

Independent Contractors

Change Needed to Clarify, Simplify, Safeguard Status

Summary

Background

Workers and businesses seeking alternative work arrangements in response to economic, technological and social changes have created more opportunities for independent contractors than ever before. Individuals with an entrepreneurial spirit prefer the freedom and opportunities the independent contractor arrangement provides, while businesses seek creative, cost-effective mechanisms to fill specialized needs. The Government Accounting Office, in a report presented in July 2006, found that the number of independent contractors in the workforce grew from 6.7 percent in 1995 to 7.4 percent in 2005, bringing the nationwide total to 10.3 million.

The decision to classify a worker as an independent contractor or an employee is an important and challenging one for a business. The wrong decision, even if inadvertent, carries stiff consequences, such as back pay, back payroll taxes and fines. If the individual is found to be an employee and not an independent contractor, the employer also may be obligated to pay any required contributions, such as the employer's and employee's share of Medicare and Social Security, federal (and state) unemployment taxes, and workers' compensation benefits. Simply calling someone an independent contractor does not make them one in the legal sense. Enforcement and regulatory mechanisms are in place to deter deliberate fraudulent misclassification of employees as independent contractors, but still inadvertent misclassification occurs and is an ongoing problem creating an enormous liability for business.

Common Law Definition

Independent contractor status is determined by a set of factors applied to the treatment of the independent contractor. For the most part, independent contractors have been defined by common law as individuals who primarily:

- have discretion over and control of how contracted services are performed;
- customarily engage in an independently established business;
- have a risk of financial profit or loss;
- have control over the time and place the work is done;
- supply necessary tools and instruments; and
- perform work that requires a particular skill not ordinarily used in the course of the business with which they are contracting.

State, Federal Methods Differ

State and federal agencies, including the state Employment Development Department, the state Department of Industrial Relations and the Internal Revenue Service (IRS) have differing methods for determining independent contractor versus employee status. Each agency weighs its guideline elements differently and on a case-by-case basis. Because employers are subject to payroll taxes, benefits and workers' compensation for employees, misclassification, whether deliberate or inadvertent, triggers exposure to enormous liability, as follows:

- Unpaid payroll taxes plus penalty for failure to file to both the IRS and Franchise Tax Board.
- Unpaid taxes and penalties to the Employment Development Department for unemployment insurance.
- Back wages and other compensation.
- \$10,000 fine and one year jail time for failing to secure workers' compensation insurance.
- Attorney's fees.
- Compensatory, liquidated and punitive damages.
- Potential meal and rest period and other wage-and-hour violation penalties.

Instead of imposing new requirements and liabilities on businesses, California and the federal government should be looking at how the process of independent contractor versus employee classification could be improved and clarified. Businesses need to be confident that they have made sound business decisions by following clear and consistent guidelines or factors for classifying independent contractors. For example, some states have developed registration and exemption processes to help clarify who is and who is not an independent contractor. The California Chamber of Commerce will continue to evaluate the laws in other states to help identify and develop ways to revise the current complex and unreliable system.

Independent Contractors (continued)

Past Activity

In 2008, businesses successfully opposed two bills designed to deter the use of independent contractors:

- SB 1490 (Padilla; D-Pacoima), which died in the Senate Appropriations Committee, would have created a new requirement for persons hiring independent contractors. The provisions of the bill were potentially unenforceable, burdensome for businesses and costly to the state.
- SB 1583 (Corbett; D-San Leandro) proposed to hold an “advisor,” along with the decision-maker, jointly and severally liable for misclassifying an individual as an independent contractor, if it is later determined that the individual was misclassified, creating unjustified civil liability for “advisors.” This bill was vetoed by Governor Arnold Schwarzenegger.

Neither bill addressed the problem of clarifying and finding some assurance for businesses and independent contractors that they are properly treated as independent contractors.

CalChamber-opposed SB 622 (Padilla; D-Pacoima) in 2007 would have created a new excuse to sue employers and expose them to excessive new penalties for “willful misclassification” of independent contractors. The bill was vetoed by Governor Schwarzenegger.

It has been many years since California has seen a major legislative effort to clarify these guidelines and provide some level of certainty. In 1999, CalChamber-sponsored AB 70 (Cunneen; R-Los Altos) would have provided a “safe harbor” similar to that which the IRS enacted into federal law in 1978. The safe harbor defines actions the employer can take to establish the legitimacy of their classification, such as never having treated the individual in question as an employee, not having treated any workers holding substantially similar positions as employees, and having a reasonable basis for treating the individual as an independent contractor.

In 2000, CalChamber-sponsored AB 2737 (Margett; R-Arcadia/Cunneen; R-Cupertino) would have provided some clarity by putting into statute the complex, 20-point common law test used as a guide by the IRS to determine independent contractor status. This bill proposed that the test would be satisfied if the business could show that it had properly complied with 11 of the 20 rules. Although both AB 70 and AB 2737 received bipartisan support, neither made it to the Governor’s desk.

CalChamber Position

- Support legislation designed to clarify, simplify and safeguard independent contractor tax status.
- Oppose legislation that restricts or prohibits the use of independent contractors.
- Oppose increasing fines and penalties for misclassification.
- Support conformity between state and federal rules and regulations.

Reasons for Position

- California cannot afford to maintain the disincentive placed on businesses that use the services of independent contractors in good faith.
- Independent contracting presents a viable entrepreneurial opportunity for individuals to grow their own business, contributing to the health and growth of the California economy.
- Both businesses and independent contractors benefit from the contractual relationships.
- During this prolonged economic downturn, California should do all it can to stimulate and maintain successful businesses.

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