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PROPERTY & CASUALTY

CLASSIFYING WORKERS AS EMPLOYEES OR INDEPENDENT CONTRACTORS

A recent published report indicated that Fedex Corporation was facing taxes and penalties of more than \$319 million for 2002 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 reclassified as employees instead of independent contractors. Fedex Ground uses 15,000 drivers who are paid as independent contractors. While Fedex asserts that it has "strong defenses to the IRS tentative assessment and will vigorously defend" its position that Fedex Ground owner-operators are independent contractors, we need to examine this issue because of 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 in general 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 can 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.

Mailing Address: P.O. Box 511077 Livonia, Michigan 48151-7077

Cambridge Plaza Building: 15415 Middlebelt Road, Livonia, Michigan 48154-3805 T: 734.525.0927 F: 734.525.0612 www.cambridge-pc.com

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? **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?
2. **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 employee/independent contractor 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.