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The “ABCs” of Misclassification in the Wake of *Dynamex*

In April, the California Supreme Court issued a pro-employee ruling in *Dynamex Operations West, Inc. v. Superior Court*. This ruling will heavily impact businesses and workers in California and could have a ripple effect across state and industry lines.¹

Employers in the construction and affordable housing industries may be affected; however, all business owners considering the hiring of independent contractors should familiarize themselves with this case as it may provide evidence of future sentiment by the courts that is against the classification of workers as independent contractors.

This article will examine the following topics:

1. Worker classification or misclassification
2. The *Dynamex* ruling and its impact on construction and affordable housing
3. Pros and cons of the independent contractor model
4. Strategies to manage risks associated with independent contractors

About the Author



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The Classification of Workers

Employers must classify workers as employees or independent contractors. This determination impacts individual workers, employers, and government agencies. Under an employee-based labor structure, employers pay employment taxes and employees have access to the following rights and labor protections:

- Workers' compensation rights
- Minimum wages, hours, and conditions
- Rights to unionize and collectively bargain
- Health benefits
- Anti-harassment and discrimination protection
- Employer-provided retirement benefits²

When workers are classified as independent contractors, employers are not burdened with providing these benefits and associated costs.



Methods of Classification

Simply identifying the correct standard for classifying workers can be a challenging task for any company, particularly one with operations in multiple states. The factors vary and depend on the state, agency, and jurisdiction. For example, the criteria used to classify workers for payroll tax purposes may be different than the criteria used for workers' compensation.

Complicating matters further, the Internal Revenue Service, U.S. Department of Labor, State Unemployment Compensation Boards, State Workers' Compensation Insurance Agencies, and State Departments of Labor all have varying rules and criteria used to determine independent contractor status.³ Business owners considering an independent contractor model are strongly advised to consult with legal counsel licensed and experienced in the relevant jurisdiction(s) to ensure proper classification methods.

The Financial Impact of Classification

The interests of workers, companies, and government agencies are not aligned when it comes to classification and the financial impact is significant. Employment taxes equate to billions of dollars in annual tax revenue for government agencies. The misclassification of employees as independent contractors reduces this revenue. Florida, North Carolina, and Texas estimate a combined loss of over \$2 billion in tax revenue due to misclassification.⁴

For employers, multiple studies show the costs associated with employee classification can make up as much as 40 percent of the total employee cost. With thinning profit margins and the need to win bid projects, companies naturally look at legal ways to minimize these costs, including the use of independent contractors.

Misclassification in Affordable Housing

Misclassification in the affordable housing industry received a spike in attention shortly after the recession as contractors and subcontractors were eager to be a part of winning bids. Contractors throughout the country were winning government-sponsored construction bids, often by not including certain employee costs due to the misclassification of workers as independent contractors.⁵

North Carolina estimates that 45 percent of the 826 companies taking part in construction of government-funded apartments during the recession deducted no taxes from laborers and mechanics. States are understandably taking a more aggressive approach toward enforcement and are funding task forces for that purpose.

In an effort to combat misclassification, the North Carolina State Senate approved Senate Bill 407 which, if passed, will require businesses to disclose any misclassification investigations to occupational licensing boards.

Last year, the *Miami Herald* reported a federal investigation into Related Group, Miami's biggest developer, which allegedly "lowered costs on an affordable housing project by hiring subcontractors who failed to pay employment taxes." The majority of subcontractors for one project in particular, Edificio Pineiro, are alleged to have treated their laborers, painters, and bricklayers as independent contractors rather than employees.⁶



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The Dynamex Case

In *Dynamex*, two worker drivers claimed that Dynamex, a delivery company, improperly classified them as independent contractors and engaged in unlawful and unfair business practices, thus depriving the workers of various labor protections. In its April ruling, the California Supreme Court agreed.

In doing so, the Court created a presumption that a worker is an employee and placed the burden of proof on *the company* to prove the worker is an *independent contractor*. The ruling applied the popular “ABC Test” to determine worker classification for purposes of wage order compliance.⁷

Already adopted by over 25 states, the “ABC Test” requires a company wanting to classify a worker as an independent contractor to demonstrate the following criteria:

- (A) The company does not direct the worker in the performance of his job.
- (B) The worker performs work outside the scope of the company’s typical business.
- (C) The worker has made the affirmative decision to go into business for himself.

In order to ensure accurate classification as an independent contractor, all three criteria must be satisfied.⁸

In this case, the Court held that Dynamex failed Part “B” of the “ABC Test” because the company was in the same business and providing the same driving services that were being performed by the workers.

While *Dynamex* is important and its impact will certainly be felt widely across many industries, it is critical to be aware that *Dynamex* is a California decision and applies to California wage orders, as opposed to other rights or benefits such as workers’ compensation, for example.



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Pros and Cons of the Independent Contractor Model

Companies considering the use of independent contractors should consider all of the potential impacts to their business, positive and negative.

The Pros

If a true independent contractor relationship exists between the worker and the company, a company will not have to pay payroll tax, workers' compensation, social security, or be subject to wage orders or overtime laws.

The Cons

When utilizing independent contractors, employers need to be aware of these implications:

- Reduced control over the worker, pricing and work being performed
- Potential lack of "team member" mindset by the worker
- Increased scrutiny
- The liability and responsibility of screening and vetting subcontractors to ensure workers are being classified correctly
- Increased responsibility to make sure the company has an effective risk transfer program in place with subcontractors, including applicable indemnification and hold harmless language.



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Risk Management Strategies

The following strategies can help business owners reduce or mitigate the risks of employee misclassification:

1. Employers should always consult with a tax professional and attorney to determine proper adherence to applicable state laws.
2. Using “common sense” to determine classification is not always effective. Companies need to consider the complete picture of the worker and the worker’s relationship with the company. For example, having workers sign a written independent contractor agreement or making the worker provide his or her own tools are common practices that are not effective methods for ensuring independent contractor classification.
3. Businesses should always carefully screen subcontractors and ensure effective written subcontractor agreements are in place as part of a risk transfer program. The agreements should contain clear and applicable indemnification and hold harmless language.
4. When working with subcontractors, companies should obtain copies of their workers’ compensation policies to make sure limits and coverage are appropriate. A dramatically low premium may be a clue that it is a “ghost policy,” and not one intended to effectively cover employees. Remember, if a subcontractor fails to carry the proper workers’ compensation insurance, you may be held responsible.
5. Similar suggestions apply when contracting with a staffing company. Using staffing companies who are violating labor laws may subject a business to violations.⁹
6. Filing an SS-8 form will ask the IRS to determine whether a worker is an employee or independent contract. Employers should keep in mind the bias of the classifying agency. While this may not always be the best way to determine worker classification, it is a tool that may be helpful.¹⁰

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Endnotes

¹*Dynamex Operations West, Inc. v. Superior Court*, S222732, (<https://scocal.stanford.edu/opinion/dynamex-operations-west-inc-v-superior-court-34584>).

²Nehamas, Nicholas. “Did Miami’s biggest developer avoid labor taxes? The feds are investigating,” *Miami Herald*. July 6, 2017, at 2. (<https://www.miamiherald.com/news/local/community/miami-dade/article159788874.html>).

³<https://www.nolo.com/legal-encyclopedia/independent-contractor-or-employee-government-decision-29681.html>.

⁴ Nehamas, at 5.

⁵ *Id.*

⁶ *Id.*

⁷ *Dynamex*, at 3.

⁸ *Id.*, at 79.

⁹ McClatchy Washington Bureau, “Tips for business owners to avoid misclassifying workers,” at 1-2. (<http://media.mcclatchydc.com/static/features/Contract-to-cheat/Tips-for-business-owners-to-avoid-misclassifying-workers.html?brand=nao>).

¹⁰ *Id.*



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