

**Contractor or Employee?  
Legal Pitfalls  
in Worker Classification**

*Presented by  
Christine H. Long  
Kevin F. Kelley*

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# What Is the Difference Between an Employee and an Independent Contractor?

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- Employee
  - An individual who performs services for you, and who is subject to your control regarding the method and manner in which the work will be performed
- Independent Contractor
  - An individual who performs services for you, but you control only the result of the work



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# Difference in Benefits

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- The biggest difference many employers notice is the benefits they must provide.

	Employee	Independent Contractor
Payroll Taxes	Yes	No
Minimum Wage	Yes	No
Overtime	Yes	No
Meal Periods/Rest Breaks	Yes	No
Reimbursement of Expenses	Yes	No
Worker's Compensation	Yes	No
Leave of Absence	Maybe	No
Unemployment Insurance	Yes	No
Disability Insurance	Yes	No
Social Security	Yes	No

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# Who Regulates the Classification of Workers?

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- State and Federal agencies both regulate the determination of independent contractor status
- Internal Revenue Service (IRS) – regulates income and employment taxes on the federal level
- Employment Development Department (EDD) – regulates employment related taxes for California
- Division of Labor Standards Enforcement (DLSE) – oversees whether the wage, hour and workers compensation laws apply
- Division of Workers' Compensation (DWC)
- Contractors State License Board (CSLB)

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# Where Does the Government Start in Determining the Status of a Worker?

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- DLSE starts with the presumption that the worker is an employee. *Labor Code Section 3357*. This is a rebuttable presumption however, and 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.
- There is a rebuttable presumption that where a worker performs services that require a license pursuant to *Business and Professions Code Section 7000, et seq.*, or performs services for a person who is required to obtain such a license, the worker is an employee and not an independent contractor. *Labor Code Section 2750.5*.

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# Employees for Wage Withholding Purposes

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- The term “employee” includes every individual performing services if the relationship between him and the person for whom he performs services is the legal relationship of employer and employee.

Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.

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# Employees for FICA Purposes

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- **Corporate Officers**, except for officers who perform no services (or only minor services) and receive no compensation

Example: *Pariani v. Commissioner*. Doctor who performed medical services for a professional association he had organized, and of which he was the sole shareholder and president, was an employee with respect to his duties as president and the medical services he provided.

- **Common law employees** – look to common law rules for determining employer-employee relationship

Example: *Ewens & Miller, Inc. v. Commissioner*. Tax Court looked to several factors, such as degree of control, investment in facilities, and permanency of relationship, to determine that certain workers affiliated with a bakery were employees.

- **Agent-Drivers or Commission-Drivers** engaged in distributing meat, vegetable, or bakery products, beverages (other than milk), or laundry or dry-cleaning services\*
  - Full-time life insurance salespersons\*
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## Employees for FICA Purposes, *cont.*

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- **Home workers** performing work at the direction of designated person on materials or goods furnished by such person\*

Example: garment workers and people who address envelopes

- **Traveling or city salespersons** engaged upon a full-time basis in solicitation (on behalf of his/her principal) of orders from wholesalers, retailers, contractors, hotels and restaurants for merchandise for resale or supplies for use in the business\*

Example: Solicitation of orders (on a full-time basis) from retail pharmacies for “X” Drug Co.

- Any individual who performs services that are included under an agreement entered into pursuant to Section 218 of the Social Security Act

Example: State and local government employees

\*Additional requirements for statutory employees: (1) worker must perform substantially all of the services himself/herself; (2) no substantial investment in facilities; and (3) services are part of a continuing relationship

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# Employees for FUTA Purposes

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- The term “employee” is defined similarly to the way it is defined for FICA purposes, except the definition does not include life insurance salespersons, home workers, or individuals who perform services that are included under an agreement entered into pursuant to Section 218 of the Social Security Act.

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# Statutory Non-Employees/Independent Contractors

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- **Qualified Real Estate Agents:** (1) licensed real estate agent; (2) substantially all compensation related to sales or other output rather than the number of hours worked; and (3) written contract stating that individual is not an employee for federal tax purposes
- **Direct Sellers:** (1) engaged in trade or business of selling (or soliciting the sale of) consumer products to a consumer (or a buyer for resale) in a location other than a permanent retail establishment; (2) substantially all compensation related to sales or other output rather than the number of hours worked; and (3) written contract stating that individual is not an employee for federal tax purposes

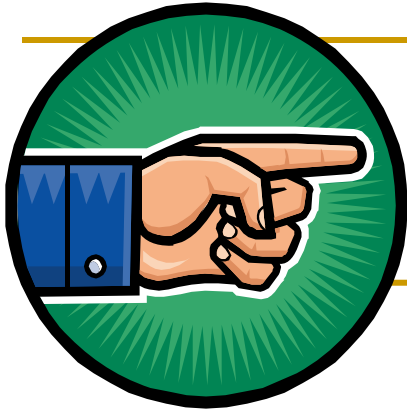
Example: A vacuum cleaner salesperson who buys merchandise on credit from a wholesale distributor, solicits sales from customer lists supplied by distributor, and conducts sales in customers' homes is a direct seller.

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What if employees agree or ask to be independent contractors? Can we have an agreement as to their status?

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- **NO** An individual can not agree to do something that is unlawful. The biggest mistake an employer makes is saying the employee preferred being an independent contractor, or worse yet, on salary.
- Types of tests used by Federal and State agencies and California Courts:
  - Behavioral control
  - Financial control
  - Type of relationship between the parties



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## Behavioral Control

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- Under this test, it will be determined whether the worker is an employee if the employer controls the means of production. In evaluating the means of production, the court and government will evaluate whether instructions are provided, the degree of instruction provided, the nature of the work, the degree of education required for the job and the particular trade or job.
- *Yak v. Brussels*. The Court held that plaintiff's worker status must be based on control of work and not an employment contract. It based its ruling on the principle that "the terms of a contract cannot override either issues of control in an employment relationship to determine worker status or the legal requirements under ERISA."
- *Waggener v. County of Los Angeles*. It was held that jurors are employees within the meaning of the Workers' Compensation Act, and the county has the responsibility to insure against injuries that a juror may sustain while the juror is providing services to the county.

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# Financial Control

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- This test includes:
  - whether there is a significant investment by the worker versus the employer
  - whether there are un-reimbursed expenses
  - whether the services are available to the public
  - the method of payment
  - the opportunity to the worker for profit or loss



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# Relationship Test



- The court and government will look at the agreement between the parties, the type of work being performed and the nature of the relationship.
- *Vizcaino v. Microsoft*. Microsoft’s “permatemp” workers were common law employees with written agreements acknowledging that they were independent contractors. The Court looked at the control of the work performed.
- *Baystate Affiliated Staffing v. Herner*. The Court ignored a written independent contractor agreement and held that the workers were employees, therefore entitled to receive overtime pay as required by the Fair Labor Standards Act (FLSA), and the staffing agencies (and their business clients) were liable for violating the FLSA.

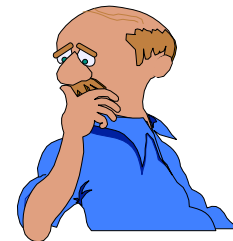
*MORAL – An Independent Contractor Agreement will not save you if you treat the worker as an employee.*

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# What If You Aren't Sure?

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- Form SS-8 – Determination of worker status for purposes of Federal employment taxes and income tax withholding
  - The form may be filed by either the business or the worker.
  - The IRS will review the facts and circumstances and officially determine the worker's status.
  - Be aware that it can take up to six months to get a determination.
- DE 1870 – Determination of employment work status for purposes of State of California employment taxes and personal income tax withholding
  - Filed by business



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# Workers Properly Classified as Employees

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- Employer must withhold (and pay over) income tax and employee's portion of FICA taxes and is responsible for paying unemployment taxes. Employer must also issue a W-2 to the employee.
  - Trust Fund Recovery Penalty/100% Penalty – Any person responsible to collect, account for and pay over tax who willfully fails to perform his responsibility is liable for a penalty equal to the total amount of tax evaded
    - Penalty only applies to trust fund portion of employment taxes (i.e., employee portion)
    - Amount of liability is equal to the amount of delinquent trust fund taxes and not in addition to those taxes
    - Penalty is not limited to a single person
    - No negligence or fraud penalty is imposed

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## Workers Properly Classified as Independent Contractors

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- For workers properly classified as independent contractors, no withholding of taxes is required, although the business must issue a Form 1099-MISC with respect to payments made to the independent contractors (in the amount of \$600 or more), and report the payments to the IRS and the EDD (for California income)

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# Workers Misclassified as Independent Contractors – Liability

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- Associated taxes for employers (on employee's portion of taxes)
  - May be liable for the entire tax
  - Reduced penalty under IRC Section 3509 for Income and FICA Taxes
    - For income taxes, liability is limited to 1.5% of the wages paid to an employee (increased to 3.0% if no 1099-MISC is provided to employee and IRS).
    - For FICA taxes, liability is limited to 20% of the normal FICA tax (6.2% Social Security tax and 1.45% Medicare tax for a total of 7.65%). Liability is increased to 40% if employer does not provide 1099-MISC to employee and IRS.
    - No relief if (1) employer intentionally disregards requirement to deduct and withhold income and FICA taxes; (2) employer withholds for income tax purposes, but not FICA tax purposes; or (3) statutory employee (for FICA purposes).

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# Workers Misclassified as Independent Contractors – Liability, *cont.*

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- IRS Forms 4669 and 4670 – Employer relieved of tax liability (but not penalties) if shows that employee reported the wages and paid the tax
- Employer's share of FICA taxes – Employer is responsible for 100% of his/her share of FICA taxes (7.65%); 6.2% Social Security tax is computed on first \$102,000 of wages, for a maximum tax of \$6,324; 1.45% Medicare tax is computed on employee's total wages.
- Federal Unemployment Tax – For 2008, tax is 6.2% of the first \$7,000 paid to each employee. This may be reduced through credits for contributions paid into state unemployment funds.

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## Workers Misclassified as Independent Contractors – Liability, *cont.*

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- Penalty for failure to deposit income, Social Security or Medicare tax on time – Penalty ranges from 2% to 10% of the applicable underpayment (delay of more than 15 days will result in a 10% penalty).
- Interest on underpayments – Interest accumulates at the Federal short-term rate plus three percentage points, from the last date allowed for payment until paid.
- Interest on penalties – Interest accumulates at the Federal short-term rate plus three percentage points, beginning 21 calendar days after the date of the IRS notice (10 business days if amount equals or exceeds \$100,000).

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# Relief Requirements under Section 530

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- Under the "Safe Harbor" rule of Section 530 of the Revenue Act of 1978, an individual will not be reclassified as a common-law employee for employment tax purposes, provided the business meets the following requirements:
  - The business did not treat the worker as an employee at any time.
  - The business filed a 1099 form for the worker on time.
  - The business has not treated workers in substantially similar situations as employees.
  - The business has a "reasonable basis" for treating the worker as an independent contractor.

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## State Liability

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- *Estrada v. Federal Express Ground Package System, Inc.* In a trifurcated trial, the court found the drivers were employees within the meaning of Labor Code § 2802 because FedEx controlled their manner of dress down to the color of their socks, the style of their hair and their day to day activities. The total damages assessed in California are believed to be approximately \$17 million.



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# Tips to Avoid Misclassification Problems

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- Review independent contractor agreements.
- Make sure independent contractors have the right to control the manner and means of accomplishing their work.
- Ensure that employees' labels or titles are consistent with their actual work experience.
- Require temporary employees or independent workers to apply for each new project or assignment.
- Review your policies and procedures and make sure there are truly differences between employees and independent contractors.

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# Contacts

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- Christine H. Long  
408.286.5800  
christine.long@berliner.com
  
- Kevin F. Kelley  
209.385.0700  
kevin.kelley@berliner.com

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# Christine H. Long

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Ms. Long represents individuals and businesses in a variety of matters, including employment issues and disputes, contract claims, real estate matters, and closely held and family-owned business disputes. Her clients range from Santa Clara Valley's oldest businesses and families to emerging technology companies, real estate brokerages, hospitality businesses, medical and professional businesses, and local service and retail businesses.

Ms. Long's employment practice includes handling claims of employment discrimination, wrongful termination, and breach of employment contract cases. Ms. Long counsels on all aspects of employment including; complaints made to the Department of Fair Employment and Housing, Labor Commissioner, and the EEOC on all matters relating to employment including compensation issues, mandatory leaves of absence, reasonable accommodations, and reductions-in-force for individuals, companies and local government.

408-286-5800

[christine.long@berliner.com](mailto:christine.long@berliner.com)

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# Kevin F. Kelley

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Mr. Kelley has over 20 years of experience in representing a variety of clients from closely held family businesses to large venture funds, investing in real estate, as well as publicly traded companies. This representation has included succession planning for family businesses, formation of all different types of closely held entities, 1031 exchanges, purchases and sales of real estate and business interests, and more traditional estate planning matters, such as drafting wills and trusts. Mr. Kelley has also acted as tax counsel on complex business acquisitions and reorganizations for both local and international clients.

Mr. Kelley started Berliner Cohen's practice in Merced, where he has been working with agricultural clients as well as real estate developers in connection with their business activities and tax needs.

209.385.0700

[kevin.kelley@berliner.com](mailto:kevin.kelley@berliner.com)