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A California appellate court found workers to be employees for unemployment insurance tax purposes because they were integral to the taxpayer's business. The court relied upon the test set forth in *S.G. Borello & Sons, Inc. v. Department of Industrial Relations* rather than applying the traditional common law. While the court suggested that this was not a change, it appears to mark the first time the California court of appeal has expressly applied the Borello test to a tax case.

Employment Taxes | A Littler Mendelson Newsletter specifically for the Employment Taxes

California Court of Appeal Expands Common Law Control Test in Tax Case: Use of Borello Economic Reality Test Upheld

By GJ Stillson MacDonnell and William Hays Weissman

On May 14, 2007, the California Court of Appeals for the Third Appellate District certified for publication its previous April 12, 2007, decision in *Air Couriers International v. Employment Development Department*.[1] This case involves the issue of whether drivers that worked for a delivery company were properly classified as employees or independent contractors for state tax purposes. The taxpayer had treated the workers as independent contractors, while the Employment Development Department (EDD) reclassified the workers as employees, resulting in an assessment for unpaid personal income taxes and payroll taxes.

The trial court found the workers to be employees as a matter of law. It relied primarily upon the case of *S.G. Borello & Sons, Inc. v. Department of Industrials Relations*.[2] Much of the court's opinion on appeal relates to whether the *Borello* test, also known as the "economic reality test," was the proper legal standard to apply. While not an employment tax case, the issue in *Borello* involved the whether share farmers were employees or independent contractors for workers' compensation purposes. In addition to reviewing the common law independent contractor factors involving level of control, *Borello* looked at the economic dependence of the worker upon its principal and the extent to which the worker is integral to the business to determine that the farmers were in fact employees.

The Air Courier Opinion

The appeals court in *Air Courier* court upheld the trial court's finding that the workers were integral to the business and that the taxpayer had sufficient control over them. The trial found these facts sufficient to hold that the workers were employees under the *Borello* test.

On appeal the taxpayer challenged the trial court's reliance on *Borello*, arguing that *Empire Star Mines* was the correct legal standard. The *Empire Star Mines* opinion held that the proper test to determine whether a worker is an independent contractor or employee is whether the principal controlled the manner and means by which the workers performed the services as well as to the desired result. This is known as the common law control test. *Empire Star Mines* also identified a variety of secondary factors, taken from the Second Restatement on Agency, that could be reviewed if control was not clear.

The *Air Courier's* court rejected the taxpayer's argument that *Empire Star Mines* court set forth control as the sole consideration in evaluating the employment relationship. Instead, the appeals court found that while *Borello* relied upon factors other than control, it still relied upon the same secondary factors as set forth in *Empire Star Mines*. It also found that *Borello* did not set forth any new standard for determining the employer-employee relationship.

Accordingly, the *Air Courier's* court stated

[1] *Air Couriers Int'l v. Employment Development Dept.*, Appeal No. CO50978, Apr. 12, 2007. This case is sometimes referred to as the *Sonic* case.

[2] *S.G. Borello & Sons, Inc. v. Department of Indus. Relations*, 48 Cal. 3d 341 (1989).

that "our review of cases construing the factors to be considered when determining whether a worker is an employee or an independent contractor supports the trial court's reliance on the Supreme Court's analysis in *Borello*. The trial court employed the proper legal standard in evaluating the evidence produced at trial."

What the Air Courier's Opinion Really Means for California Employers

The opinion held that *Borello* was the correct legal standard to apply in tax cases. The court in *Air Courier* further noted that it was not articulating any new legal standard. Instead the court reiterated the position of the court in *Borello*, which stated: "we adopt no detailed new standards for examination of the issue" of balancing the factors used to determine employee status, but instead use the same indicia of the employer-employee relationship that were articulated in *Empire Star Mines*.[3] However, it is also misleading for the court to state that *Borello* is the same as *Empire Star Mines*.

What the *Air Courier's* opinion found was that the indicia of the employer-employee relationship were essentially the same under both *Empire Star Mines* and *Borello*. Thus, the opinion did not see any significant distinction between the two cases. It dismissed all other distinctions, such as the fact that *Empire Star Mines* was a tax case and *Borello* a workers' compensation case, as having no particular significance.

However, there is in fact a fundamental difference between the control test under *Empire Star Mines* and the economic reality test under *Borello*. While that difference may not be found in the indicia of the employer-employee relationship, it is found in the application of those indicia. Under the control test, the indicia must demonstrate that the principal has the right to control the manner and means by which services are performed in addition to the results obtained, while under the economic reality test the indicia need only demonstrate that the worker was economically dependent upon the principal or was integral to the principal's business.

No California court to date has previously held that the broader *Borello* standard applied in tax cases. In fact, the court of appeal recently noted that *Borello* was "unlike common law principles" because "in addition to the control test" liberal social welfare considerations were important, and thus mandated looking at the worker's economic relationship to the principal.[4] The court in *Borello* even acknowledged this, stating that its formulation was a "departure[] from the common law principles" in light of the fact that the case involved social legislation under the workers' compensation act.[5] Further, the United States Supreme Court has specifically rejected that the economic reality test, rather than the common law control test, should apply to the determination of the employer-employee relationship for federal employment tax purposes.[6]

The *Air Courier's* opinion also appears to conflict with the EDD's regulations that define the usual common law rules for determining tax status. Remarkably, the appeals court never even mentions or cites to the regulations. Under the EDD's regulations, if the principal has the right of control, an "an employer-employee relationship exists." Further, only "if it cannot be determined whether the principal has the right to control," then are the secondary factors considered. Thus, contrary to the opinion's suggestion that control is but one of many factors that may be considered, the EDD's regulations state that the starting, and possibly ending, point of inquiry is the control test.[7]

By adopting *Borello's* economic reality test for tax purposes, the court has perhaps unwittingly expanded the common law control test used for tax purposes to include evaluation of both the economic dependence of the worker and the integral nature of the services performed. Nowhere in the common law, the secondary factors cited in *Empire Star Mines* and *Borello* or the EDD's regulations, is the concept of "economic dependence" or "integral to the business" mentioned. Nowhere is the idea that only the control "necessary" is sufficient to establish an employment relationship. Such a radical departure from over 60 years of established law is disappointing given the rather superficial nature of the court's analysis, its failure to review the basis for the distinctions between the control test and the economic reality test and the failure to even address the EDD's regulations.

The real issue is how will the EDD seek to apply the opinion. The EDD has been pushing to use "integral" as the touchstone for an employment relationship for years. Thus, the EDD is likely to seize upon this opinion as a strong legal justification for use of the integral standard to expand the scope of the employer-employee relationship.

Practical Implications for Employer

Air Courier is a court of appeal decision. *Empire Star Mines* and *Borello* are both California Supreme Court decisions. Thus, until the California Supreme Court weighs in to resolve the question of whether *Borello* applies in tax cases, employers should seek to limit its application to the extent possible.

For employers that use or are contemplating using independent contractors, this may be a good time to reevaluate the relationship and ensure that the workers are properly classified. It may also be a good time to make sure that adequate documentation is being maintained to substantiate the worker's status. For employers faced with an examination of worker status by the EDD, the following steps are suggested:

- Carefully prepare the presentation of all evidence to the EDD auditor. It is now more important than ever that evidence be properly presented to the EDD to avoid superficial findings that workers are integral to the business, such that the EDD leaps to the conclusion that the workers are employees.

[3] *Borello*, 48 Cal. 3d at 354.

[4] *JKH Enters., Inc. v. Department of Indus. Relations*, 142 Cal. App. 4th 1046, 1062-1063 (2006).

[5] *Borello*, 48 Cal. 3d at 352-54.

[6] *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318 (1992); see also *United States v. Webb, Inc.*, 397 U.S. 179 (1970).

[7] CAL. CODE REGS., tit. 22, § 4304-1.

- Get counsel involved as early in the process as possible, preferably before meeting with or providing information to the auditor.
- Focus the EDD on its own regulations and general common law principles, which do not include economic dependence or the integral nature of the services performed.

GJ Stillson MacDonnell is a shareholder and chair of Littler's Employment Taxes Practice Group and William Hays Weissman is a senior associate in Littler's Employment Taxes Practice Group. If you would like further information, please contact your Littler attorney at 1.888. Littler, info@littler.com, Ms. MacDonnell at gjmacdonnell@littler.com or Mr. Weissman at wweissman@littler.com.