STAY CLASSY: WHY WORKER CLASSIFICATION MATTERS, COMMON MISCLASSIFICATIONS, AND THE LATEST TRENDS

By: Sydney E. Wright, Esq.

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

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 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. Worker classification impacts 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. Assistants – does the worker hire, supervise, and pay their own 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 their 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 their 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 provided 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. Corporate officers of exempt organizations

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

iii. Full-time life insurance salespersons.

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

v. 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 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) - Enacted by Congress in 1938 to eliminate "labor conditions detrimental to the maintenance of the minimum standard of living necessary for health, efficiency, and general well-being for workers."

1. To accomplish this goal, the FLSA requires covered employers to pay nonexempt employees at least the Federal minimum hourly wage (presently $7.25) for all hours worked, and overtime at time and one-half the employee's regular rate.

2. However, this protection, along with other protections provided by the FLSA, do not apply to independent contractors.

3. 2021 Independent Contractor Rule – Before the adoption of the 2024 Rule, the DOL issued the 2021 Independent Contractor Rule. Under the 2021 Rule, worker classification was determined using the two "core" factors test. The factors to be considered under this test are:

a. the nature and degree of control over the relevant work (more probative);

b. the individual's opportunity for profit or loss (more probative);

c. the amount of skill required for the work;

d. the degree of permanence of the working relationship; and

e. whether the work is part of an integrated unit of production.

4. The two "core" factors, namely, (1) the nature and degree of control over the relevant work and (2) an individual's opportunity for profit or loss, were given more weight in the worker classification analysis. The three other factors were considered less probative.

5. The 2021 Rule was recently superseded by the 2024 Rule.

6. 2024 Independent Contractor Rule – The 2024 Rule abandons the two "core" factors approach in favor of a totality of circumstances approach wherein no one factor is given more weight. Under the DOL's 2024 Rule, the six factors relevant to this approach now include:

a. The opportunity for profit or loss depending on managerial skill;

b. Investments by the worker and potential employer;

c. The degree of permanence of the work relationship;

d. The nature and degree of control over performance of the work and working relationship

e. The extent to which the work performed is an integral part of the potential employer's business; and

f. The skill and initiative of the worker.

7. The 2024 Rule states that "additional factors may be relevant in determining whether the worker is an employee or independent contractor for purposes of the FLSA[.]" The DOL included this provision to emphasize that "the [above] enumerated factors are not to be applied mechanically but viewed along with any other relevant facts in light of whether they indicate economic dependence or independence."

H. National Labor Relations Act (NLRA) – In 1935, Congress passed the National Labor Relations Act ("NLRA"). Only employees who are covered by the Act have the right to join a union, engage in collective bargaining, and have the right to engage in "protected concerted activity" under the Act.

1. The NLRA establishes the National Labor Relations Board (NLRB), which has jurisdiction over labor disputes and which supervises union elections.

2. The NLRA applies to employees at union *and* non-union workplaces. However, the text of the Act excludes certain types of workers from coverage and explicitly excludes independent contractors.

3. "Concerted Activity" Case Study: NLRB Case No. 34-CA-12576

a. After a work-related incident, an employee criticized her supervisor in a post on Facebook, which prompted other employees to reply to the posting. The employee was suspended the next day and later fired. After an investigation, the NLRB issued a Complaint alleging the employee was unlawfully fired because she engaged in protected concerted activity when she criticized her supervisor on Facebook. The Complaint also alleged that the company's handbook contained several unlawful provisions. Prior to a hearing, the company agreed to revise the provisions in the handbook, which were alleged to be unlawful. The company also reached a private settlement with Dawnmarie regarding her termination.

b. In this case study, Souza was a union member. However, the same NLRA protections would have applied if she had not been a union member, provided she still qualified as an "employee" under the NLRA.

4. On June 13, 2023, the National Labor Relations Board ("NLRB") reinstated the common-law agency test for determining worker status found in the Restatement (Second) of Agency § 220. Under that test, the Board looks at the following factors, with no one factor being decisive:

   a. The extent of control, which by agreement, the employer may exercise over the details of the work.

   b. Whether or not the one employed is engaged in a distinct occupation or business.

   c. The kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision.

   d. The skill required in the particular occupation.

   e. Whether the employer or the workman supplies the instrumentalities, tools and the place of work for the person doing the work.

   f. The length of time for which the person is employed.

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

   h. Whether or not the work is part of the regular business of the employer.

   i. Whether or not the parties believe they are creating the relation of master and servant.

   j. Whether the principal is or is not in business.

5. Under the prior test, the NLRB placed special emphasis on whether a worker has "entrepreneurial opportunity." Under the new test, "entrepreneurial opportunity" is merely one additional consideration among the other nondispositive factors above that the Board must consider. Further, when considering entrepreneurial opportunity under the new test, weight should only be given to actual (not merely theoretical) entrepreneurial opportunity. Whether actual entrepreneurial opportunity exists should be determined by analyzing the limits employers impose on workers seeking such opportunities.

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

   1. ERISA-governed plans define the participants who are eligible to participate in the benefits they provide.

   2. Whether a worker is classified as an employee or a contractor is often determinative of eligibility.

J. Michigan Unemployment – The Michigan Unemployment Insurance Agency (UIA) administers the unemployment insurance program that provides temporary financial assistance to individuals who become unemployed through no fault of their own. Benefits are paid through taxes on employers covered under the Michigan Employment Security Act.

1. The UIA applies the IRS 3-factor test to determine if a person performed services as an employee or as an independent contractor. If a person performing services is an employee, then the employee's wages are subject to state unemployment taxation and the employee may be eligible for unemployment benefits. If, however, the person is found to be an independent contractor, then the employer pays no state unemployment taxes on the individual's earnings and the person's services are not covered employment.

2. IRS 3-Factor Test:

a. A. Behavioral Control - Does the company control or have the right to control what the worker does and how the worker does his or her job?

b. B. Financial Control – Are the business aspects of the worker's job controlled by the payer (these include things like how the worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)?

c. C. Relationship of Parties - Are there written contracts or employee type benefits (such as pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?

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. CONSEQUENCES OF WORKER MISCLASSIFICATION

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.

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 include backpay and "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. Companies that take steps to ensure that eligibility language in each ERISA plan is drafted in an effective manner, consistent with judicial precedent, can eliminate exposure to misclassification liability under ERISA, even if the workers can ultimately establish they were misclassified.

3. 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. Family Medical Leave Act ("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 I-9 Forms 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 AND TRENDS

One Towne Square, Fifth Floor, Southfield, MI 48076
p (248) 354-4030 | f (248) 354-1422 | maddinhauser.com