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Management-side employment law advice for the entertainment industry

Classification of Workers: Independent Contractor versus Employee
by David Albert Pierce, Esq.

INTRODUCTION

Independent contractor status provides clear benefits to companies and to those individuals who choose to operate in that manner, provided that such status is accurate. Misclassification of a worker as an independent contractor can lead to significant federal and state liabilities including monetary penalties as well as other civil and criminal sanctions. Additionally, these penalties may be imposed on the company, as well as the individual(s) responsible for the misclassification. The penalties are so severe that companies should give great deliberation to the issue with the assistance of legal counsel before attempting to categorize a worker as an independent contractor.

Typically, tax collection agencies have been the most hostile toward independent contractor status. Recently, though, other parts of the federal government, such as the **Equal Employment Opportunity Commission ("EEOC")** have joined the attack. On a state level, the **Department of Labor Standards Enforcement ("DLSE")** scrutinize the classification of independent contractor status if a worker brings a wage claim or the company is subject to a DLSE audit. California's unemployment office which is known as the **Employment Development Department ("EDD")** gets involved when an independent contractor makes a claim for unemployment benefits and the employer objects on the grounds that the person was a contractor rather than an employee. This type of event can trigger audits resulting in astronomical penalties for the company that mis-classifies workers.

Several federal and state laws cover employers whose workers are employees. The most significant federal statutes are the **federal Internal Revenue Code ("IRC")** enforced by the IRS, and the **federal Fair Labor Standards Act ("FLSA")** enforced by the federal **Department of Labor ("DOL")**. Similarly, the California Franchise Tax Board regulates state tax withholdings and the state Department of Labor Standards Enforcement ("DLSE") regulates state wage-hour laws. The IRC obligates employers to

pay employment taxes (federal unemployment insurance, Social Security and Medicare) on behalf of employees and to withhold taxes (income, Social Security and Medicare) from employees. These obligations are not applicable to independent contractors. The DOL and DLSE require minimum and overtime wages to be paid to employees but not to independent contractors.

Similarly, workers' compensation laws also benefit employees but not independent contractors. And, any employer who has suffered the tragic event of a worker becoming seriously injured or killed on the job will tell you that the employer would much rather have that tragedy subject to the workers' compensation arena applicable to employee injuries than to have the tragedy played out in state court where an independent contractor's award for damages (and punitive damages) is left to the discretion of a jury.

Other employee rights and employer obligations are triggered where there is a *bona fide* employer-employee relationship. Generally, protection is available to employees, and not independent contractors, for: discrimination under the Age Discrimination in Employment Act, the Americans with Disabilities Act and Title VII of the Civil Rights Act; payments under the Social Security Act; and, leave under the federal and state family and medical leave laws. Alternatively, in the world of copyright law it is the independent contractors, and not employees, who enjoy certain copyright protection in their works under the Copyright Act. Therefore, it is necessary for an employer to understand who is properly classified an employee and who is an independent contractor.

Government agencies seem to focus their audits on certain industries. Agency statistics indicate that high-tech and entertainment companies are increasingly being examined.

Various federal agencies use one of two different tests for determining independent contract or status. Certain state agencies use a third type test for their own investigations. The tests are drawn from statutes, regulations, rules, policies, rulings, case law and the like. The more familiar test is called the "**right of control**" test, it applies under the IRC. The second test is called the "**economic reality**" test, it applies to the FLSA. A hybrid of these two tests often referred to as the "**multi-factor test**" is used by the California Division of Labor Standards Enforcement ("DLSE") in their analysis of determining who is an employee. These tests apply numerous factors to determine the nature of the employment relationship between the worker and employee; whether the worker is an independent contractor or employee. An employer can appropriately classify its workers only if it has an understanding of the facts underlying the employment relationship. Job situations are typically complex, and no one test addresses every scenario. It is also often unclear when to use which test and how to apply the right test, and since the tests frequently overlap, differentiating among them can be difficult. Moreover, using the tests to determine a worker's status can result in one result and application under one test and the opposite result and application under another. One court made the following observation about determining a worker's status:

[E]ven when the same person performs the same acts at the same time in the same place under the same conditions conceivably he could not be

considered an employee under some common law standards and some federal statutory definitions while he nevertheless could be considered an employee under those of others. This absence of a universality in qualities and definition unavoidably breeds ambiguity and confusion requiring courts to assess a broad spectrum of facts in their quest to clarify and determine who is and who is not an employee.⁽¹⁾

Thus, employers enter into dangerous waters when they attempt to classify a worker as an independent contractor, and simply because one federal or state agency may agree with the employer's classification does not mean that all other agencies will also find the classification to be proper.

Right to Control Test (IRC)

The right to control test, commonly applied by the IRS, distinguishes an employee from an independent contractor based on the extent of control an employer can exercise over a worker. The more control and supervision by the employer, the more likely the worker will be deemed an employee. The converse holds true as well -- the less control the employer can exercise, the more likely the worker will be considered an independent contractor. The right to control test takes a narrow approach to the employment relationship, focusing on only those factors that evidence control.

The control factors in this test are derived from case law in which courts analyzed employment relationships to determine when an employer can be held liable for the torts of its workers. The reasoning was that if an employer had control over its worker, then the employer should be liable to others for that worker's actions.

The common law control factors include:

1. The extent of control which it is agreed that the employer may exercise over the details of the work;
2. Whether or not the worker is engaged in a distinct business or occupation;
3. The kind of occupation, and whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision;
4. The skill required in the particular occupation;
5. Whether the employer or worker supplies the instrumentalities, tools and workplace;
6. The length of time for which the worker is employed;
7. The method of payment, whether by the time worked or by the job;
8. Whether or not the work is a part of the regular business of the employer;
9. Whether or not the parties believe they are creating an employer-employee relationship; and
10. Whether or not the worker does business with others.

Under the IRC, if the employer has the right to control the worker, that individual is deemed an employee and the company is subject to tax obligations. If the company does not exercise control over the worker but instead gives that worker significant independence, then the worker is generally viewed as an independent contractor.

The IRC definitions of employee and employer offer little guidance in distinguishing between employees and independent contractors. Specifically, the IRC defines a worker as simply: (A) an officer of the corporation; (B) an individual determined to be an employee under the common law rules; and (C) a statutory employee. However, a statutory employee is defined differently under the regulations for each of the three types of federal employment taxes; Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax Act (FUTA) taxes, and federal income tax withholding. The effect of the statutory employee provisions is to deem an individual who otherwise would qualify as an independent contractor under the common law factors to be an employee for tax purposes.

While the term employee is defined slightly differently for each of the federal employment taxes, the principal test of an employee status for purposes of all federal employment taxes is the common law test. The IRS has identified twenty factors to guide businesses in classifying workers as employees or independent contractors. Under the following circumstances identified by the IRS, a worker would typically be an employee:

1. Instructions are given to the worker.
2. Training is provided to the worker.
3. The worker's services are integrated in the business.
4. The worker's services are rendered personally and cannot be substituted.
5. The worker is hired, supervised and paid by the company.
6. A continuing company-worker relationship exists.
7. The worker has set hours of work.
8. The worker's full-time services are required.
9. Work is done on the company's premises.
10. There is an order or sequence set by the company for the worker.
11. The worker is required to submit reports.
12. The worker is paid by the hour, week or month rather than by the task.
13. The worker is reimbursed for business and/or traveling expenses.
14. The employer furnishes the tools/materials.
15. No major investment is required by the worker.
16. The worker cannot realize a profit or loss.
17. The worker cannot work for more than one business at a time.
18. The worker is limited in making services available to the general public.
19. The company can discharge the worker.
20. The worker can terminate the employment. [\(2\)](#)

Employer penalties can be severed for misclassifying, intentionally or not, an employee as an independent contractor. The employer may be obliged to pay back taxes and contributions, including the employer's and employee's share of Medicare and Social

Security, federal (and state) income taxes that should have been withheld, federal (and state) unemployment taxes, unemployment compensation taxes and workers' compensation benefits if the employee is injured on the job and was not covered under workers' compensation. Both tax and workers' compensation laws impose individual liability on the persons responsible for the misclassification if the company does not (or cannot) pay these amounts. In addition, to back taxes, interest and large penalties that often far more than the back tax itself are also assessed for improper classification of employees.

Economic Reality Test (FLSA)

The economic reality test, commonly applied under the FLSA, broadens coverage by taking a more inclusive approach to classifying a worker as an employee than the right to control test. The economic reality test focuses on the purpose of the legislation under which the test is applied. If the purpose of the law is to protect or benefit the worker, then the court looks to all the circumstances involved to determine the economic reality of the workplace situation. Generally, if the individual is not only controlled by, but also depends upon the employer, that person is an employee entitled to the coverage under that law rather than an independent contractor.

The rationale of this test is that it is important to compensate or provide protection to those who look to their employer for financial security and well-being. Factors in addition to those that simply emphasize control come into play such as legislative policies and purposes and the worker's role in relation to the operation of the company. This test generally applies to legislation requiring minimum wages and overtime pay, protection from discrimination, Social Security, retirement benefits, family and medical leave, unemployment insurance, and workers' compensation insurance.

An administrative ruling by the Department of Labor (DOL) Wage-Hour Administration summarized the FLSA economic reality test by stating that "an employee, as distinguished from a person who is engaged in a business of his own [an independent contractor], is one who, as a matter of economic reality follows the usual path of an employee and is dependent on the business which he serves."⁽³⁾ This Opinion Letter listed six factors courts found significant, and stated no single factor was controlling. Where these six factors exist, the worker is likely to be classified as an employee:

1. A limited amount of the worker's investment in facilities and equipment.
2. The nature (close supervision) and degree of control (high) retained or exercised by the company.
3. The worker's limited opportunities for profit and loss.
4. The small degree of the worker's independent initiative, judgment, and foresight in open market competition with others required for the success of the operation.
5. A high degree of permanency of the work relationship.

6. The broad extent to which the services are an integral part of the company's business.

Other courts interpreting the FLSA under the economic realities test also focus on how dependent the worker is on the company for continued work. Unlike an employee, an independent contractor does not depend solely on the company for economic stability and can, and often has to, pursue other jobs.

An employer who misclassifies an employee as an independent contractor under the FLSA, and therefore does not pay that worker minimum or overtime wages, may be liable for those wages and an equal amount as liquidated damages. Penalties are more severe for willful violators.

Multi-Factor Test (DLSE)

In determining whether a worker providing service to an employer is an independent contractor or an employee, there is no single determinative factor. Rather it is necessary to closely examine the facts of each service relationship and to then apply the multi-factor test adopted by the California Supreme Court in *S.G. Borello & Sons, Inc. v. Dept. of Industrial Relations* (1989) 48 Cal.3d 341.

Prior to *Borello*, the leading case on this subject was *Tieberg v. Unemployment Insurance Appeals Bd.* (1970) 2 Cal.3d 943, which held that "the principal test of an employment relationship is whether the person to whom service is rendered has the right to control the manner and means of accomplishing the result desired." Under this test, "if the employer has the authority to exercise complete control, whether or not that right is exercised with respect to all details, an employer-employee relationship exists."⁽⁴⁾

Borello brought about a sharp departure from this overriding focus on control over work details. The growers who were found to be employers by the *Borello* court did not have the authority to exercise supervision over work details, yet the court ruled that they retained "all necessary control" over their operations. The simplicity of the work, or the existence of a piece-rate based payment system, may make it unnecessary for an employer to assert control over work details. Under such circumstances, the employer may retain "all necessary control" by indirect means.

The control test applied rigidly and in isolation is often of little use in evaluating the infinite variety of service arrangements.⁽⁵⁾ While the right to control the work remains a significant factor, the *Borello* court identified the following additional factors that must be considered:

1. Whether the person performing services is engaged in an occupation or business distinct from that of the principal;
2. Whether or not the work is part of the regular business of the principal;

3. Whether the principal or the worker supplies the instrumentalities, tools and the place for the person doing the work;
4. Alleged employee's investment in the equipment or materials required by his task;
5. The skill required in the particular occupation;
6. Kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the principal or by a specialist without supervision;
7. Alleged employee's opportunity for profit or loss depending on his managerial skill;
8. Length of time for which the services are to be performed;
9. Degree of performance of the working relationship;
10. Method of payment, whether by time or by the job;
11. Whether or not the parties believe they are creating an employer-employee relationship.

These "individual factors cannot be applied mechanically as separate tests; they are intertwined and their weight depends often on particular combinations."⁽⁶⁾ These factors must be applied with "deference to the protective legislation," in a manner that will effectuate the provisions of the Labor Code, in view of the history and fundamental purposes of the legislation.⁽⁷⁾

The party seeking to avoid liability has the burden of proving that persons whose services he has retained are independent contractors rather than employees. Simply, there is a presumption of employment.⁽⁸⁾ "The modern tendency is to find employment when the work being done is an integral part of the regular business of the employer, and when the worker, relative to the employer does not furnish an independent business or professional service."⁽⁹⁾

The existence of a written agreement purporting to establish an independent contractor relationship is not determinative. "The label placed by the parties on their relationship is not dispositive, and subterfuge will not be countenanced."⁽¹⁰⁾ The Labor Commissioner, and the courts, will look behind any such agreement in order to examine the facts that characterize the parties' actual relationship. The fact that a person may be hired to work for only a short period of time is also not always a determinative factor. The so-called "share farmers," found to be employees in *Borello*, were engaged to provide services during the course of a sixty-day harvest season. Despite the seemingly temporary nature of this arrangement, the court observed that their seasonal positions are continuous and integrated into the grower's business. Similar analogies can be made to motion picture and television production companies utilizing temporary employees during the production period.

Conclusion

There is no one concrete definition for an independent contractor. A variety of tests for identifying the existence of a bona fide "independent contractor relationship" have been

established by courts, the IRS, unemployment departments, the Department of Labor and other government agencies. These different tests often place an employer in peril as one agency may find a bona fide independent contractor relationship exists while another unrelated agency may deem the independent contractor relationship a sham thereby causing liability to the employer.

Each of these tests contain a certain element of subjectivity. Generally, all of the tests seek to answer the same broad question of whether the individual is providing a service that a separate company would provide and whether the individual is acting like a separate company rather than as an employee. Independent contractors work at an "arms length" basis with the company that hires it and the contractor must exercise a level of discretion and independent intellect in the manner that he/she performs the contracted assignment. Since government agencies cannot agree on one precise definition, few employers are capable of rendering a determination without first understanding each test and how each test is interpreted. To this end, companies are encouraged to consult with skilled employment law counsel prior to classifying a worker as an independent contractor.

1. *EEOC v. Zippo Mfg. Co.*, 713 F.2d 32, 35-36 (3d Cir. 1983) (interpreting who is an employee under the Age Discrimination in Employment Act).

2. Rev. Rul. 87-41, 1987-1 C.B. 296. It is important to note that the ruling warns employers against excessive reliance on the factors. The IRS states that the factors are designed only as guides and cannot necessarily be applied across the board since typically no work situation embodies all of the factors. They also cannot be applied according to any mathematical formula -- while all of the factors may help determine if an individual is an employee under common law, the importance of each factor will vary based on the job and other facts.

3. W&H Opinion Letter, No. 832, June 25, 1968.

4. *Empire Star Mines Co. v. Cal. Emp. Com.* (1946) 28 Cal.2d 33, 43.

5. 48 Cal.3d at 350.

6. *Id.* at 351.

7. *Id.* at 353.

8. *Id.* at 349, 354; California Labor Code § 3357.

9. 48 Cal.3d at 357.

10. *Id.* at 349.