



Putting the human back into human resources

New Focus on Independent Contractor v. Employment Status

When the new proposed federal budget was unveiled for 2010, it included some surprises for employers. Within the budget, the Federal Department of Labor (DOL) received a whopping \$117 billion in funds earmarked for worker protection programs. The Wage and Hour Division was allocated \$244 million, of which it anticipated allocating \$25 million to the new Misclassification Initiative. This initiative is focused on finding ways to eliminate any perceived incentive to employers to misclassify workers as Independent Contractors rather than employees.

The initiative expects to impose sanctions and penalties for misclassification both of workers as Independent Contractors as well as misclassification of employees as exempt employees under the executive, administrative, professional and outside sales exemptions provided under the Fair Labor Standards Act (FLSA).

Workers who are classified as Independent Contractors are generally not subject to employee tax withholding by the Company for which they provide work. However, if the worker is misclassified, they are also deprived of other benefits to which they may be legally entitled such as health, dental, and other benefits offered to other employees, as well as time off benefits such as vacation, sick, holiday or PTO hours. This may also result in lack of benefits under a retirement plan such as a 401(k) plan, coverage on a workers' compensation plan, and payment of overtime that would otherwise be required.

Additional exposure exists for companies who hire workers and incorrectly classify them as Independent Contractors, as they generally fail to contribute the appropriate taxes for unemployment, as well as to provide the required match to social security and Medicare taxes.

Under the new initiative, the DOL has hired 177 new investigators who are focused on enforcement of FLSA requirements regarding classification of workers.

The California Employment Development Department has been focused on the same investigational initiative for the past 18 to 24 months, and has developed a plan to work towards an audit of all employers and companies who file 1099 forms for Independent Contractors.

With the focus from both the federal DOL and the state Employment Development Department (EDD), it becomes imperative that all companies learn the distinctions in what constitutes an employment relationship versus an Independent Contractor relationship, both under the FLSA as well as the California Department of Labor Standards Enforcement (DLSE).

Many employers believe that the distinction is a matter of choice, or a philosophical determination, when in fact the criteria to make the determination is well outlined by both the federal DOL and the state DLSE. Both entities have developed a set of specific criteria used to make the determination. The federal DOL utilizes a 20 factor test, while the California DLSE looks to a 10 factor test that also relies on the federal

20 factor test as additional criteria. The California test is accompanied with a form DE 38 that employers may use in making the correct determination.

Within California, audits are routinely conducted by EDD, which usually includes a full audit of the company's complete financial records, in addition to their payroll records and tax returns. When a misclassification is discovered, EDD typically assesses the employer with the cost of State income tax withholding that should have been deducted from the payment, as well as the State unemployment (SUI) and disability insurance (SDI) taxes that should have been withheld or paid by the company.

Additionally, EDD has the ability, and often assesses a penalty for failure to issue the worker an itemized pay stub as required by California Labor Code, as well as a penalty for failure to maintain a time record for non-exempt worker. EDD may also assess an additional penalty for failure to maintain a time record of meal periods for non-exempt workers who work more than five hours in any work shift.

Many companies set workers up as Independent Contractors and subsequently issue the worker a 1099 for all monies paid each year. Frequently during an audit, companies disclose that this practice is being done at the request of the worker.

It is critical for companies to thoroughly understand the requirements under both the federal DOL as well as the state DLSE, as the burden falls on the employer to correctly classify all workers. Companies are also responsible to offer workers the benefits to which they are entitled, as well as to handle tax obligations according to the law. Failure to do so exposes the company to significant financial exposure, for taxes, penalties, as well as interest on the assessment that they may owe.

Additionally the company may find that they are responsible for additional recompense for benefits the worker did not receive, but to which they should have been entitled if they were correctly classified as an employee.

For correctly classified Independent Contractors, companies are required to file a Report of Independent Contractor, form DE 542 within 20 days of entering into a contract with a value of \$600.00 or more, or of paying the contractor \$600.00 or more.