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Tax Trivia:

The new IRS Manual includes provisions for collecting taxes in the aftermath of a nuclear attack.

CALIFORNIA ADOPTS SUBSTANTIAL NEW PENALTIES FOR EMPLOYERS WHO “WILLFULLY” MISCLASSIFY WORKERS AS INDEPENDENT CONTRACTORS RATHER THAN EMPLOYEES

Classification of workers as employees or as independent contractors has long been a controversial and troubling issue in tax law. Many employers prefer to classify workers as independent contractors to avoid payroll tax liability and inclusion of such workers in employee benefit plans. The recession reportedly has only increased the number of employers who are doing so. Government agencies are generally biased towards employee classification so that the employer is required to withhold payroll taxes and bear liability for a significant portion of the payroll taxes, buy workers' compensation insurance, and laid-off employees are eligible for unemployment compensation. While contractors are legally obligated to pay equivalent self-employment taxes, the rate of noncompliance among contractors is significant.

SB 495 (codified as Sections 226.8 and 2753 of the Labor Code) provides a clear deterrent to classifying workers as independent contractors in all but crystal clear cases. Under SB 495, if the Labor and Workforce Development Agency (“Labor Agency”) or a court finds that an employer has “willfully” misclassified an individual as an independent contractor, the employer can be fined civil penalties of not less than \$5,000 or more than \$15,000 “per violation.” If the employer is found to have repeatedly misclassified individuals as independent contractors, the civil penalties will be no less than \$10,000 or more than \$25,000 “per violation.”

“Willful misclassification” is defined as “avoiding employee status for an individual by voluntarily and knowingly misclassifying that individual as an independent contractor.” The difficulty with determining whether an employer has “willfully” misclassified an individual as an independent contractor is the lack of a clear test for determining whether a worker is an employee or an independent contractor. A number of different factors are reviewed and weighed in making this determination and proper classification is often uncertain and often is in the eye of the beholder. When the beholder is an employee of the California EDD and Department of Labor, the worker is almost always deemed an employee. At this time, it is not clear how aggressive the government will be in asserting “voluntary and knowing misclassification” but given the State budget problems, the historic bias of the state agencies for employee classification and reports that more employers are classifying workers

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Tax Trivia:

Southerners called the Tariff of 1928 the "Tariff of Abominations"

CALIFORNIA ADOPTS SUBSTANTIAL NEW PENALTIES FOR EMPLOYERS WHO "WILLFULLY" MISCLASSIFY WORKERS AS INDEPENDENT CONTRACTORS RATHER THAN EMPLOYEES (CONT.)

as contractors to lighten their own financial burden during the recession, there is a significant possibility that the Labor Agency will rigorously enforce this new law.

The bill also provides for civil penalties "per violation" but nowhere does the bill explain what they intend to count as a "violation." There are a number of possibilities. Each paycheck paid to each contractor that fails to withhold taxes could amount to a "violation" and a separate penalty imposed for each check paid; each quarterly payroll tax return that fails to report the worker as an employee could be a "violation" and penalties imposed based on the number of quarterly returns so filed; a "violation" may refer to each misclassified worker so that only one penalty per misclassified worker is imposed; or it could mean something else. In any case, substantial penalties could roll up quickly.

In addition to the civil penalties, the bill imposes *scarlet letter* punishment. If an employer is found guilty of willfully misclassifying workers, the employer has to post prominently on its website in an area accessible to all employees and the general public (or if the employer does not have a website, at each location where violations occurred) a notice that must be signed by an officer, posted for one year, and which contains the following statements:

1. The employer has been found to have committed a serious violation of the law;
2. The employer has changed its business practices to avoid committing further violations;
3. That any employee who believes that he or she is being misclassified as a contractor can contact the Labor Agency (contact information for the Agency must be included); and
4. The notice is being posted pursuant to a state order.

If the employer is a licensed contractor, the Labor Agency will notify the Contractors' State License Board of the violation and the Board is required to initiate disciplinary action.

In addition, advisers who knowingly advise an employer to treat an individual as an independent contractor will be jointly and severally liable for the penalties if the individual is found not to be an independent contractor. Two categories of advisers are expressly

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Tax Trivia:

The Tax Code is 10 times
larger than the Bible.

CALIFORNIA ADOPTS SUBSTANTIAL NEW PENALTIES FOR EMPLOYERS WHO "WILLFULLY" MISCLASSIFY WORKERS AS INDEPENDENT CONTRACTORS RATHER THAN EMPLOYEES (CONT.)

excluded from this potential liability: (1) employees providing advice to their employer and (2) lawyers. Many accountants have become very concerned about this potential liability and will no longer advise clients on classifying workers (apparently the lawyer lobby was more assertive than the accountant lobby in this case).

Given the new punitive penalties, employers should carefully review all of the workers they treat as independent contractors and, when there is any doubt, reclassify the workers as employees.

In contrast to the stick enacted by SB 495, the IRS is encouraging employers to reclassify workers as employees with a carrot. In Announcement 2011-64, the IRS announced its Voluntary Classification Settlement Program (VCSP) which permits employers to reclassify workers as employees for future tax periods with substantial relief for federal employment taxes for past periods that the employer would owe if the workers were reclassified as employees for such past periods. To qualify for VCSP, the employer must not be under audit by either the IRS, Department of Labor or a state agency (i.e., the change over must be voluntary), must have consistently treated the workers as independent contractors, and must have filed all required Form 1099s for the previous three years. Under VCSP, the employer must agree to (1) pay slightly over 10% of the employment tax liability that would have been due on such workers for the last year; (2) will not be liable for any interest or penalties; (3) will not be subject to audit on the reclassified workers; and (4) will agree to extend the statute of limitations for three additional years for the first three years following reclassification. Form 8952, Application for Voluntary Classification Settlement Program, is used to apply for VCSP. For employers under audit, a less favorable Classification Settlement Program is available.

If you have any questions, please contact me at 310-441-2500 or mbarrett@mbarrettlaw.com.