



**Center for Cooperatives**  
UNIVERSITY OF WISCONSIN-MADISON

# **Worker Co-ops: FAQs about Employment Status**

---

October 2017

---

By: Lynn Pitman  
University of Wisconsin Center for Cooperatives  
October 2017

Review and Contributions:  
Chris Smithka and Bradley D'Orazio  
University of Wisconsin Law School Law and Entrepreneurship Clinic

## Introduction

---

Members of a worker cooperative have roles as both workers and business owners. Each of these roles has different interests and priorities.

As workers, members may be seeking the stability of a regular paycheck and the benefits a business may pay to employees. These wages and benefits are operating expenses for a business, and are deducted from revenue to calculate net profitability. Individual employees pay income taxes on the wages that they receive.

As business owners, members take on the rewards and risk of operating a business, including the inevitable fluctuations in its net profit. They must consider the longer-term financial health and profitability of the business. Typically, business owners are compensated by their claim on the business's net profit, rather than through wages. The net profitability is not guaranteed; it will fluctuate depending on how the business performed in a given year. The owner's share of the business's net profit is taxed as owner income.

Members must work to integrate these two sets of interests and operate as both employees and owners. However, this hybrid role of members as both worker and owner is sometimes at odds with both existing tax and employment laws.

Tax laws make a distinction between employee and business owner, because the tax obligations for each are different.

Employment laws also are based on a distinction between business owner and employee. These laws have been developed to protect an employee from possible unfair treatment by a business owner.

The following FAQs highlight some of the basic legal requirements that should be considered when a cooperative develops hiring and employment policies.

It is important for a worker cooperative to review the specifics of its employee policies with a knowledgeable attorney. There are many exceptions to tax and employment law which are not included in these FAQs, including some that are specific to a particular business sector.

## Employee Status

---

### 1. Since worker members own the co-op, we're owners, not employees. Right?

Not exactly. Ownership of shares or equity in a business does not necessarily mean that a worker isn't legally required to be treated as an employee. There are standards that are used to evaluate whether a worker should be treated as an employee, an independent contractor, or a business owner for tax purposes, and to meet labor law standards.

### 2. What difference does it make if we label ourselves employees?

Employee status has both tax and labor law consequences.

Taxes that fund Social Security, Medicare, and unemployment compensation programs are based on wages paid. Employee status determines whether the employer contributes to paying a portion of these taxes, or whether the worker must pay all taxes. The Internal Revenue Service (IRS) enforces these tax requirements.

The federal Fair Labor Standards Act (FLSA) was established to protect workers by setting minimum standards for wages, overtime, and conditions of employment. Employee status, as well as other conditions, determine how FLSA standards are applied to the individual. The Department of Labor/Wage and Hour Division (DOL/WHD) enforces these regulations.

Tax or labor law violations can result in a business being required to pay back wages and financial penalties, so it is important to understand these issues.

### 3. What are the legal standards for determining whether a worker member should be classified as an employee or an independent contractor?

Employee status is determined by the degree of control and independence that a worker has on the job<sup>1</sup>.

Both the IRS and FLSA have guidelines to determine whether a worker should be classified as an employee.

The IRS determines whether a worker is an independent contractor by considering the degree that the worker:

- Receives less extensive instructions on the work to be done, but not how it should be done;
- Receives training from the business about required procedures and methods;
- Has significant investment in the work;
- Is not reimbursed for some business expenses;
- Has the opportunity to realize a profit or incur a loss;
- Receives benefits from the business; and
- Has a written contract that shows the relationship the worker and business intend.

See here for more information: <https://www.irs.gov/pub/irs-pdf/p1779.pdf>

---

<sup>1</sup> FLSA exempts enterprises from these standards if they fall below \$500,000 in sales, or in some health-care, education, and government sectors. However, employees are covered by the standards if the work regularly involves them in interstate commerce. Interstate commerce is very broadly defined, so a large portion of employees are covered: <http://www.dol.gov/whd/regs/compliance/whdfs14.pdf>

The FLSA guidelines are broader. Under this standard, a set of “economic reality” factors are used to evaluate whether an individual is *economically dependent* on the business, and thus an *employee*.

The factors considered can vary, and no one set of factors is exclusive. The following factors are generally considered when determining whether an employment relationship exists under the FLSA:

- Is the worker performing work that is an integral part of the business?
- Do the worker’s managerial skills affect the worker’s opportunity for both profit and loss?
- What kinds of investment does the worker make in facilities and equipment compared to the employer?
- Does the worker exercise independent business judgement and initiative?
- Is the relationship with the employer indefinite, which suggests an ongoing employee relationship?
- What kind of control does the employer have about how the work is performed, pay amounts, hours worked, and whether the worker is free to also work for others and hire helpers?

See: <http://www.dol.gov/whd/regs/compliance/whdfs13.pdf>

#### *In Wisconsin*

The Wisconsin Bureau of Labor has a six-part test sometimes referred to as the "economic realities" test to determine whether the worker is an employee or independent contractor. This test is based on Wisconsin common law, meaning that it is not listed in the statutes but rather based on legal principles developed in previous case law. The six parts of the test are:

- The degree of control exercised by the employer;
- The worker's opportunity for profit or loss based upon his/her managerial skills;
- The worker's investment in equipment or employment of helpers;
- The degree of special skill required for the work;
- The degree of permanence of the relationship between the parties;
- Whether the services constitute an integral part of the employer's business.

The first part of the test, “The degree of control exercised by the employer,” is the most important. None of the other five parts is given more or less weight, as the test is described.

Not all of the six parts, or even a majority of the six parts, of the test need to be met. How the parties involved refer to the relationship is not relevant. The determination of whether a worker is an employee or an independent contractor must be based on all of the circumstances in the relationship between the parties.

#### **4. Can a worker co-op decide to use an independent contractor relationship with its members?**

A business cannot decide to classify a worker as an independent contractor, even if the worker has signed an agreement to work as one.<sup>2</sup> See question no. 3 for a discussion of the factors considered to determine worker classification under the IRS and FLSA guidelines.

---

<sup>2</sup> The misclassification of employees as independent contractors is growing, and the federal government has identified it as an important issue to address as the workforce continues to change. (see DOL website: <https://blog.dol.gov/2015/07/15/employee-or-independent-contractor/> )

## **5. Can an individual be considered an employee under one test and an independent contractor under another test?**

Yes, it would be possible for an individual to be considered an employee under one test and an independent contractor under another test. Different agencies (both state and federal) have similar, yet different requirements for classification as an independent contractor.

For example, an individual could be considered an independent contractor for the purpose of unemployment insurance in Wisconsin, but an employee for the purpose of worker's compensation. It is important to examine each individual case under each specific test.

---

## **Tax Requirements for Employees, Employers, and Independent Contractors**

### **6. How does employment status affect worker payroll taxes?**

The Social Security and Medicare programs are funded through taxes on either wages and self-employment income.

The Federal Insurance Contributions Act (FICA) tax collects taxes for these programs through the payroll process. When a worker is classified as an employee, the employer pays for half the FICA amount owed by the employee. The employer also withholds the other half owed by the employee from wages, and pays it directly to the federal government. The employer must also withhold estimated federal and Wisconsin income taxes for employees.

If a worker is an independent contractor or a business owner, the worker is responsible for the entire amount of the Social Security and Medicare taxes. The individual is responsible for making these payments by filing self-employment (SECA) taxes quarterly, based on estimated self-employment income. No estimated federal income taxes are withheld from payments to independent contractors.

### **7. Who pays taxes for unemployment compensation programs?**

Employers are required to pay wage-based taxes to fund federal and state unemployment compensation programs for workers who have lost their jobs. Employees are not responsible for paying these taxes, and they are not withheld from individual's wages. In Wisconsin, employers are required to establish an unemployment insurance tax account with the Wisconsin Department of Workforce Development.

In contrast to an employee, a business typically does not pay unemployment taxes on payments to independent contractors or business owners, who usually are not eligible for unemployment benefits.

#### *In Wisconsin*

In order to determine whether an individual is an employee or an independent contractor for the purpose of unemployment insurance in Wisconsin, Wis. Stat. § 108.02(12)(b) establishes a two part test. The first part of the two part test concerns "control or direction." The worker must be free of the employer's control or direction to be considered an independent contractor. If the

worker is found to be under the control or direction of the employer, the worker is considered an employee.

The second part of the test is "six of nine conditions". The worker must meet six of nine conditions in this section to be considered an independent contractor. If the worker does not meet at least six of the nine conditions, the worker is an employee. The nine conditions are:

1. The individual advertises or otherwise affirmatively holds himself or herself out as being in business.
2. The individual maintains his or her own office or performs most of the services in a facility or location chosen by the individual and uses his or her own equipment or materials in performing the services.
3. The individual operates under multiple contracts with one or more employing units to perform specific services.
4. The individual incurs the main expenses related to the services that he or she performs under contract.
5. The individual is obligated to redo unsatisfactory work for no additional compensation or is subject to a monetary penalty for unsatisfactory work.
6. The services performed by the individual do not directly relate to the employing unit retaining the services.
7. The individual may realize a profit or suffer a loss under contracts to perform such services.
8. The individual has recurring business liabilities or obligations.
9. The individual is not economically dependent upon a particular employing unit with respect to the services being performed.

The worker must meet the conditions of both parts of the two-part test to be classified as an independent contractor. If the worker meets the conditions of one section but not the other, the worker is an employee for purposes of unemployment insurance in Wisconsin.

#### **8. Does employee status affect eligibility for workers' compensation benefits?**

Yes. If a worker is an employee, the individual is eligible to receive benefit payments for job-related injuries. Workers' compensation insurance programs are governed by state law, and require employers to purchase coverage through a state workers' compensation insurance program, a commercial carrier, or on a self-insured basis.

Employers that lack the legally required workers' compensation insurance coverage may be sued by an employee.

#### *In Wisconsin*

Independent contractors are not eligible for worker compensation benefits from the business that hires them, assuming that they meet all of the nine criteria set forth in Wisconsin Statute § 102.07(8). The nine criteria are:

1. Maintains a separate business with his or her own office, equipment, materials and other facilities.
2. Holds or has applied for a federal employer identification number with the federal internal revenue service or has filed business or self-employment income tax returns with the federal internal revenue service based on that work or service in the previous year.
3. Operates under contracts to perform specific services or work for specific amounts of money and under which the independent contractor controls the means of performing the services or work.
4. Incurs the main expenses related to the service or work that he or she performs under contract.
5. Is responsible for the satisfactory completion of work or services that he or she contracts to perform and is liable for a failure to complete the work or service.
6. Receives compensation for work or service performed under a contract on a commission or per job or competitive bid basis and not on any other basis.
7. May realize a profit or suffer a loss under contracts to perform work or service.
8. Has continuing or recurring business liabilities or obligations.
9. The success or failure of the independent contractor's business depends on the relationship of business receipts to expenditures.

Independent contractors are responsible for obtaining individual insurance policies that could provide similar coverage.

**9. If members of a worker co-op have employee status, are their patronage refunds subject to payroll taxes?**

Members who receive a patronage refund must report it as annual income, and include it in calculations to determine how much they owe as income tax.

But worker cooperatives typically have not paid payroll taxes on these refunds, because they are not considered wages. Refunds are dependent on the co-op's profitability in a given year, and on the Board of Directors decision to make a distribution. The individual amounts are calculated on hours worked, or some other formula established by the cooperative to determine patronage. Patronage refunds have been considered similar to dividends received by wage-earning employees who are shareholders in a traditional corporation. However, several years ago, the IRS determined that employee worker-members in a California worker cooperative should pay self-employment taxes on the refund.<sup>3</sup> The cases has been contested, and written guidance on this question has been requested.

---

<sup>3</sup> In that case, it appeared that the IRS was treating patronage refunds in the same way that it treats patronage refunds made to member owners of agricultural cooperatives. In those cases, the members are independent business owners of their farm operations, and are using the cooperative for services to support their primary farm business. Any patronage refund is additional income to them, and may be subject to self-employment tax. <http://www.gwilson.com/documents/Article4%28PatronageDivTax%29.pdf>

If a worker member has been classified as an employee, and is being paid market-rate wages, it seems reasonable to assume that a patronage refund is not subject to self-employment taxes. But consulting with tax and legal advisors on this issue is prudent.

## Wage and Working Condition Requirements for Workers with Employee Status

---

### 10. What does the FLSA require? <sup>4</sup>

The basic requirements for workers with employee status are:

- Workers must be paid the federal minimum wage of \$7.25 per hour for all hours worked;
- Workers must receive overtime pay of at least time and one-half for hours worked in excess of 40 hours in a workweek.

<http://www.dol.gov/whd/regs/compliance/whdfs23.pdf>

However, some categories of employees are exempt from federal minimum wage and overtime provisions – see questions 11 and 12.

The FLSA prohibits sex-based wage differentials, and employment discrimination. These provisions are enforced by the Equal Employment Opportunity Commission. [www.eeoc.gov](http://www.eeoc.gov)

### 11. Are there other labor laws that cover employees?

Yes. Other federal labor laws applying to employees include:

- On-the-job safety standards;
- Family and medical leave.

See: <http://www.dol.gov/whd/reg-library.htm>

State laws may also include requirements related to wages and work conditions. The law which sets the higher standard must be observed.

*In Wisconsin*

For regulations governing labor laws in the state of Wisconsin, visit:

[https://dwd.wisconsin.gov/er/labor\\_standards\\_bureau/](https://dwd.wisconsin.gov/er/labor_standards_bureau/).

### 12. If our worker co-op decides that all of its worker-owners are employees, does that mean that FLSA overtime requirements apply to everyone, regardless of their job responsibilities?

No. FLSA standards don't apply to certain types of work and work situations within a business.

---

<sup>4</sup> The FLSA also includes other requirements and provisions for employers. (<http://www.dol.gov/whd/regs/compliance/hrg.htm> )

A common exemption from minimum wages and overtime requirements applies to executive, professional, and administrative employees.

The exemptions are based on the following general conditions:

- the employee is compensated on a salary or fee basis that is at least \$455 per week<sup>5</sup>;
- the employee's most important or major duty performed is directly related to the management or general business operations of the business, or requires advanced knowledge;
- the employee exercises independent judgement on significant matters.

See [https://www.dol.gov/whd/overtime/fs17a\\_overview.htm](https://www.dol.gov/whd/overtime/fs17a_overview.htm) for the specific tests for each of the executive, professional, and administrative exemptions.

*In Wisconsin*

The Wisconsin exemptions from overtime requirements are governed by Wis. Admin. Code § DWD 274.04. These exemptions apply to salaried executives, administrative employees, and professionals.

For more information visit the State of Wisconsin Workforce Development website:

[https://dwd.wisconsin.gov/er/labor\\_standards\\_bureau/publication\\_erd\\_8298\\_p.htm](https://dwd.wisconsin.gov/er/labor_standards_bureau/publication_erd_8298_p.htm)

**13. Do FLSA requirements for minimum wage and/or overtime apply to employees in all types of businesses? What about workers like taxi drivers or farm workers?**

FLSA standards also include exemptions based on the type of business. But the exceptions are specific and narrowly defined. Your local WHD office will have more detailed information. See:

<http://www.dol.gov/whd/regs/compliance/hrg.htm#2>

*In Wisconsin*

In Wisconsin, certain businesses are exempt from overtime, including agriculture, domestic service, some non-profit organizations, and federal agencies. See here for more information:

[https://dwd.wisconsin.gov/er/labor\\_standards\\_bureau/publication\\_erd\\_8298\\_p.htm](https://dwd.wisconsin.gov/er/labor_standards_bureau/publication_erd_8298_p.htm).

**14. Does the FLSA cover employee wages if they include commissions, tips, or are based on piece work?**

Yes. There are guidelines for how these forms of compensation are used to calculate a worker's hourly "regular rate". The regular rate is compared to minimum wage, and is used to calculate overtime pay rates.

Overtime pay may not be required for certain commissioned employees of retail or service establishments.

See: <http://www.dol.gov/whd/regs/compliance/whdfs15.pdf>

<http://www.dol.gov/whd/regs/compliance/whdfs20.htm>

---

<sup>5</sup> This increases to \$913 per week as of December 1, 2016.

*In Wisconsin*

The Wisconsin exemptions from minimum wage requirements are governed by Wis. Admin. Code § DWD 272. For more information visit the State of Wisconsin Workforce Development website: [https://dwd.wisconsin.gov/er/labor\\_standards\\_bureau/minimum\\_wage.htm](https://dwd.wisconsin.gov/er/labor_standards_bureau/minimum_wage.htm)

**15. Do I only need to follow only federal guidelines for minimum wages, OT, and exempt status?**

Employers must always follow federal guidelines for minimum wages, OT, and exempt status. However, since state law can require stricter standards, employers must also be aware of any applicable and relevant and state laws. For example, Wisconsin employers should consult Wisconsin laws and regulations in addition to federal laws and regulations.

## Other Questions

---

**16. If a worker co-op uses a working interview as part of the hiring process, does it need to pay the applicant for those hours on the job?**

Probably so. The FLSA's minimum wage and overtime requirements cover workers who have an employment relationship with the employer. Employment is very broadly defined, and covers any work that the employer directs or allows to take place. An applicant performing work as part of the hiring process would be acting as employee, and would fall under FLSA.

Since the applicant doesn't have a permanent employee relationship with the business, it might seem that the applicant could be paid as an independent contractor. However, the nature of the work and the control by the employer are more important considerations. Paying the applicant as an independent contractor would not be appropriate in this case.

See: <http://www.dol.gov/whd/regs/compliance/whdfs13.pdf>

**17. Can a worker co-op make payroll deductions for an employee's membership equity fee if they bring worker wages below minimum wage?**

A written agreement with the employees is required for voluntary payroll deductions. No deductions for items that benefit or reimburse the employer may be made from an employee's wages if it brings an employee's pay below minimum wage.

If the deduction is voluntary and benefits the employee, however, meeting minimum wage requirements is not an issue.

*In Wisconsin*

In Wisconsin, the deductions from wages also need to be clearly stated on a pay stub or other paper accompanying the paycheck per Wis. Stat. § 103.457.