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Employee or Independent Contractor?

Understanding alternative work arrangements – and how to structure them

Introduction

The issue of whether an individual is an employee or an independent contractor can have far-reaching effects on both the individual and the company for whom they provide services. However, companies often pay little attention to either the distinction between the two statuses or the possible effects of an incorrectly described relationship. Without giving much thought to the request, companies often agree to treat individuals as independent contractors at the request of the individuals, who for their part, are simply seeking to minimize their income taxes. Many do not realize that they cannot create and maintain an independent contractor relationship merely by calling it such in a written independent contractor agreement, withholding taxes or ensuring that the contractor is an incorporated entity. Rather, third parties such as Canada Revenue Agency (CRA), the Workplace Safety and Insurance Board (WSIB), the Minister of Labour or the courts have the final say as to whether an individual is an employee or an independent contractor. This insight will explain the distinctions between employees and independent contractors and why it is important for companies to pay attention to the distinctions between the two statuses.

The issue of whether an individual is an employee or an independent contractor arises most frequently in the Tax Court of Canada. This is because it is in the financial interests of the CRA for individuals to be employed by a company rather than to have an independent contractor relationship with that same company. Employees are subject to statutory deductions from their pay for Employment Insurance and Canada Pension Plan contributions. Independent contractors are not. Moreover, income tax deductions at source are not required, the calculation of income tax can differ between an employee and an independent contractor, and generally speaking, independent contractors are usually able to obtain better tax treatment than employees.

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Consequences

A. CRA

If a company has incorrectly treated an individual as an independent contractor, only to be told by CRA that the individual is deemed an employee, the financial consequences can include the requirement that the company pay CRA all outstanding Employment Insurance and Canada Pension Plan contributions, with or without a fine. From the employee's perspective, the change in designation can affect their income taxes and may require additional amounts to be paid to CRA.

B. WORKPLACE SAFETY AND INSURANCE

The WSIB and the Workplace Safety and Insurance Appeals Tribunal also apply similar legal tests in respect of premiums that must be paid by most Schedule "A" employers for workplace insurance for their employees. Where it is determined by the Board that independent operators are really employees under the Ontario Workplace Safety and Insurance Act (WSIA), it can render a company in breach of the WSIA for not remitting premiums for these workers. Breaches under the WSIA can lead to:

i. Investigation by the Board;

ii. The charging of the outstanding amount due on the company's premiums, together with interest; and

iii. A guilty finding in respect of a provincial offence and the levying of fines, under which directors and officers of a company can be fined up to CA$25,000 and companies can be fined up to CA$100,000.

C. ONTARIO EMPLOYMENT STANDARDS ACT, 2000

Similar tests are also applied when distinguishing an employee from an independent contractor for the purposes of looking at employee entitlements under the Employment Standards Act, 2000 (ESA). An individual who is deemed to be an independent contractor is ineligible for certain ESA benefits such as overtime pay, pregnancy and parental leave, vacation pay, statutory notice and, where applicable, statutory severance upon termination. The problem from the perspective of a company is that if an individual is a deemed employee but has not been provided with any of these statutory rights, the employer will be in breach of the ESA. The consequences of a breach of the ESA run the gamut from an order that the employee be compensated to a significant fine to imprisonment. Additionally, corporate directors can be found personally liable under the ESA for things such as unpaid vacation pay and unpaid overtime wages. Further, a failure to provide pregnancy or parental leave where required under the ESA can lead to a complaint of discrimination under the ESA or the Human Rights Code. Finally, employers are required to provide terminated employees with a Record of Employment within five days of termination, in order that the employee can apply for Employment Insurance benefits from Human Resources Development Canada. Employers who fail to do so are in breach of the ESA.

D. WRONGFUL DISMISSAL CLAIMS AT COMMON LAW

The distinction between employees and independent contractors can also arise upon a termination of the relationship by the company. Assume for a moment that you work for a company in the high tech industry that has hired an individual as an independent contractor. Your company is diligent about properly documenting contractual relationships and accordingly, you have provided your contractor with a written independent contractor agreement. You want to ensure that the agreement looks like an independent contractor agreement rather than an employment agreement because you know that the terms of the agreement are one of the things that the courts take into account when determining whether someone is a contractor or an employee. Therefore,

among other things, the agreement states that either party may terminate the agreement on 10 days' notice. This type of termination clause is one that is often found in independent contractor agreements. However, this sort of termination clause would not be found in a well-drafted employment agreement. Rather, an employment agreement in the high tech industry might provide for minimum statutory notice and severance to be paid on termination pursuant to the provisions of the ESA, or amounts in excess of those minimums.

Now let's assume that your company no longer requires the services of your independent contractor and you decide to terminate them six years after hire. You provide the 10 days' notice set out in the agreement. However, your contractor believes that for all intents and purposes they are really an employee, and they decide to commence a legal claim for wrongful dismissal. At trial, the judge looks not only at the terms and conditions of the written agreement but the way in which the individual was treated by the company, and determines that the individual was really an employee rather than a contractor. The notice that you provided, 10 days, does not equal the statutory minimum of six weeks under the ESA. Moreover, your company may have had an obligation to pay statutory severance, which in this case would be a further six weeks. Because none of this has been provided for and is not even contemplated under the agreement, the court disregards the agreement and instead awards damages under the common law, which in this case equals several months of pay in lieu of notice. This is clearly not what either party contemplated when the arrangement was entered into but unfortunately, your company is left having to pay the price.

What to do?

Given the possible negative effects on a company when an employee is incorrectly described as an independent contractor, it is important that companies take a close look at those relationships when they are first entered into. There is a well-known saying: "If it walks like a duck and talks like a duck, it probably is a duck." Likewise for employees. If, after looking at the individual who is going to enter into an independent contractor agreement, you come to the conclusion that they will appear to be in an employment relationship with your company, then they are likely an employee and no amount of contractual drafting is likely to remedy the situation. So what do the courts look at when determining whether an individual is an employee or an independent contractor, and how can your company structure the relationship in order to assist in making it appear more firmly one way or the other?

HOW TO DISTINGUISH A CONTRACTOR FROM AN EMPLOYEE

Until recently, the Tax Court of Canada applied one or more of four tests in order to distinguish an employee from an independent contractor. Those tests have generally also been followed by the Courts in deciding whether an individual is an employee or an independent contractor to determine notice entitlement with respect to a wrongful dismissal claim, and in deciding whether an individual is an employee or an independent contractor under both the WSIA and the ESA. The first test is the "control test", where the Court looks at the degree of control exercised by the company over both the individual and the work to be performed. The second test is the "integration test", where the Court looks at the degree to which the individual performing the work is an integral part of the company's business. The third test is the "economic reality test", where the Court looks at:

i. The degree of control exercised by the company;

ii. Whether the company or the individual owns the "tools" used by the individual;

iii. Whether the individual has a chance to make a profit from the relationship; and

iv. Whether the individual likewise has the chance to end up in a loss position from the relationship.

Finally, the fourth test is the "specified rule test", which asks whether the services performed by the individual are for a specified result.

The Supreme Court of Canada has since moved away from following one or more of these four strict tests. In the 2001 case of *671122 Ontario Ltd. v. Sagaz Industries Canada Inc. (Sagaz)*, the court enunciated the test for distinguishing between an employee and an independent contractor as follows:

> "The central question is whether the person who has been engaged to perform the services is performing them as a person in business on his own account. In making this determination, the level of control the employer has over the worker's activities will always be a factor. However, other factors to consider include whether the worker provides his or her own equipment, whether the worker hires his or her own helpers, the degree of financial risk taken by the worker, the degree of responsibility for investment and management held by the worker, and the worker's opportunity for profit in the performance of his or her tasks. It bears repeating that the above factors constitute a non-exhaustive list, and there is no set formula as to their application. The relative weight of each will depend on the particular facts and circumstances of the case."[1]

1 *671122 Ontario Ltd. v. Sagaz Industries Canada Inc., [2001] 2 S.C.R. 983 (S.C.C.)*

The test in Sagaz contains elements of the control test and the economic reality test, but not the integration test or the specified rule test. Moreover, it makes it clear that the test is free flowing, and likely to be greatly impacted by the particular facts of each case. What then, are some of the "facts" that the courts will look at in order to determine whether an individual is an employee or an independent contractor?

The court will often look to the written agreement between the parties as a starting point, because it may give some guidance as to the intention of the parties in framing their relationship. However, a written agreement is not determinative. If an individual with an independent contractor agreement is treated like an employee in most respects, the court is likely to find that they are an employee. Likewise, if an individual with an employment agreement is treated like an independent contractor in most respects, the court is likely to find that they are an independent contractor. What if the individual has incorporated as a company through which they perform services? Or what if the individual or their company has a GST number? If an individual appears to be an independent contractor for a number of reasons, this will be helpful in convincing the court as to the proper relationship between the parties. Once again however, these reasons are not determinative.

The following is a non-comprehensive list of factors that the courts may look at when determining the status of the individual providing services to your company. It goes without saying that the more you are able to craft the relationship to meet the definition that you want, the more likely you are to get a court to agree with you if the relationship is ever called into question. Among the factors that the courts may look at are the following:

i. Statutory deductions – if you take statutory deductions from the pay of your service provider, the courts will make the finding that you intended them to be an employee;

ii. Hours of work – if you want the individual to be classified as a contractor, you should not monitor their hours of work;

iii. Exclusivity arrangements – if you want the individual to be classified as a contractor, you should not require them to enter into an exclusivity arrangement whereby they are not permitted to work for any other company or entity at the same time that their are providing services to your company;

iv. Profit or loss – if you want your service provider to be a contractor, your arrangement with them should permit them to take the risk of profit or loss. In other words, if the contractor performs their work ahead of time and/or ahead of budget, they will be able to make a greater profit than if the work was merely performed on time and on budget. Likewise, if they perform their work behind time and/or behind budget, they will take a loss on the project. One way to ensure that your contractor assumes the risk of profit and loss, is to structure a commission arrangement. Another way is to agree to a fixed price for each portion of work to be delivered by your contractor;

v. Termination of the agreement – as discussed above, employees whose employment is being terminated in Ontario are entitled, at a minimum, to notice or pay in lieu of notice (and sometimes also statutory severance) in accordance with the ESA. Contractors do not have those entitlements and generally speaking, a contractor should have the same right to terminate their agreement with the company as does the company. In other words, the notice period for termination by either the contractor or the company should be the same, and none of the notice requirements that flow to employees under statute or common law should be extended to the contractor;

vi. Job-site location – wherever possible, an individual who wishes to be treated as a contractor should work off-site. The exception will occur when it is absolutely necessary for the contractor to attend the site to perform tasks relating to the services purchased. Likewise, if a contractor needs to work out of the company's office, a service fee or rent should be charged to them for that office space;

vii. Terms of service – whereas an employee will generally be given a job title and a vague framework of tasks and/or services to perform in relation to that job title, a contract for services should refer to the specific tasks or services to be provided;

viii. Job titles – contractors are not employees. Therefore, they should not be given job titles within the company, nor should they be made an officer or director of the company. Generally speaking, contractors should not have business cards which identify them with your company;

ix. Integration – contractors work for themselves and generally have the freedom to perform services for more than one company or entity at a time. Therefore, contractors should not be made to integrate into the company through mandatory attendance at company social functions (e.g., holiday parties) or company meetings (unless those meetings relate specifically to the services which the contractor is performing). In a 2002 Tax Court of Canada decision[2], one of the factors which the court looked at in determining that a bicycle courier was a contractor, was the fact that the bicycle couriers had a different Christmas party than the office staff, and the couriers paid their way at their party unlike the office staff who did not have to pay.

x. Benefits – do not treat your contractors as you would your employees. Just because your employees may receive health, dental or other benefits does not mean that those benefits should be extended to your contractors. If your contractors desire the same benefits, they should be arranging for them and paying for them on their own. Likewise, vacation should not be provided to independent contractors;

xi. Tools – contractors generally own and use their own tools, whether they be large items such as cars, computers or machinery, or smaller items such as stationary and supplies. Likewise, contractors are generally responsible for the maintenance, insurance and upkeep of those tools. If you require a contractor to use company tools in order to perform a specified task, consider a service fee or rental arrangement;

xii. Authority – a contractor does not represent your company. Therefore, do not give them the ability to bind the company by signing contracts or cheques on the company's behalf;

xiii. Length of agreement – generally speaking, an employment arrangement will be for an indefinite period of time. If you are preparing an agreement for a contractor, try to narrow the length of the agreement to the specified time period or specified task for which you will require their services. While it is possible to permit for extensions of the agreement, remember that an independent contractor agreement that is perpetually extended will begin to resemble an agreement for an indefinite period of time and may ultimately be taken to indicate that the relationship between the parties has transformed from a contractor relationship to an employment relationship;

xiv. Business expenses – contractors' business expenses should be built into the fee for services to be performed and accordingly, should not be separately reimbursed in the same fashion that the business expenses of employees would ordinarily be reimbursed;

xv. Insurance – contractors should be responsible for their own insurance coverage, including WSIA premiums and liability insurance. Subject to a specific exception under the WSIA which permits companies to extend coverage to contractors, companies should not do so; and

xvi. Incorporation – wherever possible, have your independent contractor incorporate as a separate company and obtain separate Goods and Services Tax registration.

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2 *Velocity Express Canada Ltd. v The Minister of National Revenue and Stephane Boileau, [2002], Docket nos. 2001-2427 (EI), 2001-3220 (EI), 2001-2428 (CPP), 2001-3221 (CPP) (Tax Court of Canada)*

Other legal developments

Not only are companies required to consider all of the foregoing when engaging workers, but there are a number of cases which have muddied the waters in this area even further. One example is the Ontario Superior Court of Justice decision of Justice Sheppard in *Aqwa v. Centennial Home Renovations Ltd.*[3] In that case the Plaintiff signed an independent sales agent agreement with the Defendant in May 1995. The agreement between the parties contained a termination clause which stated that either party could terminate the agreement at any time, without notice or penalty. The agreement was terminated in December 1996.

When looking at the arrangement between the parties, one could make the argument both for the Plaintiff looking like an independent contractor and for him looking like an employee. On the employee side, any sales which the Plaintiff made were subject to the approval of the Defendant. He was advertised by the Defendant as a "Branch Manager" of the company. However, on the contractor side, the Plaintiff understood that he was being hired as an independent contractor. Moreover, he declared himself for tax purposes as deriving his income from a business, and he organized himself and advertised himself separately from the Defendant.

Some of the facts could be viewed to support him as both an employee and a contractor, including the fact that he was not limited to any particular area in Ontario where he could attempt to make sales but for all intents and purposes he was limited to the Barrie area. Moreover, although the Plaintiff did not operate through a corporation, there was nothing to prohibit him from doing so. Finally, he was not required to attend sales meetings, although he was encouraged to do so.

Upon termination, no notice was given to the Plaintiff. He claimed that he was an employee and therefore entitled to reasonable notice of termination. Justice Sheppard entered into a discussion about working arrangements in today's world, where he stated that:

> "It is becoming more and more common in today's business world that 'employers' (not in the strict legal sense) are turning more and more to hiring individuals on a fixed term contract which are often renewed repeatedly but for a further fixed term. This type of relationship developed as the country was pulling itself out of a prolonged recession and employers were seeking to avoid paying the high cost of employee benefits. It is not for the court to comment on that approach other than to say that the court should accept what parties to an agreement have agreed to, and the court should be reluctant, except in the most exceptional circumstances, to re-characterize that which the parties have agreed to something more in line with a personal point of view. Such a re-characterization could have serious and harmful consequences for both the employer and the employee. The employee could face re-assessment for income tax disallowing deductions for business related expenses for past taxation years. The employer could face re-assessments assessing penalty and interest amounts for having failed to deduct and withhold tax in respect of commission source income paid to the employee, again for a number of past taxation years."

While it appeared that Justice Sheppard was going to rule that the Plaintiff was indeed an independent contractor and therefore not entitled to reasonable notice of termination, he then went on to state that:

> "... as a matter of law on the facts of this case, [the Plaintiff] was entitled to an award of damages to reflect the special nature of the contractual relationship between the parties and the breach of that
> relationship. That relationship, although independent, was closely connected to or akin to an employment relationship but by their own agreement was not an employment relationship."

3 *Aqwa v. Centennial Home Renovations Ltd. (c.o.b. Centennial Windows), [2001] O.J. 3699 (S.C.J.); [2003] O.J. No. 1077 (Ont. C.A.)*

The court awarded the Plaintiff damages which were calculated as five times the average monthly commissions and bonus, in effect a five-month notice period. Aqwa was appealed however and in the spring of 2003, the Ontario Court of Appeal reversed the trial decision. In doing so, the Court stated:

> "We accept that it will be appropriate for a court to decline to enforce a contract or a provision in a contract where it would be unconscionable to enforce that term or that contract. We see no basis in the evidence, however, for a finding of unconscionability... The most that can be said is that the [Plaintiff] was presented with a standard form agreement, which he could accept or reject as he saw fit. There was no evidence of pressure or duress or the other usual indicia of unconscionability. Nor was the [Plaintiff] in a vulnerable position when he was presented with the agreement."

The Court of Appeal, while rectifying what appears to have been an improper decision rendered by the lower court, did not provide further guidance respecting the distinction between employees and independent contractors in the context of wrongful dismissal actions. This is particularly unfortunate, given that the Alberta court, in recently looking at this issue, has created a new form of relationship between companies and their workers, one termed the 'dependent contractor' relationship. In the case of *JKC Enterprises Ltd. v. Woolworth Canada Inc.*[4], the court found that a family-owned trucking company which employed nine people delivering appliances for Woolco for 16 years, was a dependant contractor and entitled to nine months' notice of termination of the relationship between them. The court found, when determining that a dependent contractor relationship existed, that in some cases a relationship between the parties will exist which is midway between the traditional employer/employee relationship and the normal independent contractor relationship. The court proposed a test which looks at:

i. The duration and permanency of the relationship between the parties;

ii. The degree of reliance or closeness of the relationship; and

iii. The degree of exclusivity of the relationship.

The court found that if some of these factors exist, a dependent contractor relationship will exist, thus requiring reasonable notice of termination to be given in the absence of a clear contractual notice requirement.

In determining what reasonable notice should be in the context of a dependent contractor relationship, the court adopted the following guidelines:

i. Exclusivity of the relationship and the time needed by the contractor to re-establish a viable business;

ii. The extent of staff and equipment maintained by the contractor;

iii. The length of the relationship between the parties;

iv. Whether or not there was inventory which the contractor needed to dispose of;

v. The type of business involved and the time required to establish new business relationships; and

vi. The economic conditions at the time of the termination of the relationship.

Essentially, the court found that reasonable notice in a dependent contractor relationship may be less than in a traditional employer/employee relationship but should have regard to the above factors and commercial reality.

In summary, this is an area of the law which appears to be less clear as time goes by. It is hoped that an appellate court will review the area in its entirety in the near future, in order to provide some guidance with respect to the issues raised by the recent cases. In the meantime, employers should take care to ensure careful drafting of independent contractor agreements and to ensure that the treatment of those individuals in the workplace mirrors the intent of the parties.

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4 *JKC Enterprises Ltd. v. Woolworth Canada Inc. (2001), 12 C.C.E.L. (3d) 51 (Alta. Q.B.)*

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