

# WORKER CLASSIFICATION: BAN THE F-WORD

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The words “freelancer”, and even “permalancer” are often used in the creative business world. This makes the industry low hanging fruit for state payroll auditors.

Now that so many workers have filed for unemployment benefits due to COVID19 economics, it will be even easier for states to identify misclassified workers. A “misclassified worker” is one who was treated like an independent contractor who should have been put on payroll. When a person who received a federal form 1099-MISC files for unemployment benefits, payers can be identified easily.

In many states, legislation and guidance has been issued that goes beyond the IRS standard. The IRS standard, also called the Borello test, addresses the degree of control the “employer” exerts on the worker. It allows for some grey area, but ultimately, auditors interview the 1099 recipient to determine if that person truly understands how to operate an independent shop.

While the Borello test is still the easiest test to pass, it’s not a given. Many states are rewriting the rules to be less grey and more specific. The new rule is often called the ABC test (**see our blog on this test** if you are a Californian, or if it applies in your state). Know the rules where you work!

We all have our best chance at the beginning of the relationship to determine if we should classify a worker as a contractor or an employee. This determination should be done before we commit to pay a person in any fashion. Most importantly, it is up to the payer, not the recipient (!) to make this determination.

## Some rules of thumb:

Replace the word “freelancer” with vendor, supplier or contractor. You may have the perception that freelancers don’t go on payroll because they come and go, work for only a short time, and have other gigs. However, those workers may be temporary employees.

If the role they fill is a "usual and necessary" job for the company, they must go on payroll. For example, if you hire an Art Director at ad agency, they should go on staff every single time because that's a standard position at an agency.



*Need some help or clarification?  
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## Have your team ask these questions for us UP FRONT:

1. Do **we exert control** on the overall relationship and work details? Even if you're not exercising control but retain the right to do so.
2. Do they work from their **own office** and use their **own equipment** on their **own schedule**?
3. Can they hire their own staff to complete the project?
4. Will they **bill us for a JOB or PROJECT** as opposed to time billing?
5. Do they have a **business license**? If they provide that, it's proof to the EDD. This is our best work-around.
6. Can they show us **evidence that they carry their own General Liability Business and Workers Comp insurance**? (We want that, or we must cover them by the way.)

If those answers are predominantly "NO", or if it's not perfectly clear, we need to err on the conservative side, and put the person on payroll as "temporary staff". The HR Solutions Team will be happy to help with the classification when you're unsure.

If we get all "YES" answers, proceed and get a W9 - and copies of their biz license, web site home page, insurance certificates – before we pay them. Have them provide a contract or scope of work too; it is an exhibition of their control in the relationship. Do NOT pay them until you have the paperwork.

## Things that make us more comfortable classifying a worker as a contractor:

1. They are an LLC or an S-Corp = the W9 they fill out has a taxpayer ID that is not their SSN. \*Note that a single member LLC is not considered self-employed in some states, and that is specifically true in California.
2. They have their own staff or can subcontract the work we give them out to another worker if they get overloaded.
3. They have lots of other clients and obviously present themselves to the world independently from any other organization.
4. They provide a high level of skill, in a specialized field, and the high level of pay they receive makes that clear.
5. They give the payer the ICA with a Statement of Work (SOW), thereby showing "control" of the work relationship.



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## When Government Agencies Come Knocking

The risk is very high now, so we're heightening our attention to best possible practices! We can't "coach" people on how to be business owners and look right. The state employment department is now calling people we send 1099s to and they are interviewing them. They ask those questions above – and if their answers are not perfect, they reclassify the worker as an employee and charge back employment taxes, plus penalties and interest. Further, if just one worker is misclassified, the state may ask to see all records for all workers paid, both employees and contractors, and they ask for three years of records!

## Who are the enforcers?

- Department of Labor (DOL)
- Division of Labor Standards Enforcement (DLSE)
- CA Employment Development Department (EDD) or other state equivalent
- Franchise Tax Board (FTB)
- Department of Industrial Relations (DIR), including worker's comp. division
- Internal Revenue Service (IRS)
- Labor & Workforce Development Agency (LWDA)
- Contractor's State Licensing Board
- Private civil action – individual, class, collective & PAGA

## What will they ask for?

- 1099 forms
- Corporate Tax Returns
- State employment tax reports
- General ledger and general journal
- Annual Finance Statements (Income & Expense, Balance Sheet, etc.)
- W-2s and W-4s
- City business license/Ownership verification
- BOE Sales Tax License
- Sample ICAs
- Sample employment agreement (offer letters)
- Sample invoices sent to you by ICs
- Check registers, check stubs, cancelled checks and bank statements
- Contact info for ICs
- "Job" descriptions for independent contractors



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Crackdown continues full force in California and the cost of misclassifying is huge. This is the exposure:

- Federal Tax Liability
  - FICA contributions
  - Medicare contributions
  - FUTA contributions
  - Employee's federal income tax liability
  
- CA Tax Liability
  - Unemployment insurance
  - Employment training tax
  - Disability insurance
  - Employee's state income tax liability
  
- FLSA (Federal) and CA Wage/Hour Liability
  - Overtime, minimum wage
  - Missed meal/rest break premium pay (1 hour of pay for every occurrence)
  - Unreimbursed business expenses
  
- Worker's Compensation Liability
  - Personal injury for workplace injuries
  - Unpaid worker's comp premiums, penalties
  - Shutdown of business

In addition to the above, **penalties** for "voluntarily and knowingly" misclassifying an employee are assessed as follows:

- \$5,000 - \$10,000 per violation
- \$10,000 - \$25,000 per violation if pattern



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*Jenn has more than 25 years of outsourced HR, accounting and finance experience, with a particular expertise in startups and the advertising and creative production industries. She is passionate about seeing companies utilize the latest accounting and HR technology to maximize their efficiency, productivity, and ultimately, success.*

*Before joining Armanino, Jenn founded and led Team Jenn Corp., a firm dedicated to the strategic financial management of startups and small businesses, offering a comprehensive back office solution with accounting, finance and HR solutions. Previous roles include stints at advertising giant Ogilvy and Mather, and in the cash management industry.*

