



Mark Smith:

The Department of Labor came out with new regulations that essentially said, "We're going to look at two primary factors in determining whether someone's an employee or an independent contractor."

Jeff Large:

That's Mark Smith, shareholder and attorney in business law at Rhoades McKee. You might remember him from the last episode where we talked about attracting and retaining employees. Today, we're discussing work classifications.

Mark Smith:

The regulations look at first, the nature and degree of control over the work that the person's going to perform. So, for example, if you were to hire me to come in and paint your house, you would say, "Here's the rooms I want painted. Here's the colors. Go at it." And I would be an independent contractor because you're not saying, "Here's the paint. Here's the brushes. Here's the hours I want you here. Here's all the details associated with it." But if I show up and I have a crew of people with me and I tell them all those same things and I treat them as independent contractors, chances are I made a mistake in terms of my classification, because those individuals don't have any control over the work.

They're following my instructions, as their boss, as to how to paint, when to paint, the means and methods. "Hey, put a drop cloth down. Hey, put masking tape around the window," all the details associated with it. So, it's an issue of control over the work itself. And if you put it in the context of businesses, someone will say, "I want you to come in and I want you to perform this task." And then the issue is, are you controlling how they perform it or are you just giving them the task and leaving it up to them to do it?

Jeff Large:

Today, on Conversations With a Business Attorney, Mark and I are discussing a couple key issues around work classifications. When should you classify someone as an employee and when should you classify someone as a contractor? What are the consequences of doing this incorrectly or incorrectly classifying someone? And how do you lower your company's liability by making sure you have the best classifications from the start? I'm your host and fellow business owner, Jeff Large. Let's pick the conversation up with Mark's example on what constitutes an employee versus a contractor.

Mark Smith:

As a business, I call in an IT vendor, for example, and say, "Hey, my computers don't work, fix them." They're an independent contractor doing it. But if I hire someone and say, "I want you here from 9:00 to 5:00 every day, and I want you to go through each of these machines and I want you to handle all the employee issues associated with tech," then they're going to be an employee. That's going to be the proper classification. The other thing that the Department of Labor regulations looks at most heavily is the individual's opportunity for profit or loss in connection with doing the work.

So, in my painting example, I have this crew of people working for me and I say, "I'm going to pay you 10 bucks an hour for doing this work," that individual doesn't really have the opportunity to control their profit or loss, other than by the amount of work they do. I'm going to work eight hours or 10 hours or six hours, and each of those has a financial consequence. But if I say, "I'm



going to bid on your project and I'm going to do your work, this painting work," just using the same example, I can decide I'm going to do it myself and I'm going to do this for \$5,000. I can choose to come in every day and work to get the \$5,000 job done, or I can bring in six other people and knock it out in a day and control how much profit or loss I make on that particular job. And the same is true with people working for different companies.

Jeff Large:

Now, at this point of the conversation, I began wondering if there were a set standards for determining the difference between someone who is an employee versus someone who is a contractor. Now, beyond the variables of control that they have to do their job or their ability to earn a profit, Mark walks through how this can often be a case-by-case determination.

Mark Smith:

It's a fact-intensive analysis every time you look at it. And I mean those are the two primary factors is the control and the ability to earn a profit. But the courts and the Department of Labor and even the IRS look at other factors to paint a more full picture. So, they look at the permanence or impermanence of the relationship. If you have someone that's assisting you every single day from 8:00 to 5:00, they never work for anybody else and they've done it for 30, 60, 90 or days, or a year, chances are that'll tilt towards them being an employee rather than a contractor because they provide their service solely to you. And it's more in the form of a permanent relationship than a temporary one-off kind of thing.

The courts and the Department of Labor also look at the skill involved in the process. If you have someone coming into your factory as a, "independent contractor," and all they're doing is making widgets the same way every single day and there's no skill or ability involved, chances are they're going to be an employee, not an independent contractor because there's no judgment, there's no exercise of control over the work.

Jeff Large:

Do certain of those variables weigh heavier than other of those variables?

Mark Smith:

The first two that I talked about weigh the heaviest, and that is the nature and degree of control over the work and the ability to control whether profit or loss arises from the work. Those are the ones that the new regulations say are the most critical factors in getting into the analysis. And the others are just fill in the rest of the picture if those don't give us a clear direction. And that becomes necessary because people are creative and innovative, and so they'll put together a contract that makes it look like someone's an independent contractor, and it'll say on paper that you have control and you have this and you have that. But what really is going on here is that the person's an employee, they're not an independent contractor. And there are huge financial incentives to have someone as an independent contractor as opposed to an employee.

Jeff Large:

Now, again, determining whether someone is an employee or an independent contractor can be confusing for a business owner. Fortunately, Mark gives some more examples to help bring some clarity to this issue.

Mark Smith:



It's difficult in the abstract to just come up with a bright line sort of this is an employee, this is an independent contractor. I mean, the regulations are over 200 pages long, and so they have given some examples within the regulations that sort of tease out that difference. So, for example, in the trucking industry, you have owner-operators. They own their own truck, they agree to take a job or not take a job. But the logistics company that may hire them and match them with a load that needs to go from A to B may put a GPS device on their truck to track where they are. They may put a governor on their truck to control their speed because those are things that are necessary to meet regulatory requirements. In that example, the owner-operator's still an independent contractor, even though he or she is being subject to being tracked as to where they are and is being subject to speed limitations because of the regulations, and may even be subject to delivery deadlines.

They're agreeing that I will deliver this load from here to there, but how they do it is kind of up to them. They can decide, "Do I eat at McDonald's or Burger King along the way? Do I follow a trunk line load or a freeway? How do I get there?" They have some independence that's associated with that. As opposed to you have the same truck driver and now they get their paycheck from the company that owns the truck. They're in essentially the same type of vehicle doing the same sort of work, but the company is saying, "On this day, you're going to deliver parts to Ford. And on this day you're going to deliver them to GM, or you're going to deliver pizza ingredients to SpartanNash." They specifically control what loads they pick up, how and when they deliver them, the dollars per hour they get paid, or the cents per mile, or dollars per mile these days. So, there's a lot more control as opposed to someone that owns their own vehicle, and is just subject to some limited control in terms of they do their work.

Jeff Large:

It sounds like, I don't want to create a false sense of what it is, but as the employer, perhaps the more control I have over the situation, the more I should be considering if this is an employee or not.

Mark Smith:

Yeah. Oh, absolutely. Yeah, more control equals much higher likelihood of employer-employee status.

Jeff Large:

What about when there's situations where processes are involved? Let's say, is there any notable difference between an employer-enforced process versus a collaboratively-developed process, the worker bringing their own process to the table?

Mark Smith:

Probably the latter where the employee or the person doing the service brings the process to the table. They're more likely an independent contractor than if they're simply implementing a process that the person paying for it wants them to do. So, if you're just implementing the work that the employer wants, chances are you're an employee.

Jeff Large:

I think about even going back to say your painting or maybe a home construction example.

Mark Smith:



I mean, the construction industry is probably one of the areas where we see probably the most abuse in terms of the employee versus independent contractor relationship. So, if you have a general contractor residential builder, and he or she literally uses the same framing crew, the same painters, the same drywallers, the same shingler on every single job, and those individuals don't give bids for the work, they don't give estimates for the work, they don't give invoices for the work, they show up when and where required, chances are they're employees. But if you have a drywall company that works for 10 different general contractors and gives us an estimate, "Yeah, I'll do the drywall on this house for X amount of dollars." And they do that for several different general contractors, chances are they are independent contractors.

So, even if it's a single person, you don't need a company to be an independent contractor. It can be I'm a drywaller. I work for whatever residential builder wants to hire me, and I give estimates and I do the work and I give an invoice when I'm done and I bill for it. And I control how profitable it is because maybe I show up by myself or I show up with three buddies, and we knock it out. And obviously, it takes less time if I have more people, and of course I got to figure out how much to pay them and still make money doing it, but can I do this work for this amount of money and make a profit on it?

Jeff Large:

Okay. Yeah, a perfect example. Let me back up a little bit. What I was referring to or what I failed to clarify was more of as I'm a homeowner and I hire a team to come and do their thing. Is there much of a difference between like we said of, "Hey, I need this room painted," and then that team brings all their supplies and does their thing, versus me saying, "Hey, I need this room painted. I would love it done by this deadline," clarifying like, "You're going to tape off everything, right? You're going to do two coats, right?" Clarifying all those things, does that change the dynamic?

Mark Smith:

No, because it's a one-off kind of relationship, it's not a repetitive relationship. As opposed to I'm reporting to the contractor that hired me and the contractor now tells me all of those details, that makes me more like an employee of the contractor. As opposed to I'm just meeting with this homeowner once and they've got this list of demands and I'm agreeing to them, that doesn't make me their employee.

Jeff Large:

I've spent a lot of time getting clear on the distinction between who is an employee and who is a contractor, but why? Mark explains that there are big consequences for business owners who do not get this right.

Mark Smith:

So, there are huge consequences of getting it wrong. People hire independent contractors or classify them as independent contractors to avoid all kinds of regulatory compliance. There's the FICA and FUTA that gets paid in terms of the paycheck. There's the immigration screening that comes along with hiring employees, the I-9s, the W-2s, the social security, visa kinds of things. The application of the federal regulatory statutes, Fair Labor Standards Act, for example, which would require you to pay a minimum wage and over time to employees that you don't have to pay to independent contractors. The implementation of things like the Family Medical Leave Act, the Affordable Care Act, the ADA. A lot of those are triggered by how many employees you



have. So, if you think you're avoiding that regulatory compliance by calling what's really an employee, an independent contractor, and you get it wrong, the consequence is the fines and penalties associated with correcting that circumstance.

We see it most often in the Fair Labor Standards Act where someone will classify someone as an independent contractor that's really an employee, and they'll have them work 60 or 80 hours a week, and they'll pay them the full hourly rate they agreed to pay them, but they don't pay them overtime because, hey, they're not an employee. I don't have to pay overtime over 40. Well, if they're wrong and the employee files a complaint with the Department of Labor or the Department of Labor itself does an audit and determines that these people are underpaid, you have not only the obligation to pay the unpaid overtime, but up to two times the unpaid overtime, plus the attorney's fees associated with pursuit of that claim. And so, that creates a real problem, a financial problem for the employer. Because if they're found liable for even 1\$ of unpaid overtime, the other side gets all of its attorney's fees. I've had numerous examples where clients were maybe \$15,000 shy in terms of paying overtime and end up with an \$80,000 attorney fee being opposed against them. So, that's just one example.

Jeff Large:

How do you advise going about this then if we're unclear?

Mark Smith:

You really need to consult with counsel and go through the details of what this relationship looks like. The Internal Revenue Service has a form called the SS-8, that at least for purposes of the Department of Internal Revenue can be used for a determination as to whether the IRS will consider the person to be an employee or independent contractor. The downside is it takes six to eight months for the IRS to make that determination in the best of times. And the relationship may have come and gone before the determination was made, and you're kind of self-reporting that you have this circumstance. And so, if you've handled it incorrectly, you've given them the smoking gun that finds the way to you. But if you want to kind of do it in the abstract and you have the luxury of time to determine how to classify this individual before they start, that's one way of doing it.

Jeff Large:

Still feeling a little confused? Maybe a little scared? Don't worry. Mark goes on to explain some helpful tips and truths to lower your company's liability.

Mark Smith:

Almost every individual that you hire, if you have a company, to do work that's core to your company is an employee. So, if it is part of what your company does, it's not some ancillary one-off sort of project and you hire someone to do it, chances are they're going to be an employee. So, if your company does printing and you hire someone to come in to set up your presses every morning, chances are they're an employee, even though you may say, "Well, you're an independent contractor. I'm only hiring you for this one task that happens two hours every morning between 8:00 and 10:00." If it's every day and it's integral to what you do, they're going to be an employee. Really the easiest thing is the default position should be if I have a company and I'm hiring someone to do some of my core work, chances are they're an employee.

Jeff Large:



Let's move to types of employees. So, let's say we've determined, for whatever reason, that we're going to have employees. You've said a couple of times now you've alluded to the differences between a salaried employee and an hourly employee. How does that break down?

Mark Smith:

So, the regulations for the Department of Labor create three, what are known as, salaried-exempt positions. So, those are, roughly speaking, professional, supervisory, and administrative positions. They're somewhat self-evident. I mean a professional position, doctor, lawyer, CPA, that sort of thing. If they are on your payroll, the chances are they're going to be salaried exempt. And salary exempt simply means you set a salary, they work however many hours are required to complete the task, they get paid the same amount, whether it takes them 20 or 80 to do it, and there's no overtime obligation associated with their work over 40 hours. Those same sort of rules apply to the other two categories of exempt work.

Administrative work, so things like the HR department or the OSHA compliance department, people that are involved in administering the work, but not on an hourly basis, typically can be exempt from overtime as well. And then, the third is supervisory. So, you have shop foreman, or a manager, even several levels of management would qualify, but you have to supervise at least five people in order to fit that exemption. And so, the courts and the Department of Labor look at whether the person fits one of those exempt categories or not. And if they don't, then they have to be paid on an hourly basis.

People can get paid on a salary basis if they're not exempt, but they still need to be paid over time. So, sometimes internally, politically, it's best to say someone's a salaried employee. They get the same amount every week. But that's really only a description of the amount of hours times their hourly rate to come up with that salaried amount. But if they are not in one of these exempt positions, if they work over the 40 hours, they have to be paid overtime. So, some people just don't like being called an hourly employee. So, fine, we'll call you a salary employee. You're just not salaried-exempt. That's the sort of general distinctions between the hourly and salary.

Jeff Large:

What about perhaps pros and cons of these different types of positions? As we're evaluating how to fill out our company, what other things should I be keeping in mind?

Mark Smith:

Well, the salaried-exempt positions are the ones where the amount of work is going to vary, typically on the high side of 40 hours. And you want to have the ability to have someone that does have the obligation to work more than 40 hours if that's what it takes to get their job done. But you know what your financial exposure is associated with that. It's the amount of salary that you've committed to pay. Whereas someone who's doing a repetitive task, sometimes client orders are going to require it to go over 40 hours, then okay, we will pay the overtime associated with that.

I mean, you really have to look at what the average number of hours are that are going to be expected of the person to determine are we better off having them as hourly or salary? So, for example, I told you earlier that HR could be a salaried position, could also be an hourly position. You could say, "All I need is a part-time person, 10 hours a week, 20 hours a week. I'll pay them an hourly rate, rather than having to meet the statutory minimum salary, which is now in the mid-30s. I'll pay them 20 bucks an hour for 20 hours at a time." If they are going to work 40



hours or more on a consistent basis, you're probably better off making them salary than hourly because you'll be bumping into that overtime obligation.

Jeff Large:

Maybe to kick it back over to you more, what are some of the most frequently asked questions you receive on this topic of employee classification?

Mark Smith:

Well, right now, we're not receiving all that many. When the Obama administration was implementing a change to the salary requirements, we fielded all kinds of questions regarding who really qualified as salaried-exempt and how do we avoid having to pay the additional amount? Because it went from literally in the low-20s to the mid-40s was the increase in salary, and a lot of companies just couldn't support that. So, through litigation, the regulation got enjoined by a federal district court in Texas and put on hold. And then, ultimately, implemented during the Trump administration in the mid-30 range as the base salary number that has to be paid for everyone that's within one of these exempt categories.

And so, then the questions reverted back to we can live with this salary range, but now we have to determine are these individuals properly classified as salaried-exempt, or are we trying to be too over-inclusive and putting someone that supervises one other person as salaried-exempt as a supervisor? So, now we look at the kind of nuts and bolts of how does this job description fit within those exempt categories? And it's really literally just going through the job description and comparing it to the hallmarks that the Department of Labor's established for purposes of each of those exempt positions. There are other exempt positions we haven't talked about. They're different. I mean, they're like commission salespeople and that sort of thing that have to be looked at, but the big ones are the ones I already mentioned.

Jeff Large:

Yeah. And sort of in that same vein, what are some things that maybe you wish employers knew or thought about more before they came to speak to you about these issues?

Mark Smith:

It's always more difficult when the bullet has already been fired and the person is already on staff and working, and some time has gone by and there's potential exposure already. What we hope that they think about is, "Hey, I'm creating a new position. Help me understand how I can categorize this position. Should it be salaried exempt? Should it be hourly? And how can we maybe tweak the job description to fall one way or the other?" And it's not just the job description. It's how the job is actually performed, but it's always easier when we get the issue on the front end as opposed to, "We already have some exposure here. Now what do we do? And how do we rectify what we've already made a mistake on in the past?" And so, it's like anything else, seek counsel before you make the decision and it'll help you make the best decision that you don't have to worry about later on.

Jeff Large:

A big thanks to Mark Smith for sharing his time and wisdom on today's show. If you need help better understanding this crazy world of employee classifications, consider reaching out to Mark or one of his peers. You can learn more at [rhoadesmckee.com](http://rhoadesmckee.com). That link will be in the show notes. Conversations With a Business Attorney is a project from Rhoades McKee, and it's



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***Cautions to Take When Categorizing a New Hire***

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