

HOW TO PROPERLY CLASSIFY YOUR WORKFORCE AS EMPLOYEES OR INDEPENDENT CONTRACTORS

I. INTRODUCTION

One of the most common cost-cutting approaches used by small businesses is to “outsource work” to independent contractors who can frequently perform the work at a fraction of the cost of an employee. Independent contractors do not require overhead, benefits, handbooks, or meal breaks, and, if the employer decides it no longer needs their services, the independent contractor cannot sue for wrongful termination. To a small business owner short on capital, using independent contractors to generate the company’s goods and services can have a dramatic impact on the bottom line. The problem is that the distinction between an independent contractor and an employee is frequently blurred and filled with many misconceptions. In the words of Bruce Springsteen, “Trust none of what you hear, and less of what you see.”

While most people are aware that there is a difference between employees and independent contractors, the importance of the distinction is lost on many. Simply referring to your work force as independent contractors does not mystically transform them into independent contractors in the eyes of the law. Aware that many businesses seek to avoid paying workers’ compensation insurance and a host of other employment-related taxes by classifying their employees as independent contractors, the state legislature and the courts have constructed a number of requirements that must be fulfilled for an employer to legally enjoy the savings generated by utilizing independent contractors.

The purpose of this article is to dispel the misconceptions and provide a basic outline of the requirements an employer must satisfy in order to legally classify his or her workforce as independent contractors. The law accords disparate treatment to employees and independent contractors in many areas, including payroll and income tax treatment, workers’ compensation coverage, wage and hour law, and employer tort liability, to name only a few. As a result, the decision to treat workers as employees or independent contractors has far-reaching repercussions. Although the legal distinction between the two classifications involves a complex and fact-intensive inquiry, the good news is that if you’re still reading, then you’re already more informed than most. This article might not answer all of your questions, but you will at least be in a position to ask the right questions to avoid the pitfalls of the employee/independent contractor distinction.

II. RISKS AND REWARDS OF CLASSIFYING YOUR WORK FORCE AS INDEPENDENT CONTRACTORS

Employees and independent contractors are entitled to fundamentally different sets of rights under California law. For example, an independent contractor is not entitled to protection under California’s wage and hour laws. From the business perspective, this means no obligation to comply with laws regarding minimum wage, overtime premiums, meal breaks, rest breaks,

vacation pay, sick time, or reimbursement of work-related expenses. Additionally, companies need not provide workers' compensation insurance for independent contractors. Businesses are also not obligated to make payments to unemployment insurance, disability insurance, social security taxes, or payroll taxes for workers who are properly classified as independent contractors. Independent contractors are also not protected by many state and federal antidiscrimination laws.

All small business owners are, or should be, aware of the tangible benefits available to a company that can classify its workers as independent contractors. What is less well known are the potentially severe liabilities that attach to an improper classification. An improper classification can lead to a business being monetarily liable to the worker, first and foremost, for violation of wage and hour laws. This most frequently arises when an unhappy independent contractor takes the business owner to court seeking to have his status changed to that of an employee in order to collect overtime wages for the 15 hour days he or she allegedly worked to complete the project. In addition to the wage and hour liability, various government agencies such as the IRS, the state Division of Labor Standards Enforcement ("DLSE") and the California Employment Development Department ("EDD") (which administers state unemployment and disability programs), will also have cause to come after the company. Finally – and perhaps most frighteningly – the District Attorney's Office can bring *criminal* charges for violation of the Workers' Compensation Act.

III. DISPELLING THE MISCONCEPTIONS

Before moving on to the present state of the law, a number of popular misconceptions should be addressed. First, that an individual wants to be treated as an independent contractor is not determinative of whether the person actually is an independent contractor in the eyes of the law. The classification is a legal determination that cannot be displaced by the understanding of one, or even both, parties. It is also no defense that the worker has signed a written contract agreeing to act as an independent contractor. Such private agreements may be *relevant*; but a contract cannot protect a business from exposure.

That a worker only performs occasionally, or on an on-call basis, does not mean that the worker is an independent contractor. In a similar vein, it is of no consequence that a worker performs assignments for more than one company. Again, while such circumstances may be relevant to determining the proper classification of a worker, neither is determinative. Finally, some businesses have made the mistake of classifying an individual as an independent contractor either because the person was compensated on a commission, as opposed to hourly, basis, or because the person was provided with a 1099 tax form. Employees and independent contractors alike may be paid on an hourly, commission, or piece-rate basis, and tax treatment depends on proper classification status, not vice-versa.

IV. CALIFORNIA'S DISTINCTION BETWEEN INDEPENDENT CONTRACTORS AND EMPLOYEES

Historically, the distinction between employees and independent contractors was developed in order to limit an employer's liability for injuries caused by the hired help. As a logical matter, employers should only be responsible for the intentional wrongdoing of those individuals whose behavior the employer has a right to control. In recognition of this basic premise, the common law "control test" arose. The "control test" is based on the premise that if an employer controls certain aspects of an individual's working conditions, that individual is an employee and not an independent contractor. An employer is presumptively responsible for the acts of the former, but not the latter.

Under the control test, the crucial inquiry is "whether the person to whom service is rendered has the right to control the manner and means of accomplishing the result desired." In other words, if the worker is responsible for controlling the particulars of the work – the "means" to whatever end is pursued – then the worker is likely an independent contractor. On the other hand, if the company has pervasive control – for example, if the business is entitled to give specific directions that it expects to be followed, or if the company can discharge the worker at any time with impunity – then the control test would likely support a finding that the worker is an employee.

By way of example, a leading case applied the control test to cab drivers, all of whom had signed agreements with the cab company purporting to classify them as independent contractors. The court quickly moved beyond the contractual language, however, because the cab company exercised both direct and indirect control over various aspects of the work. The company provided instruction on general behavior of the drivers, including personal appearance, cleanliness of the vehicle, driving techniques, and interaction with the public. Additionally, the drivers received instructions from the dispatcher, which they were expected to follow. Drivers were told where to go and when to return to the yard, and if they attempted to refuse the dispatcher's direction, they would be refused future fares, and could be written up or terminated. Finally, the company assigned each drivers' hours, and prohibited its drivers from driving cabs for other companies. On these facts, it was determined that the cab company "exercised pervasive control over the enterprise as a whole," and that the drivers were therefore employees under the law.

Unfortunately, the relatively-simple control test has been tweaked and modified a number of times over the years in order to remain relevant to the ever-changing and potentially limitless varieties of business relationships in the modern workplace. The right to control still remains the principal inquiry, but various other factors must now be considered when classifying workers. Precisely which factors are relevant, and the weight attributed to each, is a complex inquiry. California case law has augmented the basic common-law control test with additional common law principles. *S.G. Borello & Sons v. Dept. of Industrial Relations* is the key California decision detailing the factors that comprise this approach. In *Borello*, the court evaluated the following factors in addition to the control test:

- (a) whether the one performing services is engaged in a distinct occupation or business;

- (b) 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;
- (c) the skill required in the particular occupation;
- (d) whether the principal or the worker supplies the instrumentalities, tools, and the place of work for the person doing the work;
- (e) the length of time for which the services are to be performed;
- (f) the method of payment, whether by the time or by the job;
- (g) whether or not the work is a part of the regular business of the principal; and
- (h) whether or not the parties believe they are creating the relationship of employer-employee.

In its analysis, the court in *Borello* explicitly cautioned that these factors are not to be applied in a strict manner, and are not entitled to equal weight. Instead, the court reasoned that “the individual factors . . . are intertwined and their weight depends often on particular combinations.” In addition to these factors, courts will also consider the purposes of whatever statutory scheme is alleged to be violated in reaching a conclusion regarding the proper classification of workers. In California, the *Borello* test is generally used in cases involving state wage and hour laws, state discrimination, harassment, retaliation under the Fair Employment and Housing Act, and workers’ compensation. All business owners should be aware that both the courts and the California Labor Code have expressed a strong preference towards finding an employee-employer relationship. In the event a dispute arises between a business owner and an independent contractor, the Courts will generally find the existence of an employer-employee relationship unless the business can persuasively establish that the relationship is that of a principal and independent contractor. In practical terms, this means that any close call will likely go against the business owner.

Further complicating matters is the fact that the *Borello* test is not universally applicable. For example, the EDD will generally apply the common-law control test in determining liability for state income tax withholdings or unemployment and disability insurance payments. Additionally, different tests (often with similar factors) are used by federal authorities and the IRS, respectively. For example, California *federal* courts apply the “economic realities” test to determine whether a worker is properly classified. This test involves evaluating six factors, each of which overlap with the factors of the *Borello* test, including:

- (a) the degree of the alleged employer’s right to control the manner in which the work is to be performed;
- (b) the alleged employee’s opportunity for profit or loss depending upon his managerial skill;

- (c) the alleged employee's investment in equipment or materials required for his task, or his employment of helpers;
- (d) whether the service rendered requires a special skill;
- (e) the degree of permanence of the working relationship; and
- (f) whether the service rendered is an integral part of the alleged employer's business.

As another example, the IRS, in its love of complexity, has promulgated Revenue Ruling 87-41, which breaks the control test into three categories and twenty factors deemed to be relevant to determining who has control over the worker's work. With all the tests, however, it is clear that as a company's control over the details of the work increase, so does the likelihood that the worker will be found to be an employee. Suffice to say that a business seeking to properly classify its workers must deal with a number of moving targets, each of which is intricate in its own right.

V. RECOMMENDATIONS

A. Is There Magic Language That Can Create An Independent Contractor Relationship?

As earlier discussed, even a written contract stating that an individual is an independent contractor will not insulate a business from liability stemming from a misclassification. However, that does not mean that memorializing the parties' understanding in a written agreement is a bad idea. Instead, a written agreement can and should be considered in determining whether an individual is properly classified. Furthermore, careful drafting of such an agreement can strengthen the company's defenses. And although there are no "magic words," there are terms to which courts have traditionally attributed particular meaning in the context of employee classification.

- "Company" and "business" are neutral terms describing an entity for whom someone is performing services. Neither term indicates whether the entity is an employer, on the one hand, or a recipient of contracted services, on the other.
- "Worker" and "service provider" are neutral terms describing an individual performing services – generally, an independent contractor, not an employee.
- "Contract for" and "retain" are often used to describe the establishment of an independent contractor relationship, while "hire" tends to describe the establishment of an employer-employee relationship.
- "Customer" and "client" describe the user of the services that an independent contractor provides.

- “Employee” and “employer” describe the parties in an acknowledged employment relationship. On the flipside, the terms “contractor” and “consultant” are often used to refer to an independent contractor.

Thus, the proper drafting of a written agreement – with consistent use of the appropriate language – is a useful document to have, if and when any questions arise about the classification of a worker. While there is no contract that can totally insulate a company from misclassification issues, it is certainly better to have the contract than to have nothing.

B. Should I Seek Legal Advice?

To ask this question is to know the answer. Leave the legal stuff to the experts, and focus on running a profitable business. Countless companies have tried to cut corners and save costs by attempting to classify their workers based on some quick Internet research, only to pay a heavy price in the end. Save yourself the worry by broaching the issue with seasoned employment law counsel at the earliest opportunity. A 30 minute phone call may cause you to slightly alter your approach and steer clear the various landmines that lie ahead. As with many things – dental work comes to mind, and specifically, root canals – prevention of legal issues is less costly (and less painful) than correcting a problem that has been allowed to go untreated.

Obviously, the sooner you address the legal employment issues presented by your company, the easier it will be to minimize the problems. However, the reality is that very few businesses have the capital or the desire to actually undertake a thorough analysis of the employee/independent contractor distinction at an early juncture, and that the issue rears its ugly head after the company has made a classification decision, and the company has reason to believe that the classification may be incorrect. These companies are then forced into deciding whether to immediately rectify the classification issue – and thereby alert all their workers that they were, in fact, misclassified for the past weeks, months, or years – or to do nothing, which is to continue to violate the law.

C. Can I Self-Educate?

There is a great deal of information on this topic available via the Internet, but not all of it is accurate. For those looking for additional information, the following are trustworthy websites that address some of the intricacies of the employee/independent contractor distinction. It must be remembered, however, that each source’s information is accurate only for the body of law and jurisdiction of the entity hosting the website.

- The California Division of Labor Standards Enforcement (“DLSE”) is a branch of the state Department of Industrial Relations. The DLSE website contains a helpful page of “Frequently Asked Questions” on the topic of independent contractors and worker classifications, available at http://www.dir.ca.gov/dlse/FAQ_IndependentContractor.htm.
- The IRS also maintains a series of informative pages covering the topic of independent contractors. The website also offers links to IRS publications and webcasts. It is available at <http://www.irs.gov/businesses/small/article/0,,id=99921,00.html>.

Although these websites are helpful, they rank a very distant second to actual legal advice. However, they are certainly more reliable than the sites that attempt to classify workers based on user-provided information.

VI. CONCLUSION

The complexities inherent in the employee/independent contractor distinction are many, and the law is constantly evolving. Although the California Labor Code and the state courts more often than not find in favor of employees, with the proper documentation and work environment it is possible to accurately classify your workforce as independent contractors. Hopefully this article will provide a starting point for you to begin the process of analyzing whether your workers should be classified as employees or independent contractors.



Jeffrey Wertheimer is a partner in the Employment and Labor Department of Rutan & Tucker, LLP, where he draws on more than two decades of litigation and counseling experience to protect business and employer interests. Mr. Wertheimer has successfully defended clients in a variety of employment matters, including class action and multi-plaintiff wage and hour, harassment, disability discrimination, retaliation, wrongful termination, and breach of contract claims. Mr. Wertheimer may be contacted at jwertheimer@rutan.com.



Brandon Sylvia is an associate attorney in the Employment and Labor Department of Rutan & Tucker, LLP. Mr. Sylvia's practice involves representing employers in a broad range of employment-related litigation, including wage-and-hour class action disputes, trade secret litigation, and retaliation, harassment, and discrimination claims. Mr. Sylvia may be contacted at bsylvia@rutan.com.