WORKER CLASSIFICATION: WHY IT MATTERS AND AN UPDATE ON THE LATEST TRENDS

I. WORKER CLASSIFICATION: THE BASICS

A. Persons who are retained to render services can meet any number of classifications: employees, contractors, subcontractors, agents, and brokers. An important distinction is made between "employees" and "independent contractors."

B. Definitions: "employee" vs. "independent contractor."

1. An employee is a person retained to render services for another person or an entity in exchange for wages or salary.

2. An independent contractor is a person or entity contracted to perform work for—or provide services to—another person or entity as a nonemployee.

C. There is no single test or criteria for determining whether a worker is an employee or an independent contractor.

1. In fact, a worker may be classified as an employee for one purpose and as an independent contractor for another.

2. Different governmental agencies and the laws and regulations governing employees and independent contractors use different and sometimes (but not always) overlapping standards for determining worker classification. For example, the criteria and tests used by the IRS to determine worker classification differ from the criteria and tests used for classification under the Fair Labor Standards Act.

3. Contractual agreements and labeling of workers as "independent contractors" are not sufficient to establish that the workers are, in fact, independent contractors as opposed to employees.

D. One unifying principle in worker classification, however, is the "right to control."

1. For employees, employers control both "what" the employees do and "how" they do it. Employees typically have established hours, work at a designated location, follow a set of directives, policies and procedures established by the employer, and are paid a regular wage or salary.

2. For independent contractors, employers control only what the independent contractor will do. Control over "how" the work will be done remains with the independent contractor. In this way, independent contractors are like self-employed entities. Independent contractors typically set their own hours, determine for themselves the best way to accomplish their objectives, and are paid when their tasks are completed.

3. In short, employers retain a great deal of control over employees and much less control over independent contractors.

E. The classification of workers will impact the duties and obligations of the employer.

1. For workers classified as employees, the employer must:

   a. Collect and remit taxes, including federal and state income tax withholding, FICA (both employee and employer portions), FUTA (federal unemployment taxes), and state unemployment taxes.

   b. Comply with state and federal labor laws applicable to employees.

   c. Comply with ERISA.

2. For workers classified as independent contractors, the employer is not required to collect or remit employment taxes. Moreover, independent contractors are generally not covered by federal labor laws.

F. The IRS utilizes various tests for worker classification.

1. In 1987, the IRS published Revenue Ruling 87-41 which included a "20-Factor Test" for determining worker classification. The 20 factors are:

   a. Instructions – does the worker have to comply with instructions about when, where and how to conduct the work?

   b. Training – is the worker required to be trained as directed by the employer?

   c. Integration – does the worker's work constitute an integral part of the employer's business?

   d. Services Rendered Personally – are the services to be rendered by the worker required to be rendered personally?

   e. Hiring, Supervising, and Paying Assistants – does the employer hire, supervise and pay assistants?

   f. Continuing Relationship – is the relationship between the worker and the employer ongoing or a one-off engagement?

   g. Set Hours of Work – is the worker required to work specific hours?

   h. Full Time Required – is the worker required to devote substantially all of his/her time to the business of the employer?

   i. Doing Work on Employer's Premises – is the worker required to perform the work on the employer's premises?

   j. Order or Sequence Set – is the worker required to perform the work in an order or sequence determined by the employer?

   k. Oral or Written Reports – is the worker required to submit regular oral or written reports to the employer?

   l. Payment by Hour, Week, Month – is the worker paid at a regular interval?

m. Payment of Business and/or Traveling Expenses – does the employer ordinarily pay for the worker's business and/or traveling expenses?

n. Furnishing of Tools and Materials – does the employer furnish tools and materials to worker?

o. Significant Investment – does the worker invest in and/or maintain the facilities used by the worker in performing the work?

p. Realization of Profit or Loss – does the worker share in the profit or suffer loss as a result of the work performed?

q. Working for More Than One Firm at a Time – does the worker perform more than de minimis work for multiple, unrelated employers at the same time?

r. Making Service Available to General Public – does the worker make his or her services available to the general public on a regular and consistent basis?

s. Right to Discharge – does the employer retain the right to discharge the worker?

t. Right to Terminate – does the worker retain the right to end the relationship with the employer?

2. Simplified Three-Factor Test.

a. Behavioral Control – does the employer control:

i. When and where the work is performed?

ii. What tools or equipment is used?

iii. What workers are hired to assist?

iv. What order or sequence the work will be completed?

b. Financial Control – does the employer control:

i. The worker's reimbursement for expenses?

ii. The worker's investment in the work?

iii. The worker's ability to work for others?

iv. How and when the worker is paid?

c. Type of Relationship – between the worker and employer:

i. Is there a written agreement describing the relationship between the parties?

ii. Is the worker eligible for, and does the employer provide, benefits like insurance, pension, vacation or sick pay?

iii. Is the working relationship permanent?

iv. Are the services provide by the worker a key aspect of the regular business of the employer?

3. Statutory Employees.

a. Workers in certain occupations are considered "statutory employees":

i. Agent-drivers or commission drivers engaged in distributing meat, vegetable or bakery products; beverages (other than milk); or laundry or dry cleaning.

ii. Full-time life insurance salespersons.

iii. Home workers performing work according to furnished specifications on materials provided, which products are required to be returned to the principal.

iv. Full-time traveling or city salespersons soliciting orders from wholesalers or retailers for merchandise for resale or for supplies used in their business operations.

b. Statutory employees must be in one of four specified occupations and satisfy the following requirements:

i. Contract must specify that the worker will perform substantially all of the services.

ii. Worker shall have no substantial investment in the facilities.

iii. There is a continuing relationship between employer and worker.

G. Fair Labor Standards Act (FLSA) – worker classification is determined using the "economic realities test." The factors to be considered under this test are:

1. The extent to which the services rendered are an integral part of the employer's business.
2. The permanency of the relationship.
3. The amount of the worker's investment in facilities and equipment.
4. The nature and degree of control by the employer.
5. The worker's opportunities for profit and loss.
6. The amount of initiative, judgment or foresight in open market competition with others required for the success of the worker.
7. The degree of independent business organization and operation.

H. National Labor Relations Act (NLRA) – text of the law specifically excludes independent contractors from coverage. The National Labor Relations Board, which often makes classification decisions, uses a "right to control" standard which weighs a number of factors:

1. Extent of control by employer over the details of the work.
2. Whether the worker is engaged in a distinct occupation or business.
3. The kind of occupation and whether it is customary (in the geographic location) for the worker to do the work under direction of a supervisor.
4. The skill required for a particular occupation.
5. Whether the employer supplies the tools and place of work.
6. The length of time the worker is employed.

7. The method of payment, whether by time or by the job.

8. Whether the work is an integral part of the employer's business.

9. The intent of the parties.

I. Employee Retirement Income Security Act (ERISA) – uses similar criteria to those utilized in the NLRA worker classification analysis.

J. Michigan Unemployment – applies the economic realities test which weighs the following factors:

1. The employer's control of a worker's duties.

2. The payment of wages.

3. The right to hire and fire and the right to discipline.

4. The performance of duties as an integral part of the employer's business towards the accomplishment of a common goal.

K. Michigan Worker's Disability Compensation Act (MWDCA) – applies the three-part test set forth in the MCLA § 418.161(1)(n):

1. The worker does not maintain a separate business.

2. The worker does not hold himself or herself out to and render service to the public.

3. The worker is not an employer under the MWDCA.

II. <u>THE CONSEQUENCES OF WORKER MISCLASSIFICATION</u>

A. Tax Liabilities - if an employer misclassifies a worker as an independent contractor, the tax consequences can include substantial interest and penalties in addition to the principal amounts of the tax.

1. Failure to Withhold: If an employer fails to withhold, then the employer is liable for:

a. 1.5% of wages paid to employees.

b. 20% of employee's share of FICA (Social Security tax).

c. 100% of employer's share of FICA.

d. 100% of federal unemployment tax.

NOTE: If employer fails to file 1099-MISC and other reports, the amounts in a. and b. above are doubled. Also, if an employer intentionally disregards the reporting rules, the IRS will attempt to collect 20% of wages paid to employees and 100% of the FICA due, both employer's and employee's shares.

2. Personal liability for the unemployment taxes owed may be imposed on any person who has effective control over the finances of the employer.

B. Wage Claims Under FLSA.

1. FLSA requires that employers pay employees time and one-half of their regular rate of pay for every hour they work in excess of 40 hours in a given workweek.

2. If employer misclassifies its workers as independent contractors, it could give rise to wage and hour claims under FLSA.

3. The penalties under FLSA in addition to backpay, employers are liable for "liquidated damages" in an amount equal to the amount of backpay unless they can show (i) their actions were taken in good faith, and (ii) they had reasonable grounds to believe they were complying with FLSA.

C. ERISA Exposure.

1. Failure to properly classify workers as employees could lead to disqualification of a qualified retirement plan, which, in turn, could lead to adverse tax consequences to plan participants.

2. NOTE: To prevent retroactive extension of eligibility for workers who are initially classified as independent contractors, but are later reclassified as employees, benefit plans should include language that

states any worker that is reclassified shall not be retroactively deemed an employee for purposes of eligibility in the plan.

D. FMLA Violations.

1. Similar to FLSA, liquidated damages in an amount equal to the wages, salary, employment benefits or other compensation denied or lost due to the employer's violation of FMLA may be awarded to the aggrieved worker unless the employer can show their actions were taken in good faith and that they had reasonable grounds for their actions.

E. I-9 Violations.

1. Employers are responsible for obtaining and maintaining properly completed Forms I-9 for each employee.

2. Penalties for failure to complete properly or retention of the I-9 forms can range from $250-$3,000 per employee.

F. Other Potential Consequences.

1. Age Discrimination Claims.

2. WARN Act Violations.

3. Worker's Compensation Violations.

III. LATEST DEVELOPMENTS IN WORKER CLASSIFICATION CASES

A. *Jammal v. American Family Insurance Co.*, No. 17-4125 (6th Cir. Jan. 29, 2019).

1. 6th Circuit Court of Appeals reviewed the question of whether, for purposes of ERISA, insurance salespersons are employees or independent contractors.

2. The Court cited the standards for worker classification for ERISA purposes set forth in *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 321 (1992).

3. The first factor under *Darden* looks to "whether the skill [required of an agent] is an independent discipline (or profession) that is separate

from the business and could be (or was) learned elsewhere." The Court noted that the skill required of insurance agents weighs in favor of independent-contractor status because "the sale of insurance is a highly specialized field" that requires "considerable training, education, and skill."

4. *Darden's* eighth factor examines "the hired party's role in hiring and paying assistants." The Court cited the fact that the insurance salespeople have primary authority over hiring and paying their own assistants, and that factor should weigh in favor of independent-contractor status.

5. The Court also noted that, although the right to control the means and manner in which the work is carried out is still an important inquiry, its importance is diminished in the worker classification analysis for ERISA purposes, where the central question is whether the employer has assumed responsibility for the person's pension status.

6. The Court ultimately determined that, because the majority of the *Darden* factors fell in favor of independent-contractor status, the insurance salespeople were properly classified by American Family as independent contractors.

B. *Hood v. Uber Techs., Inc.*, No. 1:16-cv-00998 (M.D.N.C. Jan. 3, 2019).

1. 5,200 Uber drivers filed a class action claiming they were misclassified as independent contractors and not employees. The drivers claimed further that due to their appropriate status as employees, they were owed minimum wage and overtime compensation under FLSA.

2. The case was settled for $1.3 million.

3. In their submission in support of settlement, the drivers acknowledged that the company had a "'significant chance' of either prevailing on the merits, by a finding that the drivers are independent contractors, or of achieving a reduction of liability if not required to compensate for drivers' wait time."

4. NOTE: Only about $735,000 of the $1.3 million settlement went to the drivers ($150/driver). The remainder went to attorneys' fees, court costs, and litigation and settlement expenses.

C. *Dynamex Operations West, Inc. v. Superior Court of Los Angeles*

1. The Court examined the issue of whether truck drivers were properly classified as employees or independent contractors for purposes of California's wage and hour laws.

2. The Court found the drivers were employees by applying the ABC Test, under which a worker will be deemed an employee unless:

   a. The worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact.

   b. The worker performs work that is outside the usual course of the hiring entity's business.

   c. The worker is customarily engaged in an independently established trade, occupation or business of the same nature as the work performed.

3. The Court found that the employer retained sufficient control over the drivers, that the drivers performed work that was central to the employer's business, and that the drivers were not customarily engaged in the type of work being performed outside of their role with the employer. As such, the drivers were deemed employees and not contractors.

4. Ninth Circuit Court of Appeals issued an opinion on May 2, 2019 that would make the *Dynamex* standard for worker classification be retroactively applicable.

D. *Diva Limousine v. Uber Technologies Inc.*, No. 18-cv-05546 (N. D. Cal. Sept. 10, 2018).

1. Competing limousine company that classifies its drivers as employees sues Uber alleging that Uber's classification of its drivers as independent contractors is incorrect under California law, and such misclassification gives Uber a competitive advantage because Uber does not have to pay minimum wage or other payments under wage and hour laws, which allows Uber to undercut the competition on prices for ride services.

2. Case is pending.

E. DOL Opinion Letter (FLSA2019-6)

1. Letter arose from request for determination on service providers in "gig" economy like Uber and Lyft.

2. DOL went through the "economic realities test" factors and found that the service providers are independent contractors for purposes of FLSA, concluding that both the company and service providers have a relationship of "economic independence, rather than economic dependence."

F. *Q.D.-A, Inc. v. Indiana Dep't of Workforce Dev.*, No. 19S-EX-43 (Jan. 23, 2019).

1. Indiana Supreme Court addressed the question of how the state's three-prong ABC test used for worker classification under Indiana Unemployment Compensation Act should be properly applied.

2. Company connects drivers directly to customers needing vehicles delivered to them. Company argued that drivers were independent contractors. Indiana Department of Workforce Development disagreed.

3. Indiana Supreme Court sided with the Company, emphasizing that the drivers were not under the Company's control or direction, that the drivers performed services outside the Company's usual course of business, and that the drivers ran independently established businesses.