft* case had signed written agreements that

93. See *Microsoft*, 120 F.3d at 1010.

set forth their understanding that Microsoft was engaging each as an independent contractor. In the court’s view, the other terms set forth in the agreements – that is, the terms providing that the workers would not be eligible to participate in the company’s benefit plans – were not separate, freestanding agreements. Instead, the court said, the agreement that the workers’ would perform services as independent contractors was a mutual mistake, and the workers’ eligibility to participate in the plans hinged on the determination of their status as employees or independent contractors. Given the parties’ mutual mistake about the workers’ legal status, the terms providing that they were not eligible to participate in the benefit plans “merely warn the Workers what happens to them if they are independent contractors.”<sup>94</sup>

The Ninth Circuit’s reasoning is deadly for Paradise County’s argument. The county’s argument is that the workers’ agreement to perform services without receiving benefits constituted separate contract terms that survived, even when their agreement to forego the payment of overtime and the withholding of taxes were found to be void. But the *Microsoft* decision says that an agreement to work without benefits is not separable from the agreement to work as an independent contractor, but part and parcel of it. Although the Ninth Circuit does not state it as such, the clear import of its holding is that if a worker is not an independent contractor for tax purposes, the worker is not an independent contractor for the purposes of benefits eligibility.

### *A Waiver Must Be Knowing and Voluntary*

But what about the argument that the new workers had waived their legal rights to benefits by entering into independent contractor agreements in which they agreed to work without them? In *Microsoft*, the company chose not to argue that the workers had waived their rights to participate in the benefit plans. The court nevertheless made the point that if Microsoft had argued waiver, the court would have had to consider whether the waivers were knowing and voluntary, given that they were based on the mistaken premise that the workers were independent contractors. The court was skeptical that it would find the waivers knowing and voluntary in such a circumstance.<sup>95</sup>

As a general principle of law, a waiver of one’s rights must be knowing and voluntary. This is true as

94. See *Microsoft*, 120 F.3d at 1011-12.

95. See *Microsoft*, 120 F.3d at 1012-13.

a matter of North Carolina contract law. As the North Carolina courts have said, “a waiver is sometimes defined to be an intentional relinquishment of a known right. The act must be voluntary and must indicate an intention or election to dispense with something of value or to forego some advantage which the party waiving it might at his option have insisted upon.”<sup>96</sup>

To prevail on the waiver argument, Paradise County would have to show that the workers could have insisted on receiving benefits, but chose not to do so. The problem for the county is that had the workers known that they were not legally independent contractors and that they were employees, they would likely have insisted upon receiving benefits.

Counter-Argument #2 fails.

### **Counter-Argument #3: There Was No Offer and Acceptance, No Mutual Assent**

There is one more argument that Paradise County might make. For there to be a legally enforceable contract, there must be an offer by one party and an acceptance of that same offer by another. Another way of saying this is that there must be mutual assent or a “meeting of the minds.”<sup>97</sup> The county might therefore argue as follows: (1) Even if the county had “offered benefits” to the workers because it offered benefits to its employees and, as it turns out, the workers were common-law employees, (2) the workers did not know the terms of the offer – they were never given information about benefits because both parties mistakenly thought the workers were independent contractors. Therefore, (3) without knowledge of the terms, the workers could not accept those terms and the parties could not be said to agree to the same terms.

This argument was also considered and rejected by the Ninth Circuit in the *Microsoft* case. Under Washington state contract law, an employment contract can be accepted even when the employee does not know its precise terms. The plaintiffs in the *Microsoft* case, the court said, clearly knew of the benefit plan offered to employees, even if they did not know the terms. The fact that Microsoft, the

96. See *Guerry v. American Trust Co.*, 234 N.C. 644, 648 (1951); *Sidden v. Mailman*, 150 N.C.App. 373, 377 (2002), *disc. rev. denied*, 356 N.C. 678 (2003).

97. See *Goeckel v. Stokely*, 236 N.C. 604, 607(1952); *Walker v. Goodson Farms, Inc.*, 90 N.C.App. 478, 486, *disc. rev. denied*, 323 N.C. 370 (1988).

employer, made an error about whether or not the plaintiffs were employees eligible to participate did not change the fact that there was an offer. The plaintiffs accepted the offer by performing services for Microsoft as employees.<sup>98</sup>

There is no corresponding North Carolina case law standing for the proposition that an employee can accept the terms of an employment contract even where the employee does not know the precise terms. But this is not a radical notion. In reality, many people accept offers of employment without knowing the details of the employer’s benefit plans – oftentimes, without knowing whether or not particular benefits are offered at all. The North Carolina courts have held, however, that when an employer represents that an employee will earn a benefit after working for a period of time, the employee accepts the offer by beginning to work.<sup>99</sup> This rule seems to lead to the conclusion that the Paradise County workers accepted the county’s offer of benefits when they began to perform services for the county and that the parties effectively agreed to the same terms.

Counter-Argument #3 fails.

### **Does Paradise County Owe the Three Workers the Value of Lost Benefits?**

Under North Carolina law, an employer’s offer of benefits is accepted and becomes an enforceable contract once the employee meets the conditions of the offer (usually there are no conditions other than that the worker begin employment).<sup>100</sup> Thus, when an employer misclassifies an employee as an independent contractor, it owes the employee the value of the benefits it should have, but failed to provide.

What happens, then, when an employee misclassified as an independent contractor and excluded from the employer’s group health plan has obtained health insurance individually? Although there are no North Carolina cases that address this issue directly,<sup>101</sup> it follows from the contract law principle

98. See *Microsoft*, 120 F.3d at 1014-15.

99. See *Roberts v. Mays Mills*, 184 N.C. 406 (1922); *Hamilton*, 118 N.C. App. at 11.

100. See *White*, 97 N.C.App. at 132; *Rucker*, 98 N.C.App. at 103; *Brooks*, 56 N.C.App. at 804-5.

101. Indeed, research for this Bulletin has revealed no cases in any jurisdiction addressing this issue.



that govern employee benefits that the employer will be liable for the value of the health insurance premiums that the employee had to pay out-of-pocket, less the amount of any premium contributions that employees regularly make under the employer's plan. Employers would face even greater liability if a member of the misclassified employee's family suffered from a serious medical condition and had incurred expensive medical bills. In that case, the employer would not only have to reimburse the employee for the cost of the premiums, but also for any out-of-pocket medical expenses that would otherwise have been covered under the employer's group health plan.

## Conclusion

Most people performing services for a public-sector organization are "employees" within the common-law definition of that term. True independent contractors are few. Government employers can unwittingly accrue substantial unfunded liabilities in the form of unpaid overtime, unpaid employer FICA contributions, and penalties for violating the FLSA and Internal Revenue Code, as well as liability for unpaid benefits, when it misclassifies an employee as an independent contractor. For this reason, it is crucial that each public employer establish a procedure whereby it does an individualized analysis of any proposed relationship with a worker it plans to engage on an independent contractor basis. Few will so qualify.

Appendix A to this Bulletin sets forth a model checklist of factors that a public employer should consider when evaluating whether a worker is an independent contractor or common-law employee. Employers should modify this checklist as is appropriate to the nature of their organization as a whole or to a particular department. Every proposal to engage a worker as an independent contractor must be assessed individually. Whether that worker legally qualifies as an independent contractor will depend on the particular facts and circumstances of the arrangement.

**Appendix A:  
A Model Checklist to Help Determine Independent Contractor or Employee Status**

Employers should modify this checklist as is appropriate to the nature of their organization as a whole or to a particular department. Every proposal to engage a worker as an independent contractor must be assessed individually. Whether that worker legally qualifies as an independent contractor will depend on the fact and circumstances of the individual situation.

**PART I: The answer “yes” indicates that the factor weighs in favor of employee status, while the answer “no” indicates that the factor weighs in favor of independent contractor status.**

<u>Factor</u>	<u>Yes</u>	<u>No</u>
1. Does the hiring organization have the <b>right</b> to control when, where and how the worker will do the job, or the order and sequence in which the worker will perform services? (Check “yes” even if the organization does not intend to exercise that right).		
2. Does the hiring organization set the worker’s hours and schedule?		
3. Must the work be performed personally by the worker (as opposed to the worker subcontracting it out or furnishing his or her own substitute)?		
4. Is the hiring organization providing training of any kind?		
5. Does the hiring organization provide the worker with the tools, supplies, and/or equipment needed to do the job (as opposed to requiring the worker to bring his or her own tools, equipment and supplies to the job)?		
6. Does an employee of the hiring organization supervise the worker?		
7. Does the worker have to submit written or make oral reports?		
8. Is the work performed on the hiring organization’s premises or at a site controlled or designated by the hiring organization?		
9. If the worker is performing services off-site, does the hiring organization have the right to send supervisors to the site to check up on the worker? (check “yes” even if the organization has no intention of exercising that right)		
10. Can the worker be fired at the will of the hiring organization?		
11. Can the worker quit the job at will without incurring any liability?		
12. Will the hiring organization hire, fire and pay the worker’s assistants?		
13. Will the worker be paid by the hour, week or month (as opposed to being paid for the successful completion of the job or piece)?		
14. Has the hiring organization unilaterally set the worker’s rate of pay?		
15. Does the hiring organization reimburse the worker for expenses and travel?		

<u>Factor</u>	<u>Yes</u>	<u>No</u>
16. Is the relationship between the hiring organization and the worker going to be a continuing relationship?		
17. Does anyone else perform the same or similar services for the organization as an employee?		
18. Are the services performed by the worker part of the core or day-to-day operations of the hiring organization?		
19. Is the worker a current employee in another capacity?		
20. Was the worker an employee at any time during the past year and did the worker provide the same or similar services as an employee?		

**PART II: Here, the answer “yes” indicates that the factor weighs in favor of independent contractor status, while the answer “no” indicates that the factor weighs in favor of employee status.**

<u>Factor</u>	<u>Yes</u>	<u>No</u>
21. Does the worker perform similar services for others as an independent contractor?		
22. Does the worker advertise his or her services to the public?		
23. Has the worker made any investment in facilities or equipment needed to do the work?		
24. Does the arrangement between hiring organization and worker allow the worker to make a profit or suffer a loss?		

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