

Independent Contractors

Clear, Consistent Classification Guidelines Can Prevent Inadvertent Errors

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 U.S. Government Accountability Office, in a July 2006 report, 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.

Current State/Federal Policy

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. Simply calling someone an independent contractor does not make that person one in the legal sense. Enforcement and regulatory mechanisms are in place to deter deliberate fraudulent misclassification of employees as independent contractors, but inadvertent misclassification still occurs and is an ongoing problem creating an enormous liability for business.

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 business.

State and federal agencies, including the state Employment Development Department (EDD), the state Department of Industrial Relations and the federal Internal Revenue Service (IRS) have differing factors 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, which may include the following:

- unpaid payroll taxes plus penalty for failure to file to both the IRS and state Franchise Tax Board;
- unpaid taxes and penalties to the EDD for unemployment insurance;
- back wages and other compensation;
- \$10,000 fine and six months jail time;
- attorney's fees;
- compensatory, liquidated and punitive damages; and
- potential meal-and-rest period and other wage-and-hour violation penalties.

Instead of imposing new requirements and liabilities on businesses, California 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.

Past Activity

In 2008, businesses successfully opposed two bills designed to deter the use of independent contractors: SB 1490 (Padilla; D-Pacoima) and SB 1583 (Corbett; D-San Leandro). SB 1490, 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 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. Neither bill addressed

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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 the Governor.

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 adopted following the passage of federal legislation in 1978. The safe harbor defines actions the employer can take to establish the legitimacy of an employee's classification — such as never having treated the individual in question as an employee, not treating 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-Los Altos) would have provided some clarity by putting into statute the complex, 20-point common-law test the IRS uses as a guide 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

The CalChamber supports legislation designed to clarify, simplify and safeguard independent contractor tax status and opposes legislation that restricts or prohibits the use of independent contractors.

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 relationships.
- During a potentially prolonged period of economic uncertainty, California should do all it can to stimulate and maintain successful businesses.

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