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Independent Contractor Status Raises IRS Eyebrows

Contractor Status Is Cheaper for Employers; Some Workers Are Crying Foul

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LOS ANGELES - They donned DirecTV uniforms, drove cars bearing the company logo and installed equipment at the request of DirecTV supervisors.

But they weren't paid minimum wage or overtime, never got reimbursed for mileage, and had to foot the bill for ladders, hammers and cable connectors.

Saulo Guzman and Ivan Morales, installers working for a DirecTV subcontractor, are now going after the satellite television provider for allegedly violating labor codes by treating them as independent contractors even though DirecTV controlled virtually all aspects of their work, including assignments and scheduling, according to their complaint. Their lawyer is seeking class action status in the lawsuit, which was filed last year in Los Angeles Superior Court.

Federal and state governments are cracking down on companies that misclassify employees as independent contractors, a long-held practice that strips workers of many legal protections and amounts to billions in lost tax contributions to government agencies each year. The move may drive employers to self-regulate in an area where abuses have run rampant for decades but in doing so, expose themselves to future lawsuits over perceived past violations.

Since 2009, at least four states have passed laws giving labor enforcement agencies more teeth in auditing and penalizing companies that illegally classify employees as independent contractors. The latest proposal in Congress, the Employee Misclassification Prevention Act, was introduced by Sen. Sherrod Brown (D-OH) in the Senate and Rep. Lynn Woolsey (D-CA) in the House, in April.

In California, Attorney General Jerry Brown has for months prosecuted trucking companies over the alleged misclassification of truck drivers. Massachusetts Attorney General Martha Coakley has launched a similar campaign against restaurant meal delivery companies. And in February, President Obama proposed a \$25 million initiative to beef up enforcement efforts by the Department of Labor's Wage and Hour Division to track misclassification by employers. Also proposed are grants to state unemployment agencies to audit violators.

The flurry of enforcement activity is "exploding," employment lawyers say, and could compel employers to curb what labor groups have long called the exploitation of workers through misclassification.

"I expect to see an increasing number of government agency audits," said Mark Budensiek, a partner at Rutan & Tucker in Costa Mesa, who represents and advises employers. "Right now, I'm seeing an increased number of employers asking about the possibility of using independent contractors rather than hiring back employees. I tell them, 'Be careful. The government is going in the opposite direction you are.'"

For employers, classifying workers as independent contractors even though their role is, at a minimum, similar to that of a regular employee means saving money on benefits, unemployment contributions and workers' compensation. Contractors are not protected under most discrimination and health and safety laws, nor are they legally eligible for overtime pay and minimum wage, allowing employers to largely skirt liability in those areas.

But for governments, misclassification means getting shorted in tax contributions from employers. Up to 30 percent of U.S. employers illegally classify employees as independent contractors, creating a \$15 billion tax gap, according to statistics from the Department of Labor and the U.S. Government Accountability Office.

In California, audits by the state's Employment Development Department last year netted \$140 million in additional tax revenue from companies that misclassified some 70,000 workers. Among them was Merchandising Concept Group, Inc., which contracted with clothing manufacturers to make product displays in retail stores. The EDD found the company had misclassified 148 "detailers" workers who made the displays as contractors, and issued a \$110,000 penalty.

Improperly classifying employees is both a workers' rights and tax evasion issue that have intersected for years. But some say it's starting to take center stage as a labor-backed Democratic president holds office the same time a recession is prompting employers to rely more heavily on the practice to cut costs.

"It's an area that's quite ripe for the government to engage in those enforcement efforts," said Walter Cochran-Bond, a plaintiffs lawyer in Pasadena who represented public employees misclassified as temporary workers by the Metropolitan Water District. "The fact that their tax revenues have gone down gives them all the more reason to make sure they're receiving the taxes they should be receiving from these employers."

In the last decade, major class actions against corporations over alleged misclassification of workers have raked in record-breaking awards against WalMart, FedEx and Microsoft. In 2008, a wage-and-hour class action against the Orange County Register for classifying newspaper delivery carriers as independent contractors scored a nearly \$30 million settlement. Now, lawyers for the carriers are launching suits against four other California newspapers.

Incentives for employers to use and in some cases abuse independent contractors may be peaking, in light of the economic downturn.

"We're in a recession and employers can cut their labor costs by up to 30 percent if they move to an independent contractor model in certain areas of their business," said Stacey McKee Knight, a partner at Katten Muchin Rosenman in Los Angeles. "That independent contractor model is always going to be attractive because it's cheaper."

McKee Knight represents employers and management in many industries, including trucking and retail, in litigation arising out of claims of misclassification of independent contractors and exempt employment status. She has seen enforcement agencies who have a stake in worker misclassification the IRS, Department of Labor and California Employment Development Department investigate her clients with greater zeal than before.

In February, the IRS began a three-year effort to conduct random audits of 6,000 U.S. companies to make sure they pay their share of taxes.

"Self-regulation is critical right now because of the number of agencies looking at this issue," McKee Knight said. "I think there's going to be more investigations and audits. Before, you had these agencies that were beleaguered and understaffed. Now they're getting money committed to hiring people for this purpose. While it may not draw litigation, it's certainly going to tie up employers in audits."

Lawyers who represent plaintiffs in misclassification claims say that while enforcement is key, litigation will continue because it's simply too widespread a practice with not enough manpower to hold companies accountable.

"Of course we welcome any effort by government agencies, but I'm skeptical it's going to bring these practices to a halt," said Cornelia Dai, a civil rights attorney specializing in employment law at Hadsell Stormer Keeny Richardson & Renick in Pasadena. "There's going to continue to be much more litigation because employers will continue trying to keep costs down and this is an easy way to do it."

If companies begin to reclassify workers as a result of an audit, it could actually lead to more litigation, said Greg Karasik, a partner at Spiro Moss in Los Angeles who is representing the cable installers in the case against DirecTV.

"If they try to fix the problem, it could bring the problem to light," he said. "Companies not only have the immediate expense of having to pay them more money, but there's also the potential of exposing themselves to a lawsuit because now people realize they were employees and (can) seek compensation for the time they were misclassified. It's a risk a company takes. They have to evaluate whether they're better off taking the risk of enforcement action or a lawsuit."

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