

EARLE LAW OFFICES

A PROFESSIONAL CORPORATION

19925 Stevens Creek Boulevard

Post Office Box 1925

Cupertino, California 95015

WWW.EARLELAW.COM

408.786.1060

EARLELAW Newsletter

Risks and Benefits of Using Independent Contractors Instead of Employees

by Anthony F. Earle, Esq.*

May 2007

People who start and run businesses do so to earn profits. In order to maximize profits, it is necessary for a business to maximize revenue while simultaneously minimizing costs. Since labor is the single greatest expense for many businesses, it follows that many businesses endeavor to minimize the cost of labor so that profit will be maximized.

The cost of labor can vary depending upon whether the person performing the labor is classified as an “employee” or as an “independent contractor” (hereinafter “IC”).

The cost to a business of an employee consists not only of the salary or wage paid to the employee, but also the payroll taxes paid on behalf of the employee, as well as fringe benefits paid to the employee.

It is often said that when a business hires an employee, the business must then pay one half – the “employer’s share” – of the employee’s payroll taxes (Social Security and Medicare taxes, collectively known as “FICA” taxes). FICA taxes are currently 12.4 percent of the amount paid to a worker, with Social Security taxes (for 2007) paid on “only” the first \$97,500 of income. 6.2 percent is withheld from the employee’s gross pay; the employer pays the other 6.2 percent directly to the government. In reality, however, the employee is paying the entire 12.4 percent, as the employer would pay nothing if it had not hired the employee. Furthermore, a person who is self-employed as an IC is responsible for paying the entire 12.4 percent FICA tax.

Thus, where it is lawful to classify a worker as an IC rather than as an employee, the worker will, all other things being equal, need to demand (and receive) total remuneration that is 6.2 percent greater than total remuneration paid to an employee, in order to receive the same amount of total compensation.

The worker who is classified as an IC instead of as an employee must also receive greater monetary remuneration to compensate for benefits the worker would otherwise have received as an employee. Examples of such benefits include vacation time, sick leave, health insurance, and unemployment and disability insurance.

Initially, it may appear that it would be in the best interest of both employers and workers to classify workers as employees rather than ICs. Classifying workers as employees allows an employer to pay workers a lower cash wage and to provide certain fringe benefits to employees, the value of which may be greater to employees than is the cost to the employer.

However, where it is legal to do so, it often is advantageous to both employer and worker for the worker to be classified as an IC. The employer benefits because compensation paid to ICs is determined by actual results, e.g., completed work, rather than mere availability to work. In other words, employers pay ICs only for productive work which, in turn, usually lowers total payments to workers. Other significant advantages to the employer include not having to provide workers’ compensation and unemployment insurance for ICs, and not having to ensure compliance with the myriad of labor laws that

apply to employees but not to ICs. Taken together, these and other advantages which accrue to the employer who uses ICs instead of employees can result in substantial reductions to the employer's cost of labor.

Advantages to a worker of being classified as an IC rather than as an employee include the potential to earn – and retain – much greater income than would otherwise be possible as an employee, and to have greater freedom and security. As an employee, a worker typically will earn a fixed hourly wage or salary, regardless of how much or how little work is actually accomplished. An IC's earnings, on the other hand, are directly related to what the worker accomplishes. The harder the IC works and the more the IC accomplishes, the greater the IC's earnings.

Not only can a worker earn more, in absolute dollars, where the worker is classified as an IC rather than as an employee, the IC can also retain more of those earnings because an IC, unlike the employee, may deduct from taxable income various business expenses that an employee may not deduct, even though the employee may incur the same expense. The IC also has more freedom and security than the employee because the IC, unlike the employee, typically has many (or at least several) clients or customers, while the employee has but one employer. If, for some reason, an IC ceases to do business with a particular client or customer, the IC will be only partially unemployed, as the IC will still have other clients or customers from whom the IC can obtain work. The employee, however, typically has but one employer. If the employee ceases working for that one employer, the employee is completely unemployed.

Thus, where it is lawful to do so, hiring a worker as an IC rather than as an employee creates a win-win situation for employer and worker alike.

An "employee" is defined as "every person, including aliens and minors, rendering actual service in any business for an employer, whether gratuitously or for wages or pay, whether the wages or pay are measured by the standard of time, piece, task, commission, or other method of calculation, and whether the service is rendered on a commission, concessionaire, or other basis." Labor Code § 350(b). "Employee" is also defined as "every person in the service of an employer under any appointment or contract of hire or apprenticeship, express or implied,

oral or written, whether lawfully or unlawfully employed, and includes" aliens and minors, elected and appointed public officials, corporate officers and directors, household laborers, prison inmates in assigned work, members of a partnership or limited liability company, and certain other persons. Labor Code § 3351.

An IC, on the other hand, is defined as "any person who renders service for a specified recompense for a specified result, under the control of his principal as to the result of his work only and not as to the means by which such result is accomplished." Labor Code § 3353.

Factors which are considered important when determining whether a worker is an employee or IC include: "That the individual has the right to control and discretion as to the manner of performance of the contract for services in that the result of the work and not the means by which it is accomplished is the primary factor bargained for." Labor Code § 2750.5(a). "That the individual is customarily engaged in an independently established business." Labor Code § 2750.5(b). "That the individual's independent contractor status is bona fide and not a subterfuge to avoid employee status. A bona fide independent contractor status is further evidenced by the presence of cumulative factors such as substantial investment other than personal services in the business, holding out to be in business for oneself, bargaining for a contract to complete a specific project for compensation by project rather than by time, control over the time and place the work is performed, supplying the tools or instrumentalities used in the work other than tools and instrumentalities normally and customarily provided by employees, hiring employees, performing work that is not ordinarily in the course of the principal's work, performing work that requires a particular skill, holding a license pursuant to the Business and Professions Code, the intent by the parties that the work relationship is of an independent contractor status, or that the relationship is not severable or terminable at will by the principal but gives rise to an action for breach of contract." Labor Code § 2750.5(c).

Although it generally is less expensive for a business to hire an IC instead of an employee, doing so is not without risk.

Work performed by employees who are improperly classified as ICs may result in violations of minimum wage, overtime, payment of wage, unemployment, state disability, and other related laws. Remedies for such violations may be obtained, in certain cases, through direct suits by the employee against the employer, or through actions by various government agencies against the employer. Remedies for violations include recovery of unpaid wages, civil penalties, and, in certain cases, criminal sanctions.

A business that utilizes ICs instead of employees may also be subject to claims that it violates equal employment laws for alleged employment practices which are completely legal with respect to ICs, but unlawful with respect to employees. A ruling holding that the purported IC was in fact an employee and that otherwise lawful conduct is made unlawful simply as a result of the reclassification of the worker, could result in a substantial judgment being entered against the employer.

Furthermore, because ICs are not employees, ICs are not entitled to benefits under the Workers' Compensation Act. Therefore, ICs are not barred from bringing personal injury lawsuits against the employer for whom the IC works. Labor Code § 3600, 3706.

Finally, a business that improperly classifies workers as ICs instead of as employees may be subject to claims brought by its competitors under the Unfair Competition Act. Business & Professions Code § 17200 et seq.

In summary, classifying workers as ICs rather than employees, where lawful, provides significant advantages to both employers and workers. California and federal laws, however, strongly discourage this type of arrangement by providing for the imposition against employers of varied and substantial remedies to redress the improper classification of workers. Penalties and other remedies against workers for improperly accepting IC status are, as a practical matter, virtually non-existent.

Employers who contemplate classifying workers as ICs rather than as employees should seek and obtain appropriate legal advice prior to making this employment decision.

* Anthony F. Earle, Esq. represents individuals and small businesses in both litigation and non-litigation matters. Mr. Earle practices in the areas of business law, estate planning, family law, probate, real estate law, and trust administration.

Mr. Earle is licensed to practice law in all California state trial and appellate courts, the United States Court of Appeals for the Ninth Circuit, and federal trial courts in the Northern District of California. He is a member of the American Bar Association and the Santa Clara County Bar Association.

This *Newsletter* is not intended to provide readers or others with legal advice. Reading or receipt of this *Newsletter* does not constitute the creation of an attorney-client relationship. The information in this *Newsletter* should not be relied upon as a substitute for legal advice.

© 2007. All Rights Reserved.