

Penalties for Misclassifying Workers as Independent Contractors

Misclassification of workers as independent contractors rather than employees can carry serious consequences for your nonprofit organization. The classification of workers affects tax liability, as well as standards of employment¹. A new California law, California Labor Code Section 226.8, adds another important consequence of determining the relationship between an employer and a worker. Section 226.8, which went into effect on January 1, 2012, imposes new penalties on employers for incorrectly classifying workers as independent contractors. In addition to state-imposed penalties, employers continue to face federal penalties under the IRS Code. This alert provides some guidance in classifying your workers, discusses the implications of the new California law, and offers suggestions about and what you can do to avoid liability.

What is California Labor Code Section 226.8?

California Labor Code Section 226.8 imposes new penalties on employers who willfully misclassify their employees as independent contractors. Willful misclassification is defined as “voluntarily and knowingly misclassifying that individual as an independent contractor.” The law also penalizes employers who charge fees or make deductions from compensation to an individual who has been willfully misclassified as an independent contractor.

Courts have not had the opportunity to provide practical guidance on what constitutes “voluntarily and knowingly” misclassifying workers under Section 226.8. However, a well-reasoned good faith misclassification would likely fall short of the standard. Conversely, intentionally flying just below the “right to control” standard (discussed immediately below) may constitute willful misclassification.

¹ This alert focuses only on penalties imposed for misclassifying workers, and not other issues associated with classification of workers.

How do I determine whether a worker is an employee or an independent contractor?

The common law test to determine whether a worker is an employee or independent contractor is imprecise and requires an analysis of several factors of the employer-worker relationship. These factors must be weighed against each other and considered in light of the total circumstances. They include:

- 1) Who has the right to control the worker's manner and means of performing his or her duties – an independent contractor has more control over the day-to-day details of his or her job than an employee;
- 2) The skill required in the worker's job – independent contractors often perform highly skilled jobs;
- 3) Whether the worker is engaged in a distinct business or occupation – if the worker is engaged in a distinct business or occupation, it is more likely the worker is an independent contractor;
- 4) Whether the work is done under supervision – the more an employer is directly supervising the worker, the more likely he or she is an employee;
- 5) Whether the worker can be discharged at will or for cause – allowing discharge at will often weighs in favor of an employer-employee relationship;
- 6) Who supplies the tools, instrumentalities and place of work – if the worker supplies these, he or she is more likely an independent contractor;
- 7) The length of time the services are to be performed – discrete jobs are generally performed by independent contractors;
- 8) The method of payment, whether by time or by the job – payment by time generally signals an employee relationship;
- 9) Whether the work is part of the regular business of the principal – if it is, the worker is more likely an employee;
- 10) Whether the parties subjectively believe they are creating an employer-employee relationship.

See S. G. Borello & Sons, Inc. v. Dep't of Indus. Relations, 48 Cal.3d 341, 350-51 (1989); 38 Cal. Jur. 3d Independent Contractors §3.

Though not dispositive, the most important factor in the analysis is who has the right to control the worker's manner and means of performing his or her work. This is referred to as the "right to control test."

A few examples may help illustrate the application of the test:

A cleaning maid who worked in the home of her employers and charged \$16 per day was found by a court to be an employee of one of her employers who asked her to clean a vacant apartment he managed. The court found the maid an employee because the employer brought her to the apartment, told her what to clean, and provided her with cleaning equipment to complete the job. *Johnson v. Workmen's Comp. Appeals Bd.*, 41 Cal. App. 3d 318 (1974).

A carpenter was found to be an independent contractor even though he was paid by the hour in *Germann v. Workers' Comp. Appeals Bd.*, 123 Cal. App. 3d 776 (1981). The most important factor

in the court's analysis was the right to control – the employer did not instruct the worker on how to complete the job, he was only concerned about the outcome of the project.

Finally, a writer was considered an independent contractor of a magazine publisher where the publisher did not control the means and manner by which the writer wrote the story. Although the publisher thoroughly edited and revised the article and had final say over the finished product, the court found that the employer did not exert the level of control that characterizes an employer-employee relationship. Additionally, the court was persuaded by the fact that the writer was paid by the job, did not work on the publisher's premises, and that his job required great skill. *D.A.R.E. America v. Rolling Stone Magazine*, 101 F. Supp. 2d 1270 (2000).

For federal tax purposes, the IRS uses three tests to determine worker classification: the behavioral control test, the financial control test, and the relationship between the parties. These tests consider factors similar to the common law test described above, also focusing on the right to control factor.

Who are statutory employees?

Some workers are statutory employees under both federal and California law. These workers must be classified as employees, even if they would be considered independent contractors under the common law test.

- 1) Any officer of a corporation is an employee of that corporation.
- 2) An agent or commission driver who distributes meat products, vegetable products, fruit products, bakery products, beverages (other than milk), laundry, or dry cleaning for someone else.
- 3) A full-time life insurance salesperson who sells primarily for one company.
- 4) A home worker who works by guidelines of the person for whom the work is done, with materials furnished by and returned to that person or to someone that person designates.
- 5) A traveling or city salesperson (other than an agent-driver or commission-driver) who works full time (except for sideline sales activities) for one firm or person getting orders from customers. The orders must be for merchandise for resale or supplies for use in the customer's business. The customers must be retailers, wholesalers, contractors, or operators of hotels, restaurants, or other businesses dealing with food or lodging.
- 6) The author of a commissioned or specifically ordered work is a statutory employee of the person commissioning the work if the parties expressly agree in a written instrument signed by them that the work shall be considered a work made for hire, and the ordering or commissioning party obtains ownership of all the rights comprised in the copyright in the work.
- 7) Any person with a membership interest in a Limited Liability Company (LLC) treated as a corporation for federal income tax purposes is an employee of that LLC.
- 8) Any unlicensed contractor performing services requiring a contractor's license is an employee of the licensed or unlicensed contractor who hired the unlicensed contractor.

What are the state penalties for willfully misclassifying employees as independent contractors under Section 226.8?

The penalties for violating Section 226.8 include fines between \$5,000 and \$15,000 per violation of the law, in addition to any other fines allowed by law. If the employer is engaged in a pattern or practice of violating this law, the fines are increased to between \$10,000 and \$25,000 per violation.

In addition to fines, an employer that violates the law is required to post notice of its violation in a prominent location on its website for 1 year. If the employer does not have a website, it must post notice of the violation in each location where the violation occurred, in a prominent area accessible to all employees and the public.

Section 226.8 is enforced by the Labor Commissioner of the California Labor and Workforce Development Agency. The Labor Commissioner may investigate complaints by workers and, if necessary, initiate either a civil suit or a hearing before the Labor Commissioner pursuant to California Labor Code Section 98.

Section 226.8 may also be enforceable through California's Private Attorneys General Act, which allows a private citizen to pursue civil penalties on behalf of the Labor and Workforce Development Agency, provided the citizen complies with the notice and waiting procedures of the Act. However, the availability of these actions for violations of Section 226.8 is unclear at this time.

What are the tax-related penalties for misclassifying workers?

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 misclassification was intentional, or if statutory employees are misclassified, the employer is liable for the full amount of both the federal income tax that should have been withheld as well as the employee's and employer's share of Social Security and Medicare taxes.

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.

How can I reduce risk of violating laws regarding classification of workers?

To avoid incurring state and federal penalties, you should engage in a thoughtful analysis of whether your workers are employees or independent contractors. Since the analysis is very fact-specific, it is important to evaluate your relationship with each worker and not merely each type of job or position.

If you are unsure about the classification of your workers, you may want to take further steps to be sure you are in compliance. Consider seeking legal advice, such as contacting CORP for legal assistance, and/or review the following resources:

State Resources

The California Employment Development Department (EDD) has provided the following resources for classifying your workers:

- **California Employer's Guide 2012** – A comprehensive guide for employers in California, available at http://www.edd.ca.gov/pdf_pub_ctr/de44.pdf.
- **Employment Determination Guide (DE 38)** – A self-assessment that asks a series of “Yes” or “No” questions regarding your treatment of workers to help determine whether you are correctly classifying your workers. The guide is available at www.edd.ca.gov/pdf_pub_ctr/de38.pdf.
- **Determination of Employment Work Status for Purposes of State of California Employment Taxes and Personal Income Tax Withholding (DE 1870)** - After you complete and return this form, the EDD will send you a written determination stating whether your workers are employees or independent contractors based on the information that you have provided. This publication is available at www.edd.ca.gov/pdf_pub_ctr/de1870.pdf.
- **Precedent Tax Decisions** by the CUIAB - Available on the CUIAB's Web site at www.cuiab.ca.gov/precedent_decisions.shtm.
- **Web-Based Seminars** on employee and independent contractor issues, available at http://www.edd.ca.gov/Payroll_Taxes/Web_Based_Seminars.htm.
- **Live Assistance** on worker classification issues from the Taxpayer Assistance Center at (888) 745-3886.

Federal Resources

- **Employer's Tax Guide (IRS Publication 15)** – Comprehensive tax guide for employers provided by the IRS, available at <http://www.irs.gov/pub/irs-pdf/p15.pdf>.
- **Form SS-8** – If you would like the IRS to determine whether your worker is an employee or independent contractor, submit Form SS-8, available at <http://www.irs.gov/pub/irs-pdf/fss8.pdf>.

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