New Fines For Misclassifying Independent Contractors

By Robert W. Wood

It's no secret that the Internal Revenue Service, U.S. Department of Labor and many state agencies are taking aim at businesses that use independent contractors. Paying an independent contractor means no wage withholding, no employment taxes (shared one-half each by employers and employees), no unemployment insurance, no workers' compensation, and no liability for pensions or fringe benefits. Companies can even avoid the legal hassles and red tape of nondiscrimination laws that generally cover only employees.

In fact, when you consider the advantages of using independent contractors, with the woefully amorphous question of which workers do and don't qualify, it's no wonder that some businesses push the envelope. And that leads to enforcement. Especially now that tax revenues everywhere are suffering, something has to give.

It isn't just the enforcement of existing laws that ramps up. The legislatures are adding to this already volatile stew. California's passage of SB 459 - set to take effect Jan. 1, 2012 - dramatically increases the stakes with these new rules: California's Labor and Workforce Development Agency (LWDA) can levy fines from $5,000 to $15,000 per violation for "willfully misclassifying" an employee; the penalty is increased to $25,000 per violation if there is a "pattern and practice" of "willfully misclassifying" workers; consultants who advise employers on independent contractor engagements that are later discredited face joint and several liability for these penalties. Notably, practicing lawyers are excluded; and it's unlawful to charge misclassified independent contractors any fee or take deductions from the compensation paid such contractors.

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This last rule may sound especially confusing, but it can have large potential effects. Some companies provide certain items to independent contractors and charge the contractor's account, deducting their cost from the contractor's pay. The new law adds a delicate wrinkle. If the contractor is reclassified as an employee, it becomes unlawful to make any such charge or deduction.

For example, a company might contract with an independent contractor for $50 an hour of pay, with a $20 deduction for the contractor's use of company equipment so that the contractor nets $30 per hour. If this contractor is reclassified as an employee, the company must pay $50 per hour despite the written contract. Common subjects for this kind of provision include goods, materials, space rental, services, government licenses, repairs, and equipment rentals or maintenance.

Such a provision could materially alter the economics and more than outweigh any potential savings from using contractors in the first place. Of course, many companies have been encouraged by advisers to use offsets in paying independent contractors (e.g., charging them for use of company facilities and equipment) to help bolster the arm's-length nature of the arrangement. Now employers may be hoist by their own petard.

These new barriers will probably scare some businesses away from using independent contractors. Note that these penalties *are in addition* to existing taxes, penalties and interest that may be imposed for misclassifying contractors. California's Labor Commissioner can enforce the law, but so can private parties by lawsuits.

Moreover, there could be enforcement by agencies, departments, commissions, boards and divisions of the LWDA. This would apparently include the Workers' Compensation Board, the Employment Development Department, and the California Unemployment Insurance Appeals Board.

Potential public relations issues should be addressed too. If a business is found to have willfully misclassified an independent contractor, a prominent public notice about the violation must be posted. For most businesses, this will be a prominent website notice, although any violator without a website must instead post the notice in a prominent location where the violation occurred that is accessible to employees and to the general public.

The notice must state that the entity was found to have willfully misclassified an independent contractor and that the employer changed its business practices to avoid committing further violations. It must inform persons who believe they have been misclassified how to contact the LWDA. The notice must be posted for a full year after the final (after all appeals) decision has been issued.

Who qualifies as an independent contractor or employee can be a difficult question by itself. In fact, some people have criticized the new law for not taking steps to help clarify that morass. Myriad factors are considered based on the amount of control the company has over the worker. As a result, misclassifications occur all the time.

Once you make a decision and treat a worker in a certain way, how do you know you won't be labeled as "willful" if it turns out you misclassified them? "Willful misclassification" means avoiding employee status for an individual "by voluntarily and knowingly misclassifying that individual as an independent contractor." Does a good faith dispute over the individual's classification mean you *can't* be "willful?"

Unfortunately, this is not clear, but businesses may now have an even greater incentive to make a good record of how they made decisions and why those decisions are defensible. The law does not try to address what is a "voluntary and knowing" act of misclassification. Employers who are not careful could end up defending themselves over such issues.

There has long been concern at the state and national level that the construction industry is particularly rife with misclassification. With no wage withholding, the workers may never pay their taxes. Even if they do, they will pay much later than via withholding and often will omit the self employment tax that is the counterpart to employment taxes. The new law therefore has an added provision about construction contractors.

Any final determination that a California licensed contractor has willfully misclassified a worker must be sent to the Contractors' State License Board. Apparently trying to avoid any doubt about what should happen next, the law says that the License Board "shall" initiate disciplinary action against the contractor within 30 days.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.