Employee vs. Independent Contractor: Avoiding Misclassification and the New California "ABC Test"

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Most small business owners in the U.S. realize the importance of classifying workers correctly, whether as an employee or an independent contractor. However, business owners not familiar with the risks of misclassification may be tempted to simply label a worker as an "independent contractor," without examining the worker's true role in the company. After all, where a company retains the services of an independent contractor, the business can avoid payroll taxes and certain labor laws otherwise applicable to employees. This can prove a costly mistake.

The risks arising from misclassifying an employee as an independent contractor can be considerable. The hiring entity may find itself responsible to the employee for back pay for overtime, retroactive employee benefits, and even payment of the employee's back income taxes. Insurance companies may require retroactive insurance premium payments and the federal and state governments can assess significant penalties and interest in addition to the payment of back taxes. For example, California provides for new penalties of between $5,000 and $25,000 for the "willful misclassification" of independent contractors. If the employee retains counsel and brings a civil suit against the business, the business may become liable for the attorneys' fees incurred by the employee in bringing the lawsuit. Such fees can be significant.

How do you know if your worker is rightfully an independent contractor or an employee? It depends on where the employee is working, as each state can treat the issue differently. The Internal Revenue Service ("**IRS**") gives guidelines for federal tax purposes and

many, but not all, states follow the IRS guidelines or have enacted similar rules. However, the California Supreme Court recently strengthened the California guidelines for determining if a worker is an independent contractor or an employee.

The New California "ABC Test"

On April 30, 2018, the California Supreme Court handed down its decision in *Dynamex Operations West, Inc. v. Superior Court,* which clarified the standards that employers should use when determining whether their California workers should be classified as employees or independent contractors. The Court held that workers are presumed to be employees unless the hiring entity can prove that the worker qualifies as an independent contractor under the "ABC test" that is already being used in some other states.

In order to satisfy the requirements of the ABC test, the hiring entity must prove each of the following three factors:

a) That the worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact; *and*
b) That the worker performs work that is outside the usual course of the hiring entity's business; *and*
c) That the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed.

The application of this new test will require many companies to reevaluate the employment status of many of their workers. Some workers who may have qualified as independent contractors before this ruling may have to be converted to employees going forward.

Federal IRS Guidelines

Many states do not have specific guidelines for determining whether a worker is an employee or an independent contractor. In these situations, hiring entities must look to federal law for guidance. The IRS guidelines state that this determination is made through examining the relationship between the worker and the hiring entity. It is important to consider all evidence of the degree of control and independence. The IRS divides this evidence into three categories: 1) Behavioral Control, 2) Financial Control, and 3) the Type of Relationship of the parties.

Under Behavioral Control, it is important to determine whether the hiring entity has a right to direct and control what work is accomplished by the employee and how the work is completed. If the right to control and direct work exists, more likely than not, the worker is an employee.

Financial Control covers whether or not the hiring entity has a right to direct and control the financial and business aspects of the worker's job, including reimbursement of business expenses, whether the worker uses his own or the company's facilities or tools, whether the worker performs services for other companies, how the worker is paid, whether the worker receives paid vacation or other benefits, and whether or not the worker experiences a profit or loss. Again, where the business exercises financial control or offers benefits that shift risk from the worker to the employer, the more likely it is that an employment relationship will be found to exist.

In the Type of Relationship category, it is important to consider written contracts describing the relationship, although the label placed on the relationship by the parties will not be determinative of whether the worker is, in fact, an employee or independent contractor.

And even in instances where the contract for services does not provide employee-type benefits (such as insurance, pension plan, and paid time off) to a worker, that worker can still be found to be an employee. The trier of fact will consider the permanency of the relationship and whether or not the worker's services are key to the regular business of the company.

The "take away" for business owners is simple: be honest in your characterization of the worker and seek the assistance of a qualified attorney if there is the slightest question that the characterization may be challenged.

More information can be found on the IRS website or in Publication 1779, "Independent Contractor or Employee."

Each state may have different rules for avoiding misclassification of employees. Please contact us if you would like assistance conducting an analysis of your current workers.