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High Income Workers: Independent Contractor (1099) or Employee (W-2)?

The Problem - Dynamex. The news has spread about the California Supreme Court's April 30, 2018, ruling in ***Dynamex v. Superior Court***.[1] The news is that ***Dynamex*** established a new "ABC" test that further pushes California business owners to classify workers as employees (W-2) rather than independent contractors (1099-MISC):

"Under this test, a worker is properly considered an independent contractor … only if the hiring entity establishes: (A) that 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; (B) that the worker performs *work that is outside the usual course* of the hiring entity's business; and (C) that 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 *[emphasis added]*."

When asked how to classify professional associates and other high income staff, most legal and tax advisors are focused narrowly on the ABC test and are advising their owner-clients that *all* staff members must be treated as W-2 employees. While I believe that full time workers generally need to be classified as employees under ***Dynamex*** and Federal law, I also believe that if the worker is part time or works for multiple owners, both business owners and high income workers (annual income over $150,000) can use independent contractor status to take advantage of a great tax saving opportunity. Here's why:

- **Substantial Benefits for Independent Contractors.** Section 199A of the 2017 Tax Cuts and Jobs Act makes independent contractor status far more desirable to high income workers than it ever was for business owners.[2] Switching from employee to independent contractor status now gives high income workers a tax cut of $12,500 to $24,000 annually – even when taking into account the worker's payment of the owner's (former) half of the social security and Medicare (FICA) tax.[3]

- **Substantial Benefits for Business Owners.** The owner also benefits financially. By hiring an independent contractor, the owner is not required to provide or pay the usual employee costs of: **(a)** FICA taxes (over $10,000 annually on high income workers); **(b)** worker's compensation insurance (ranging from about $225 for real estate agencies, $1,300 for dental offices, and $5,505 for general building contractors[4]); and **(c)** employee benefits for "full time" (30 hours or more per week) workers, whether contractually or legally required.[5] These matched financial incentives now permit business owners and workers to be fully in agreement on independent contractor status!

- **The Existing Federal 3-Part Test.** Although ***Dynamex*** has its own 3-part ABC test, there is a longstanding Federal 3-part test for determining independent contractor or employee status.[6] The Federal test has a somewhat overlapping different approach than ***Dynamex***, focusing on behavioral control, financial control, and type of relationship, and remains the Federal tax standard for determining independent contractor or employee status.

- **The "New" California ABC Test.** ***Dynamex*** does not change or supplant the Federal 3-part test for determining independent contractor or employee status. The "new" ABC test in ***Dynamex*** isn't really that new, in that it consolidates the original multi-factor text from the 1989 California Supreme Court case

Borello v. Dept. of Industrial Relations.[7] Also, that consolidation essentially duplicates another 3–part test set forth in the 1991 California Appeals Court case ***Yellow Cab v. WCAB***, a test currently used by the California Department of Industrial Relations for determining independent contractor or employee status.[8] For these reasons, I consider the drama surrounding this "new" ABC ***Dynamex*** test to be a bit overblown, although ***Dynamex*** *did* endorse the ***Yellow Cab*** approach over ***Borello***.

- **New California Factor: Legislative Intent.** In addition to promoting the ***Yellow Cab*** test, ***Dynamex*** also declares that the "underlying legislative intent and objective of the statutory scheme at issue" must be considered when applying the ABC test and other applicable law. This is the true impact of ***Dynamex***: allowing California agencies and attorneys to use legislative intent arguments to expand or even avoid the literal terms of the statutes being interpreted, this time in the context of classifying workers as independent contractors or employees. Legislative intent for Federal law has been a consideration for quite some time already, but ***Dynamex*** reminds us that this argument has always been there and clarifies its usefulness in the California context.

Legislative Intent of Worker Classification Laws. Two categories of "intent" typically support Federal and California legislation concerning the proper classification of workers: **(a)** protecting lower-wage workers that have little negotiating power against the owner trying to avoid employee-based costs (e.g., FICA taxes and employee benefits); and **(b)** preventing loss of tax receipts when the owner fails to withhold taxes from workers who fail to pay taxes altogether. However, it's not safe to assume that every employment-related statute passed by Congress or the California legislature contains that same legislative intent, since legislative intent is very specific to the statute in question.

The Danger to Workers: Loss of Tax Benefits. High income workers have an immense financial incentive to maintain independent contractor status, particularly in light of the huge tax savings available to the S corporation business structure ($12,500 to $24,000 annually). Employee status requires the worker to work as an individual, rather than as a contracting S corporation, and eliminate ALL of those tax benefits, as well as all other corporate tax deductions that are disallowed to employees.

The Danger to Business Owners - Risks of Misclassification. Business owners must ensure proper classification of their high-income workers. Both the IRS and the California Employment Development Department (EDD) make business owners liable for misclassified workers' unpaid taxes not subjected to tax withholding, and the EDD imposes serious penalties ($5,000 and up per violation) for business owners that willfully misclassify workers as independent contractors.[9]

New California Factor: Burden of Proof. ***Dynamex*** also shifted the burden of proof to the owner that the worker's independent contractor classification is justified. This shift isn't so much a legal issue as it is a business/compliance issue. It is now imperative that the owner have a good argument in place that its worker is, in fact, an independent contractor. This, in turn, requires that the owner obtain and commit to writing the relevant facts surrounding the relationship between the owner and worker, at the earliest possible time after that relationship begins.

The Solution: Highly Customized Independent Contractor Agreements. Fortunately, with ***Dynamex*** and pre-existing Federal law, we have a powerful argument that these high-income workers are independent contractors, *precisely because they benefit from independent contractor status*! If the legislative intent of the statute is to protect workers, then interpret the statute that way, to allow these licensed workers to be classified as independent contractors. Therefore, business owners and their high-income workers can and should cooperate in creating a comprehensive and customized independent contractor agreement, long before any government

investigation or tax audit occurs, to demonstrate that independent contractor status is both justified and mutually desired. In my opinion, that contract must do the following:

- Describe how this worker's particular fact situation satisfies both the ***Dynamex*** ABC test and the Federal 3-part test, and therefore establishes the worker is an independent contractor.
- Compare that fact situation to the legislative intent behind the applicable statutes to show how that legislative intent is not served by treating this worker as an employee, and therefore justifies independent contractor status.
- Don't run afoul of the Federal economic substance doctrine.[10] In short, this doctrine will require that the reasons for the parties' structuring of a transaction (in this case, the choice of independent contractor status over employee status) cannot be strictly tax-based; there must be another substantial business purpose *and* a meaningful change in the parties' economic position to support that choice. If economic substance is not established, the IRS can impose a 40% underpayment penalty on the taxpayer.[11]
- Use that combination of facts, legal tests and legislative intent to have the worker assure the owner that treating the worker as an independent contractor isn't "willful misclassification" of an employee that otherwise could expose the owner to California penalties.
- Document that the worker instigated creation of the contract, either alone or under joint representation with the owner. A worker taking the initiative to argue for independent contractor status backs up the worker's claim to be an independent business. If the owner is the sole client, the worker's claims are likely to be viewed as disingenuous: if those claims were drafted on the owner's behalf, it looks like the owner is forcing independent contractor status on the worker. This situation would conflict directly with any legislative intent to protect workers from being forced into independent contractor status.

The Final Result – Tax and Penalty Protection. This contract not only provides justification of independent contractor status, but also creates major roadblocks for the IRS and the EDD seeking additional taxes and penalties from the owner or worker. These roadblocks don't even need to be airtight: they only need to be strong enough to encourage the IRS or EDD to spend their limited resources pursuing far less protected targets.

 Mr. Olson has been a licensed attorney since 1984 with a primary focus on dental practice transitions for over 25 years. His practice includes mergers and acquisitions (practice sales and purchases, and partnership formations, buy-ins and buy-outs); corporate, business and real estate law; estate planning; and related tax issues. Learn more about Mr. Olson at **www.trans.dental/about.html**.

Footnotes and Links:
[1] *Dynamex v. Superior Court* (2018) 4 Cal.5th 903
[2] Public Law No. 115-97 (12/22/2017), 26 United States Code §199A
[3] For details, please see my May 2018 article Huge Tax $avings for S Corporations.
[4] Rates based on the California "pure premium rate" in effect on 7/1/18 for workers earning $150,000 annually, not considering the owner's experience rating.
[5] IRS Information Page: Identifying Full-time Employees
[6] IRS Information Page: Independent Contractor (Self-Employed) or Employee?
[7] *Borello v. Dept. of Industrial Relations* (1989) 48 Cal.3d 341
[8] *Yellow Cab v. Workers Compensation Appeals Board* (1991) 226 Cal.App.3d 1288
[9] California Labor Code §226.8
[10] Now codified at 26 United States Code §7701(o)
[11] 26 United States Code §6662(i)