

MISCLASSIFICATION OF EMPLOYEES AS INDEPENDENT CONTRACTORS

by
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A person who performs services for another may be classified as either an employee or an independent contractor. The relationship between an employee and his/her employer differs significantly from the relationship between an independent contractor and its principle. Misclassifying an employee as an independent contractor can result in an audit of your business and cost a business a substantial amount in back wages, taxes, benefits, as well as, tremendous penalties and fines by both the IRS and the Employment Development Department of the state of California (the "EDD"). In some cases, audits and assessments have completely ruined a business.

Classifying a service provider as an independent contractor frees a business from several obligations such as tracking hours, paying required tax withholdings for wages, overtime, statutory benefits such as worker's compensation coverage, unemployment benefits, health benefit plans and pension plans. Further, it limits liability for the errors and wrongs committed by the independent contractor.

Under California Labor Code Section 3353 an "independent contractor" is defined as:

Any person who renders service for a specified recompense for a specified result, under the control of his principle as to the result of his work only and not as to the means by which such result is accomplished.

Within the last several years, both the state of California and the Internal Revenue Service have commenced a campaign of aggressive scrutiny regarding the classification by a business of independent contractor status on a service provider in order to determine whether or not that status, is in reality, and employer/employee relationship. Needless to say, after an audit and as determined by the EDD and the IRS, many alleged independent contractors are re-cast as employees and the businesses are assessed fines and penalties.

At 4600 IRS manual, Exhibit 4640-1, the IRS has established a checklist of 20 factors, based on the common law as developed in past court cases and administrative hearings. Those factors are only a guide for determining whether or not a service provider is an employee, and the IRS recognizes that the "degree of importance of each factor varies depending upon the occupation and the actual context in which the services are performed. If a business is able to answer "Yes" to all first *four* questions, it is dealing with an independent contractor. If a business is able to answer "Yes" to any of the questions 5 through 20, it means that the worker is "probably" an employee.

In California, the Department of Industrial Relations, Division of Labor Standards Enforcement (the "DSLE"), controls wages paid to employees and defines an independent contractor through reference to a list of 21 criteria. Pursuant to Labor Code 2750.5, there is a

rebuttable presumption that where a worker performs services that require a license pursuant to Business & Professions Code § 700 et seq., or who performs services for a person who is required to obtain such a license, the worker is an employee and not an independent contractor.

The recharacterization of independent contractors as employees is not unusual in California when a business has been audited by the EDD, because it uses a stricter and more inflexible standard adopted by the California Supreme Court in *S.G. Borello & Sons, Inc. v. Department of Industrial Relations*, (1989) 48 Cal. 3d 341. In that case, the Court determined that the DSLE factors “[c]annot be applied mechanically as separate tests, they are intertwined and their weight depends often on particular combinations.” The *S.G. Borello* Court also found that “under the applicable rules for determining employment status, the substance of the relationship is more controlling than its form.”

According to the *S.G. Borello* case, the state is entitled to first apply a basic test to determine whether the principal has the right to “direct and control the manner and means” by which the service is performed. If the principal has the “right of control,” the worker will automatically be interpreted to be an employee even if the principal never actually exercises the control. If it is not clear from the face of the relationship whether the principal has the “right of control,” then, and only then, is reference made to a list of secondary factors that are evidence of the existence or nonexistence of the right of control.

THE IRS CHECKLIST FOR DETERMINING AN EMPLOYEE VERSUS A CONTRACTOR

1. **Profit or loss.** Can the worker make a profit or suffer a loss as a result of the work aside from the money earned on the project?
2. **Investment.** Does the worker have an investment in the equipment and facilities used to do the work? The greater the investment, the more likely independent contractor status will be found.
3. **Work for More than One Client.** Does the worker perform services for more than one client at a time?
4. **Services Offered to the General Public.** Does the worker offer services to the general public?
5. **Instructions.** Does the business have the right to give the worker instructions about when, where and how to perform the services?
6. **Training.** Does the business train the worker to do the job in a particular manner?
7. **Integration.** Is the worker’s services so important to the business that those services have become a necessary part of the business?

8. **Hiring Assistants**. Does the business hire, supervise and pay the worker's assistants or staff?
9. **Services Rendered Personally**. Does the business require that the worker provide the services personally or may the services be delegated to someone else?
10. **Work Hours**. Does the business set the work hours or is the worker the master of his/her own time?
11. **Continuing Relationship**. Is there an ongoing relationship between the worker and the business?
12. **Full-Time Work**. Must the worker spend all of his or her time performing the services of the business?
13. **Work performed on Premises of Business**. Must the worker perform the services on the premises of the business, or does the business control the route or location where the services are performed.?
14. **Sequence of Services**. Does the business have the right to control and determine the order in which services are performed?
15. **Reports Required**. Is the worker required to submit reports accounting for the worker's actions?
16. **Pay Schedule**. Is the worker paid by the hours, day, week, or month as opposed to being paid by the job or on commission?
17. **Expenses**. Is the worker reimbursed for expenses for business or travel costs?
18. **Tools and Materials**. Is the worker provided by the business with the equipment, tools and/or materials necessary to perform the services?
19. **Right to Fire**. May the business fire the worker at any time?
20. **Worker's Right to Quit**. May the worker quit at any time without incurring any liability to the business?

W-2 CONTRACTORS

Some businesses have taken it upon themselves to identify workers as "W-2 Contractors." This designation is an oxymoron. A worker is either an employee or an independent contractor, never both. There is technically no such thing as a "W-2 contractor." Only employees may receive W-2 forms at the end of the year for tax purposes. All other

workers and service providers must receive a 1099 IRS form. Therefore, the terms “W-2” and “contractor” are contradictory terms. However, for internal policies of certain types of businesses, it is a helpful designation to be able to differentiate between employees that are entitled to receive all benefits offered by the business versus other employees only entitled to receive a limited subset of benefits. If the designation of an employee is in doubt, it is a more conservative approach for the business to pay a worker’s payroll tax obligations and issue a W-2 form than risk an audit.

9 WAYS TO PREVENT MISCLASSIFICATION OF INDEPENDENT CONTRACTORS

The list below is not intended to be comprehensive but only suggestive of ways to avoid potential of misclassification of employees.

1. Except with respect to the smallest of projects, always use a written agreement with an independent contractor which describes the scope of work to be performed with specificity, the compensation paid, the limitations of the business relationship and obligation of the contractor to pay its/his/her own taxes.

2. Pay the independent contractor on a project by project basis rather than by the hour.

3. Never provide a contractor with employee type benefits such as health insurance, vacation or sick days, 401K matching, or an expense account.

4. Do not provide the contractor with an employee handbook or other documents regularly provided only to employees.

5. Do not invite the contractor to regular employee meetings or functions.

6. Do not impose conditions on the contractor concerning work hours, unless absolutely necessary for the completion of the project.

7. Do not instruct the contractor on how to perform or complete the project. This prohibition does not prevent an employer from establishing the guideline or parameters of a job project or setting forth the specifications of the work to be created, engineered or built.

8. Do not provide software, tools or other supplies or equipment to the contractor.

9. Make sure that contractors have business licenses, and/or contractor or professional licenses as required by statute. Also request that contractors have general liability insurance.

EXAMPLES OF INDEPENDENT CONTRACTORS AND COMMON LAW EMPLOYEES

1. Independent Contractors

A. An attorney or accountant who has his or her own office, advertises in the yellow pages of the phone book under “Attorneys or “Accountants,” bills clients by the hour, is engaged by the job or paid an annual retainer, and can hire a substitute to do the work.

B. An auto mechanic who has a station license, a resale license, buys the parts necessary for the repairs, sets his or her own prices, collects from the customer, sets his or her own hours and days of work, and owns or rents the shop from a third party.

C. Dance instructors who select their own dance routines to teach, locate and rent their own facilities, provide their own sound systems, music and clothing, collect fees from customers, and are free to hire assistants.

D. A repairperson who owns or rents a shop, advertises the services to the public, furnishes all of the tools, equipment, and supplies necessary to make repairs, sets the price for services, and collects from the customers.

2. Common Law Employees

A. An attorney or accountant who is employed by a firm or company to handle their legal affairs or financial records, works in an office at the firm or company’s place of business, attends meetings as needed, and the Company bills the clients and pays the attorney or accountant on a regular basis.

B. A bookkeeper who works at home for only one client, does not advertise services to the public, and performs accounting services on a software program provided by her single client.

C. An auto mechanic working in someone’s shop who is paid a percentage of the work billed to the customer, where the owner of the shop sets the prices, hours, and days the shop is open, schedules the work, and collects from the customers.

D. Aerobic instructors working in a health club where the club sets hours of work, the routines to be taught and pays the instructors from fees collected from the customers.

E. A repairperson working in a shop where the owner sets the prices, the hours and days the shop is open, and the repairperson is paid a percentage of the work performed or an hourly wage.

CONCLUSION

Upon request in writing, both the IRS and the EDD will provide employers with a written determination as to whether or not a particular worker is an employee or an independent contractor. (IRS form SS-8, and EDD form 1870). Misclassification of a worker could be costly,

therefore, a business may wish to seek legal counsel to assist it in making such classifications prior to the performance of services and in order to avoid adverse findings. The creation of independent contractor agreements between the business and a service provider, which agreements set forth the relationship and obligations of the parties, may help to substantially limit exposure to any claim of misclassification, but such an agreement will not be conclusive of the relationship.

Payroll tax audits conducted by EDD have disclosed misclassified workers in virtually every type and size of business. Certain service industries seem more prone to have a higher number of misclassified workers than others. Historically, industries at higher risk of having misclassified workers include businesses that use:

- Construction workers
- Seasonal workers
- Short-term or “casual” workers
- Outside salespersons

If you are in these industries, you should take special care to classify your employees and contractors correctly.

The information provided herein is not intended as legal advice and should not be acted upon. If you have additional questions about this subject matter or would like to consult with an attorney about this or related subject matters, please call Jennifer J. Hagan or James Hagan at The Hagan Law Firm (650) 322-8498.

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