

CONTRACTOR OR EMPLOYEE?

LEGAL PITFALLS IN WORKER CLASSIFICATION

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Introduction

Employers oftentimes improperly classify their employees as independent contractors. This misclassification happens for a number of reasons. Sometimes it is because the worker requests the particular classification. Other times it is because the employer benefits economically by not having to pay payroll taxes, the minimum wage or overtime. Additionally, employers do not have to cover independent contractors under workers' compensation insurance, and are not liable for payments under unemployment insurance, disability insurance, or social security.

The state agencies most involved with the determination of independent contractor status are the Employment Development Department (EDD), which is concerned with employment-related taxes, and the Division of Labor Standards Enforcement (DLSE), which is concerned with whether the wage, hour and workers' compensation insurance laws apply. There are other agencies, such as the Internal Revenue Service (IRS), Division of Workers' Compensation (DWC), and the Contractors State Licensing Board (CSLB), that also have regulations or requirements concerning independent contractors. As different laws may be involved in a particular situation such as a termination of employment, it is possible that the same individual may be considered an employee for purposes of one law and an independent contractor under another law. Because the potential liabilities and penalties are significant if an individual is treated as an independent contractor and later found to be an employee, each working relationship should be thoroughly researched and analyzed before it is established.

How Do Government Agencies Determine Worker Classification?

There is no set definition of the term "independent contractor" and as such, one must look to the interpretations of the courts and enforcement agencies to decide if in a particular situation a worker is an employee or independent contractor. In handling a matter where employment status is an issue, the 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. Consequently, it is necessary to closely examine the facts of each service relationship and then apply the law to those facts. For most matters before the DLSE, depending on the remedial nature of the legislation at issue, 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. In applying the economic realities test, the most significant factor to be considered is whether the person to whom service is rendered (the

employer or principal) has control or the right to control the worker both as to the work done and the manner and means in which it is performed. Additional factors that may be considered depending on the issue involved are:

1. Whether the person performing services is engaged in an occupation or business distinct from that of the principal;
2. Whether or not the work is a part of the regular business of the principal or alleged employer;
3. Whether the principal or the worker supplies the instrumentalities, tools, and the place for the person doing the work;
4. The alleged employee's investment in the equipment or materials required by his or her task or his or her employment of helpers;
5. Whether the service rendered requires a special skill;
6. The kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the principal or by a specialist without supervision;
7. The alleged employee's opportunity for profit or loss depending on his or her managerial skill;
8. The length of time for which the services are to be performed;
9. The degree of permanence of the working relationship; and
10. The method of payment, whether by time or by the job.

Whether or not the parties believe they are creating an employer-employee relationship may have some bearing on the question, but is not determinative as this is a question of law based on objective tests. Further, employees may request to be classified as independent contractors when in fact they are not.

There is also 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*.

Even where there is an absence of control over work details, an employer-employee relationship will be found if (1) the principal retains pervasive control over the operation as a whole, (2) the worker's duties are an integral part of the operation, and (3) the nature of the work makes detailed control unnecessary. *Yellow Cab Cooperative v. Workers Compensation Appeals Board* (1991) 226 Cal.App.3d 1288.

Can the Principal and Worker Agree that the Worker is an Independent Contractor?

The existence of a written or oral agreement purporting to establish an independent contractor relationship is not determinative. *Borello*, at 349. The Labor Commissioner and courts will look behind any such agreement in order to examine the facts that characterize the parties' actual relationship and make their determination as to employment status based upon their analysis of such facts and application of the appropriate law. Further, the fact that a worker is issued a 1099 form rather than a W-2 form is also not determinative with respect to independent contractor status. *Toyota Motor Sales v. Superior Court* (1990) 220 Cal.App.3d 864, 877.

California's Common Law Test

California uses an approach in regulating employment that is different in many respects from that of the Federal government. One interesting approach is the application of the California Supreme Court decision found in *S.G. Borello & Sons v. Department of Industrial Relations*, (1989) 48 Cal.3d 341. The Court held that migrant harvesters of the grower's cucumber crop were employees and not independent contractors, even though the written contract between the harvesters and the grower expressly provided that the harvesters were independent contractors, not employees, and were not covered by workers' compensation. The grower had claimed that the workers were not employees because it had control only over the result and not over the means by which the result was accomplished. In reaching its conclusion that the workers were employees, the Court said the "control-of-work details" test for determining whether a person rendering service to another is an "employee" or an excluded "independent contractor" must be applied with deference to the purposes of the protective legislation. The nature of the work, and the overall arrangement between the parties, must be examined to determine whether they come within the "history and fundamental purposes" of the workers' compensation law.

In summary, California has determined that in workers' compensation matters, independent contractor status is found "when the provider of service has the primary power over work safety, is best situated to distribute the risk and cost of injury as an expense of his own business, and has independently chosen the burdens and benefits of self-employment."

California also uses the "California common law" test for income tax withholding, unemployment insurance and disability insurance. Under this test, "the most important factor is the right of the principal to control the manner and means of accomplishing a desired result". Basically, the more control the employer has, the more likely the worker is liable to be classified an employee.

If there is any doubt, California looks at the following ten items that essentially match the test in Section 220 of the Restatement of Agency:

1. Whether or not the worker is engaged in a separately established occupation or business;
2. The kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of a principal without supervision;

3. The skill required in performing the services and accomplishing the desired result. (Lower-skill workers are more likely to be found to be employees);
4. Whether the principal or the person providing the services supplies the instrumentalities, tools, and the place of work for the person doing the work;
5. The length of time for which the services are performed to determine whether the performance is an isolated event or continuous in nature;
6. The method of payment, whether by the time, a piece rate, or by the job (with payment by piece rate or job being some evidence of independent contractor status);
7. Whether the work is part of the regular business of the principal. (If it is, the worker is more likely to be an employee);
8. Whether or not the parties believe they are creating the relationship of employer and employee;
9. The extent of actual control exercised by the principal over the manner and means of performing the services; and
10. Whether the services being performed are for the benefit or convenience of the principal as an individual, or for the principal engaged in a business enterprise.

Economic Realities Test

The Federal Government uses either the “federal common law test” or the “economic realities” test. The Ninth Circuit identified the following factors as distinguishing employees from independent contractors under the “economic realities” test:

1. The degree to which the alleged employer has the right to control the manner in which the work is to be performed;
2. The worker’s opportunity for profit or loss depending upon his or her managerial skill;
3. The worker’s investment in equipment or materials required for the task, or the worker’s employment of helpers;
4. Whether the service rendered requires a special skill;
5. The degree of permanence of the working relationship; and
6. Whether the service rendered is an integral part of the alleged employer’s business.

Common Law Test Under ERISA

ERISA requires employers to consider the principal's right to control the manner and means by which the product is accomplished and the following additional twelve factors:

1. The skill required;
2. The source of the instrumentalities and tools;
3. The location of the work;
4. The duration of the relationship between the parties;
5. Whether the principal has the right to assign additional projects to the workers;
6. The extent of the worker's discretion over when and how long to work;
7. The method of payment;
8. The worker's role in hiring and paying assistants;
9. Whether the work is part of the regular business of the principal;
10. Whether the principal is in business;
11. The provision of employee benefits; and
12. The tax treatment of the worker.

IRS Factors (Revenue Ruling 87-41, 1987-1 C.B. 296)

Under Federal tax law, the IRS originally focused on whether sufficient control exists to conclude that an employer-employee relationship exists based on 20 factors. When evaluating relationships, IRS agents were previously instructed that "special scrutiny is required in applying the twenty factors to assure that formalistic aspects of an arrangement designed to achieve a particular status do not obscure the substance of the arrangement (that is, whether the person or persons for whom the services are performed exercise sufficient control over the individual for the individual to be classified as an employee)."

The twenty factors are:

1. Instructions. A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily thought to be an employee.
2. Training. Training a worker often indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner.

3. Integration. Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control.
4. Services Rendered Personally. If the services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results.
5. Hiring, Supervising and Paying Assistants. Generally, the party that hires, supervises and pays assistants will be the party that exercises control over them on the job.
6. Continuing Relationship. A continuing relationship between the worker and the person or persons for whom the services are performed tends to indicate that an employer-employee relationship exists.
7. Set Hours of Work. The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control.
8. Full Time Required. If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work.
9. Doing Work on Employer's Premises. If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere.
10. Order or Sequence Set. If a worker must perform services in the order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker's own pattern of work but must follow the established routines and schedules of the person or persons for whom the services are performed.
11. Oral or Written Reports. A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control.
12. Payment by Hour, Week, or Month. Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor.
13. Payment of Business and/or Traveling Expenses. If the person or persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee.

14. Furnishing of Tools and Materials. The fact that the person or persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employer-employee relationship.
15. Significant Investment. If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value to an unrelated party), that factor tends to indicate that the worker is an independent contractor.
16. Realization of Profit or Loss. A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees), is generally an independent contractor, but the worker who cannot is an employee.
17. Working for More Than One Firm at a Time. If a worker performs more than *de minimis* services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.
18. Making Service Available to General Public. The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship.
19. Right to Discharge. The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer.
20. Right to Terminate. If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship.

Recently though, the IRS has shuffled most of these 20 factors into various portions of a new three-area test that examines behavioral control, financial control and type of relationship between the parties.

Behavioral Control

Under the behavioral control test, the IRS looks for facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired, including the type and degree of:

1. Instructions the business gives the worker. An employee is generally subject to the business' instructions about when, where, and how to work.
2. The key consideration is whether the business has retained the right to control the details of a worker's performance or instead has given up that right.

3. Training the business gives the worker. An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

Financial Control

The financial control test covers facts that show whether the business has the right to control the financial and business aspects of the worker's job. This includes:

1. The extent to which the worker has unreimbursed business expenses. Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important.
2. The extent of the worker's investment. An independent contractor often has a significant investment in the facilities he or she uses in performing services for someone else. However, a significant investment is not necessary for independent contractor status.
3. The extent to which the worker makes services available to the relevant market. An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.
4. How the business pays the worker. An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is usually paid by a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.
5. The extent to which the worker can realize a profit or loss. An independent contractor can make a profit or loss.

Relationship of the Parties

Facts that show the parties' type of relationship include:

1. Written contracts describing the relationship the parties intended to create.
2. Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.
3. The permanency of the relationship. If you engage a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that your intent was to create an employer-employee relationship.

4. The extent to which services performed by the worker are a key aspect of the regular business of the company.

Definitions Provided by the Internal Revenue Code and Treasury Regulations

Employee for Wage Withholding Purposes. The term “employee” for wage withholding purposes includes an officer, employee, or elected official of the United States, a State, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing. The term employee also includes an officer of a corporation. See IRC § 3401(c). According to the Treasury Regulations, 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. See Treas. Reg. Sec. 31.3401(c)-1(a). 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. See Treas. Reg. Sec. 31.3401(c)-1(b).

Employee for FICA Purposes. The term “employee” for FICA purposes (i.e., Social Security and Medicare) includes the following:

1. Any officer of a corporation; however, an officer who does not perform any services or performs only minor services in his capacity as an officer, and who neither receives nor is entitled to receive any remuneration directly or indirectly, is not an employee. See IRC § 3121(d)(1); Treas. Reg. Sec. 31.3121(d)-1(b).

Example. A physician who performed medical services for a professional association he had organized, and of which he was the sole shareholder and president, was an employee of the association with respect to both his duties as president and the medical services he provided. Although other doctors also performed medical services for the association, he was the only individual who supervised, controlled, and directed its business. See *Pariani v. Commissioner*, T.C. Memo 1997-427 (1997).

2. Any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. See IRC § 3121(d)(2).

Factors. The Tax Court has listed the following factors as relevant in determining whether a worker is a common-law employee for FICA purposes: degree of control; investment in facilities; opportunity for profit or loss; right to discharge; whether work performed is integral part of business; permanency of relationship; nature of the relationship the parties thought they created; and the provision of employee benefits. See *Ewens & Miller, Inc. v. Commissioner*, 117 T.C. 263 (2001); *Rivera v. Commissioner*, T.C. Summary Opinion 2004-77 (2004).

Example. Using the first seven factors listed above, the Tax Court found that an employer (a manufacturer of bakery products) that attempted to convert its

employees to independent contractor status had both common law employees and statutory employees – bakery production workers, cash payroll workers, and outside salespersons were common law employees, while route distributors were statutory employees. See *Ewens & Miller, Inc. v. Commissioner*, 117 T.C. 263 (2001).

3. Any individual (other than an individual who is an employee under (1) or (2), above) who performs services for remuneration for any person:
 - a. as an agent-driver or commission-driver engaged in distributing meat products, vegetable products, bakery products, beverages (other than milk), or laundry or dry-cleaning services, for his principal. See IRC § 3121(d)(3)(A).
 - b. as a full-time life insurance salesperson. See IRC § 3121(d)(3)(B).
 - c. as a home worker performing work, according to specifications furnished by the person for whom the services are performed, on materials or goods furnished by such person which are required to be returned to such person or a person designated by him. See IRC § 3121(d)(3)(C).

Example. Home workers include so-called garment workers who make quilts, buttons, gloves, bedspreads, clothing, needle craft products, etc., and people who address envelopes. A worker's investment in sewing equipment that is necessary to fabricate quilts, bedspreads, clothing, and other needle craft products is presumed not to be a substantial investment in facilities. See Private Letter Ruling 9511001.

4. As a traveling or city salesman, other than as an agent-driver or commission-driver, engaged upon a full-time basis in the solicitation on behalf of, and the transmission to, his principal (except for side-line sales activities on behalf of some other person) of orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments for merchandise for resale or supplies for use in their business operations. See IRC § 3121(d)(3)(D).

Example. Salesman A's principal business activity is the solicitation of orders from retail pharmacies for X Drug Co. A also occasionally solicits orders for drugs on behalf of Y Co. and Z Co. A is within the occupational class of full-time traveling or city salespersons with respect to his services for X, but not with respect to his services for Y or Z. See Treas. Reg. Sec. 31.3121(d)-1(d)(3)(iv)(b), Ex. 1.

Example. Salesman B's principal business activity is the solicitation of orders from retail hardware stores on behalf of the R Tool Co. and the S Cooking Utensil Co. B regularly solicits orders for both companies. B is not within the occupational class of full-time traveling or city salespersons with respect to his services for either R or S. See Treas. Reg. Sec. 31.3121(d)-1(d)(3)(iv)(b), Ex. 2.

Note: For the four categories mentioned above (commonly known as “statutory employees”), the following three tests must be met: 1) the contract of service contemplates that the worker performs substantially all of the services himself/herself; 2) the worker does not have a substantial investment in facilities used for doing the work, other than transportation facilities; and 3) the services are part of a continuing relationship with the person for whom they are performed (i.e., they are not in the nature of a single transaction). See IRC § 3121(d)(3).

5. Any individual who performs services that are included under an agreement entered into pursuant to Section 218 of the Social Security Act (a voluntary agreement between a state and the Commissioner of Social Security extending FICA coverage to state and local government employees). See IRC § 3121(d)(4).

Employee for FUTA Purposes. The term “employee” for FUTA (unemployment) purposes has the meaning assigned to such term by IRC Section 3121(d), except that IRC Sections 3121(d)(3)(B) and (C) and 3121(d)(4) shall not apply. See IRC § 3306(i).

Statutory Non-employees/Independent Contractors. Certain types of workers are treated by statute as nonemployees/independent contractors.

- A. Qualified Real Estate Agents. Any individual who is a sales person if:

1. Such individual is a licensed real estate agent;
2. Substantially all of the compensation for the services performed by such individual as a real estate agent is directly related to sales or other output (including the performance of services) rather than to the number of hours worked; and
3. The services performed by the individual are performed pursuant to a written contract providing that the individual is not to be treated as an employee for federal tax purposes. See IRC Section 3508(b)(1).

- B. Direct Sellers. Any person if:

1. Such person:
 - (a) Is engaged in the trade or business of selling (or soliciting the sale of) consumer products to any buyer on a buy-sell basis, a deposit-commission basis, or any similar basis which the IRS prescribes by regulations, for resale in the home or somewhere else other than in a permanent retail establishment;
 - (b) Is engaged in the trade or business of selling (or soliciting the sale of) consumer products in the home or somewhere else other than in a permanent retail establishment; or

- (c) Is engaged in the trade or business of the delivering or distribution of newspapers or shopping news.
- 2. Substantially all of the compensation for the performance of the services described above is directly related to sales or other output rather than to the number of hours worked; and
- 3. The services performed by the individual are performed pursuant to a written contract providing that the individual is not to be treated as an employee for federal tax purposes. See IRC Section 3508(b)(2).

Example. A vacuum cleaner salesperson who buys the merchandise on credit from the wholesale distributor, solicits sales from customer lists supplied by the distributor, and conducts the sales activity in the customers' homes is a direct seller and not an employee of the distributor. See Private Letter Ruling 9132035.

Employment Tax Obligations

- A. Workers Properly Classified as Employees. Employer must withhold income tax and employee's portion of Social Security and Medicare taxes. Employer is responsible for paying Social Security taxes, Medicare and unemployment taxes on an employee's wages. Employer must give to each employee a W-2 showing the amount of taxes withheld from the employee's pay. Furthermore, under IRC Section 6051(a)(13), a employer is required to report on a W-2 the total amount of deferrals for the year under nonqualified deferred compensation plans, even if the employee is not currently taxed on compensation deferred under the plans.
 - 1. Trust Fund Recovery Penalty/100% Penalty (IRC Section 6672). Any person who has a duty to collect, truthfully account for, and pay over any tax imposed by the [Code], that willfully fails to collect such tax, or truthfully account and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, is personally liable for a penalty equal to the total amount of the tax evaded, or not collected, or not collected or not accounted for and paid over.
 - (a) General Observations
 - (i) The penalty only compensates the government for the amount of taxes collected by employers that are not paid over. In other words, the 100% penalty applies to the trust fund portion of employment taxes (i.e., employee portion) and not the portion of the taxes imposed on the employer.
 - (ii) The term "penalty" is misleading. The amount of the liability imposed by IRC Section 6672 is equal to the amount of delinquent trust fund taxes and is not in addition to those taxes.

- (iii) The penalty is not limited to a single person. The statute says “any person” having the duty to collect and pay over may be liable for the penalty, and, accordingly, the penalty may be, and frequently is, asserted against more than one person.
 - (iv) No negligence or fraud penalty may be assessed against a person in the event that the trust fund recovery penalty is assessed. The trust fund penalty is the only civil penalty imposed for failure to collect and pay over trust fund taxes.
 - (b) Method to Reduce Trust Fund Recovery Penalty. If under audit, then the “responsible person(s)” should make voluntary payments and designate the payment as payment towards the trust fund portion of the taxes.
- 2. California Unemployment Insurance Code Section 13073. Any employer or person failing to withhold the amount due from any taxpayer and to transmit the same to the EDD after service of notice is liable for such amounts.
- B. Workers Properly Classified as Independent Contractors. Employers are not required to withhold or pay any taxes with respect to independent contractors, although employers are required to issue information statements (Form 1099-MISC) with respect to payments made to independent contractors (if in the amount of \$600 or more) and report the payments to the IRS and the EDD (for California income). Furthermore, if an independent contractor defers compensation under a nonqualified plan, the employer must report the deferrals on a Form 1099 (See IRC Section 6041(g)).
- C. Workers Misclassified as Independent Contractors. If an employer misclassifies a worker as an independent contractor, files a Form 1099-MISC with respect to that individual, and fails to withhold and pay income, FICA, and FUTA taxes with respect to that worker, the employer will be liable for the taxes, penalty and interest described below, unless the employer is eligible for relief (described below).

Taxes and Liabilities

- 1. Failure to Withhold Income Taxes. If an employer fails to deduct and withhold income tax on wages by reason of treating the recipient employee as not being an employee, the employer’s liability for wage withholding is limited to 1.5% of the wages paid to the employee. See IRC Sec. 3509(a)(1).
 - (a) Increased Penalty for Failure to Provide Information Return. If an employer treats a worker who is an employee as an independent contractor, but does not provide the IRS and worker with the information return required for treating a worker as an independent contractor (Form

1099-MISC), the liability is doubled to 3%, unless such failure is due to reasonable cause and not willful neglect. See IRC § 3509(b)(1)(A).

- (b) **Example.** Alpha Corp treats a worker, E, as an independent contractor when he should have been treated as an employee. Alpha timely files Form 1099-MISC with the IRS and provides a copy to E. E earns \$50,000 from Alpha during the year. Alpha doesn't deduct and withhold any taxes from payments made to E. E pays the entire amount of income taxes due to the IRS on the wages earned. Nevertheless, under the above rules setting employer liability for misclassifying an employee as an independent contractor, Alpha is liable for \$750 ($\$50,000 \times 1.5\%$). If, without reasonable cause, Alpha had failed to file the Form 1099-MISC, Alpha's liability would have doubled to \$1,500 ($\$50,000 \times 3\%$).

2. **Failure to Withhold Employee's Portion of FICA Taxes.** If an employer fails to deduct and withhold the employee's portion of FICA tax (Social Security and Medicare) from wages by reason of treating the recipient employee as not being an employee, the employer's liability is limited to 20% of the normal employee FICA tax. For 2008, there is a 6.2% social security tax and 1.45% Medicare tax (for a total of 7.65%).

- (a) **Increased Penalty for Failure to Provide Information Return.** If an employer treats a worker who is an employee as an independent contractor, but does not provide the IRS and worker with the information return required for treating a worker as an independent contractor (Form 1099-MISC), the liability is doubled to 40%, unless such failure is due to reasonable cause and not willful neglect. See IRC § 3509(b)(1)(B).
- (b) **Inapplicability of IRC Section 3509.** IRC Section 3509 will NOT apply:
- 1) if the employer intentionally disregards the requirement to deduct and withhold income tax or FICA taxes from the employee's wages;
 - 2) if, with respect to any wages, the employer deducted and withheld income tax from those wages, but failed to deduct and withhold FICA tax from those wages; or
 - 3) to the employee portion of FICA taxes with respect to an individual who is a statutory employee as described in IRC Section 3121(d)(3) (e.g., certain agent- or commission-drivers, life insurance salespeople, home workers, and certain other salespeople).
- (c) **Forms 4669 and 4670.** Employers that do not qualify for the reduced rates may still be relieved of the payment of tax not withheld from the employee's wages if the employer can show that the employee has reported the wages and paid the tax. In order to prevail, the employer must obtain a signed IRS Form 4669, Statement of Payments Received,

from the employee stating that the income was reported and the taxes attributable to the income have been paid. The employer needs a signed IRS Form 4669 from each employee for each year relief is being requested. Additionally, the employer must complete and sign IRS Form 4670, Request for Relief from Payment of Income Tax Withholding, and submit this with the IRS Form 4669 to request relief from payment of the tax liability. The employer, however, remains liable for any penalties or additions to tax for failure to withhold the tax.

- (d) California Unemployment Insurance Code Section 13071. If the employer fails to deduct and withhold tax, and thereafter the tax against which the tax may be credited is paid or the taxpayer reports to the Franchise Tax Board the wages or gross income against which the tax would have been imposed, the tax so required to be deducted and withheld shall not be collected from the employer; however, in no case shall the employer be relieved from liability for any penalties with respect to the failure to deduct and withhold.

3. Employer's Share of Social Security and Medicare Taxes (IRC Section 3111). An employer is responsible for 100% of his share of FICA taxes (7.65%: 6.2% Social Security tax and 1.45% Medicare tax). For 2008, the 6.2% Social Security tax is computed on the first \$102,000 of the employee's wages. Thus the maximum Social Security tax for 2008 is \$6,324 (6.2% of \$102,000). The 1.45% Medicare tax is computed on the employee's total wages (no ceiling).

4. Federal Unemployment Tax (IRC Sections 3301 and 3306(b)). The tax is 6.2% through 2008, and 6.0% for 2009 and after, of the first \$7,000 paid to each employee as wages during the calendar year. Unlike FICA taxes, only employers and not employees are liable for the FUTA tax. In fact, even if an employer is not subject to any state unemployment compensation law, the employer is nevertheless liable for the tax.

- (a) Credits (IRC Section 3302). Employers get a credit against FUTA tax for contributions paid into state unemployment funds. There is a limit, however, on the credit that can be taken for state payments. Credits cannot exceed 90% of the federal base rate (6%), so as a practical matter, the minimum federal tax is .8% (10% of 6%, or .6%, plus the .2% surcharge).

5. Penalty for Failure to Deposit Income, Social Security or Medicare Tax on Time (IRC Section 6656). Unless the failure is due to reasonable cause and not willful neglect, a penalty equal to the applicable percentage (see below) of the amount of the underpayment is imposed for failing to make required tax deposits with government depositories.

- (a) Rate of Penalty. The penalty ranges from 2% to 10% of the applicable underpayment depending upon the extent of the delay in depositing the taxes. A delay of more than 15 days after the due date will result in a 10% penalty.

6. Interest on Underpayments (IRC Section 6621(a)(2)). Interest on underpayment of income, Social Security, or Medicare tax, which begins accumulating on the last date allowed for payment of the tax, continuing until the date paid, is the federal short-term rate plus three percentage points, compounded daily, and is adjusted quarterly.

7. Interest on Penalties (IRC Section 6601(e)(2)). Interest on penalties and additions to any tax, which begins accumulating 21 calendar days after the date of the IRS notice (10 business days if the amount for which such notice and demand is made equals or exceeds \$100,000), continuing until the date paid, is the federal short-term rate plus three percentage points, compounded daily, and is adjusted quarterly.

Safe Harbor: Section 530 of the Revenue Act of 1978

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 taxpayer meets the following requirements:

1. For purposes of employment taxes, the business did not treat the worker as an employee at any time.
2. The business filed a 1099 form for the worker on time. (This is required if the business pays the contractor \$600 or more during the year—or pays an attorney any amount.)
3. The business has not treated workers in substantially similar situations as employees.
4. The business has a “reasonable basis” for treating the worker as an independent contractor because it relied on:
 - Case law, published rulings or a technical advice memorandum or private letter ruling pertaining to the particular business;
 - A past IRS audit of the business resulting in no assessment of payroll taxes for workers holding positions substantially similar to the position held by the work in question; and
 - A long-standing recognized practice of a significant segment of the industry.

The IRS concluded in IRS Letter Ruling 9801001 that a company’s reliance on the advice of legal counsel is an established reasonable basis for the independent contractor treatment. To be effective, you need to have the advice in writing.

There are exceptions to the Safe Harbor statute. The safe harbor applies only to federal employment taxes, not for other purposes. California is not bound by the Safe Harbor statute. The safe harbor does not apply to technical services performed after October 22, 1986, pursuant to an arrangement between the employer and another organization (for example, leased employees).

What Remedies Are Available to Workers Who Have Been Misclassified?

Employees who believe they have been misclassified can either file a wage claim with the Division of Labor Standards Enforcement (the Labor Commissioner's Office), or they can file an action in court to recover the lost overtime premiums. In both situations, it will first be necessary to determine the employment status, that is, employee or independent contractor, before the issue of overtime can be addressed and decided. Additionally, if it is determined that the worker was an employee and the worker no longer works for the employer, the worker can make a claim for the waiting time penalty pursuant to Labor Code Section 203.

Recent Cases

Estrada v. FedEx Ground Package System, Inc.

The Second District Court of Appeal has affirmed a certification order and trial court finding that FedEx drivers are employees, and affirmed the plaintiffs' right to recover attorneys' fees. Three drivers brought this class action against FedEx Ground Package System, Inc., contending that, for the limited purpose of their entitlement to reimbursement for work-related expenses, they were employees, not independent contractors. They sought reimbursement and declaratory and injunctive relief, and obtained class certification for their reimbursement claim.

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 (Phase I), ordered FedEx to reimburse some (about \$5 million, including prejudgment interest) but not all of their expenses (Phase II), granted most of the equitable relief sought by the drivers (Phase III), and ordered FedEx to pay the drivers' costs and attorneys' fees (about \$12.3 million). The Court of Appeal affirmed the finding that the drivers are employees, the certification order, and the finding that attorneys' fees are recoverable. The California Supreme Court refused to hear the final appeal or overturn the lower Court's decisions.

Vizcaino v. Microsoft Corp., 173 F.3d 713 (9th Cir. 1999) (Microsoft III)

Microsoft hired programmers with the understanding that they would not be eligible for benefits given to Microsoft's regular employees, that they were classified as temporary employees and that they were paid not through payroll but accounts receivable.

In years just prior to their hiring, the IRS had examined Microsoft's employee records and had determined the Microsoft's programmers were not independent contractors but were actually employees. Learning of the IRS ruling, the programmers sought employee benefits from Microsoft. Microsoft argued that only the few hundred individuals who had been working as independent contractors until their positions were reclassified by the IRS in 1990, were employees, while the rest would have to establish individually that they were the common law employees of Microsoft and not of the temp agency that hired them.

The Ninth Circuit rejected Microsoft's "either/or" formulation and ruled that all 10,000 to 15,000 workers were presumptively Microsoft employees, even if they also were the common law employees of the temp agencies. The court's decision relied heavily on the fact that

Microsoft had conceded in the trial court and in a prior appeal (for purposes unrelated to determining the scope of the class) that all “class members” were its common law employees. The court also concluded that because the IRS had determined in 1990 that positions, and not merely individuals, had been misclassified, it would be appropriate to place the burden on Microsoft to disprove that any worker occupying such a “reclassified” position was the company’s common law employee. In a revealing passage, the court expressed its belief that “application [of the Darden factors] generally turns on factual variables within an employer’s knowledge, thus permitting categorical judgments about the ‘employee’ status of claimants with similar job descriptions.”

As a result, the Ninth Circuit held that the programmers were eligible to receive benefits. The court did note that Microsoft could have easily limited the programmers’ right to participate in the benefits, had they used explicit language in the plan.

This case demonstrates that employers cannot rely solely upon contractual labels in establishing whether a worker is an independent contractor.

Other Cases

Courts have found employer-employee relationships in the following instances:

- Golf course as the employer of caddies paid and directed by individual golfers, *Clairmont C. Club v. Industrial Accident Comm’n* (1917) 174 Cal. 395, 397.398; *Ware v. Workers’ Compensation Appeals Bd.* (1999) 78 Cal. App. 4th 508, 514.515 (although members paid caddies, club provided them as integral part of its business and therefore employment presumed).
- A hospital as the employer of a student nurse working for school credit and not a salary. *Anaheim General Hospital v. Workmen’s Comp. App. Bd.* (1970) 3 Cal. App. 3d 468, 472.474.
- A movie stuntman hired to perform a rodeo stunt during a three-day engagement as an employee.
- A cosmetologist working at a beauty shop. *Truesdale v. Workers’ Compensation Appeals Bd.* (1987) 190 Cal. App. 3d 608, 617.
- A newspaper carrier hired to deliver newspapers (despite signed agreement stating carrier was an independent contractor). *Gonzalez v. Workers’ Compensation Appeals Bd.* (1996) 46 Cal. App. 4th 1584, 1594.
- A taxicab driver as employee of a taxicab company notwithstanding an agreement between the driver and the company purporting to establish a lessor-lessee relationship. *Yellow Cab Cooperative, Inc. v. Workers’ Compensation Appeals Bd.* (1991) 226 Cal. App. 3d 1288.

What Are the Problems with Leased Workers?

Businesses have increasingly used “leased workers” (leased from temporary agencies or other similar businesses) in an attempt to avoid workers being classified as employees. Often this is not sufficient. The Ninth Circuit has ruled that the federal common law test takes priority. The IRS has held that workers previously employed by the business are subject to federal withholding.

Depending on the amount of control the contracting business exerts (or has the right to exert) over the leased employees, it may be held to be a joint employer with the leasing agency.

Withholding Issues related to Leased Workers.

Income Tax Withholding: IRC Section 3401(d)(1). If the employer for whom services are performed does not have control of payment of the wages to the employee, whoever does have control of the payment of the wages is treated as the employer for purposes of withholding income tax on wages. Thus, a person other than a common law employer is treated as the employer for wage withholding tax purposes if: (1) the common law employer does not have control of the payment of wages, and (2) the third party has control of the payment of the wages.

FICA Withholding. The U.S. Supreme Court has held that the rule of IRC Section 3401(d)(1) applies to determine the identity of the employer with respect to FICA withholding, as well as income tax withholding. See *Otte v. U.S.*, 419 U.S. 43 (1974).

Ways to Protect Yourself

There are certain items you can include in your independent contractor agreements, which may aid you in any claim that the worker is an employee. Your agreement should include the following:

- The worker is responsible for his/her own taxes etc;
- The worker will not be receiving benefits;
- Principal is interested in the results, and has no say in the method, manner or means of performance;
- The worker will submit invoices on his/her letterhead;
- The worker has provided a copy of his/her own business card;
- The worker will work at home or, alternatively, will pay rent for use of the business’s office and equipment;
- The worker is free to work on projects for others; and
- The term of the agreement is for a fixed period (rather than being open-ended).

Whenever you are in doubt, you should consult a professional. The small up front investment for review of an agreement or relationship may save you thousands of dollars in penalties down the road.

The information contained in this publication is general in nature and does not constitute legal advice. The authors of this publication would be pleased to discuss in greater detail its contents and its application to your specific situation.