

Independent Contractors Under U.S. Law: Knowing Your ABCs

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A recent trend in U.S. employment law has been the adoption of stricter and stricter tests for when a worker may be classified as an independent contractor rather than an employee. Independent contractor relationships are often less expensive and easier for employers to administer since employers are not responsible for providing healthcare benefits to independent contractors and do not have to pay employment taxes for their independent contractors. Many workers also prefer to be classified as independent contractors because they believe that they will have more freedom to work on behalf of multiple customers as independent contractors.^[1]

The actual legal test for whether a worker may be classified as an independent contractor varies significantly from state to state. While some states apply what is referred to as the “Control and Direction Test,” which, as the name suggests, puts a significant emphasis on the degree to which the company controls the manner in which the putative contractor’s work is performed, many U.S. states apply what is called the “ABC Test,” which is far stricter. States applying some version of the ABC test include California, Connecticut, Delaware, Illinois, Indiana, Massachusetts, Nebraska, Nevada, New Hampshire, New Jersey, Vermont, Washington, and West Virginia.

The first part of the ABC test begins with the same concept as the “Direction and Control Test,” but applied more strictly. The worker must be *free* from control or direction by the company, both under the terms of the parties’ contract and as a matter of reality. U.S. courts repeatedly emphasize that it is the reality of the worker’s work for the company that matters, not just what the parties’ contract says. If the parties’ contract prohibits the company from exercising direction or control over the worker, but the company’s agents and employees in fact exercise such control, the worker will be deemed an employee not an independent contractor.

The second part of the ABC test requires that the worker perform work that is outside the usual course of the hiring entity’s business. Put another way, the work the worker is performing for the company cannot be the same work that the company is primarily

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engaged in for its customers. For example, a company in the business of installing cable windows could not hire a worker to install windows as an independent contractor. However, a company in the financial services industry could hire a window installer as an independent contractor to install windows in buildings it owns or leases.

The third part of the ABC test requires that the worker be customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the company. Put another way, the worker needs to have his or her own ongoing business with multiple customers and the work done for the company has to be the same kind of work the worker's own separate business engages in on behalf of other customers. To refer back to the example in the second part of the test, the window installer needs to have his or her own separate business installing windows for other customers.

The consequences for misclassifying workers as independent contractors can be dire. Many misclassified workers work long hours and can rack up substantial overtime. That computer programmer you retained as an independent contractor for \$5,000 a week to assist with a project at crunch time and who worked 70 hours a week for 10 weeks could be owed an *additional* \$32,000 over the \$50,000 you already paid. What is worse, if you did not track the worker's hours, a U.S. court will presume that the number of hours the worker claims to have worked is accurate. You could end up paying for 80 hours of work a week even if the worker only worked 60.

In addition, companies will be held liable for unpaid employment taxes and, if the IRS thinks you intentionally misclassified workers, criminal penalties of up to a year in jail and up to a \$500,000 fine. Companies that are required to comply with the Affordable Care Act will have to pay additional penalties for failing to provide health care coverage to employees where required.

The independent contractor test in the United States is often significantly more strict than that in Canada. Canadian companies looking to retain independent contractors for their U.S. operations should take care to familiarize themselves with the increasingly strict independent contractor test in the United States. Those that ignore their independent contractor ABCs could face substantial liability.

[1] This belief is actually erroneous. An employer and an employee can agree that the employee is free to work for other employers.