

## First Wednesday

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A Monthly Discussion of Employment Law Issues and Other Hot Topics for Management

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### Misclassified Independent Contractors Still Pose a Big Risk for Employers

At first blush, businesses that use the services of independent contractors — instead of employees — might avoid a lot of headaches. There's no need to pay workers' compensation insurance for independent contractors, or provide benefits, and independent contractors aren't covered by wage and hour laws or many state and federal discrimination laws. Independent contractors also aren't entitled to unemployment insurance benefits and can't unionize.

But companies must keep in mind that misclassifying an employee as an independent contractor is a serious mistake that can have costs that far outweigh the benefits. The IRS is planning to conduct 6,000 random audits over three years to identify businesses that have misclassified employees as independent contractors (which will lead to hefty fines).

This will again become as big an issue as it was in the mid-1990s when *Vizcaino v. Microsoft* was decided. *The New York Times* reported in February 2010 that President Obama's 2010 budget anticipates revenue of \$7 billion over ten years as a result of efforts to identify misclassified independent contractors. The penalties for companies include back taxes to make up for short payrolls, plus interest and fines. Additionally, misclassified employees would have the right to sue for back benefits, expense reimbursements, vacation, and other benefits they missed out on by being misclassified.

So, employers should take the time now to make sure they aren't putting themselves at risk if the federal or state agencies (or one or more of the independent contractors or a class of workers!) pursues a claim against the company. A misclassification can lead to unexpected claims for unemployment benefits, claims for unpaid wages, fringe benefits, or workers' compensation, claims of discrimination, and investigations by the IRS or the California Employment Development Department ("EDD").

#### The Legal Test (or is it Tests?)

It's important to note there are some common misconceptions about what makes a person an independent contractor. Just because someone asked to be treated as an independent contractor, or signed an agreement to provide "independent" contractor services, or works without supervision, or works for other businesses, or is on-call, or only works occasionally, or is paid commission does not mean they are an independent contractor.

Whether or not a person is an independent contractor or an employee depends on several factors, and which test is being applied for what purpose. Perfect clarity is lacking because there are multiple tests. There is a California common-law test, a test that's used in the workers' compensation context, a test used by the IRS, and one for the unemployment or disability insurance arena. The outcome of an investigation will turn on the facts of the situation, and what test is being applied in which context.

## California Common-Law

California courts and administrative agencies such as the EDD and the Department of Labor Standards Enforcement ("DLSE") apply common-law principles derived from case-law to determine if an individual is a contractor or an employee. The test is called the economic realities test, and the most important factor is the independent contractor's right to control the manner and means of accomplishing the desired result. Besides "control," there are several other factors to work through:

- Can the person be discharged at-will without cause?
- Is the person engaged in a distinct business?
- Is the work performed under close direction or by a specialist without supervision?
- What skills are required in the occupation?
- Does the employer provide the instruments, tools, and place for doing the work or performing the services?
- How long are the services going to be provided?
- Are the services paid for by the amount of time spent, or by job?
- Is the work performed a regular part of the employer's business?
- Do the employer and the contractor think the relationship was one of business/independent contractor?

Only by considering all of these factors can employers begin to evaluate whether or not someone is an independent contractor. No one factor is determinative, so each one must be weighed until a judgment call – one way or the other – leads to a classification based on the law. The DLSE provides more details on who should be classified as an independent contractor online at: [http://www.dir.ca.gov/dlse/FAQ\\_IndependentContractor.htm](http://www.dir.ca.gov/dlse/FAQ_IndependentContractor.htm).

## Workers' Compensation

In 1989 the California Supreme Court liberalized the rule in the workers' compensation context (so that more service

providers would be deemed employees and not independent contractors), based on the purposes of the workers' compensation system. (*S.G. Borello & Sons, Inc. v. Department of Industrial Relations* (1989) 48 Cal.3d 341). In addition to applying the right-to-control test set forth above, the administrative law judge in a workers' compensation case will apply additional factors:

- Does the person have an opportunity for profit or loss depending on his or her managerial skills?
- Does the person invest in equipment or materials to perform the task(s)?
- Does the person employ helpers?
- Do the services require a specific skill?
- What is the degree of permanence of the relationship?
- Is the service an integral part of the alleged employer's business?

If an independent contractor is injured while performing services, and it turns out the person should have been classified as an employee, the penalty can be severe. In addition to paying for the individual's injuries, the employer may also have to pay third parties who were injured as a result of negligent acts by the person, if they were performed during the course of employment.

## The IRS

The IRS uses a different test to determine whether someone is an independent contractor, although the test, like the California common law one, looks in part at the employer's control over the person. Both behavioral control (direction as to how, when, and where to do the work, what tools or equipment to use, what assistants to hire, and where to purchase supplies and services) and financial control (whether the person made a significant investment in his or her work, whether or not they are reimbursed for expenses, and the person's opportunity for profit or loss) are major factors in the IRS test. Additionally, the IRS looks at the relationship of the parties, including whether the person is getting benefits and whether there is a written contract between the parties defining the relationship. These factors are balanced to achieve a final determination of the person's status. More information on the IRS test is available on the IRS website at: <http://www.irs.gov/pub/irs-pdf/p1779.pdf>

## Unemployment or Disability Insurance

For purposes of determining eligibility to receive unemployment or disability benefits, California Unemployment Insurance Code section 621(b) defines an

employee as “an individual who, under usual common law rules, has a status of an employee.” If a court finds the employee was misclassified, the employer will have to pay amounts due for unemployment and disability insurance contributions, and state income tax withholding.

## Conclusion

It is as important as ever that businesses in all sectors of the business world examine the use of independent contractors. Misclassification is an expensive mistake, and given the government’s renewed focus on this issue, it is important that employers pay attention to this hot employment issue now, before an audit or lawsuit.

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