If It Looks Like a Duck: Consultant (Mis)Classification

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Melanie advises Canadian and international businesses, from start-ups to well-established companies, on a wide range of employment issues touching every phase of the employment relationship, with an emphasis on the high-technology sector.

When your company has a job to be performed, there are two basic classifications to choose from:

- employment arrangements, in which your company contracts directly with an employee to perform work for wages, or
- consulting arrangements (also known as independent contractor, contractor or services arrangements), in which your company engages an individual or a business or entity to provide its services for fees.

Who controls that choice?
Any consulting relationship must satisfy the applicable legal tests. Thus, the parties do not have total freedom of choice – even when both sides agree upon a consulting arrangement, sometimes the law just says, "No!"

What does the classification matter?
The law assumes that in an employment relationship the employee is vulnerable, because typically employers have a stronger bargaining position. Therefore, the law tends to favour and protect employees. Independent of any written agreement between the parties, the law imposes numerous "extra" obligations on employers under statutory rules and regulations and under the common law.

The law assumes that a true consulting relationship, in contrast, is a commercial relationship in which both parties have relatively equal bargaining power. Therefore, the law will not normally impose any "extra" obligations beyond the actual written agreement made between the parties.

Correctly or incorrectly classifying the relationship makes a significant difference, both in terms of the obligations and entitlements owed to and by each party, and in terms of the obligations owed by each party to others (including the dreaded taxman).

If the relationship is reclassified as employment (or as a "dependent contractor" relationship, which falls into a grey zone between employment and consulting), then the result will likely be quite different from what the parties expected and intended.

What triggers a review of the classification?
Reviews often occur because the parties have fallen out. Reviews also occur on a random basis (as, for example, during a routine income tax audit or workplace safety audit) or are triggered inadvertently (if, for example, a pregnant consultant applies for employment insurance benefits).

Be aware that numerous government agencies (among them, boards and agencies that deal with tax, employment insurance, pension, health taxes, occupational health and safety, human rights and employment standards) all have a right to "kick the tires."

What tests apply?
Courts and agencies have different mandates and different agendas, and they often apply different tests – sometimes, with different results!

The legal tests are complex and inconsistent, varying in terms of the factors and the weight assigned those factors. Both Canadian taxing authorities (in Canada Revenue Agency's publication RC4110) and U.S. taxing authorities (in the IRS "20 Point Test") publish a list of questions that focus primarily on the issues of control, the degree of risk of profit or loss assumed by the consultant and the degree of integration between the consultant and the operations of the business. Regardless of what test applies, the wording of any written agreement does not itself determine the classification; other relevant facts and circumstances of the relationship considered include the overall structure, purpose and internal operations of the potential "employer"; the set-up of the consultant, and the manner in which the relationship actually operates.

Fundamentally, though, at the heart of each legal test is the "duck test": if it looks like a duck, walks like a duck and talks like a duck, it's a duck! The more a consulting relationship looks and operates like an employment relationship, the more likely it will be classified, or reclassified, as an employment or dependent contractor relationship.

How do you make the right choice from the outset?
Quite often, consulting seems more appealing: the consultant can access the more favourable tax treatment given to self-employment income, and the business can avoid the legal and administrative burdens attaching to employment relationships. The duck test demonstrates why these apparent advantages can back-fire.

Some considerations are easily accommodated in either relationship. Both consultants and employees can be hired under short-term, fixed-term or project-specific agreements; both can work part-time or "as needed"; and for both, termination liabilities can be controlled through specific contractual termination provisions. Therefore, other considerations should drive the decision.

Some considerations tip the scales toward employment. A long-term (or indefinite), full-time and exclusive work arrangement, involving the provision of services of a kind normally (or already) performed by employees, is likely to be classified as employment.

But frankly, the choice is often decided by practical considerations, regardless of the legal tests and risks. A business in its infancy may not be ready to be an employer. If particular talent is hard to find, the best (or only) candidates may insist on being consultants.

What should a consulting contract contain?
No matter what, a written consulting agreement, properly finalized and signed before the engagement begins, is vital. In addition to the usual commercial terms and a clear description of the services, consider the following protective features:

- confirmation of independent contractor status and limitations on the consultant's authority,
- confidentiality provisions,
- ownership of work product, data, intellectual property rights or inventions provisions (unlike an employment relationship, unless the consultant contractually agrees to these, the business will not have ownership),
- where appropriate, warranties about the work and original workmanship, and
- early termination provisions.

What happens if the relationship is reclassified?
Generally, adverse consequences can include any or all of the following:

- The "employee" may be required to pay additional income tax on income that should have been treated as employment income, plus interest and penalties.
- The "employer" may be required to pay interest or penalties on the income tax which should have been withheld, employment insurance, Canada Pension Plan contributions, workers compensation and employer health tax premiums – both the employer and employee portions – that should have been deducted and remitted, together with interest and penalties.
- The "employer" may owe additional payments (overtime pay, vacation pay, termination notice or severance) to the "employee."

Last but not least: any existing written agreement may be partially or fully invalidated, so if the parties are still working together, a new written agreement will need to be made.

The bottom line: remember the duck test, and make an informed choice.