WORKER CLASSIFICATION: EMPLOYEE vs. INDEPENDENT CONTRACTOR

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I. INTRODUCTION

Worker classification is critical for purposes of federal and state labor laws. Generally, the rights and protections afforded to employees are not available to independent contractors. To clarify whether an individual is an employee or independent contractor, courts and administrative bodies have produced various tests to make worker classification determinations, which are discussed below. Due to changes in presidential administrations, the U.S. Department of Labor ("DOL") has shifted back and forth between worker classification tests for purposes of the federal Fair Labor Standards Act ("FLSA").

For many years, the DOL had not yet formalized a regulation, but rather issued informal guidelines. In 2021, however, Trump administration issued a new rule known as the Independent Contractor Rule ("IC Rule"). The Trump-era rule was rescinded by the Biden Administration, but then subsequently reinstated by a federal court. The 2021 test focused on two core factors – the worker's nature/degree of control over the work and the worker's opportunity for profit or loss.

The Biden Administration's DOL, however, has issued a new IC Rule, effective March 11, 2024. The DOL has stated that this rule is "more robust" and "restores the multifactor analysis used by courts for decades, ensuring that all relevant factors are analyzed." The analysis rejects the "core" factor approach and takes a broader view of employee that focuses on whether the worker is "dependent on an employer for work."

Some commentators suggest that the new rule could introduce more ambiguity and a greater potential for litigation in the future. There are already a variety of legal challenges to the new rule that are pending in federal court, but the rule has gone into effect and is the test that should apply for determining worker classification under the FLSA. This memorandum will provide a brief overview on the different tests for determining worker classification status and 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 (including CA, IL, MD, NJ and OH) 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 and the Independent Contractor Rule

Finally, courts have traditionally applied the "Economic Realities Test," which weighs a non-exhaustive list of six factors to determine worker classification under the FLSA. The FLSA is a federal law that requires employees, as opposed to independent contractors, to be paid a minimum wage and overtime compensation for hours worked in excess of a 40-hour work week.

The new 2024 DOL IC Rule test will continue to weigh the following factors as part of the determination as to whether workers are employees or independent contractors in business for themselves:

> (1) the degree of the employer's right to control the manner in which the work is to be performed;
> (2) the worker's opportunity for profit or loss depending upon his or her managerial skill;
> (3) the worker's investment in equipment or materials required for his or her task;
> (4) whether the service rendered requires a special skill;
> (5) the degree of permanence of the working relationship; and
> (6) whether the service rendered is an integral part of the employer's business.

While no single factor is dispositive, under the 2021 Rule, the first two factors were considered the most probative and afforded greater weight than any other factor. Thus, the Trump-era DOL attempted to simplify the traditional test, by emphasizing consideration of whether the worker is in control of the work. The Biden-era DOL has rejected that approach and emphasized a "totality of the circumstances" analysis that eliminates "core" or "weighted" factors.

III. CONSIDERATIONS FOR INDEPENDENT INSURANCE AGENCIES

The DOL has consistently listed worker misclassification as an enforcement priority. For example, during the Obama Administration, 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.

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. It is clear that the fight over how to classify workers will continue, at both the state and federal level. As such, individual lawsuits and class actions remain a significant risk.

The Biden Administration has heightened its focus on worker classification. Under the new IC Rule, there is an increased risk that workers, including those who want to be independent contractors, may be classified as employees under the FLSA. The lack of key factors will likely increase the potential for ambiguity and litigation. 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 and federal laws. While the new IC Rule is subject to a number of challenges in court and may change in the future, agencies should take this opportunity to review and consider their procedures for classifying workers and their independent contractor agreements generally.