Using Independent Contractors in California

If you are using independent contractors in California, you should check with your lawyer to ensure you have not misclassified them. California Senate Bill 459 (SB 459), which became effective January 1, 2012, subjects violators to civil penalties of $5,000 to $15,000 per violation. This may be increased to $10,000 to $25,000 per violation if an established pattern or practice of misclassification is found.

To further complicate matters, SB 459 provides no guidance to employers in determining whether an individual is an independent contractor. Yet the new law imposes joint and several liability on any person who advises an employer to treat an individual as an independent contractor, unless the advisor is an attorney who gave the advice in the capacity of legal counsel to the employer or the misclassified individual.

Moreover, an employer's decision to classify a worker as an independent contractor can be challenged as a result of any number of triggers, such as a federal or state tax audit, a benefits dispute, a workers' compensation claim, an unemployment claim, a wage and hour lawsuit, a federal Department of Labor (DOL) audit (or its state equivalent), merger/acquisition due diligence or a discrimination lawsuit.

Independent contracting is especially prevalent in such broad industry categories as agriculture, construction and professional services, and in a diverse set of specific occupations, including cab drivers, construction workers, emergency room physicians, financial advisors, mystery shoppers and truck drivers. In California, the industries most likely to use independent contractors include service professionals, landscaping, construction and manufacturing.

So what is an independent contractor?

There is no set definition for an "independent contractor." In California, if there is a dispute as to whether an individual should be classified as an employee or an independent contractor, the worker is presumed to be an employee. The Department of Labor Standards Enforcement (DLSE) makes the same presumption.

The actual determination of whether a worker is an employee or independent contractor depends upon a number of factors, all of which must be considered, and none of which is controlling by itself. For most matters before the DLSE, this means applying the "multi-factor" or the "economic realities" test adopted by the California Supreme Court in the case of *S. G. Borello & Sons, Inc. v Dept. of Industrial Relations* (1989) 48 Cal.3d 341. The most significant question in the independent contractor/employee determination is "whether the person to whom service is rendered has the right to control the manner and means of accomplishing the result desired."

Depending on the agency doing the audit, different tests will be used to determine a person's classification. When the principal has the "right of control," the worker will be an employee, even if the principal never actually exercises the control. If the principal does not have the right of direction and control, the worker will generally be an independent contractor. The strongest evidence of retained right of control is the ability to discharge an employee at will without cause.

The DLSE, the Fair Labor Standards Act (FLSA), California and the California Employment Development Department (EDD) use many of the same tests when evaluating whether someone is an independent contractor, including:

- Does the principal have the right to direct and control the manner and means in which the worker carries out the job?
- Is the worker engaged in an occupation or business distinct from that of the alleged employer?
- Is the work highly skilled and specialized?
- Does the alleged employer supply the worker with supplies, tools and a place for the worker to perform the work?
- Is the type of work performed usually done under the direction of an employer or by a specialist without supervision?
- Is the method of payment salary, by time or by the job?
- What is the length of time for which the work is to be performed for the alleged employer? Are the services provided on a long-term or repetitive basis?
- Is the work a part of the regular business of the alleged employer? Work which is a necessary part of the regular trade or business is normally done by employees.
- Does the worker's managerial skill impact his or her opportunity for profit or loss? An individual is normally an independent contractor when he or she is free to make business decisions which impact his or her ability to profit or suffer a loss, not just the risk of not getting paid.
- Do you have employees who do the same type of work? If the work being done is basically the same as work that is normally done by your employees, it indicates that the worker is an employee even if the work is being done on a one-time basis. For instance, to handle an extra workload or replace an employee who is on vacation, a worker may be hired to fill in on a temporary basis and would be considered a temporary employee. (Note: If you contract with a temporary agency to provide you with a worker, the worker is normally an employee, but may be an employee of the temporary agency.)
- Did the worker previously perform the same or similar services for you as an employee?
- Does the worker believe that he or she is an employee?

The Internal Revenue Service (IRS) uses a different test for employment which considers behavioral control, financial control and the relationship of the parties:

- Behavioral Control - Generally, anyone who performs services for you is your employee if you have the right to control what will be done and how it will be done;
- Financial Control - Who directs or controls the business aspects of work? Independent contractors are in business for themselves, offer their services to the public and have a significant financial investment in the facilities used in performing services. They can realize a profit or incur a loss; and
- Relationship of the Parties - How do you and the worker perceive your relationship? A permanent relationship and worker benefits generally indicate an employer-employee relationship. However, the substance of the relationship determines whether your workers are employees, not a job title or written contract.

Determining whether you have an employee or independent contractor can be a complex task. Employers can conduct their own audit to determine if independent contractors are properly

classified, but it is a good idea to work with an employment attorney to protect information developed during the audit and ensure that classifications are consistent with applicable law.

A self-audit should include the following steps:

- Identify independent contractors;
- Review written agreements to determine how the contractor relationship is structured;
- Examine documentation related to how the contractor is paid; and
- Consider the type of services performed by the contractor and whether employees perform similar services.

Since IRS and DOL audits can generally go back three years, employers are wise to conduct self-audits at least this often, or more, if there is a change in structure, ownership or operations.

Penalties for Misclassification

In the event of an audit, the burden of proof will be on the employer to show that the worker is an independent contractor. Improper classification of a worker as an independent contractor can lead to substantial financial damages for the employer, including back taxes, penalties and interest.

The IRS imposes strict penalties for misclassifying workers, whether intentional or unintentional. For unintentionally failing to withhold federal income tax, the penalty is 1.5% of the wages paid. The penalty is doubled to 3% if the employer did not file a Form 1099-MISC for the worker with the IRS. The penalty for unintentionally failing to withhold the employee's share of Social Security and Medicare taxes is 20% of the employee's share of the tax. The penalty is doubled to 40% if the employer did not file a Form 1099-MISC for the worker with the IRS.

If the IRS suspects fraud or intentional misconduct in employee classifications—in other words if it believes a company deliberately misclassified its workers to avoid taxes—additional fines can be imposed, including criminal penalties. For example, if the IRS determines that employee classifications were intentionally adjusted to avoid overtime pay, the employer could be subjected to penalties that include 20% of all wages paid to the worker and 100% of FICA that should have been withheld, including both employer and employee portions.

The IRS may levy criminal penalties of $1,000 and/or one year in prison for failure to properly classify and withhold wages. If the IRS obtains a felony conviction against a person or company for "attempting to evade or defeat tax," the fines are up to $100,000 ($500,000 in the case of a corporation) or imprisonment of not more than five years, or both, together with the costs of prosecution (I.R.C. §7201).

Finally, a responsible person (including corporate officers and employees or members or employees of a partnership) with authority over the financial affairs of the business who willfully fails to collect and pay taxes may be held **personally liable** for the total amount of the uncollected tax up to 100% under the provisions of the Internal Revenue Code (I.R.C.), as well as be subjected to criminal prosecution.

The misclassified employee could also claim an entitlement to employee benefits that were not provided when he or she was erroneously classified as an independent contractor, as well as unemployment insurance benefits when the relationship ends.

An employer could always be liable for failing to secure workers' compensation insurance for the employee, which could include penalty assessments and stop orders for failure to secure coverage, up to 10 days' wages for any worker who loses time because a stop order prohibited the worker from performing services for the employer, and criminal penalties, including imprisonment.

California state law also imposes tax penalties for misclassifying workers. These penalties include repayment of back payroll taxes, subject to interest and a 10% penalty on the unpaid taxes. Failure to withhold and pay payroll taxes can also result in a misdemeanor charge and the employer can be fined up to $1,000 or sentenced to jail for up to one year, or both. In addition to any fines or penalties assessed by either the IRS or a state agency, the misclassified employee can seek up to three years' worth of unpaid wages (including overtime and meal and rest break violations) and penalties for violating the California Labor Code.

If found guilty of misclassifying workers, the employer will be faced with costly audits by the IRS, EDD, and Department of Industrial Relations, additional taxes, penalties, and interest, plus revocation of state/local license.

Misclassifying employees as independent contractors can also lead to significant overtime liability under the FLSA, whether triggered by a lawsuit or by a DOL audit. FLSA liability can be compounded by the fact that companies often fail to keep FLSA-compliant time records for workers mistakenly believed to be independent contractors.

Inadequate time records subject employers to recordkeeping penalties and diminish their abilities to defend civil lawsuits—as courts generally accept employees' own calculations of their hours worked absent specific evidence to the contrary.

The FLSA provides for overtime liability, plus liquidated damages and attorneys' fees. Penalties include liability for overtime compensation going back for a period of two years and liquidated damages in an amount equal to the amount of overtime owed.

Willful violations are defined in the FLSA under 29 U.S.C. § 255 and may be the basis for an aggrieved employee's double recovery. Employers bear the burden of proof when an employee challenges an exemption or designation, regardless of whether the misclassification is inadvertent and "sloppy" or calculated and "willful."

California SB459

SB 459 significantly increases the penalties that may be assessed against employers who "willfully misclassify" individuals as independent contractors and imposes a punitive public notice requirement on employers who are found to have misclassified these types of employees.

SB 459 briefly:

- Prohibits the willful misclassification of workers as independent contractors to avoid properly classifying them as employees;
- Prohibits charging misclassified workers any fees or making deductions from their compensation where those acts would have violated the law if the individuals had not been mischaracterized;
- Gives the Labor and Workforce Development Agency authority to assess penalties and take other action against violators, and requires it to report violators who are licensed contractors to the Contractors' State License Board; further it requires the Contractors' State License Board, once notified, to bring an action against the contractor;
- Subjects violators to civil penalties of $5,000 to $15,000 per violation, in addition to any other penalties or fines permitted by law;
- Subjects violators engaged in a pattern of violations to a civil penalty of $10,000 to $25,000 for each violation; and
- Subjects non-lawyers who advise an employer to misclassify a worker to joint and several liability with the employer.

The law also requires employers who are found to have engaged in such misclassification "to display prominently" for one year on their Internet websites or in an area accessible to employees and the general public, a notice announcing that the employer "has committed a serious violation of law by engaging in willful misclassification of employees."

Since 2010, 11 states passed laws curtailing the use of independent contractors or increasing penalties for misclassification: California, Connecticut, Florida, Kansas, Maine, Nebraska, New York, Pennsylvania, Utah, Vermont, and Wisconsin. Ten states have passed laws of a similar nature in the three years prior to 2010, bringing the total number of states to 21 that have targeted independent contractor misclassification. In addition, at least 18 state legislatures have proposed bills intended to limit the use of ICs or make misclassification more costly.

Many of these independent contractor laws provide for civil and criminal penalties, debarment from state contracts, presumptions in favor of employee status, and private rights to bring individual or class action suits for misclassification of employees. Some of the new laws have targeted industries in which misclassification is regarded by legislators as more prevalent, such as construction.

Nancy J. Leppink, deputy administrator of the U.S. Department of Labor's Wage and Hour Division, and California Secretary of Labor Marty Morgenstern have entered into a memorandum of understanding regarding the improper classification of employees as independent contractors. The U.S. Department of Labor and the state of California will embark on new efforts, guided by the memorandum, to protect the rights of employees and level the playing field for responsible employers by reducing the practice conducted by some businesses of misclassifying employees. This partnership is the 12th of its kind for the U.S. Department of Labor.

Joseph J. (JJ) Minioza is a shareholder in the California law firm of Ericksen Arbuthnot. You can contact him at 510.832.7770.