Employers of Record and the Creative Production Industry: Solving the Problems of Employee Versus Contractor Misclassification and Employee Payroll Management

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Executive Summary

California's employee classification law, AB-5,[1] has been in force since 2020. Under AB-5 the general rule is that a worker is presumed to be an employee unless a legally recognized exception applies. Two kinds of legally recognized exceptions exist. One is if the law excludes a worker from being subject to it. The other is if the employer can successfully qualify a worker as a contractor by using an appropriate test method under the law. With few exceptions, such as a still photographer working under contract, creative production professionals do not qualify for exception to the general rule of AB-5. They are employees under California law.

Creative production companies have been slow to change their hiring policies and practices to prevent employee misclassification under the new law. Furthermore, so far, the state of California has not aggressively applied AB-5 to them. These employers should not, however, expect this lax enforcement environment to continue indefinitely. AB-5 has survived multiple federal and California state court challenges to its constitutionality.[2] It is not going to go away. Companies that continue to rely on pre-AB-5 ways of classifying workers as independent contractors, like hiring workers who hold themselves out as sole-member limited liability companies, may find these tactics ineffective against claims of misclassification.

Nationwide estimates of the percentage of employers that misclassify employees range from 10 to 30 percent.[3] Even when misclassification is not intentional, the consequences of misclassifying an employee as a contractor can be severe. In California, misclassification violations can lead to financial penalties and the need to compensate employees for minimum wages and overtime, plus liability for unpaid tax withholdings for income, unemployment, and Social Security. They may also be required to provide their new employees with workers' compensation coverage and employee benefits. California laws other than AB-5 can impose additional penalties for misclassification, and individuals can bring civil lawsuits on their own.

Using an employer of record (EOR) is a legal, safe, practical, and affordable way for creative production companies to hire project workers without having to worry about their status as employees or contractors under AB-5. In addition to ensuring labor law compliance, an EOR can also benefit a production company by taking over some of the administrative burdens associated with managing employees, like payroll responsibilities.

The ending of the California Covid-19 State of Emergency at the end of February 2023[4] will make it easier for creative production employers to resume full operation but will also expose them to increased AB-5 compliance scrutiny from state agencies and project personnel. Engaging with an EOR now will help ensure trouble-free labor relations going forward as the state continues to expand its enforcement of its presumptive employee classification for workers.

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[1] Bill Text - AB-5 Worker status: employees and independent contractors. (ca.gov)

[2] See, e.g., Supreme Court rejects challenge to California's worker classification law, letting AB5 stand

[3] Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs, U.S. Department of Labor Employment and Training Administration, February 2000

[4] Governor Newsom to End the COVID-19 State of Emergency

Employee Misclassification: The Problem and Why its Existing Solutions are Insufficient

"If you see ten troubles coming down the road, you can be sure that nine will run into the ditch before they reach you."

From the perspective of a California creative production company owner, Calvin Coolidge's quote above might have a calming effect - until you realize that the tenth trouble headed your way is the state's employee classification law, AB-5. Although this law has been effective from 2020, creative production companies have not yet fully understood its requirements nor the consequences for failing to meet them. Changes in California's labor environment, however - including the upholding of the constitutionality of AB-5 by state and federal courts and the ending of California's Covid-19 State of Emergency - suggest that complacency is no longer an option and continued ignorance of the law poses a significant threat of misclassifying employees as contractors.

Although AB-5 has captured the attention of California employers in recent years, by itself the law does not change how state and federal laws that govern employee classification work or the penalties for violating them. Therefore, analysis of AB-5 should be done in the context of the laws that come into play if a misclassification occurs.

This white paper will reveal how current practices that creative producers rely on to deal with the contractor-versus-employee question for project workers are unsatisfactory and unsustainable in the long term. Further, it will show that existing workarounds to workers becoming employees do not address all the potential problems that can occur when defining who an employee is and who is that person's employer. Lastly, this paper will suggest how, by engaging an employer of record to handle their worker hiring, these companies can best protect themselves from misclassifying employees.

Why Does Employee Misclassification Matter?

Even if it happens accidentally, misclassification is not a victimless crime. Although employers understandably tend to focus on the immediate consequences to themselves when it comes to the costs of misclassifying employees, the negative effects of misclassification burden many others as well.

- Misclassification hurts marketplace competition. Businesses that comply with employee classification laws are at a disadvantage to those that do not, because they can end up paying as much as 40 percent more in total labor costs.

- Misclassification hurts employees. Employees who are improperly classified as contractors lose out on significant advantages and benefits of employment status like overtime pay, workers compensation benefits, health and unemployment insurance, and family and medical leave benefits. They cannot bring lawsuits before the California Labor Commissioner to recover unpaid wages, cannot collect penalties for willfully unpaid wages, and have no employment-based right to sue for unlawful discrimination or retaliation.

- Misclassification hurts society. Every year the federal and state governments lose billions of dollars in uncollected Social Security, Medicare, unemployment insurance, and employee income tax revenues due to improperly classified workers.[5]

Employee misclassification happens more often than you may realize. It should come as no surprise, then, that governments have been putting more emphasis on cracking down on employers who misclassify their employees.

How Does Employee vs. Contractor Misclassification Happen?

Misclassifying employees as contractors comes from two main causes: *unintentional misclassifications*, such as good faith mistakes in interpreting and applying federal and California laws governing the employer-employee relationship, and *willful misclassifications*, which are misguided efforts to save money. Both can get a hiring company into legal and financial trouble. As we will see, though, federal and California labor laws distinguish between these two mindsets, treating a willful misclassification more severely than a mistaken interpretation of the law based on an honestly held belief.

***Question:* "As long as I issue models or other talent payment on their last day of work on the project, can I avoid wage claim complaints?"**

Answer: California law requires an employer who discharges an employee to immediately pay the employee all earned but as yet unpaid wages due that individual. This amount includes unused vacation hours that the employee has accumulated. If a wage-related dispute exists between the employer and the employee, then the employer must pay to the employee all wages or partial wages the employer does not dispute are owed to the employee. Employee wage claim complaints can, though, involve more than not being timely paid upon discharge. These complaints include claims for unpaid overtime, meal and rest breaks that were not provided, and for hours they worked off the clock.

Unintentional Misclassification

If a company is claiming that a worker is an independent contractor, then it is up to the company to prove that.[6] In the creative production industry many employers rely on widely held, long standing, and largely unquestioned beliefs about how to classify the personnel they hire for a project. These beliefs include:

- *Thinking that an independent contractor agreement between the parties will preclude the finding of an employer-employee relationship*. Courts generally try to defer to the intent of the parties in a contract if the purpose is legal, including the waiver of some legal rights or remedies. Employment agreements that contain employee non-compete and confidential information non-disclosure clauses, or that require employees to use binding arbitration of disputes instead of filing lawsuits, are examples of this. But employee misclassification is one area where courts and government agencies that enforce labor laws will disregard an agreement. An independent contractor

[5] Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention | U.S. GAO

[6] California Labor Code §5705(a)

agreement will not prevent a court or agency's conclusion that an employee relationship exists if the relevant classification test reveals such a relationship. The same is true for believing that using a 1099 form instead of a W-2 form will be persuasive in establishing a contractor relationship when the test points to one of employment.

- *Believing that a worker's expressed desire to work as a contractor will trump a governmental or judicial finding that the worker is an employee*. Some employees prefer to consider themselves contractors. Others mistakenly believe that they are. But in the same way that an independent contractor agreement will not override the creation of an employment relationship, the worker's honest desire or belief in being a contractor will not prevent that person being legally found to be an employee.

- *Relying on "traditional" treatment of some workers as contractors, based on the way things have always been done before coupled with a lack of worker complaints in the past*. As we will see, the California legislature wrote AB-5 to be comprehensive in identifying the proper worker classification test to use in virtually any work environment. This makes prior, common law-based understandings of who is an independent contractor unreliable. Knowing how AB-5 works is the cornerstone to understanding how to classify workers in any industry now, including creative productions.

- *Mistakenly thinking that the lack of significant California enforcement of AB-5 and other misclassification laws in the past will go on indefinitely*. Overcoming a sense of denial is an early step in the grieving process. Many California creative production employers who may have been hoping that the new, presumptive employee hiring environment that AB-5 creates would not affect them must now come to terms with the reality that the law has so far withstood repeated legal challenges and is in all probability here to stay. As a state government that loses income when employees are misclassified as contractors, California has a vested interest in overcoming employee misclassification regardless of where it happens. Creative production companies must accept that the time they must prepare for heightened scrutiny under AB-5 is borrowed.

***Question:* "Even though we have a worker on payroll, that individual is asking to be paid as a 1099 independent contractor. Can the worker's insistence on being treated as an independent contractor be a defense to a later employee misclassification claim?"**

Answer: Under California and federal labor laws, how employers and workers choose to categorize their employment or contractor relationship has no legal effect on worker classification. This is true even if a worker who is an employee under the ABC Test or a relevant alternative test asks to be treated as a contractor.

Willful Misclassification

A desire to test the limits of who is truly an independent contractor can be understandable, especially for companies that are struggling to manage labor costs; the brutal math is that employees cost more. According to some estimates, when costs including payroll taxes, minimum wage requirements, overtime pay, workers compensation, health and disability insurance, retirement pensions and matching 401(k) contributions, sick days, vacation days,

other employee benefits are accounted for, the cost of converting a contractor to an employee can raise that worker's cost to the company by about one-third.[7]

Comparison of workplace legal protections for employees and for independent contractors in the United States

Labor standard	Employee	Independent contractor
Minimum wage	√	X
Overtime pay	√	X
Unemployment insurance	√	X
Workers' compensation	√	X
Paid sick days	√	X
Paid family leave	√	X
Health and safety protections	√	X
Right to a union	√	X
Discrimination and sexual harassment protections	√	X

Source: EPI analysis of federal and state laws. Employees receive these protections in places where they are statutorily prescribed.

Economic Policy Institute

Another calculation concludes that when all the overhead costs are considered, an employer who hires an employee at a base $45 per hour versus a contractor at $75 per hour rate will ultimately pay a true $90 hourly for the employee as opposed to $83 hourly for the consultant.[8] As we will see, however, the cost of answering the employee-or-contractor question wrongly can easily outweigh any hoped-for savings on the part of the employer.

What is Willful Behavior in Misclassification?

California law defines willful misclassification as, "*avoiding employee status for an individual by voluntarily or knowingly misclassifying the individual as an independent contractor."*[9] What this means is that determining the state of mind of the people doing the hiring becomes important.

Under California law penalties for willful misclassification do not always apply to cases where a hiring company well-meaningly but still incorrectly classifies an employee as a contractor. California law leaves open, however, the possibility that other legal remedies may apply.[10] These remedies include those available under the federal Fair Labor Standards Act (FLSA).[11]

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[7] "How AB5 has instilled fear and confusion in California's arts community," Los Angeles Times, January 29, 2020; see also "Costs of an Employee vs. Independent Contractor," Houston Chronicle

[8] "Don't Be Fooled: Calculate the Real Cost of Employees and Consultants," Toptal Developers

[9] California Labor Code section 226.8(i)(4)

[10] California Labor Code section 226.8(j)

[11] 29 U.S.C. Section 201 et seq.

Real World Unintended and Willful Misclassification Examples

Published California court cases or administrative actions about independent contractor misclassification in the creative production industry are uncommon. We can, though, learn from two cases the California Labor Commissioner's Office cites as examples to show how much more serious the consequences are for willful misclassification. One addressed unintentional conduct, and the other willful behavior:

- In the unintentional misclassification example, the Department of Industrial Relations (DIR) found that a small courier business had misclassified its drivers as independent contractors instead of employees, apparently on the advice of its lawyer. The consequence was the issuance of a stop order and a fine of $1,000 per worker for failing to cover them under workers' compensation.[12] One possible mitigating factor in not finding willful behavior in this case was the reliance of the business owner on the advice of legal counsel in making its independent contractor determination.[13]

- In the willful example, the DIR concluded that a therapy provider which had incorrectly classified 1,280 therapists as independent contractors had acted deliberately. Here, the penalties are much harsher:[14]

Joint and several liability of the company and its Chief Executive Officer:

- $1,134,500 in damages owed to the misclassified employees.

- $1,677,500 as a civil penalty for not providing employees with itemized wage statements.

Company separate liability:

- $1,707,350 in damages for not giving written notice of sick leave balances and usage.

- $1,554,850 for violating sick leave provisions in California law.

- $2,710,000 in another civil penalty for willfully misclassifying the employees.

- $256,900 for not complying with paid sick leave recordkeeping requirements.

What are State and Federal Misclassification Laws Used in California?

California Laws

The California Labor Code

California requirements for minimum wages and overtime pay fall under the California Labor Code, which provides for employee complaints to the Labor Commissioner's Office for unpaid wage and overtime claims.

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[12] JKH Enterprises, Inc,. v. Department of Industrial Relations, 142 Cal. App. 4th 1046 (2006).

[13] Misclassification of workers as "independent contractors" rebuffed by the California Court of Appeal

[14] California Labor Commissioner Cites Therapy Provider for more than $9 Million for Misclassifying 1,280 Employees | California Department of Industrial Relations

AB-5

California Assembly Bill Number 5, commonly known as AB-5, became part of the California Labor Code in 2019. According to the California Legislative Analyst Office, in 2021 AB-5 applied to about one million California workers who work as independent contractors instead of employees.[15] The state legislature's inspiration for the law was the 2018 California Supreme Court decision in *Dynamex Operations West, Inc., v. Superior Court of Los Angeles*.[16] In its decision the state supreme court held that, for wage purposes, workers in California are employees by default unless the person or company doing the hiring can prove that the worker is an independent contractor.

AB-2257

After enacting AB-5 in 2020 the California state assembly passed a new law, AB-2257,[17] that modified the AB-5 ABC Test exceptions and added some new ones to cover referral agencies and service providers. This increased to 109 the total number of ABC Test exceptions.[18] For example, under AB-2257 still photographers can be professional services providers who – if they are not replacing an employee – are exempt from the ABC Test and are subject to the *Borello* test instead when they work under a written contract setting forth their pay rate and pay schedule and are not restricted to working for only one company.[19] Also, when they are making, marketing, or distributing sound recordings or musical compositions, still photographers working on recording photo shoots and album covers and film and television unit production crews working on live or recorded performances can be exempt from the ABC Test.[20]

The California Private Attorney General Act

Although the California Labor Code does not provide for a private cause of action by workers when the state does not act,[21] misclassified employees might be able to sue employers for misclassification under the California Private Attorney General Act (PAGA).[22] A plaintiff in such a lawsuit can seek against a misclassifying employer the same civil penalty as the LWDA could if it were to pursue the complaint.[23]

Unless otherwise provided for by state law, the civil penalty is $500 if the employer had no employees at the time of the alleged violation.[24] Otherwise, if the employer employed one or more employees then the civil penalty is $100 for each aggrieved employee per pay period for

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[15] The 2020-21 Budget: Staffing to Address New Independent Contractor Test

[16] 4 Cal. 5th 903 (2018)

[17] Bill Text - AB-2257 Worker classification: employees and independent contractors: occupations: professional services.

[18] AB 5 'Fix:' New Exemptions Added to California's Independent Contractor Law, California Globe, September 14, 2020

[19] California Labor Code Section 2778(b)(2)(l)(i)

[20] California Labor Code Section 2780

[21] California Labor Code §2699(h); see also Noe v. Superior Court, 237 Cal. App. 4th 316 (2015)

[22] California Labor Code § 2698 et seq.

[23] California Labor Code §2699(e)(1)

[24] California Labor Code §2699(f)(1)

the first violation and $200 per pay period for each additional violation.[25] The prevailing party in the lawsuit is entitled to recover attorney fees and costs connected with the lawsuit.[26]

Although an individual or class action lawsuit under California's PAGA can result in some recompense to wrongfully misclassified employees, the intent of the law is more to enforce public policy than to make aggrieved employees whole again. This is because three-quarters of any civil penalties assessed go to the LWDA while only one-quarter go to the employees.[27]

The California Unemployment Insurance Code

Worker unemployment insurance benefit claims come under this code, including claims of misclassified employees making claims for denied benefits.

The California Workers Compensation Act

This act governs worker claims for benefits based on work-related injuries or illnesses. Employees can make claims for workers' compensation benefits if they have been misclassified as independent contractors.

Federal Laws

The Federal Fair Labor Standards Act

Under the FLSA, for even unintentional misclassification errors employees can file lawsuits against employers to recover unpaid regular and overtime wages plus the cost of the lawsuit. If the misclassification is willful, then additional penalties can apply. Every year FLSA misclassification lawsuits cost employers across the country hundreds of millions of dollars in settlements and judgment awards:

	FY 2022	FY 2021
Back Wages	$213,161,638	$234,280,603
Employees Receiving Back Wages	152,970	193,349
Complaints Registered	19,408	20,279
Enforcement Hours	806,647	850,151.50
Average Days to Resolve Complaint	74	71.38
Concluded Cases	20,422	24,727

Source: U.S. Department of Labor, Wage and Hour Division[28]

[25] California Labor Code §2699(f)(2)
[26] California Labor Code §2699(g)
[27] California Labor Code §2699(j)
[28] U.S. Department of Labor, Wage and Hour Division, All Acts

The U.S. Supreme Court has ruled that "Congress intended to draw a significant distinction between ordinary violations and willful violations" of the FLSA.[29] It follows, then, that we should understand what an "ordinary" FLSA violation is and what a willful one is. The Court held that willful behavior is *voluntary, deliberate, and intentional* conduct that goes beyond simple negligence or an awareness of the existence of the FLSA.[30] Willful behavior is employer conduct showing either intent to misclassify an employee, or a "reckless disregard" for the risk of misclassification - that is, a risk so obvious that the employer should be aware of it.[31]

Some examples of reckless disregard include an employer's admission that it knew its payments were in violation of the FLSA before a complaint arose about it, or an employer's past FLSA violations, or its own internal investigations that should put the employer on notice of FLSA requirements, or failing to investigate FLSA-based complaints about pay practices and continuing those practices, or failing to keep accurate or complete records of employment.[32]

The National Labor Relations Act

The National Labor Relations Act (NLRA) concerns the ability of workers to organize. The National Labor Relations Board (NLRB) enforces NLRA claims. Contractors have no protection under the NLRA, and workers cannot file civil lawsuits under it.

Labor unions, businesses, and political parties can have strong preferences when it comes to how easy it should be for employees to organize. This translates into the NLRB being a hotly contested battleground for deciding whether workers should be considered employees to begin with. The NLRB's member composition can change significantly from one presidential administration to the next. This means that more than other federal agencies tasked with labor law enforcement, the NLRB's common law-based test for employee misclassification can vary considerably when the political winds in Washington, D.C. change direction.[33] For example, the Trump Administration changed the NLRB test for classifying employees from a test established during the Obama Administration, which in turn had changed the test used before it; under the Biden Administration the NLRB apparently seeks to change the test back to what it was during the Obama Administration.[34]

Although currently the ABC Test does not apply to worker or contractor classification under the NLRA, proposed legislation in Congress would, if enacted into law, make the ABC Test the standard for the NLRB to use.[35]

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[29] McLaughlin v. Richland Shoe Co., 486 US 128, 132 (1988)

[30] *McLaughlin*, 486 U.S. at 133

[31] Safeco Ins. Co. of America v. Burr, 551 U.S. 47, 68, (2007).

[32] See, e.g., Smith v. Keypoint Government Solutions Inc., No. 1:2015cv00865 - Document 95 (D. Colo. 2016)

[33] See, e.g., NLRB to Decide Whether Misclassification Is Standalone Violation of the NLRA, National Law Review, April 22, 2023

[34] NLRB Announces it Will Revisit its FedEx and SuperShuttle Decisions in Atlanta Opera | Foley & Lardner LLP, January 12, 2022; see also Biden's NLRB Targeting Employee Misclassification as Independent ULP | Husch Blackwell, March 4, 2022

[35] Text - H.R.842 - 117th Congress (2021-2022): Protecting the Right to Organize Act of 2021 | Congress.gov | Library of Congress

Who Enforces Employee Misclassification Laws?

As part of the California Labor Code AB-5 applies to California labor laws and wage orders, including those governing minimum wages, overtime pay, unemployment insurance, workers compensation, and paid family leave.

The California Labor and Workforce Development Agency (LWDA),[36] the Department of Industrial Relations (DIR)[37], the Bureau of Field Enforcement (BOFE),[38] and the Employment Development Department (EDD)[39] all have enforcement authority for claims involving worker misclassification, wage claims, payroll taxes, and payment of unemployment and worker's compensation insurance. As we will see later, except for limited situations like civil lawsuits and individual and class action lawsuits under the California Private Attorneys General Act,[40] workers generally do not have a private cause of action for misclassification under California law.

Where do Misclassification Complaints Come From?

A common way employers find themselves subject to being audited for employee misclassification is when employees file complaints. There are several ways how employee complaints can force the issue of misclassification with one or more California or federal government agencies:

- Employees can file a complaint for wages with the California Labor Commissioner's Office.[41]

- Employees can file a claim with the California Employment Development Department (EDD) for employment-related insurance benefits, such as unemployment insurance, disability insurance, and paid family leave.[42]

- Employees can file a complaint with the US Department of Labor for federal labor law violations.[43]

- An employee can request the Internal Revenue Service to determine that person's employment status for Federal tax purposes.[44]

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[36] Employment Status | LWDA (ca.gov)
[37] California Department of Industrial Relations - DIR Fraud Prevention
[38] DLSE - Bureau of Field Enforcement (ca.gov)
[39] Misclassified as an Independent Contractor (ca.gov)
[40] Private Attorneys General Act (PAGA) | LWDA
[41] Labor Commissioner's Office: How to File a Wage Claim. See also Report a Labor Law Violation
[42] Claims, State of California Employment Development Department
[43] How to File a Complaint | U.S. Department of Labor
[44] Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding

- Federal and California law allow an employee to file a civil lawsuit to seek money owed in unpaid wages.[45] It is not necessary for the employee to wait for or exhaust that person's government-related misclassification remedies to file such a lawsuit.[46]

Not all of these complaints will directly concern misclassification, but they are likely to trigger an investigation into the topic. For example, a claim for denied workers' compensation insurance benefits can lead to an investigation of that worker's employment status; or an IRS employment status request will lead to that agency issuing its own conclusions. These are non-binding in the legal sense, but if the IRS decides that an employment relationship exists then that is a red flag for the employer and for any investigating agency.

Some government agencies, like the EDD, do not necessarily wait for worker misclassification complaints but on their own initiative inspect and audit hiring companies to make sure that they are properly classifying employees for payroll tax requirements. Because multiple state agencies have enforcement authority over employee misclassification claims, employers who engage in the practice can soon find themselves subject to injunctive orders, damages claims, fines, tax liabilities, civil penalties, and even criminal liability.

What Happens if You Get Audited for Employee Misclassification?

For many California businesses that hire workers, their introduction to employee misclassification comes in the form of an audit. If you have not already experienced one, then let us begin our examination of misclassification by seeing how one works.

Example of an EDD Payroll Tax Audit

If you are the subject of an EDD audit, you can expect the following to occur:[47]

- An interview with an EDD auditor. This is the starting point of the audit, during which the auditor will explain the purpose of the audit and ask questions to learn about how your company is organized and how it operates. It is also an opportunity for you to ask any questions you have for the auditor.

- A review of your recordkeeping for your workers. This will usually begin with an examination of one calendar years' worth of payroll records and payments made, but can cover up to three years.

- A follow-up interview with the auditor about any questionable worker classifications and payments. If the auditor has questions about whether you are engaging in misclassifications or other labor law violations, this is where you will first encounter them. This interview, which can take place in person or by telephone, is also your opportunity to ask questions to the auditor. The object of this discussion will be to resolve with the auditor any findings that person may have from the audit.

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[45] See, e.g. 29 U.S.C. §216(b)

[46] See, e.g., Murphy v. Kenneth Cole Productions Inc., 40 Cal.4th 1094,1117 (2007)

[47] EMPLOYMENT TAX AUDIT PROCESS, California Employment Development Division

An EDD payroll tax audit will lead to one of four results: *No Change,* in which the auditor finds no actionable items; *Underpayment* or *Overpayment*, if applicable, or a combination of overpayments and underpayments.

What are the Tests Used to Classify Workers as Employees or Contractors?

The ABC Test

The purpose of the California state assembly in enacting AB-5 was to codify into statutory law the holding of the *Dynamex* decision. The immediate effect of the *Dynamex* decision was to simplify the procedure to determine whether an independent contractor relationship exists. In place of prior court decisions that required employers to consider up to eight considerations,[48] the court established a simpler three-part test that has become known as the "*ABC Test.*"[49]

The ABC Test is commonly used when classifying workers under the California Labor Code, the California Unemployment Insurance Code, and for California Wage Orders.[50] If any of these expressly define a term like "*employee*," "*employer*," "*employ*," or "*independent contractor,*" though, then that term controls over the ABC Test.[51] For example, in workers compensation cases, the Labor Code definition of the term "employee" controls.[52]

Under the ABC test a worker is legally considered to be an employee instead of an independent contractor *unless* the hiring person or company can prove *all* the following:

- **A: The autonomy of the worker**. *The worker is free from the control and direction of the hirer in connection with the performance of the work, both under the contract for the performance of such work and in fact.* A key question to consider here is whether the worker is subject to the kind of control that the hiring business typically exercises over employees. This control over the details of the work does not need to be direct or precise; if the overall nature of the arrangement between the parties and the work to be done

[48] S.G. Borello & Sons, Inc. v. Department of Industrial Relations, 48 Cal. 3d 342 (1989)
[49] California Labor and Workforce Development Agency, "ABC Test"
[50] California Labor Code §2775(b)(1)
[51] California Labor Code §2775(b)(2)
[52] California Labor Code §3551

supports an employee classification, then that can be enough to support a finding of employee status.

- **B: Business dissimilarity between the employer and the worker's services**. *The worker performs work that is outside the usual course of the hiring entity's business. An underlying assumption of the ABC Test is that businesses hire contractors to do work that they do not need to do in conducting regular business.* For example, a call center that hires a janitorial service to clean its facilities is unlikely to see the janitorial workers become employees because of the distinct nature of the work they do, unrelated to the call center's regular business. On the other hand, the more likely it is that a contractor is providing services that are comparable to those an employee would provide, the more likely it becomes that an employer-employee relationship will exist. **Of the three elements of the ABC Test it is this element that causes hiring companies the most trouble when trying to classify a worker as an independent contractor.**
- **C: The customary practices of the worker**. *The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity.* One way to hire additional workers to perform services like those of the hiring company is when the workers are themselves engaged in a business of their own and it is that business that the employer contracts with. This is also known as the "*business-to-business exception*" to the default employee classification. We will take a closer look at it next.

***Question:* "If the worker has a valid business license, and bills through that business, is that enough to qualify that person as an independent contractor?"**

Answer: Qualifying for the business-to-business exemption under AB-5 requires a contractor business to be more than a convenient way to avoid being classified as an employer. Agencies like the California EDD or LWDA will scrutinize a contractor business to see if it observes all the formalities of being a true legal entity, including whether it observes the required formalities of maintaining the business, whether the business has clients other than the employer, and how the business markets its services. If the investigation concludes that the contractor is not really a business, then it is more likely that an employer-employee relationship will result.

The Business-to-Business Exception: Dilettantes Need Not Apply

Before AB-5 became law, one indicator employers relied on when concluding that a worker was a contractor was to hire workers who hold themselves out as separate businesses. Not all such workers, however, take seriously the formalities of owning and operating a legal entity business - and not all employers take them seriously as such.

Arrangements between employers and workers to avoid the worker being classified as an employee by going through the motions of hiring a separate company, when the worker is still serving in the capacity of an individual, are something that the drafters of AB-5 squarely took aim at when drafting the new law.

Under AB-5 the worker's business must be real and not contrived. The advantages of doing business as a legal entity instead of a sole proprietor, like personal liability protection and certain tax advantages, are significant enough that state governments restrict how freely entrepreneurs

and professionals can take advantage of them. Generally, to qualify for protection as legal entities, companies like partnerships, limited liability companies, and corporations must take seriously the formal trappings of being a business. The more complex the nature of the legal entity, the more stringent the requirements are for it to shoulder these administrative burdens.

This commitment includes doing things like properly creating and maintaining the business entity under state law, drawing up proper organizational documentation such as bylaws or an operating agreement, holding required meetings and keeping required minutes and records, and obtaining all necessary licenses or other governmental and other qualifications to do business in their industries. Advertising and engaging in other marketing services as a legal entity and performing business services for more than one client can both be persuasive factors to support the existence of an independent contractor relationship.

Businesses that intentionally or through neglect fail to observe these legal formalities risk having a court disregard their claimed entity status. This is like the legal concept of *"piercing the corporate veil."* **A person who does not observe the customary burdens of operating and maintaining a legal business entity is unlikely to qualify as a business under the ABC Test**. Thus, for example, a worker who claims to be doing business as a legal entity like an LLC but who is a sole proprietor likely will not qualify as a business for the business-to-business exception. This is true even if the worker's intent to one day create the LLC is real.

Additional Classification Tests

Perhaps lost in the attention paid to the ABC Test is that it does not apply to all contractor-or-employee determinations.[53] Nor is it the test that the federal government and California may use depending on the circumstances.

The Borello "Manner and Means" Test

Most often under AB-5 the ABC Test is the first thing to consider for most employee-or-contractor situations. Two broad exceptions exist to this general rule, however, in which instead of the ABC Test an earlier, common law-based test can still apply. One of these exceptions is for certain professions including doctors, lawyers, architects, insurance professionals, accountants, and others.[54] The other is for cases in which a court finds that the ABC Test does not apply, but for reasons other than a different California statute taking precedence over AB-5.[55] This might occur if, for example, the court finds that a federal law preempts AB-5.

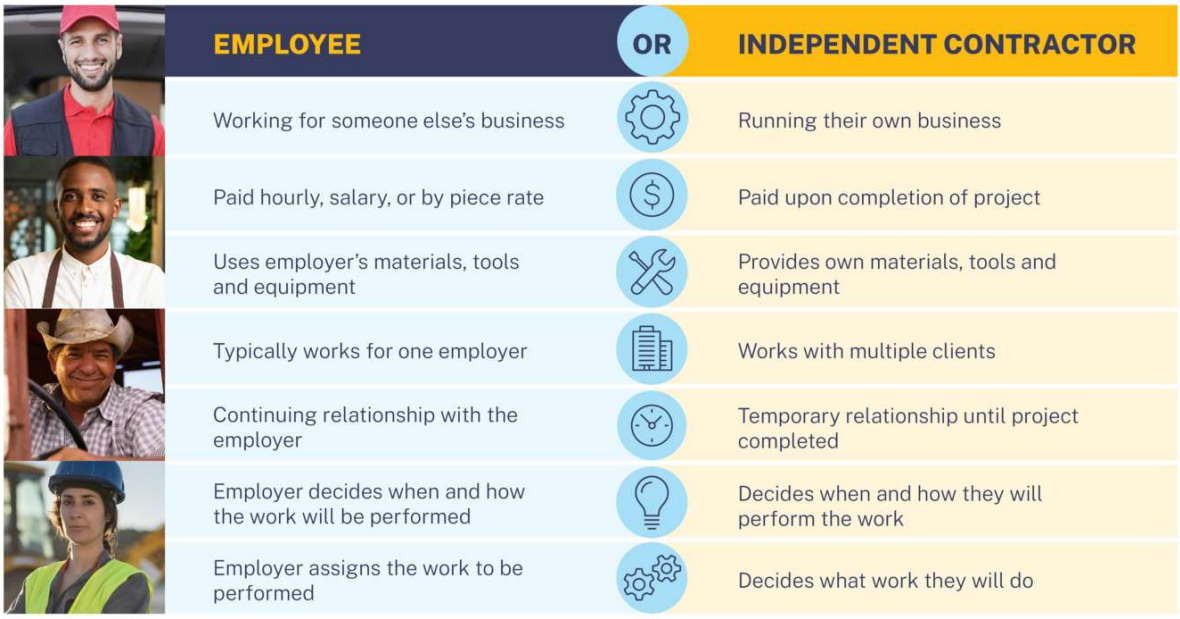
This pre-*Dynamex* common law test goes by two names: the manner and means test and the *Borello* test, after the 1989 California appeal court ruling that laid out its elements. Instead of the three requirements of the ABC Test, all of which the hiring company must meet to categorize a worker as a contractor, the *Borello* test includes several more factors to consider, and not all of them are of equal significance:[56]

- Does the worker performing the services hold out as being engaged in an occupation or

[53] California Labor Code §2775(b)(2) and (3)
[54] California Labor Code Section 2750.3(b)
[55] California Labor Code Section 2750.3(a)(3)
[56] *Borello*, 48 Cal.3d at 351.

business distinct from that of the employer?

- Is the work a regular or integral part of the employer's business?
- Who supplies the instruments, tools, and the place for the worker doing the work, the hiring business, or the worker?
- What has the worker invested in the business, like equipment or materials required by their task?
- Does the service provided require a special skill?
- Is the kind of occupation usually done under the direction of the employer or by a specialist without supervision?
- Does the worker's opportunity for profit or loss depend on their managerial skill?
- What is the length of time during which the services are to be performed?
- What is the degree of permanence of the working relationship?
- What is the method of payment, whether by time or by the job?
- Does the worker hire its own employees?
- Does the employer have the right to fire the worker at will? Or would worker termination give rise to an action for breach of contract?
- Do the worker and the hiring company believe they are creating an employer-employee relationship?



In addition to the *Borello* decision, the California Labor Code codifies factors that go into deciding the contractor-or-employee question.[57] Based on *Borello's* original 13 test elements, DIR guidance can consider up to 21 such factors.[58]

[57] California Labor Code Section 2750.5

[58] State of California, DIR, Division of Labor Standards Enforcement, "Independent Contractors"

Question: **"What job roles are exempt from AB-5? Is there anyone on set I can safely pay as a 1099 independent contractor?"**

Answer: AB-5 and its companion bill AB-2257 provide for more than 100 specific exemptions from the ABC-Test. Most of these exceptions are unrelated to the creative production industry. If your company hires still photographers, though, AB-2257 has provisions that might apply to them.

Under AB-2257 contracts for professional services providers that meet some specific conditions are not subject to the ABC Test. Still photographers are professional service providers for this purpose, as long as:

The photographer works with you under a written contract.

The project does not involve working in motion pictures, including

The contract specifies the rate of pay for the photographer.

The contract includes an obligation to pay the photographer by a defined time.

The photographer is not replacing an employee who was doing the same work for you at the same volume of work.

The photographer is not doing most of the project work at your business location.

The photographer is not restricted to working only for your company.

This is not the first series of qualifications that the photographer must meet. Next, the hiring company must prove all of the following:

The photographer has an independent business location separate from the hiring entity. This can be the photographer's home.

If the photographer works in a city or other jurisdiction in California that requires that person to have a business license or business tax registration to perform the professional services under the contract, then those must be in order along with any other professional licenses required for the individual to work as a professional photographer.

The photographer must be able to negotiate or set that person's own compensation rate.

Aside from the project end date and reasonable business hours, the photographer is free to set that individual's own hours of work.

The photographer customarily does the same kind of work with one or more other hiring companies, or at least holds out the photographer's professional services as being available to others.

The photographer must customarily and regularly exercise discretion and independent judgment in performing professional services.

If the photographer meets all of the criteria above, then the *Borello* test will apply to determine whether that person is an employee or an independent contractor. As you can see, California law has a strong preference toward seeing photographers classified as employees. It is not impossible to hire a photographer as an independent contractor providing professional services, but the requirements are extensive and detailed, and if you or the photographer fail to meet them all then the ABC Test exemption will likely not apply.

Other Employee Classification Tests

Some classification tests other than the ABC Test and the Borello test that can apply in limited situations include:

- California's employment anti-discrimination law test.[59] This test is outside the scope of this white paper, so we will not consider it further here.

- The federal "economic realities" test.[60] The Fair Labor Standards Act applies to employers who are engaged in interstate commerce or who have total annual sales of $500,000 or more.[61] For situations when the FLSA applies, courts apply a seven-part test that parallels several of the *Borello* test factors like the nature and degree of the employer's control over the worker, the permanency of the relationship, the amount of the worker's investment in facilities and equipment, and the extent to which the worker's services are integral to the employer's business.

- The IRS "control" test.[62] In cases where a tax court must determine whether a worker is a common law employee or an independent contractor, the court considers seven factors which, like the economic realities test, are like the *Borello* factors.

Consequences of Employee Misclassification

Because misclassifying employees as contractors can lead to violations of California and federal laws, those laws provide different kinds of remedies for misclassification violations. Generally, these include restitution remedies, employer fines, and additional civil and possibly criminal penalties. Although properly compensating employees is an important part of employee misclassification remedies, another purpose is to discourage repeat behavior by an offending employer and to serve as a warning to other companies not to make the same mistake.

If a company misclassifies an employee as a contractor, what happens next depends in part on whether the misclassification was willful. Unwitting or negligent misclassification will trigger some remedies and penalties. But if the misclassification is willful, then the financial and legal risks to the hiring company increase significantly.

Unintended Misclassification: The Negligence Standard

Unintended misclassifications are usually negligent ones, meaning that a reasonable person in the employer's place would not have drawn the same conclusions or made the same decisions that led to the contractor classification error. **A "good faith" mistake is not a form of absolution**. It does not excuse the employer from having to do right by its misclassified employees and the government by catching up on wages and taxes. Criminal negligence, like an unintended AB-5 or FLSA violation, is ordinarily a misdemeanor offense punishable by a year or less in jail and - compared to willful misclassification - relatively minor fines and penalties.

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[59] California Government Code Section 12940

[60] Fact Sheet 13: Employment Relationship Under the Fair Labor Standards Act (FLSA) | U.S. Department of Labor

[61] Fact Sheet 14: Coverage Under the Fair Labor Standards Act (FLSA)

[62] See, e.g., Weber v. Commissioner, 103 T.C. 378, 387, 1994 WL 461872 (Aug. 25, 1994), aff'd. per curiam, 60 F.3d 1104 (4th Cir. 1995)

Willful Misclassification: Intent or Reckless Disregard

The answer to whether an employer's misclassification is willful depends in part on whether federal or California law applies.

Willful Misclassification Under Federal Law: the FLSA

According to the U.S. Supreme Court, under the FLSA what escalates an unintended misclassification into a willful one is when the employer acts either purposefully or with a "reckless disregard" about whether its actions violate the law.[63] An example of purposeful behavior is deliberately misclassifying an employee as a contractor, knowing that person is an employee. An employer whose acts demonstrate an unjustifiably high risk of harm, that the employer knows about or is so obvious that it should know, engages in reckless disregard behavior.[64]

Examples of willful misclassifications that courts have found when applying the FLSA include:[65]

- An employer's admission that it knew its classification procedures were in violation of the FLSA before the employee complaint.
- After being put on notice of an FLSA violation, the employer continues with an allegedly improper practice without further investigation.
- Past FLSA violations that would put the employer on notice of FLSA requirements.
- Not keeping accurate employment records.
- Results of earlier internal investigations that disclosed similar FLSA violations.

Willful misclassification violations, being knowing or reckless in nature, are subject to more severe punishment than negligent infractions. These can include felony-level penalties that can lead to imprisonment at a state incarceration facility for more than a year and significantly higher fines and monetary penalties.

Federal Law: Unintended versus Willful Misclassification under the FLSA and other Laws

Penalty	**Unintended Misclassification**	**Willful Misclassification**
Employee misclassification penalty	From $5000-$15,000 per violation.	Additional fines of $10,000-$25,000 per violation.
Back payments to misclassified employees	Up to two years under the FLSA.[66]	Up to three years under the FLSA.

[63] See, e.g., McLaughlin v. Richland Shoe Co., 486 U.S. 128, 133 (1988)
[64] See, e.g., Safeco Insurance Co. of America v. Burr, 551 U.S. 47, 68 (2007)
[65] Smith v. Keypoint Government Solutions, Inc., No. 1:2015cv00865 (D. Colo. 2016)
[66] 29 U.S.C. §255(a)

Unpaid wage penalty[67]	Liquidated damages in an equal amount as the wages owed.[68]	• First violation, $100 for each failure to pay full wages. • Subsequent violations, $200 for each failure and 25% of the amount unlawfully withheld.
Waiting time penalty	None.	• Payment of up to a full day's wages for each full day the employee's final wage payment is delayed, cumulative to up to 30 days. • Payment of interest on amounts owed to the employee.
Attorney fees and court costs	May be included.[69]	May be included.
IRS tax penalties	For unemployment insurance, state disability insurance, employment training tax, and personal income tax. • Up to 3% of misclassified employee wages • 100% of unpaid employee FICA taxes • Up to 40% of FICA taxes not withheld from employee wages • $50 per W-2 tax form not filed for each misclassified employee	• Willful failure to collect taxes can lead to a penalty equal to the amount of tax not collected.[70] • Willful failure to collect taxes is also a felony punishable by imprisonment of more than one year. • Willfully failing to keep federal employment tax records is also a felony. • Individuals who are responsible to withhold federal employment taxes and who make false statements about the same commit a felony.
Wage statement penalty	• Fines. • Possible worker lawsuits.	Same as unintended.
Criminal penalties	Misdemeanor: • Fine of up to $1000. • Possible jail term of up to one year for failure to comply with recordkeeping requirements for hourly wage workers.	Felony: • Up to five years imprisonment for willful misclassification. • Fines of up to $100,000.

[67] 29 U.S.C. 216(b)
[68] 29 CFR §1620.33(b)
[69] 29 U.S.C. 216(b)
[70] 29 U.S.C. §6672(a)

Retaliation damages	Unlikely in the event of an unintentional misclassification.	Possible payment of employee wages from the day of employment termination.
Unpaid benefits under the Family and Medical Leave Act	For unpaid leave to employees covered by the FMLA.	Same as unintended.
Liquidated damages	Liquidated damages can be avoided if the employer can show the misclassification was in good faith or that reasonable grounds existed to believe the acts or omissions that constituted the alleged FLSA violations were not violations.[71]	For unpaid minimum wages and overtime compensation, successful plaintiffs can receive liquidated damages up to double the unpaid compensation amount.
Civil monetary penalty[72]	None.	Repeated or willful violations of the FLSA minimum wage or overtime provisions: $2,374 maximum per violation.[73]

Willful Misclassification Under California Law

The reason why the California Labor Code requires the misclassification to be willful is to deter nuisance actions against companies by requiring that the misclassification is an intentional or voluntary violation of a known legal duty, thereby making it more difficult to show a misclassification violation.[74] It is safe to say, though, that factors an auditor or court will consider when deciding whether an employer's misclassification was willful include the employer's intent, it's actions, it's knowledge of the relevant laws, and whether it has a history of misclassifications.

California Law: Unintended versus Willful Misclassification under the California Labor Code

Penalty	**Unintended Misclassification**	**Willful Misclassification**
Employee misclassification penalty	None: penalties only apply to willful misclassifications.[75]	From $5000-$15,000 per violation. Enforceable by LWDA[76] or by the Labor Commissioner in a civil suit.[77]
Civil penalty	• First offense, $100 for	• For each willful or

[71] 29 U.S.C. 260

[72] 29 U.S.C. 216(e)(2)

[73] Civil Money Penalty Inflation Adjustments | U.S. Department of Labor

[74] See "New California Law Prescribes Stiff Penalties for Employers' Willful Misclassification of Employees as Independent Contractors," National Law Review, October 12, 2011, citing the legislative staff comments to California Labor Code §226.8(i)(4)

[75] California Labor Code §226.8(a)(1)

[76] California Labor Code §226.8(b)

[77] California Labor Code §226.8(g); see also California Labor Code §98(a).

	each failure to pay each employee.[78] ● Each subsequent violation, $200 for each failure to pay each employee, plus 25 percent of the amount withheld.[79]	intentional violation, $200 for each failure to pay each employee, plus 25 percent of the amount withheld.[80] ● For "pattern or practice" willful violations, $10,000 to $25,000 per violation.[81] Enforceable by LWDA or by the Labor Commissioner in a civil suit.
Website notification of misclassification violation	None.	Employer's website must display for one year a notice that the LWDA or a court has found the employer has committed a serious misclassification violation, has changed its practices as a result, and provide LWDA contact information for employee misclassification claims.[82]
Joint and several liability	None.	A person other than an attorney or advisor to the employer who, for compensation or other consideration, knowingly advises the employer to misclassify an employee as a contractor will be jointly and severally liable with the employer.[83] Examples may include human resources, financial, and accounting personnel.
Back wages payments for minimum wages and overtime[84]	Up to three years.[85]	Up to three years.
Attorney fees and costs	May be awarded to the prevailing party for claims of wages nonpayment or employment-related benefits, but if employer prevails then fees and costs against employee only if employee action brought in bad faith.[86]	Same as for unintentional.

[78] California Labor Code §210(a)(1)
[79] California Labor Code §210(a)(2)
[80] California Labor Code §210(a)(2)
[81] California Labor Code §226.8(c)
[82] California Labor Code §226.8(e)(f)
[83] California Labor Code §2753(a)
[84] California Labor Code §510(a); see also California Labor Code §511
[85] See, e.g., Aubry v. Goldhor, 201 Cal.App.3d 399, 404 (1988)
[86] California Labor Code §218.5(a)

PAGA lawsuit[87]	Prevailing employees can receive 25 percent of civil penalties assessed against the employer,[88] plus attorney fees and costs of the lawsuit.[89]	Same as for unintentional.
Waiting time penalty[90]	None.	Willful failure to pay wages of an employee who is discharged or quits can lead to a penalty of up to 30 days' worth of wages.
Reimbursement for missed meal or rest breaks	None.	Penalty of up to 30 days' worth of the employee's wage, calculated using calendar days.[91]

The key takeaway from the table above is that the severity of the consequences of willfully misclassifying an employee under California law is a function of how many aggravating considerations apply: How many violations took place? How many workers were affected? And was a pattern or practice occurring? The more each of these are involved, the worse things get for the employer.

Financial Consequences for Misclassification

If employee misclassification happens, then a key goal of the enforcing state agency is to make the worker whole through restitution. This commonly involves payment of back-due minimum wages owed and any unpaid overtime. Another objective of the enforcing agency will be to bring the employer current with its new employment-related tax obligations, like payroll taxes, unemployment insurance, and workers' compensation contributions. If any of these are past due, then the employer can also be liable for penalties and interest that might accrue.

Additional Misclassification Consequences

Costs and penalties are not the only ways in which unwary or willful employers can suffer for bad decisions. A finding of misclassification can lead to a higher chance of being audited by the U.S. Department of Labor or by one of its California counterparts like the LWDA or the EDD. Misclassification of employees as contractors can lead to a broader inquiry as to whether the employer is also misclassifying between exempt and nonexempt employees. Furthermore, in some cases the employer will need to take additional steps including self-identifying on its website that it has misclassified employees in the past.

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[87] Private Attorneys General Act (PAGA) | LWDA

[88] California Labor Code §2699(j)

[89] California Labor Code §2699(g)

[90] California Labor Code §203(a)

[91] Waiting time penalties, State of California Department of Industrial Relations

Why Existing Ways to Avoid Misclassification are Unsatisfactory

AB-5 has gained much attention from California employers because of its presumed employee status and its ABC Test that makes it harder for employees to classify workers as independent contractors. But as we have shown above, the true significance of AB-5 is that it is the portal through which employers can face exposure to civil lawsuits, government administrative investigations, audits, fines, penalties, and in serious cases even a sentence to a county jail or California state prison.

It can help to think of AB-5 as buoy marking a field of dangerous underwater rocks at the mouth of a harbor, and you in your creative production business as a ship's captain trying to make that harbor. Seeing the buoy may be concerning, but it is the rocks you can't see that should worry you: AB-5 will not tear a gash into your business if you misclassify an employee as a contractor, but the laws that can get invoked if you do, like the California Labor Code and the Fair Labor Standards Act, can.

If we continue our harbor analogy further, as a business when you see AB-5 buoy dead ahead of you then you have some choices for what to do about it:

- *You can abandon your attempt to make the harbor*. AB-5 should not frighten nor discourage companies from doing business in California. In fact, by enacting AB-5 the California legislature has effectively placed the buoy over the rocks by creating a classification testing methodology to use where none existed before.

- *You can disregard the warning buoy and keep going full speed ahead*. Employers who have avoided employee misclassification troubles before by simply ignoring the possibility may be tempted into a sense of complacency. They may believe that AB-5 will not apply, or that the California regulatory agencies that investigate misclassification complaints will be too busy with high-profile industries like freight transportation or construction to get around to them.

  But as we have seen, even if you are not subject to an audit you can still become the subject of an employee claim or complaint from someone you thought was a contractor. *"Hope is not a strategy,"* as the saying goes, and going on as before in the hope that AB-5 and other misclassification laws will not affect you could lead to your own unfortunate confirmation of that saying.

- *You can attempt to pick your way through the rocks on your own and hope not to make a mistake*. Our analysis of misclassification laws should make it clear that misclassification laws can be complex and hard to apply. Federal and California laws on who is an employee and how you can tell were not written with non-lawyers in mind. Furthermore, the ways that the different employee classification laws interrelate can make it challenging to know which ones apply to you. The risk of missing a law, or misinterpreting one, is significant if you are unfamiliar with the legal framework. And

that you made your mistake inadvertently instead of willfully can be a cold comfort when your goal was not to make a mistake to begin with.

Retaining the services of a labor law attorney to guide you through the classification process can be time consuming and expensive; in our analogy it is like hiring your own underwater exploration survey team to draw up your own map of the rocks. It might work, but can you afford it?

- *You can obtain the services of a harbor pilot who knows where the rocks are and can safely take you past them*. What if someone exists who is already familiar with not only the AB-5 warning buoy, but also the rocks underneath it? Better still, what if that person is a dedicated harbor pilot, whose primary purpose is to make sure you get through to the safety of the harbor as quickly, safely, and easily as possible? When it comes to helping you to navigate your way past the perils of state and federal laws that govern misclassification, the equivalent of such a pilot exists in the form of an employer of record.

The Solution to Misclassification Worries: Use an Employer of Record

You Can Do it Yourself if You Want: Ways to Avoid Employee Misclassification

- *Be aware of the laws that apply to your business*. AB-5 is not the only California or federal law that can affect how you must classify your workers. Take advantage of government resources to learn about employee classification issues, like EDD Payroll Tax Seminars,[92] DIR labor law resources,[93] and Workers' Compensation.[94] The IRS also offers guidance on answering the employee-or-contractor question.[95]

- *Seek advice from the government*. If you aren't sure about how California will decide whether a worker is an employee or an independent contractor, then you do not need to guess. You can ask the EDD to make its own determination.[96] The IRS will also decide for you if you like.[97]

- *Seek legal advice from an attorney*. As this white paper should indicate, California and federal labor laws and their employee classification methods can be challenging to interpret and apply. What is more, the interconnection among federal and state employment, insurance, tax, and in serious situations even criminal laws can have

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[92] Payroll Tax Seminars, California Employment Development Department

[93] Before The First Employee Starts Work, California Department of Industrial Relations

[94] Division of Workers' Compensation, California Department of Industrial Relations

[95] Worker Classification 101: employee or independent contractor | Internal Revenue Service. See also Independent Contractor (Self-Employed) or Employee? | Internal Revenue Service

[96] EMPLOYMENT WORK STATUS DETERMINATION, California Employment Development Department. See also Determination of Employment Work Status for Purposes of State of California Employment Taxes and Personal Income Tax Withholding

[97] Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes, and Income Tax Withholding, Internal Revenue Service

ramifications on your business that an experienced labor and tax law attorney can help guide you through.

The trouble with relying on your own devices to comply with California and federal employee misclassification laws is that there are several of them, they are always subject to change, the consequences for getting them wrong can be severe, and in the creative production industry outside of still photographers under the ABC Test there is a good chance that everyone hired on the project will be an employee anyway. The only question will be who their employer will be.

This is where creative production firms can benefit from using an employer of record.

What is an Employer of Record?

An employer of record serves as the full legal employer of the workers who participate in your projects but leaves the day-to-day direction and supervision of their work under your control. The division of responsibility between you and the EOR is typically that the EOR handles administrative tasks including payroll, timekeeping, Worker's Compensation, and labor law compliance.

EOR co-employment services are not new; since the mid-20th Century they have been used extensively by businesses seeking to expand their operations into another country or state and want to avoid as much as possible the potential pitfalls of hiring employees there.

Some EOR services include:

- Onboarding employees, including verifications and background checks, and managing employment contracts.
- Monitoring employee attendance and other human resources activities.
- Responsibility for the worker's compensation and payroll, along with benefits and tax withholdings.
- Employee terminations.

Is an Employer of Record Different from a Professional Employment Organization?

Another term you may encounter in your consideration of an EOR is a *professional employment organization*, or PEO. How different a PEO is from an EOR depends in part on who you ask. For example, according to one view an EOR is distinct from a PEO because a PEO is a "co-employer" while an EOR has more possible employee-related liabilities than a co-employer does. Other takes on this question are not as clear-cut as this definition. One alternative interpretation is that a PEO provides EOR support as a contractual benefit to its clients. And according to the IRS, using a PEO is one way an employer can transfer its normal responsibility for paying employment taxes and filing returns to a third party if that party controls the payment of employee wages.[98]

[98] Third Party Payer Arrangements – Professional Employer Organizations | Internal Revenue Service

Our view is that, like how the government uses the behaviors of companies and workers to tell their status to one another instead of relying on formalities like labels they use to describe their relationship, trying to draw significant definitional differences between PEOs and an EORs is not as important as understanding the roles they play. Put another way, **it is unlikely that a finding that a worker is an employee instead of a contractor will turn on whether a PEO or an EOR was involved, but rather on how the client and the worker were acting toward one another and the applicable classification test to use.** Accordingly, for the rest of this white paper we will use the term employer of record or an EOR to apply to PEOs as well.

What are the Advantages of Using an Employer of Record?

"Chuck, you just make sure you stay in the chariot. I guarantee you're gonna win the damn race." That was the advice that stuntman Yakima Canutt gave to actor Charlton Heston before filming began on the chariot race scene in the movie *Ben Hur*. In a similar way, using an employer of record helps you as a creative producer to figuratively "stay in the chariot" when it comes to worker management: you stay focused on getting the most out of your workers, instead of worrying about potentially costly mistakes in classifying them or the consequences if you fail to comply with and stay current with changes in the payroll, tax, insurance, and labor law requirements that apply to them.

Engaging an employer of record cannot guarantee that you will always have smooth worker relations on a project. But it does address many of the labor-related problem areas creative producers have encountered before and still face under AB-5. Here are some specific ways how EORs help hiring companies to pay attention to what matters most in a creative production:

- Reduced risk of employee misclassification. EORs have helped businesses in California to stay out of contractor-versus-employee misclassification traps since before AB-5 became law. They are a proven way to ensure that your business can pass muster in any EDD audit and defend itself well in the event of a worker misclassification complaint.

- Compliance with current and developing federal and state payroll requirements. Avoiding employee misclassification is an important peace of mind benefit of using an EOR. A good EOR stays current with the latest California and federal changes in labor, tax, and insurance laws that affect their clients. Knowing your company's payroll procedures will not inadvertently get you into trouble is another way that an EOR can help you focus on getting the most from your workers instead of making a mistake with the laws and hoping the Labor Commissioner's office will only penalize you for an inadvertent misclassification instead of a willful one.

- Keeping complete - and secure - worker records. When looking for evidence of employee misclassification, a company's recordkeeping system is one of the first things that an auditor or a plaintiff's attorney will vigorously check. If your recordkeeping complies, then it becomes an integral part of your defense. But if you have not kept adequate records, then the door opens to one of the most common ways that a government auditor or a court can conclude that any employee misclassification violation was reckless or even willful.

- Better employee benefits. One reason why some employers try to classify workers as contractors is to avoid paying employee benefits. In the current California environment that presumes an employment relationship exists until proven otherwise, though, it is more likely that creative production companies will not be able to go on creatively classifying workers as independent contractors. In an employer-employee environment, EORs can provide their workers with employee benefits in ways the creative production enterprise might not be able to.

Are There Any Potential Pitfalls to Look for When Using an EOR?

By nature, an EOR relationship requires a division of responsibilities for the employees of the EOR. The client company has authority over the day-to-day activities of the employees, but the EOR retains the authority for hiring and where necessary disciplining or firing its employees. The client company has input into the EOL's decision making, like requesting that an employee be terminated from the project, but the responsibility to act lies solely with the EOR. This can in some situations lead to delays in the client company's ability to have its wishes carried out by the EOR.

Another potential pitfall is if the EOR fails to perform its payroll-related co-employer responsibilities like tax withholdings, the IRS can hold the client company liable for them.

Joint Employment

Joint employment is usually not the intent of the EOR and the client company but rather the result of blurred responsibilities between them, like the client company exercising HR-related decisions over the workers. Instead of a co-employment relationship between the EOR and the client company a government agency or a court might conclude that a joint employment relationship exists. In such an arrangement the employee effectively has two employers.

An example of joint employment might involve an EOR that does little to supervise its employees working for the client, often not checking on them for several days at a time, thereby effectively leaving them to the full discretion of the client company.[99] Also, under the California Labor Code an employer that willfully participates with another company to misclassify an employee is jointly liable with that other company. Note, however, that if one company willfully misclassifies an employee but the other company does not knowingly go along with it, then joint liability for co-employment does not apply.[100]

Employee Leasing

The term "employee leasing" has a general meaning, and in California a statutory one as well. The general definition of an employee leasing arrangement is one in which a staffing company supplies its clients with temporary employees, often to supplement the client's existing workforce. When the client no longer needs the leased employees, they return to the staffing company.

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[99] See, e.g., Boire v. Greyhound Corp., 376 U.S. 473 (1964)

[100] Noe v. Superior Court, 237 Cal. App. 4th 316 (2015)

In California, employee leasing is also a term used in the California Unemployment Insurance Code to cover EOR activities for client companies. In an employee leasing arrangement, a leasing employer (also referred to under the law as a temporary services employer) provides workers to clients on a temporary basis.[101] The client directs the worker's day-to-day work activities, while the leasing company handles things like payroll and tax withholdings.

The leasing employer negotiates with the client on behalf of the worker. The points of negotiation include by now topics that may be familiar to you when establishing an employee or contractor relationship:

- The time, place, and type of work, along with working conditions, quality of work, and cost of the worker's services.[102]
- Determining the worker's assignment or reassignment, although the workers can refuse specific assignments.[103]
- Retention of authority to assign or reassign a worker to another client, either in general[104] or if a client finds the worker unacceptable.[105]
- Setting the pay rate for the worker, through negotiation or otherwise.[106]
- Paying the worker from its own account.[107]
- Retaining the right to hire or fire workers.[108]

The existence of this leasing employer relationship is determinative for worker classification under the Unemployment Insurance Code:[109]

- If a client contracts with a leasing employer for a worker to provide services, then the leasing employer is the worker's employer.
- If, however, the client hires a worker from someone else who is not a leasing employer, then if the client pays the worker's salary the client becomes the worker's employer.
- If the non-leasing employer that provided the worker to the client pays the worker's wages, then the non-leasing employer does so as the agent of the client employer.

In a situation where a company "loans" an employee to another company outside of a leasing employer arrangement, who pays the loaned worker will decide who that person's actual employer is. If the loaning company continues to pay the employee's wages, then that company remains the worker's employer even if the borrowing company reimburses the loaning company.

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[101] California Unemployment Insurance Code §606.5(b).
[102] California Unemployment Insurance Code §606.5(b)(1)
[103] California Unemployment Insurance Code §606.5(b)(2)
[104] California Unemployment Insurance Code §606.5(b)(4)
[105] California Unemployment Insurance Code §606.5(b)(3)
[106] California Unemployment Insurance Code §606.5(b)(5)
[107] California Unemployment Insurance Code §606.5(b)(6)
[108] California Unemployment Insurance Code §606.5(b)(7)
[109] California Unemployment Insurance Code §606.5(c)

But if the borrowing company pays the loaned worker, then even if the loaning company still pays that worker, the borrowing company will still legally be the employer.[110]

Specific Ways EOR Relationships Benefit Creative Productions

Are There Any Independent Contractors Left in Creative Productions Today?

In California AB-5 is the beginning of the process of knowing whether a worker is an employee or a contractor. Its purpose is to establish the employee classification test standard to use. For most California businesses that hire workers, the ABC Test is the one to use unless a recognized exception exists, in which case an alternative test applies.[111] We have not described these exceptions in any detail, save for still photographers, because they do not apply to the kinds of talent and workers who contribute to creative production projects.

What you can take away from this is that creative production workers are likely subject to the AB-5 Test. And given the difficulty many creative production enterprises will have in overcoming the "B" part of that test ("*The worker performs work that is outside the usual course of the hiring entity's business*), it is also likely that your relationships with most workers hired to the project will be employer-employee ones. Situations may exist in which an independent contractor classification is proper, but as a rule companies that use the ABC Test must be ready to have employees and to deal with employee issues.

What Can an EOR do in the Creative Production Industry?

The first thing an EOR can do for a creative production company that needs to hire talent and production staff is to help make sure they are classified properly under California and federal laws. But that is only the start of the benefits of engaging an EOR.

"Payroll is payroll" - or is it? Although it is true that general principles of payroll, insurance, and regulatory compliance apply to all companies that have employees and not just those involved with creative productions, there are some unique aspects to creative productions that go beyond the basics.

For example, in California hiring the talent used in creative productions often involves dealing with talent agencies instead of more generic referral agencies; is the EOR experienced in working with talent agencies?

[110] California Unemployment Insurance Code §606.5(d)

[111] See, e.g., AB-2257 and Proposition 22

Question: **"If I hire a model or other talent through a referral agency, am I protected from employee misclassification claims?"**

Answer: AB-2257 allows companies to hire service providers through referral agencies. If the referral agency and the service provider both meet qualifications contained in the law, then instead of the ABC Test the *Borello* test will apply to answer the question of whether the service provider working for the client is an employee of the referral agency or an independent contractor of the referral agency.

The terms "client," "referral agency" and "service provider" are subject to statutory definition under the law:

> A *client* is a person or company that uses the referral agency to contract for service provider services, or a business that contracts with a referral agency to provide services from one or more service providers, who in turn must provide services to the client that are not provided on a regular basis by company employees or are outside the client's usual course of business.
>
> A *referral agency* is a business that provides clients with referrals for service providers to provide services under contract, subject to some specific exceptions, none of which apply to creative productions. The referral agency serves as an intermediary between service providers and clients, contracting separately with each of them through referral agency contracts. The law does not list all the kinds of services that service providers can offer, but it does offer some examples, one of which is photography.
>
> A *service provider* is a person who, as a sole proprietor or other business entity, contracts with a referral agency and uses the referral agency to connect with clients.

The referral agency must satisfy 11 pre-qualifications before the *Borello* test can be applied to its employee or independent contractor relationship with the service provider. Some of these steps are proving that the service provider is free from the referral agency's direction or control when performing work for clients, ensuring that service providers who must be licensed or have a business tax registration with the state of California or one of its cities or counties are properly licensed or registered, requiring service providers use their own tools and supplies and not provide services to clients under the referral agency's name, and allowing service providers to work with their own clients separate from the referral agency.

Note, however, that a referral agency-intermediated contract that puts together a client company with a service provider is not conclusive when answering the question of whether the service provider is acting as an employee of the client. This is because, as we have seen above in this white paper, the existence of an independent contractor agreement, or formally labeling the worker a contractor, or even the desire of the client and the service provider that their work arrangement be that of an independent contractor, do not control their true relationship. If the facts show that the contractor relationship between the client and the service provider is not one in fact but only in name, then unless another exception exists the ABC Test will likely apply.

- Does it communicate with each agency directly when it comes to booking terms, agency commissions and fees?

- Does the EOR know the legal considerations to onboard minors as employees, like Coogan Trust Accounts, on-set requirements for parents, permissible hours of work, and even school absence educational requirements?

Also, in addition to the laws applicable to all employees there are California laws that apply specifically to creative productions.

- One example is the California Photo Shoot Pay Easement Act.[112] Under this law, employees involved with a photo shoot, including models, are exempt from the general requirement that employees must be paid earned but unpaid wages on their date of discharge.[113] Is the EOR aware that if an employer does not comply with California laws governing payroll practices generally this could open the door to possible waiting time penalties?

- Does the EOR know the difference between meal and rest period requirements for still photography shoots and for film and video productions?

Another characteristic to look for in a creative production EOR is flexibility and scalability: creative production projects can vary from one-day shoots and single payments to multimillion dollar, multi-day engagements, and even though most of the workers will be employees some vendors and independent contractor Form 1099-based payments will also need to be accounted for, preferably in a single, integrated system.

Conclusion

Misclassifying employees as contractors is a problem that long predated California's passage of AB-5. AB-5 does not worsen the consequences for hiring companies when they misclassify their workers. Instead, it creates a statutory, rebuttable presumption of employee status for workers, carves out specific exceptions to that presumption, and shows companies which classification test to use when deciding close-call situations. Although many California businesses may see complying with AB-5 as a cumbersome annoyance or even a threat, it does benefit the state's employers by clarifying and - through the ABC Test - simplifying for many of them the classification process.

A possibly more problematic effect of AB-5, however, is that the law might make it harder for companies that misclassify employees as contractors to claim that the misclassification was inadvertent. Ignorance of the law is no defense, and the longer it remains in effect the more likely such ignorance on the part of an employer could be interpreted as reckless rather than negligent. Being aware of the law and disregarding it could be construed as willful behavior. In short, not taking AB-5 seriously may make it more likely that unwary or incurious businesses can commit misclassification violations, and that such failure can be taken as showing reckless disregard or even intentional conduct.

Aside from AB-5 concerns, California creative production enterprises that hire workers must also be vigilant for changes in other state and federal employee classification laws. Employee misclassification laws at the state and federal levels are in a period of constant re-evaluation by Congress and state legislatures, the U.S. Department of Labor, the National Labor Relations Board, and state labor regulatory agencies. For example:

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[112] Senate Bill 671, enacted September 2019

[113] California Labor Code §201.6(b)

- The question of the constitutionality of AB-5, once considered settled, has been re-opened on appeal.[114] And at least one law enacted to create an independent contractor exemption from AB-5 is also being challenged as unconstitutional.[115]

- The U.S. Department of Labor is considering changing its guidance on how to tell who is an employee under the FLSA.[116] The new rule will return the DOL employer versus contractor analysis to a totality of circumstances analysis of the economic reality test that it had used until issuing a rule in 2021 that emphasized as two "core factors" the nature and degree of the employer's control over the work and the worker's opportunity for profit or loss.[117] In considering its new rule, the DOL noted the advantage of the ABC Test for its clearer standards than the economic reality test, but backed away from adopting the ABC Test because of U.S. Supreme Court decisions holding that the economic reality test is the standard to use for FLSA purposes. The DOL has concluded that until the Supreme Court revises its court precedents or Congress enacts a law making the ABC Test the new FLSA standard, it lacks the authority to impose the ABC Test on its own.[118]

- As we have seen earlier in this white paper, Congress is considering legislation to allow the NLRB to use the ABC Test when classifying workers as employees for collective bargaining purposes.

The likelihood that workers on creative production projects will be considered to be employees under California and possibly federal law, plus the evolving nature of the labor, tax, insurance, and other laws that can apply to employer-employee relations in the creative production industry, makes using an experienced and knowledgeable employer of record a practical and prudent step to ensure that things go smoothly during all phases of the production: onboarding talent and production crew, complying with all the relevant laws and regulations during production, and making sure that everyone is paid properly and on time when the project ends.

Working with an EOR can also reduce the risks of employee complaints about employee misclassification and provide you with a solid recordkeeping system to withstand audit scrutiny from California and federal agencies that enforce labor laws.

EORs can be a key ally to creative production companies in today's complex and shifting environment of employment-related statutes, regulations, and court cases. Given the possibility of severe misclassification penalties under state and federal laws, and the potential for trouble for employers who do not comply with laws controlling the conditions and terms of their employment, working with an EOR can be the allegorical "ounce of prevention" for creative

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[114] Uber challenge to California contractor law revived by U.S. appeals court | Reuters

[115] California Supreme Court asked to step into Prop. 22 fight after union loss to Uber, Lyft, Sacramento Bee, April 25, 2023

[116] Notice of Proposed Rule: Employee or Independent Contractor Classification Under the Fair Labor Standards Act, RIN 1235-AA43

[117] Federal Register: Employee or Independent Contractor Classification Under the Fair Labor Standards Act

[118] https://www.federalregister.gov/d/2022-21454/p-284

production enterprises that want to avoid the “pound of cure” that comes in the wake of even inadvertent errors.

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