

SPECIAL REPORT

CLASSIFYING WORKERS AS EMPLOYEES OR INDEPENDENT CONTRACTORS

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A 2002 published report indicated that Fedex Corporation was facing taxes and penalties of more than \$319 Million related to an Internal Revenue Service ruling regarding the classification of independent contractors at its Fedex Ground unit. The IRS determined that Workers' Compensation at the Fedex Ground unit should be classified as employees instead of independent contractors. At the time, Fedex Ground used 15,000 drivers who were paid as independent contractors.

While Fedex asserted that it has strong defenses to the IRS tentative assessment and would vigorously defend its position that Fedex Ground owner-operators are independent contractors, we need to also examine this issue from an insurance perspective due to its insurance ramifications.

All employers, regardless of the number of employees, should be keenly aware of the differences between employees and independent contractors. The distinction between employee and independent contractor status is significant and can impact many issues, including benefit eligibility, wage and hour requirements, Workers' Compensation insurance and tax responsibilities, to name a few. For instance, an employer must generally withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee, whereas the same is generally not true for independent contractors.

Because employers may enjoy several benefits by classifying workers as independent contractors, the classification is often improperly used. In a true independent contractor relationship, an employer is not liable for FICA or FUTA taxes. Additional savings can also be enjoyed as independent contractors do not participate in employee benefit plans and generally are

not covered under a Workers' Compensation insurance policy. Bookkeeping expenses are also reduced because the employer is not required to withhold income and employment taxes for these workers. Of course, these are just a few of the benefits.

It is important to correctly classify individuals as an employee or independent contractor, as misclassification can result in substantial liabilities and penalties. This is particularly true with regard to tax responsibilities and worker's compensation issues.

The determination of whether a person is an employee or independent contractor is made on a case-by-case basis, and there is no single rule or test to make the determination. Courts have looked at many factors in making this determination, including criteria set forth by the Internal Revenue Service.

In previous years, the IRS utilized what was known as the "Twenty Factor Test" to help employers correctly classify workers as employees or independent contractors. Recently, this test has been simplified to a categorical test, wherein evidence of control and independence are examined, falling under three main categories: Behavioral Control, Financial Control, and Type of Relationship.

- 1. Behavioral control** – What amount of control does the employer have over the worker in terms of how the job is done, when and where, among other factors? Does the business have a right to direct or control how the work is done through instructions, training, or other means?
- 2. Financial control** – Does the business have a right to direct or control the financial and business aspects of the worker's job? What level of control does the employer have over a worker's pay, business expenses, overall investment, profit/loss, etc?
- 3. Relationship between the parties** – What do the facts show about how the parties perceive their relationship? Important factors would be written contracts describing the parties' intentions, the extent to which the worker is available to perform services for other businesses, whether the worker receives benefits, the permanency of the relationship, etc.

Where the employer has a significant amount of control over the individual, this may be an indication that the individual is an employee as opposed to an independent contractor. It is important to note that no single fact is determinative. Facts must be considered in their entirety.

Additional information regarding IRS criteria may be obtained at <http://www.irs.gov/pub/irs-pdf/p1779.pdf> or by calling 1-800-829-3676.

Erroneous Classification

If an employer fails to withhold the required income or employment taxes because it erroneously treated the employee as an independent contractor, the employer may be liable for those taxes that go unpaid by the worker. This obligation stems from the fact that the withholding should have been done at the source of the payment. In addition, the employer may be subject to other penalties.

Whether erroneous or intentional, misclassification of workers may also subject an employer to penalties for failure to file required tax returns, failure to pay tax due, failure to make required deposits and other penalties.

Employers should review their employee classifications and correct any misclassification immediately.

Workers' Compensation Implications

For Workers' Compensation purposes, the classification of employees and independent contractors is also very important. Michigan law requires employers of one full time or three or more part-time employees to carry Workers' Compensation coverage. Disguising an employment relationship under the label of an independent contractor will not relieve an employer of this obligation.

The Worker's Disability Compensation Act of 1969 defines "employee," in pertinent part, as:

Every person performing service in the course of the trade, business, profession, or occupation of an employer at the time of the injury, if the person in relation to this service does not maintain a separate business, does not hold himself or herself out to and render service to the public, and is not an employer subject to this act.

The Worker's Compensation Appellate Commission held, in *Spence v. Hansen Roofing & Chimney Service*, that this statutory language is the governing standard in determining whether an individual is an employee or an independent contractor. However the Commission stated that the "economic reality" test set forth in *McKissic v. Bodine* provides guidance in interpreting that language.

The *McKissic* court's "economic reality" test considers the following eight guidelines:

- (1) What liability, if any, does employer incur in the event of termination
- (2) Is work being performed an integral part of the employer's business
- (3) Does the claimant primarily depend upon the emolument for payment of his living expenses
- (4) Does the claimant furnish his own equipment and materials
- (5) Does claimant hold himself out to the public as one ready and able to perform tasks of a given nature
- (6) Is the work customarily performed by an independent contractor
- (7) Is there control, payment of wages, maintenance of discipline, and right to engage or discharge employees, and
- (8) What factors will most favorably effectuate the objectives of the statute.

In the case where an individual or company is deemed to be an independent contractor, it should be the policy of your organization to obtain certificates of Workers' Compensation and general liability insurance from the independent contractor to help insulate the employer from potential claims.

A Workers' Compensation insurance company could require the employer to pay an additional premium on audit if these certificates of insurance are not obtained.

The W.C. Act was amended in 2011 (Public Act No. 266 of 2011) and amended the previous sample standard:

Not all the factors must be present to find an employee/employment relationship, but the factors are guides to use to assess the likelihood as to whether an individual is an employee or an independent contractor.

- (1) *Instructions.* An employee must comply with instructions about when, where and how to work. The control factor is present if the employer has the right to require compliance with the instructions.
- (2) *Training.* An employee receives ongoing training from, or at the direction of, the employer. Independent contractors use their own methods and receive no training from the purchasers of their services.
- (3) *Integration.* An employee's services are integrated into the business operations because the services are important to the business. This shows that the worker is subject to direction and control of the employer.
- (4) *Services rendered personally.* If the services must be rendered personally, presumably the employer is interested in the methods used to accomplish the work as well as the end results. An employee often does not have the ability to assign their work to other employees, an independent contractor may assign the work to others.
- (5) *Hiring, supervising and paying assistants.* If an employer hires, supervises and pays assistants, the worker is generally categorized as an employee. An independent contractor hires, supervises and pays assistants under a contract that requires him or her to provide materials and labor and to be responsible only for the result.
- (6) *Continuing relationship.* A continuing relationship between the worker and the employer indicates that an employer-employee relationship exists. The IRS has found that a continuing relationship may exist

where work is performed at frequently recurring intervals, even if the intervals are irregular.

- (7) *Set hours of work.* A worker who has set hours of work established by an employer is generally an employee. An independent contractor sets his/her own schedule.
- (8) *Full time required.* An employee normally works full time for an employer. An independent contractor is free to work when and for whom he or she chooses.
- (9) *Work done on premises.* Work performed on the premises of the employer for whom the services are performed suggests employer control, and therefore, the worker may be an employee. Independent Contractors may perform the work wherever they desire as long as the contract requirements are performed.
- (10) *Order or sequence set.* A worker who must perform services in the order or sequence set by an employer is generally an employee. Independent Contractors perform the work in whatever order or sequence they may desire.
- (11) *Oral or written reports.* A requirement that the worker submit regular or written reports to the employer indicates a degree of control by the employer.
- (12) *Payments by hour, week or month.* Payments by the hour, week or month generally point to an employer-employee relationship.
- (13) *Payment of expenses.* If the employer ordinarily pays the worker's business and/or travel expenses, the worker is ordinarily an employee.
- (14) *Furnishing of tools and materials.* If the employer furnishes significant tools, materials and other equipment by an employer, the worker is generally an employee.
- (15) *Significant investment.* If a worker has a significant investment in the facilities where the worker performs services, the worker may be an independent contractor.

- (16) *Profit or loss.* If the worker can make a profit or suffer a loss, the worker may be an independent contractor. Employees are typically paid for their time and labor and have no liability for business expenses.
- (17) *Working for more than one firm at a time.* If a worker performs services for a multiple of unrelated firms at the same time, the worker may be an independent contractor.
- (18) *Making services available to the general public.* If a worker makes his or her services available to the general public on a regular and consistent basis, the worker may be an independent contractor.
- (19) *Right to discharge.* The employer's right to discharge a worker is a factor indicating that the worker is an employee.
- (20) *Right to terminate.* If the worker can quit work at any time without incurring liability, the worker is generally an employee.

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