

## SWC Business Brief

# Employee or Independent Contractor? The Rule That Never Happened



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Steas, Walker & Company, LLP (SWC)  
16875 W. Bernardo Drive, Ste. 290 | San Diego, CA 92127  
p: (858) 487-4580 | f: (858) 487-8033 | e: admin@steeswalker.com | w: SteesWalker.com

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## INTRODUCTION

# Employee or Independent Contractor? The Rule That Never Happened



The more things change, the more they remain the same. Case in point: the U.S. Department of Labor's guidelines for determining whether someone is an employee or an independent contractor. In September 2020, the Department of Labor (DOL) proposed a rule to clarify employee and independent contractor status under the Fair Labor Standards Act. This rule would have made it easier for workers to be treated as independent contractors instead of as employees. It was scheduled to take effect on March 8, 2021.

In late January 2021, a new administration moved in at 1600 Pennsylvania Avenue NW in Washington, D.C., and delayed the new rule's effective date. Then they officially withdrew the rule. You could call it "the rule that never happened." Whether that's good or bad depends on your circumstances, but withdrawing the rule hasn't made it any easier to determine whether a worker should be classified as an employee or an independent contractor.

Making this determination has always been a challenge, and it continues to be so. And the fact that some states have their own rules doesn't help matters in the least. In this *SWC Business Brief*, we explain the rules and tests to shed some light on this perplexing topic.

## Why the Distinction Matters

Worker classification has always been a hot-button issue. Pro-business administrations typically lean toward relaxing the rules, so that businesses have more leeway in determining how workers are classified. Some businesses prefer to use independent contractors because they facilitate scalability and generally cost less than employees. In addition, when they have more leeway in deciding who's an employee and who's an independent contractor, maintaining compliance with labor laws and tax laws is easier.

Pro-worker administrations, on the other hand prefer that businesses classify more workers as employees to ensure fair treatment, compensation, and benefits. When businesses have more leeway in deciding whether a worker is an employee or independent contractor, some businesses choose to hire fewer employees or even lay off employees or place them on contract (instead of hourly pay or salary) and eliminate their protections and benefits under the law.

The Biden administration would like to see more workers classified as employees and favors an *ABC Worker Classification-type Test* at the federal level like the test used in several states. However, to date, no federal rule or law has been adopted that requires an ABC test.



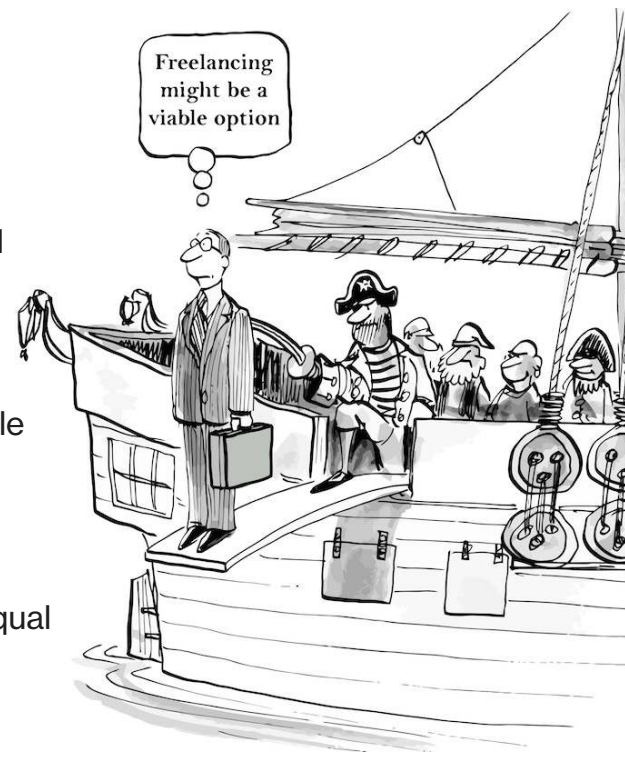
## The Economic Realities Test

Currently, the DOL uses *the economic realities test* to classify workers. The economic realities test considers a variety of factors, including the following:

- **The extent to which the services rendered are an integral part of the hiring entity's business.** An employee tends to perform services that are more integral to the business. Independent contractors, on the other hand, perform services that are generally outside the scope of the hiring entity's business, such as software development.

- **The permanency of the relationship.** Employees tend to have more permanent relationships with the business that hires them.
- **The amount of the alleged contractor's investment in facilities and equipment.** If the hiring entity is providing all or most of the equipment and supplies required to do the job and reimburses the worker for expenses, the relationship is classified as employer-employee.
- **The nature and degree that the business has control over the worker.** An independent contractor has more control than an employee over determining how to do their work.
- **The potential for experiencing profit and loss.** An independent contractor operates as a business that can earn a profit or suffer a loss based on the contractor's management decisions and actions.
- **The initiative, judgment, or foresight required for the worker to be considered successful as an independent contractor in his or her field.** For example, a computer programmer working for a firm that develops cyber-security software is an employee because the programmer is merely using that skill to perform a task as directed by management. In contrast, an independent contractor with the same skill must design and develop the software, provide an estimate, create a schedule, and perhaps hire subcontractors.
- **The degree of independent business organization and operation.** An independent contractor operates an independent business, whereas an employee serves a role within an existing business.

When using the economic realities test, no single factor is to be considered more important than any other factor. Each business-worker relationship must be evaluated based on equal consideration of all factors.



## The Proposed Rule That Never Happened

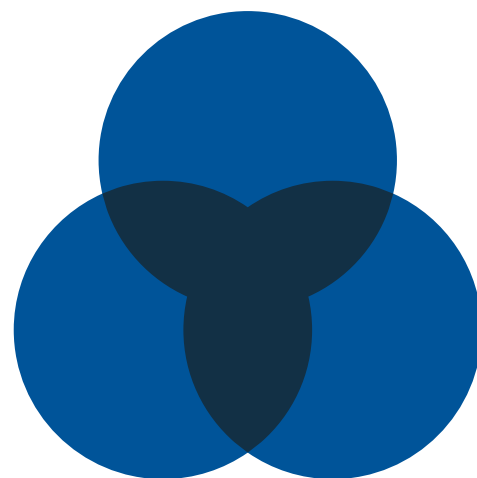
The rule that was withdrawn would have emphasized two key factors (control and opportunity for profit or loss) above all other factors, making it far easier to classify *gig workers* as independent contractors. (Note: Gig workers are independent contractors, online platform workers, contract firm workers, on-call workers, and temporary workers – including those who work for Uber, Lyft, DoorDash, Instacart, and Postmates.)

In withdrawing the rule, the DOL found that elevating two factors above the others conflicted with the spirit of the Fair Labor Standards Act and with judicial precedent, which have historically been more liberal in their classification of workers as employees.

## The Right-to-Control Test

The Internal Revenue Service and courts traditionally have used the right-to-control test (a common law test) to classify workers for tax purposes. This test weighs the following three factors:

- **Behavioral control:** How much does the hiring entity control and direct how the worker performs the work?
- **Financial control:** How much does the hiring entity control the business aspects of the worker's job? For example, an employer generally supplies all or most of the equipment and supplies an employee needs to do the work, reimburses the employee for expenses, and can prohibit the employee from working for a competing business. In contrast, an independent contractor can operate more freely and has a bigger investment in the equipment and supplies needed to do the work.
- **Relationship type:** The business-worker relationship depends on several factors, including how permanent the relationship is, whether the business provides benefits, whether the worker performs tasks that are integral to the business, and whether the worker is under contract.



**Note:** On the federal level, the same worker may be classified as an employee under the economic realities test in respect to regulations pertaining to wages and hours and as an independent contractor under the right-to-control test for tax purposes.



### The ABC Test

A few states, such as California, use the ABC test to determine compliance with both wage and hour and tax laws unless there's a specific exemption, in which case they fall back to the right-to-control test. Some states (Connecticut, Illinois, Massachusetts, and New Jersey) use the ABC test more selectively – to determine compliance with their labor, workers' compensation, unemployment, or tax laws.

With the ABC test, a worker must meet all three of the following conditions to qualify as an independent contractor:

- A. Be free from the control and direction of the hiring entity in terms of how the work is done.
- B. Perform work outside the usual course of the hiring entity's business.
- C. Be engaged in a trade, occupation, or business that's customarily conducted independently and is the same nature as the work performed.

In states that use the ABC test, some workers can be classified as employees for state purposes and as independent contractors at the federal level, which can benefit workers. The Tax Cuts and Jobs Act (2017) suspended the miscellaneous itemized deduction for unreimbursed employee expenses, so workers can deduct their expenses on Schedule C for their federal tax return and deduct unreimbursed employee expenses on their state tax return.

Whether you're a business owner trying to determine whether a worker is an employee or independent contractor or a worker wanting to know whether you should be treated as an employee or independent contractor, we can help. We'll analyze your situation according to both state and federal tests and explain the potential tax and legal ramifications associated with both employee and independent contractor status. We're committed to helping our clients do what's best for them within the confines of the law.

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