Independent Insurance Agents & Brokers of America, Inc.

WORKER CLASSIFICATION: EMPLOYEE vs. INDEPENDENT CONTRACTOR

This memorandum is not intended to provide specific advice about individual legal, business or other questions. It was prepared solely as a guide, and is not a recommendation that a particular course of action be followed. If specific legal or other expert advice is required or desired, the services of an appropriate, competent professional should be sought.

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I. INTRODUCTION

A number of actions by the U.S. Department of Labor ("DOL") during President Obama's administration, including an Administrator's Interpretation ("AI") issued in July 2015, spurred many businesses to reevaluate how they classify their workers, either as an employee or independent contractor. In June 2017, however, the DOL withdrew the AI, in which the DOL took the position that few workers can properly be classified as independent contractors. Nevertheless, the DOL emphasized that it will continue to enforce all laws and that the withdrawal does not change businesses' responsibilities under the Fair Labor Standards Act, which governs federal minimum wage and overtime requirements. Notably, the Administrator's Interpretation – or a variation thereof – could be brought back at any time by the current or a future Administration.

This memorandum focuses on the issue of whether a worker should be classified as an employee or independent contractor.

II. TRADITIONAL TESTS FOR DETERMINING EMPLOYEE OR INDEPENDENT CONTRACTOR STATUS

Courts and administrative agencies have traditionally used one of three tests for determining whether a worker should be classified as an employee or independent contractor:

- **The common law control test.**
  - The IRS uses its own control test for federal tax purposes, and that test takes into account elements from all three tests.
- **The ABC test.**
- **The economic realities test.**

Although the common law control test is typically the most straightforward, all three tests require a fact-specific inquiry of the business and worker at issue.

A. The Common Law Control Test

The common law control test states that a worker is an employee, and not an independent contractor, if the business has the right to control the means by which the worker performs his services. Absent the right to control the means by which the worker performs his services, a business can properly classify the worker as an independent contractor. Importantly, the right to control the means, not the actual exercise of that control, is determinative. For example, an outside website designer or marketing firm engaged by an insurance agency would likely be properly classified as an independent contractor if the agent lacks the right to control, and does not control, the means by which the designer or marketing firm provides its services. However, it is acceptable under the common law control test for the business to control the ends to be accomplished—*e.g.*, the development of a website and the creation of marketing materials.

1. The IRS' Version of the Control Test

For federal tax purposes, the IRS uses an expanded version of the control test, under which it considers three categories: (1) behavioral control; (2) financial control; and (3) the relationship of the parties.

a. Behavioral Control

The behavioral control category is closest to the common law control test. The IRS looks at the business' right to control the manner in which a worker performs services. The IRS considers, among other things, whether the business provided the worker with instructions or training concerning the means or methods of performing the requested services. The IRS refers to "periodic or on-going training by a business about procedures to be followed and methods to be used" as "strong evidence of an employer-employee relationship." If the business either controls or retains the right to control the manner in which a worker performs services, that factor weighs in favor of a finding of employee status.

b. Financial Control

Under the financial control category, the IRS identifies several factors for evaluating whether a business has the right to direct or control the economic aspects of the worker's activities. These factors include:

(1) whether the worker has made a significant investment. The IRS recognizes, however, that some types of work do not require large expenditures and that a significant investment is not necessary for independent contractor status;
(2) unreimbursed expenses, which are more common among independent contractors. The IRS advises not to focus on reimbursed expenses, which independent contractors may negotiate and contract to receive;
(3) whether the work provides services to other clients in the relevant market, which favors a finding of independent contractor status, but the absence of which is neutral;
(4) the method for calculating the payment owed to the worker, with a flat fee being most indicative of independent contractor status; and

(5) opportunity for profit or loss, which considers the foregoing factors, as well as whether the worker is free to make business decisions that affect the worker's profit or loss.

Significantly, unlike the economic realities test used by the DOL (see Section III of this memorandum), the IRS emphasizes as part of the financial control category that a worker's economic dependence on or economic independence from the business is "inappropriate for use in analyzing worker status."

c. Relationship of the Parties

Finally, the IRS looks at how the worker and business perceive their relationship. The IRS views the parties' actions as reflecting on their intent concerning control, and it looks at the following factors:

(1) the expressed intent of the parties, such as through a written contract or use of a 1099 or W-2;
(2) whether the worker has created her own business entity through which she provides services, which is indicative of independent contractor status, particularly when corporate formalities are followed;
(3) whether the worker received benefits traditionally associated with employee status—*e.g.*, paid vacation, paid sick days, and insurance;
(4) the length of the relationship, with an indefinite relationship indicative of employee status and a long-term relationship, absent more, indicative of neither employee nor independent contractor status; and
(5) whether the worker's services are a key aspect of the regular business activity of the company. If the worker's services are a key aspect, the IRS considers whether the business has the right to direct or control the means or methods of the worker's performance.

d. Factors of Lesser Importance

Notably, the IRS states that factors including whether the worker is engaged on a part-time or full-time basis, where the worker performs the services, and the hours of work provide less useful evidence of whether a worker is an independent contractor or an employee.

B. The ABC Test

The so-called ABC test, which is used by approximately half of the states to determine worker status pursuant to state unemployment insurance laws, provides a worker is an independent contractor if: (1) there is a near total **A**bsence of control, both by contract and in fact; (2) the **B**usiness is outside the usual course of the workplace's business or performed away from workplace's offices; and (3) the work is **C**ustomarily done by independent contractors. This test is generally viewed as leading to more findings of employee status than are found under the common law control test.

C. Economic Realties Test

Finally, some courts apply an "economic realities" test that looks first at whether the business has the right to control how the work is performed, and then considers factors such as the extent to which the worker's services are an integral part of the business, the worker's investment in her own business, and the worker's opportunity for profit or loss. Courts have applied this test mostly in cases involving laws, such as the federal Fair Labor Standards Act ("FLSA") and the Family and Medical Leave Act that define employee more broadly than it is defined under the common law.

III. CONSIDERATIONS FOR INDEPENDENT INSURANCE AGENCIES

During the Obama Administration, the DOL consistently listed worker misclassification as an enforcement priority. The DOL entered partnerships with 31 states to work on joint investigations and enforcements of the FLSA and other employment laws. Several states expanded their investigatory and enforcement efforts, particularly in low-wage fields. The federal and state efforts have been predicated in large part on the belief that many businesses skirt the FLSA and other employment laws for their own financial benefit—*e.g.*, to avoid taxes—and to the detriment of their workers, who do not receive minimum wage, overtime, family leave, and other protections afforded to employees. Under President Trump, however, the DOL appears to have de-prioritized investigations into potential worker misclassification matters.

Of particular importance to independent insurance agencies is whether an outside insurance producer can be classified as an independent contractor. This work may be considered an integral part of an agency's business, and restrictions may be placed on the outside producer's ability to generate accounts for other agencies—two factors that may be considered indicative of an employer-employee relationship. However, considerations such as lack of control by the agency, schedule flexibility, the ability to work for other businesses and the parties' classification of the relationship may cut in favor of independent contractor classification. Finally, independent insurance agencies should also consider their business clients' potential exposure to DOL enforcement actions and private misclassification claims. Even though the DOL under President Trump has put less emphasize on worker classification issues, individual lawsuits and class actions remain a significant risk.

Independent insurance agencies that classify workers performing core agency functions as independent contractors may want to consult with experienced employment and tax attorneys on whether the classification comports with applicable state laws and the IRS' control test.