

Risk Assessment

Scenario: Paying existing employees as independent contractors

Overview

In the normal operation of a business, there can be situations where an employee is asked to provide services for tasks that are outside their normal job description or employment contract. In this situation, the employer can choose to either expand the role of the employee to meet these needs, or they can create a new separate relationship with that employee as an independent contractor while maintaining their existing employment. When an employer chooses to hire an existing employee as an independent contractor, there are a range of factors that can determine whether this relationship is valid under business and tax laws which determine employee classification and employer obligations. Employers should consider these factors and risks when making the decision to hire existing employees as independent contractors as there can be legal and financial liabilities associated with misclassification that the employer may be responsible for.

Employment Classification

Employee: An employee is hired by the employer to complete specific tasks as outlined in the work agreement. In general, the employer controls what work is done, how it is done, and sets schedules or deadlines the employee must follow. As well, the employer provides the tools, equipment, supplies, space, and other resources the employee relies on to complete these tasks. An employee is paid a wage for the hours worked or based on a salary which is usually paid through the employer's payroll system.

Independent Contractor: An independent contractor is contracted by the employer to provide services but is not an employee of the employer. Independent contractors typically set their own hours, rates, and determine their own methods for completing tasks and providing services. Independent contractors also tend to work without as much oversight from the employer other than to ensure the desired result and are free to complete work in the manner they choose within the bounds of the agreement. Furthermore, an independent contractor usually provides their own equipment, supplies, transportation, and can hire and manage their own workers to help complete the work.

Signs of Misclassification

The distinction between an employee and an independent contractor can be difficult to determine if the contractor is also a salaried employee. There are various indicators that an employee has been misclassified as an independent contractor:

- The employer sets work hours, schedules, and rates
- Tasks are supervised by the employer beyond what is necessary
- The contractor is not contracted separately from their existing agreement
- The contractor is paid through the company payroll rather than through invoices
- The employer provides the tools, equipment, supplies, and other items required for the contractor to complete the task
- The contractor only has a single client or works full-time for a client
- The contractor is completing core business tasks
- The contractor is not reporting income, keeping records, or deducting expenses
- Intent of the parties involved in choosing this classification

These factors alone are not enough to determine misclassification, but if multiple factors apply to an employer-contractor relationship, then it could indicate that the employee has been mistakenly classified or that one or more parties are misrepresenting the employee/contractor relationship.

Risks and Consequences

On the surface, the distinction between an employee and an independent contractor may seem arbitrary and misclassification can be an honest mistake, but the consequences of intentionally blurring the lines between the two can include legal and financial liabilities for the employer. Should an employee become disgruntled, have an accident, cause damage, or encounter other challenges, they could dispute their classification with the employer or bring the matter to the attention of the CRA. Furthermore, issues with the contractor could result in legal liability for the employer depending on the circumstances.

Tax Risks: The CRA could become aware of the employer-contractor relationship and determine that it is a misclassification of the employee, especially given they are an existing employee on the payroll already. The CRA would look at the actual working relationship and review the factors previously established to determine if the employee is an actual independent contractor or should be considered a standard employee. As a result, the employer could become responsible for paying retroactive CPP and EI contributions, income tax withholdings, and any punitive penalties. For an existing employee, employers

are responsible for matching CPP payments beyond the employee's regular salary, as well as contributing to EI premiums. These contributions would be avoided if the employee is treated as an independent contractor and depending on the perceived intent the CRA could view these actions as evasive in nature.

Employment Benefits and Standards: Regular employees are entitled to various benefits that independent contractors are not such as overtime pay, vacation pay, holiday pay, and benefits related to ending employment. If an existing employee is working their regular hours and then completing further tasks, they would typically be entitled to overtime pay based on their employment agreement or labour law minimums. In Nova Scotia specifically, employers are required by law to pay at least 1.5 times the employees wage for hours worked over 48 hours in a single week unless there are other agreements in place that surpass this minimum such as an employment agreement that specifically provides overtime pay after 40 hours instead. These rules apply to hourly and salaried employees with few exceptions. Furthermore, employers are required to contribute vacation pay at 4% of the employees' gross wages for the first 7 years of employment beyond their hourly rate. If it is determined that an employee has been misclassified as an independent contractor, the employer could be responsible for retroactive overtime or vacation payments that the employee would have been entitled to as a salaried employee under their existing employment agreement.

Legal Liability: Salaried employees are protected by things such as employment insurance, workers compensation, and the business's general liability insurance and other forms of insurance. The employer as a result is also protected from liability or damages in situations where they are not at fault or negligent by having this insurance coverage. When an employer hires an independent contractor, some protections may extend to the contractor, but many protections are not afforded to the contractor as the contractor is expected to hold and maintain their own insurance coverages and make their own contributions to things such as employment insurance. As a result, if an accident occurs on the jobsite involving a misclassified employee it could result in lawsuits that lead to the employer being held solely liable for any damages caused to persons or property. In some cases, liability for wrongdoing may extend to directors and officers at the highest level of the business if it is determined that they acted with negligently or with intent to mislead.

Evaluation and Precautions

As a result of the above, care should be taken to ensure that independent contractors are treated separately from regular employees and particular care should be taken to establish existing employees as separate from their roles as independent contractors. There are many risks to hiring independent contractors, but further risk is taken when an employer

mistakenly or intentionally misclassifies an employee as an independent contractor as such steps should be taken to ensure proper classification.

Independent Contractor “Sniff Test”

When establishing a new business relationship with an existing employee, you can quickly assess whether they count as an independent contractor or not by answering a few simple questions:

1. What is the intent of both parties in establishing this new business relationship?
2. Is there a written contract establishing the terms of this relationship?
3. Will the contractor invoice the business for services rendered?
4. Who will determine the schedule, hours worked, and pay?
5. Will the contractor be providing their own tools and materials?

When the CRA or other bodies are considering a misclassification case the intent of those involved can determine the severity of any additional penalties beyond the retroactive payment of deductions and benefits. If the intent is to evade tax and benefit obligations, then this could lead to penalties against the employer despite independent contractors typically being responsible for their own taxes and benefits since a misclassified employee would not be considered an actual independent contractor in that situation.

Verbal contracts are a valid form of establishing business relationships but when looking at the actual facts of a larger case the lack of a written contract can suggest that the employee has been misclassified and trigger the consequences outlined above. When an employee has not been misclassified then a written contract can help further differentiate their role as an employee and their role as an independent contractor as well as establish terms for how the work will be performed and paid for.

If the contractor is invoicing the business for individual jobs completed based on terms set out ahead of time, then this could help further establish the separation of the employee's role as a contractor. However, if a contractor is not invoicing for services rendered then it calls into question how the business determines the payment for the contractor. Related to this is who is responsible for setting the schedule, hours worked, and payrate for the jobs given to the contractor. If the employer is setting the hours, setting the rate, and paying through the company payroll process rather than through invoices provided by the contractor then this could establish a more integrated role for the contractor and suggests that they may be misclassified.

Finally, contractors typically provide their own materials and equipment to complete contracted work. As well, they are often able to subcontract the work to other contractors

or hire their own employees to complete the work. If the independent contractor is using materials provided by the employer, being directed by the employer to follow certain methods and procedures and is unable to make normal business-to-business decisions such as hire employees or subcontractors, then it could suggest that the employee is misclassified. While this is most evident with existing employees who are brought on as independent contractors for additional work outside their regular roles, these factors can also be considered in the case of all independent contractors in general. The more integrated an independent contractor is in the regular function of the business the more likely they are misclassified and should be instead treated as a regular employee.

Conclusion

Not all independent contractors are misclassified employees, but in the case of an existing employee who is working for the same business as an independent contractor for some tasks there needs to be extra care taken to establish the separation of duties between the two roles. When an employee is misclassified as an independent contractor it can open the business to unnecessary risk and financial liability, especially if the business is aware or intentionally misrepresenting employees. Although employees are responsible for reporting their own income and paying their taxes, a misclassified employee would result in the employer being responsible for any back payments on CPP, EI, overtime, vacation, and other entitlements. As such it is best practices to not enter such a relationship with employees without a bona fide business-to-business agreement that clearly outlines the separation of duties, or to avoid any such relationships with employees when the proposed contract work is not significantly different from their regular work or their work will be highly integrated and integral to the operation of the business.

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I am not a lawyer, and this is not legal advice. This is an opinion piece written using the sources listed below combined with my educational background and general knowledge and should be used only as a suggestion for further research and discussion with legal professionals.

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