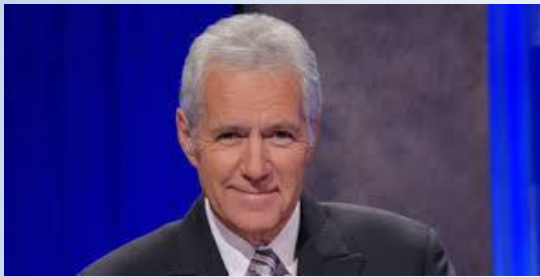


# 1099 vs. W-2s: What You Need to Know About Classifying Independent Contractors



# Your Hosts

**Lorena Fernandez, EDD Tax Administrator**



**Justine Phillips, Employment Attorney  
Sheppard Mullin**



# Classification



# Employee or Independent Contractor?

- Employee
  - must withhold payroll taxes
  - must comply with employment laws
- Independent Contractor
  - pays own taxes
  - much fewer employment laws with which to comply

# Importance of Proper Classification

- Independent contractor status is defined by law, not by the parties' agreement.
- It is critical that business owners correctly determine whether the individuals providing services are employees or independent contractors by carefully evaluating the relevant factors.
- In determining whether the person providing service is an employee or an independent contractor, all information that provides evidence of the degree of control and independence must be considered.

# Employee v. Independent Contractor Misclassification

- Why are employees misclassified?
  - Ignorance or Misapplication of applicable legal standards
    - Merely categorizing someone as an independent contractor does not make them one
    - Paying an individual as a non-employee and issuing a 1099 does not make them an independent contractor
  - Arrangements that have evolved over time and lost the proper characterization
  - Individual decision-maker fails to follow company policies or directives
  - “Cost” – independent contractors are cheaper than employees and some employers are willing to take the risk

# Damages and Theories of Recovery

- Wage and Hour Claims Under the FLSA
  - Misclassification of independent contractors can jeopardize FLSA compliance, particularly for workers in job classifications that would otherwise be non-exempt.
  - Typical problem scenario: Employer hires “independent contractors,” assuming then it does not need to make exemption determination or worry about hourly wage rates or overtime. Workers dissatisfied with perceived long hours, menial duties, or low pay claim misclassification.
- Commonly-litigated Issues:
  - Failure to pay minimum wage.
  - Failure to pay overtime.
  - Minimum wage and overtime claims often brought simultaneously.



# Determination of Contractor Status

## Different Agencies Use Different Tests

- Internal Revenue Service: Right to Control Test
- Fair Labor Standards Act: Economic Realities Test
- National Labor Relations Act: Common Law Agency Test
- Title VII of the Civil Rights Act of 1964: Combined Test
- Employment Retirement Income Security Act: Common Law Agency Test
- EDD
- Many varying state laws



# DOL

## New Guidelines



**SheppardMullin**

# Defining Independent Contractors

New Guidelines Issued by the U.S. Department of Labor in July 2015

- Broadened scope of “employment” in determining if worker is an employee or independent contractor
- “Suffer or Permit to Work” Standard
- “Economic Realities” Test

# Defining Independent Contractors

## “Economic Realities” Test

- Is the worker economically dependent on the employer, or in business for himself?
- Factors to consider:
- Is the work an integral part of the employer’s business?
- Does the worker’s managerial skill affect his opportunity for profit and loss?
- How does the worker’s relative investment compare to the employer’s investment? (cont.)

# Defining Independent Contractors

- Does the work performed require special skill or initiative?
- Is the relationship between the worker and the employer permanent or indefinite?
- What is the nature and degree of the employer's control?

# Defining Independent Contractors

## Takeaways

- Most workers will be found to be employees under this broader definition of “employment”
- DOL will likely be much more aggressive going after misclassified workers



# The IRS

# Employee v. Independent Contractor

## IRS Guidance

- 20 factor test has been replaced in an attempt by the IRS to simplify
- Factors now consolidated into 3 main groups with 11 factors
- “The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done.”



# Employee v. Independent Contractor

- Facts that provide evidence of the degree of control and independence fall into three categories:
  - Behavioral: Does the company control or have the right to control what the worker does and how the worker does his or her job?
  - Financial: Are the business aspects of the worker's job controlled by the payer? (Includes how the worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.?)
  - Type of Relationship: Are there written contracts or employee type benefits? (pension plan, insurance, vacation pay?) Will the relationship continue and is the work performed a key aspect of the business?

# Employee v. Independent Contractor

- Businesses must weigh all these factors when determining whether a worker is an employee or independent contractor.
- There is no “magic” or set number of factors that “makes” the worker an employee or an independent contractor, and no one factor stands alone in making this determination.
- Factors relevant in one situation may not be relevant in another.

# California



# California Agencies That Care

- Employment Development Department (EDD)-employment-related taxes
- Division of Labor Standards Enforcement (DLSE)--concerned with whether the wage, hour and workers' compensation insurance laws apply.
- Franchise Tax Board (FTB)
- Division of Workers' Compensation (DWC)
- Contractors State Licensing Board (CSLB)

# DLSE

- DLSE is charged with enforcement of worker misclassification.
- Employees must file complaint.
- The definition of willful misclassification is voluntarily and knowingly misclassifying an employee as an independent contractor.
- The misclassification of workers results in a loss of payroll tax revenue to the State, estimated at \$7 billion per year, and increased reliance on the public safety net by workers who are denied access to work-based protections like worker's compensation.

# DLSE Test

- DLSE starts with the presumption that the worker is an employee. Labor Code Section 3357.
- Rebuttable presumption and determination depends upon a number of factors
- Multi-factor" or the "economic realities" test adopted by the California Supreme Court in the case of *S. G. Borello & Sons, Inc. v Dept. of Industrial Relations* (1989) 48 Cal.3d 341.
- The most significant 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.

# California Labor Code 226.8 and 2753

- High priority target for federal and state enforcement
- Significant potential liability
- Additional exposure for “willful misclassification”
  - Defined as “avoiding employee status for an individual by voluntarily and knowingly misclassifying that individual as an independent contractor”
- Additional exposure for “willful misclassification”
  - Monetary penalties from \$5,000 to \$25,000 per violation
  - Joint and several liability for consultants
- Same penalties if employer erroneously charges fees to a misclassified independent contractor
- One year “scarlet letter” posting requirement



# IRS Form SS-8 (Checklist)

## **Part II** Behavioral Control (Provide names and titles of specific individuals, if applicable.)

- 1 What specific training and/or instruction is the worker given by the firm? \_\_\_\_\_
- 2 How does the worker receive work assignments? \_\_\_\_\_
- 3 Who determines the methods by which the assignments are performed? \_\_\_\_\_
- 4 Who is the worker required to contact if problems or complaints arise and who is responsible for their resolution? \_\_\_\_\_
- 5 What types of reports are required from the worker? Attach examples. \_\_\_\_\_
- 6 Describe the worker's daily routine such as his or her schedule or hours. \_\_\_\_\_
- 7 At what location(s) does the worker perform services (for example, firm's premises, own shop or office, home, customer's location)? Indicate the appropriate percentage of time the worker spends in each location, if more than one. \_\_\_\_\_
- 8 Describe any meetings the worker is required to attend and any penalties for not attending (for example, sales meetings, monthly meetings, staff meetings). \_\_\_\_\_
- 9 Is the worker required to provide the services personally? . . . . . ☐ Yes ☐ No
- 10 If substitutes or helpers are needed, who hires them? \_\_\_\_\_
- 11 If the worker hires the substitutes or helpers, is approval required? . . . . . ☐ Yes ☐ No  
If "Yes," by whom? \_\_\_\_\_
- 12 Who pays the substitutes or helpers? \_\_\_\_\_
- 13 Is the worker reimbursed if the worker pays the substitutes or helpers? . . . . . ☐ Yes ☐ No  
If "Yes," by whom? \_\_\_\_\_

# The EDD

How We Know What You Did Last Summer...



# Payroll Taxes

- Filing Reports - Quarterly
- Tax Audit Program
- Collection Division
- Audits & Investigation
- Assessments
- Information Exchange

# Statutory Employment

- Any officer of a corporation
- An agent-driver or commission-driver
- A traveling or city salesperson
- An unlicensed construction worker engaged to perform services for which a license is required
- Any member of a LLC treated as a Corporation
- Worker that has a work for hire provision in contract

# The EDD

## Common Misconceptions



# Common Misconceptions

**If I issue an Internal Revenue Service (IRS) Form 1099-MISC, then the worker is an independent contractor.**

**NOT TRUE** - An IRS Form 1099-MISC is simply a method the government uses to track and report certain types of non-employment income. Form 1099-MISC does not automatically make the worker an independent contractor.

# Common Misconceptions

**If I pay a worker less than \$600 in a year, then the worker is not subject to California payroll taxes.**

**NOT TRUE** - The amount paid to a worker is not, by itself, a factor in determining whether a worker is an employee or independent contractor. The amount paid to a worker may determine if you should issue an IRS Form 1099-MISC.



# Common Misconceptions

**The part-time, temporary, probationary, and substitute workers I employ are day laborers or casual laborers, not employees.**

**NOT TRUE** - An employee may perform services on a less-than-full-time permanent basis. The law does not exclude services from employment that are commonly referred to as day labor, part-time help, casual labor, temporary help, probationary, or outside labor.

# Common Misconceptions

**If a family member works for me, he/she is not an employee.**

**NOT TRUE** - Family members working for your business are employees and subject to California payroll taxes unless certain conditions are met.

# Common Misconceptions

**My worker and I have signed a written contract that makes my worker an independent contractor.**

**NOT TRUE** - A written contract or agreement does not necessarily depict the actual relationship. The actual practices of the parties in a relationship are more important than the wording of an agreement in determining whether a worker is an employee or independent contractor.

# Common Misconceptions

**My competitors treat their workers as independent contractors; therefore, it is okay for me to treat my workers as independent contractors.**

**NOT TRUE** - The law defines employment relationships, not you or the actions of your competitors. If you misclassify your workers as independent contractors, the Employment Development Department may assess you for the unpaid payroll taxes for any unreported employees.

# Common Misconceptions

**My worker performs similar work for other businesses, so the worker is an independent contractor.**

**NOT TRUE** - Performing similar work for other businesses is not, by itself, a determining factor. The relationship the worker may have with other businesses is not a controlling factor when determining the worker's status. The working relationship with each business is looked at separately.

# Common Misconceptions

**My worker has a city business license and business card, so the worker is an independent contractor.**

**NOT TRUE** - A city business license and business card, by themselves, do not make a worker an independent contractor. All of the common law factors need to be reviewed and weighed with respect to the specific circumstances of the services provided by each worker.

# Common Misconceptions

**I pay my workers solely by commission; therefore, they are independent contractors.**

**NOT TRUE** - The method of payment is not, by itself, a determining factor. All of the common law factors need to be considered and weighed to determine whether a worker is an employee. If the worker is an employee, then all payments for services (salary, hourly pay, piece rate, commissions, bonuses, stock options, vehicle, etc.) are wages.



# Resources

- *Information Sheet: Employment* (DE 231)
- *Information Sheet: Wages* (DE 231A)
- *Information Sheet: Casual Labor* (DE 231K)
- *Information Sheet: Family Employment* (DE 231FAM)
- *Employment Determination Guide* (DE 38)
- *Determination of Employment Work Status* (DE 1870)



# Resources (continued)

- Payroll Tax Seminars  
[www.edd.ca.gov/payroll\\_tax\\_seminars](http://www.edd.ca.gov/payroll_tax_seminars)
- Employment Status Web Based Seminar  
[www.edd.ca.gov/Payroll\\_Taxes/Web\\_Based\\_Seminars.htm](http://www.edd.ca.gov/Payroll_Taxes/Web_Based_Seminars.htm)

[www.edd.ca.gov](http://www.edd.ca.gov)

Taxpayer Assistance Center: 1-888-745-3886

# Online Services



**e-Services for Business  
Online. Anytime.**

<https://eddservices.edd.ca.gov>



**Connect With Us!**

[http://twitter.com/CA\\_EDD](http://twitter.com/CA_EDD)

[www.facebook.com/californiaedd](http://www.facebook.com/californiaedd)

[www.youtube.com/user/CaliforniaEDD](http://www.youtube.com/user/CaliforniaEDD)

## Ask EDD

**Important! Select the appropriate category from the list below. Otherwise it will delay the response.**

### Select a category.

Unemployment Insurance Benefits
Select Category
<b>Unemployment Insurance Benefits</b>
Report Fraud
Disability Insurance Benefits
Paid Family Leave
Jobs and Training
CalJOBS
Labor Market Information
Payroll Tax
Privacy
Public Records Request
Other
Legislative Issues
Work Opportunity Tax Credit (WOTC)

### Select a sub-category.

Select ONE and only ONE sub-category
EDD Tele-Cert
EDD Web-Cert
EDD Debit Card
<b>Claim Filing</b>
Alternate Base Period
Extensions
Payments
Claim Form
Update Information
Federal Extension REA Appointments
Appointment
Disqualifications & Appeals
Employment & Training
Other

<https://askedd.edd.ca.gov>

**Questions?**