Employee Classifications Guide for Group Health Plans

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It is essential for an employer to correctly classify workers as employees or independent contractors for it to comply with federal, state, and local laws. Misclassifying employees can have significant financial and legal consequences for employers, leaving them open to liability for unpaid overtime pay, payroll taxes, unpaid benefits, for example.

Employers may consider workers to be independent contractors rather than employees for numerous reasons, including in some cases the preference of the worker. Independent contractors typically do not receive the same benefits or protections as employees, and employers are not required to withhold or pay taxes on payments to independent contractors. However, an agreement between worker and employer does not control whether the worker is an employee or independent contractor in terms of employment law. In particular, the proper identification of employees is critical under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1986 (IRC).

A full discussion of all classification issues and applicable laws is beyond the scope of this guide. However, it will provide a high-level overview of classification issues for plan sponsors.

The first step in complying with these laws is understanding how they define "employee."

ERISA Common Law Employee Test

Under ERISA, an employer-employee relationship must exist as a precondition to a retirement or employee benefits plan being subject to ERISA. However, ERISA Section 3(6) defines employee as "any individual employed by an employer." In the 1992 case *Nationwide Mutual Insurance Company v. Darden*, the U.S. Supreme Court noted the circularity of this definition, and it is generally considered to be unhelpful.

Due to the absence of statutory guidance in defining employee under ERISA, plan sponsors have often defaulted to the definition of employee under the IRC, which defines an employee as an individual who

performs services for the employer as a common law employee. However, this definition has also been criticized as producing inconclusive results, especially in light of the prevalence of remote workers.

Under the U.S. Supreme Court's common law employer test under ERISA, employers should consider:

- The hiring party's right to control the manner and means by which the work is accomplished
- The skill required
- The sources of the instrumentalities and tools
- The location of the work
- The duration of the relationship between the parties
- Whether the hiring party has the right to assign additional projects to the hired party
- The extent of the hired party's discretion over when and how long to work
- The method of payments
- The hired party's role in hiring and paying assistants
- Whether the work is part of the regular business of the hiring party
- Whether the hiring party is in business
- The provisions of employee benefits
- The tax treatment of the hired party

The U.S. Supreme Court said all factors are given equal weight, with no single factor being decisive.

DOL Economic Realities Test

Due to the absence of a meaningful definition of employee under ERISA, the U.S. Department of Labor's (DOL) economic realities test under the Fair Labor Standards Act (FLSA) may be a good alternative for plan sponsors to use in their analysis and classification of employee status. The DOL Wage and Hour Division issued final regulations, effective March 11, 2024, that are intended to provide worker classification guidance for purposes of minimum wage and overtime pay eligibility under the FLSA. Plan sponsors are encouraged to use the guidance as a resource when analyzing a worker's employee or independent contractor status under ERISA.

The new DOL regulations articulate an "economic realities" test to determine employee versus independent contractor status based on the worker's entire working relationship with the employer. If the economic realities demonstrate that the worker is economically dependent on the employer for work, then the worker is an employee. If the economic realities show that the worker is in business for themself, then the worker is an independent contractor. The following facts and circumstances must be considered in making the determination:

- Opportunity for profit or loss depending on managerial skill, which considers whether a worker can earn profits or suffer losses through their own independent effort and decision making.
- Investments by the worker and the employer, which examines whether the worker makes investments that are capital or entrepreneurial in nature.
- Permanence of the work relationship, which considers the nature and length of the work relationship.

- Nature and degree of control, which considers factors that demonstrate the potential employer's level of control of the worker's performance of services and the economic aspects of the relationship, including:
    - Hiring, firing, scheduling, pricing, or pay rates
    - Supervision of the performance of the work (including via technological means)
    - Whether the worker has the right to supervise or discipline other workers
    - Whether the potential employer has the right to take actions that limit the worker's ability to work for others
- Whether the work performed is integral to the employer's business, which examines whether the work is critical, necessary, or central to the potential employer's principal business, which would indicate employee status.
- Skill and initiative, which considers whether the worker uses their own specialized skills together with business planning and effort to perform the work and support or grow a business.

A worker's status as an employee versus an independent contractor under the new FLSA guidance is a purely functional test. The worker's status is not determined by job title, employment agreement, or method of payment of wages.

The U.S. Department of Labor's (DOL) new Fair Labor Standards Act (FLSA) rules may prove to be a new standard as they make it harder for an employer to classify individuals as independent contractors. Employers looking for a conservative approach may want to use the new FLSA economic reality test in determining how to classify workers. Designating an individual as an employee under one body of law, such as the FLSA, can prompt questions of whether that person is also an employee under other bodies of law, such as the IRC or ERISA. Accordingly, many employers consider a more holistic approach to determining worker status.

IRC Worker Classification Test

The Internal Revenue Service (IRS) oversight of independent contractor classification is significant because it provides guidelines for an employers' tax liability, as well as the tax liability of its workforce. Depending on the type of business relationship an employer has with its workers, the employer may or may not be responsible for withholding income taxes, withholding and paying Social Security and Medicare taxes, and paying unemployment tax on wages. In addition, the Internal Revenue Code (IRC) classification is the standard for evaluating compliance with nondiscrimination rules for tax-favored treatment of employee benefit plans and whether an employer has offered its full-time employees group health plan coverage in accordance with the requirements of the employer shared responsibility mandate of the Affordable Care Act (ACA).

Under the IRC, an employee is anyone who performs services for a business that has the *right* to control what and how the worker's services are performed. Independent contractors are normally people in an independent trade, business or profession that offer their services to the public.

Facts that provide evidence of the degree of control and independence fall into three categories:

1. Behavioral control
2. Financial control
3. Type of relationship

Behavioral control relates to whether the business has a right to direct and control how the worker performs the task for which they are hired. In general, anyone who performs services for you is your employee if you can control what will be done and how it will be done. This is so even when you give the employee freedom of action. What matters is that the employer has the right to control the details of how the services are performed, including:

- When and where to do the work
- What tools or equipment to use
- What workers to hire or to assist with the work
- Where to purchase supplies and services
- What work must be performed by a specified individual
- What order or sequence to follow

Financial control looks at whether a worker can affect financial decisions. Does the worker have a significant investment in assets or tools? Are there unreimbursed expenses that the worker must bear themselves? Are the worker's services available to the public? What is the method of payment; do they get paid whether the work is done or not or do they get paid only if they finish the job?

Independent contractors can realize a profit or loss on a job. Can the worker make business decisions that affect his bottom line?

Relationship of the parties looks at whether there is a contract between the worker and the business and how it is worded, whether the worker gets any type of employee benefits (vacation, sick pay, pension plan, health or life insurance), and the permanency of the relationship such as continuing indefinitely or only for a specific project or period. Does the worker have their own business which they market to others?

An employer can request the IRS to determine whether a specific individual is an independent contractor or an employee by filing Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.

Employer Obligations

After determining that a worker is an employee, the employer is responsible for

- Withholding federal income tax, Social Security and Medicare taxes, and federal unemployment taxes (FUTA).
- Providing various types of health plan and tax-qualified retirement plan notices to their employees. An employer whose independent contractors are reclassified as employees must determine not only which notices should have been provided, but also how to address the prior lack of notice. For example, an

employer must consider the extent to which COBRA notices or a Summary of Benefits Coverage required under the ACA should have been provided, and the impact of failure to provide those notices at the required time. Similar consideration should be given to the failure to provide summary plan descriptions, summaries of material modifications and Form 5500 Summary Annual Reports to participants in qualified retirement plans.

Impact of Misclassifying Workers

Misclassifying workers as independent contractors can adversely affect employers and employees in several ways.

- If the employer's share of payroll taxes is not paid, and the employee's share is not withheld, the employer can be held liable for employment taxes for that worker. The IRS may also assess penalties for the failure to properly withhold and report income taxes, FICA and FUTA.
- Generally, only those benefit plans and programs covering employees are subject to ERISA. Accordingly, failing to properly classify individuals as employees rather than independent contractors could lead an employer to assume a plan or program is not subject to ERISA because it fails to cover employees. However, participation in employer-sponsored benefit plans is typically limited to employees, so the primary issue is more significantly the exclusion of independent contractors from a benefit plan and failure to provide required notices and documents under ERISA. If an excluded individual is later reclassified as an employee, the employer could be liable for any failures relating to ERISA reporting and disclosure requirements and failure to offer benefits to those employees during the period they were misclassified.
- The Affordable Care Act (ACA) requires employers with 50 or more full-time employees (or the equivalent in part-time employees) must provide health insurance to at least 95% of their full-time staff or face a potential penalty. Failure to properly classify employees can resulting in undercounting of employees for purposes of determining status as applicable large employer (ALE) subject to the requirement to offer health insurance or result in inadvertent violations of the requirement to offer coverage to 95% of employees because independent contractors would not have been included in the offers. Depending on the number of independent contractors who are reclassified as employees, ALEs may fall below the 95% threshold and trigger the penalty under IRC Section 4980H(a). ALEs are also required to comply with reporting of coverage for its full-time employees and failure to properly classify employees can result in a failure to comply with ACA reporting of coverage on Form 1095-B or 1095-C. Failure to provide employee benefits under the ACA may result in significant penalties.
- The IRC's coverage and nondiscrimination rules aim to prevent tax-favored benefits in certain welfare and retirement plans from providing a disproportionate amount of plan benefits to an employer's highly compensated employees. Misclassification as independent contractors of workers who should have been counted as employees can skew the census data used to conduct this testing — and may result in a demographic failure, meaning that the applicable plan does not pass coverage or nondiscrimination tests. This can result in a loss of tax-favored status and tax consequences to the prohibited group. Examples of the types of plans employers should consider for misclassification

impacts are IRC Section 125 cafeteria plans and its component plans, including self-insured group health plans, flexible spending account plans, group-term life insurance, and qualified retirement plans.

Voluntary Classification Settlement Program

The Voluntary Classification Settlement Program is an optional program sponsored by the IRS that provides businesses with an opportunity to reclassify their workers as employees for future employment tax purposes. This program offers partial relief from federal employment taxes for eligible businesses who agree to prospectively treat their workers as employees. Businesses must meet certain eligibility requirements and apply by filing Form 8952, Application for Voluntary Classification Settlement Program (VCSP), and enter into a closing agreement with the IRS.

Action Items for Employers

- Ensure that employee benefit plan documents, which govern the operation and administration of the plan, contain a provision excluding any individual not classified by the employer as an "employee."
- Ensure that you understand whether you are considered an applicable large employer and know how to properly count employees to avoid employer shared responsibility penalties under the ACA.
- Consult with legal counsel and tax professionals for assistance in IRS, DOL, and state laws for properly classifying workers as employees or independent contractors.
- Ensure that written agreements and terms of engagement for independent contractors clearly define the nature of the relationship, scope of work, payment terms, and responsibilities.
- Use IRS Form 1099-NEC to report non-employee compensation to independent contractors.