

A Report of the 2004-05 Civil Grand Jury
For the City and County of San Francisco

EMPLOYEE OR INDEPENDENT CONTRACTOR?

Pursuant to State law, reports of the Civil Grand Jury do not identify the names or identifying information about individuals who provided information to the Civil Grand Jury.

Departments and agencies identified in the report must respond to the Presiding Judge of the Superior Court within the number of days specified, with a copy sent to the Board of the Supervisors. As to each finding of the Grand Jury, the response must either (1) agree with the finding, or (2) disagree with it, wholly or partially, and explain why. Further as to each recommendation made by the Grand Jury, the responding party must report either (1) that the recommendation has been implemented, with a summary explanation of how it was; (2) the recommendation has not been implemented, but will be implemented in the future, with a timeframe for implementation; (3) the recommendation requires further analysis, with an explanation of the scope of that analysis and a timeframe for the officer or agency head to be prepared to discuss it (less than six months from the release of this Report); or (4) the recommendation will not be implemented because it is not warranted or reasonable, with an explanation of why that is. (Cal. Penal Code, sec. 933, 933.05)

SUMMARY OF RECOMMENDATIONS

The City should identify and adapt legal standards into a form that can then serve as documentation for the City Attorney's approval or disapproval of independent contractor status of the vendor. Completed forms such as any appended hereto as Appendix C Forms 1-5 could well serve as that documentation.

The language in Article 14 of the City grant agreement form G100 (see Appendix B) should be incorporated into City contract agreement form P 500 and P501.

The City Attorney's Office should either approve or reject each contract for services of individual vendors based on the submitted documentation described in the first recommendation.

The City should designate a department with expertise to formulate a method of monitoring the classification treatment of the sole proprietor vendor to insure that the contracting department has not, in practice, altered the terms and conditions under which contract services are being rendered. Possible tools for ongoing monitoring are continuing use by periodic resubmission of the initial form referenced in recommendation number 1, above, or a prospective written certification by departmental contract administrators that the monitoring department or the City Attorney will be notified if any of the responses given to the initial checklist change.

All documentation to support an independent contractor determination should be permanently appended to each contract with a sole proprietor vendor and maintained by the Office of Contract Administration for the length of the longest statute of limitations.

If there is currently no civil service exempt classification in which a vendor whose classification is questionable can be hired as an employee, the Civil Service Commission should create such a classification. Appointment to such classifications should be approved by the Department of Human Resources.

Glossary

Contract: an agreement between the City and a vendor to provide services (or goods) in exchange for money

Fringe Benefits: typical public sector benefits of monetary value to its employees include paid sick leave, paid vacation leave, partially or wholly employer funded medical and dental insurance, partially or wholly employer funded pension, group life, long- and short-term disability insurance

Independent Contractor: a legal status applicable under certain circumstances to workers who perform services for another person

Sole proprietor: sole proprietor (an individual as opposed to a partnership or corporation) who has performed services for the City and was paid for service under his or her own name rather than under a fictitious business name

Vendor: the designation the City gives to an independent contractor who provides services to the City

INTRODUCTION

Issues surrounding the City's complex contracting practices have been the focus of past grand jury investigations. However, the contracting issue about which we report here has not been the topic of prior grand jury inquiry. It is a single, narrow issue with regard to the contracting process: does the City contract with individuals to perform services when federal and state law might require that these individuals be hired and treated as employees of the City?

The internet is replete with articles authored by tax attorneys echoing a common theme: when an employer retains the services of a worker and erroneously treats that worker as an independent contractor rather than as an employee, the financial consequences to the employer, in the words of one tax attorney, "can be staggering".¹ We did not undertake this study as might an I.R.S. auditor seeking to determine whether or not a worker is erroneously or properly classified as an independent contractor. Nor did we attempt a complete study of the working relationship between the City and individuals it has retained to perform services for the City as an independent contractor rather than as an employee. Rather we simply chose to inquire as to whether there are steps the City could take to lower the risk of violating federal and state laws by hiring individuals as independent contractors but treating them as employees.

Our concern is that the City take reasonable steps to insure it does not misclassify its workers as independent contractors when they should be classified and treated as employees. This concern has led us to the overall recommendation that the City develop and append to each contract with a sole proprietor vendor sufficient documentation to justify the propriety of the independent contractor classification.

BACKGROUND

We understand the temptation for an employer to designate a worker as an independent contractor instead of as an employee. As the federal Ninth Circuit Court of Appeals has noted: "Large corporations have increasingly adopted the practice of hiring temporary employees or independent contractors as a means of avoiding payment of employee benefits, and thereby increasing their profits. This practice has understandably led to a number of problems, legal and otherwise."² The employer has no obligation to withhold income tax, Medicare tax or Social Security from the compensation of an independent contractor. The employer has no obligation to cover an independent contractor for state disability or unemployment insurance benefits. The employer has no overtime obligations owing to an independent contractor. The employer owes no workers' compensation to an independent contractor injured "on the job". An employer need not include independent contractors in its retirement system. An independent contractor would not work under the representation of the employer's labor unions.³ Fringe benefits⁴ that an employer extends to its employees--but are not required by law --are not extended to independent contractors. A public employer's salary ordinance does not control the amount of money that

¹ Robert L. Sommer, Esq, www.taxprophet.com

² (Vizcaino v. Microsoft, 120 F3d 1006 (9th Cir., 1997))

³ There is also a difference to the employer in terms of liability to third parties injured by independent contractors than there is for third parties injured by employees.

⁴ Typical benefits offered by public sector employers include paid vacations, sick leave, holidays, short-term disability, group health and life insurance, and pensions.

can be paid to an independent contractor: As little as the City can obtain the services for, or as much as the market and the City's budget will allow, are the prime considerations in payment to an independent contractor. Yet how the employer classifies a vendor⁵ --as employee or as independent contractor -- is an important distinction. Misclassification in the event an employer is treating the contractor as an employee carries substantial monetary penalties.

The task of deciding whether a vendor can legally be classified as an independent contractor is a fact intensive inquiry looking to the circumstances that surround the relationship between the vendor and the employer. If legal standards cannot be met, then the entity seeking services must not treat the vendor as an "independent contractor" but rather as an "employee". The critical distinction is that anyone who retains services of another and controls the manner, method and materials involved in delivery of those services is considered an employer of the vendor in which case that vendor should be treated by the employer as an employee.⁶ On the other hand, anyone who retains the services of another and surrenders to the vendor control of the manner, method and materials in the delivery of a service is not an employer; that vendor can be treated as an independent contractor. Beyond the generalizations about "control of the work" there are legally established criteria (often referred to as "the common law test") for drawing a conclusion as to whether the vendor is an employee or an independent contractor. The I.R.S. uses its version of the common law test. The State Franchise Tax Board uses a slightly different set of criteria, as does the State of California Employment Development Department, responsible for the collection and administration of unemployment insurance tax and state disability insurance tax.

In essence, the employer -- such as the City and County of San Francisco -- has to be careful not to treat an independent contractor as an employee in violation of governmental laws regulating the employer/employee relationship. To do otherwise would subject the City to substantial fiscal liability for taxes not paid, interest and penalties accruing and other related liabilities such as payment for overtime. For example, the City would not pay the independent contractor at an overtime rate no matter how many hours in a workweek the independent contractor devoted to the job. Yet, if the worker was misclassified there would be liability for overtime.⁷ The City could also find itself suddenly having to pay both the vendor's and the City's share for Medicare contributions and social security, in addition to all back taxes that should have been withheld from the vendor's compensation or contributed by the employer if the vendor had been properly classified. Taxing authorities also have the power to levy interest and substantial penalties above and beyond the actual back taxes owed.

The Microsoft case (see case citation in footnote 2, above) is one key example of how costly misclassification can be. In that case Microsoft had classified a number of software

⁵ Throughout this report we use the word "classification" as shorthand for something more than "labeling". Classification involves both the label and the treatment of the worker: it derives from the totality of circumstances under which an individual delivers services to a customer (specifically in this instance, the City and County).

⁶ Treating a vendor as an employee would require, at a minimum, compliance with all tax and overtime laws.

⁷ The danger to the employer of being required to make an overtime payment in years after the work was performed is twofold: (1) the employer, assuming that the vendor is an independent contractor, does not monitor overtime expenditure and thus budget control problems arise (2) often the vendor who is classified as an independent contractor working on an hourly basis is paid a premium dollar on the hour on the employer's assumption that it is free of overtime and fringe benefit costs.

testers, production editors, proofreaders, formatters and indexers as independent contractors or “freelancers.” These freelancers, working intermittently when Microsoft workloads spiked, did not receive any of the benefits Microsoft offered its regular employees. Microsoft claimed these vendors were independent contractors, citing operational distinctions between Microsoft’s treatment of them and of its regular staff employees. Microsoft also pointed to the fact that these vendors signed agreements acknowledging that they were independent contractors and acknowledging that they would be responsible for the payment of all taxes. The I.R.S. audited Microsoft and was not persuaded by Microsoft’s rationale for treating them as independent contractors. Thus Microsoft became liable for back taxes. But the vendors did not rest their claim simply with the tax issue. They claimed, both retroactively and prospectively, vacation, sick leave, holidays, short-term disability, and group health and life insurance as well. They also claimed they should receive the same deferred compensation (401K plan to which Microsoft matched 50 percent of the employee’s contribution in any year) and stock option benefits as received by Microsoft employees performing comparable work. The Ninth Circuit Court of Appeals agreed with the vendors.

We began our investigation into how the City would defend itself if audited or sued by requesting from the Controller a list of all independent contractors who provided services to the City in fiscal year 2003-2004 as individuals rather than as a corporation or a partnership. In response to this we learned that neither the Controller nor anyone else in the City stores information in this format. The closest the Controller could come to meeting our request was to provide us with a list of several thousand vendors – named individuals, corporations, and fictitious business names -- who provided services in the relevant time period. From this list we identified the names of approximately 700 sole proprietor vendors⁸ to whom the City tendered payment. However, when we asked the Office of Contract Administration to provide us with copies of contracts for approximately 40 of these named individuals, contracts for only approximately a dozen could be located. Then we were provided (via the Office of Contract Administration) a list of all named vendors with whom the City entered into “professional services contracts” with the approval of the Contract Administration in fiscal year 2003-2004. From this list we identified about 70 names of sole proprietor vendors. When we questioned the disparity between the Controller’s list of 700 and the Office of Contract Administration’s list of 70 we were told that the Controller does not necessarily differentiate in its record keeping between sole proprietors acting under contract and other individually named persons receiving certain types of payment from the City such as lessors receiving a lease payment or employees who are reimbursed for employment related expenses. We also learned from the Office of the Controller that should a governmental agency such as the I.R.S. perform an audit and make a demand for the all names and Social Security numbers of individuals who performed services as independent contractors in a given time period, the City would have to construct that information department by department.

None of the contracts provided to us by the Office of Contract Administration had documentation to support a conclusion that these vendors were properly classified as

⁸ Our focus was on the City’s contracting process with vendors who are “individuals” (sole proprietors, as defined above and as opposed to corporations or partnerships) because it is contracts with individuals that misclassification occurs.

independent contractors or properly treated as independent contractors during their performance of service to the City. Each of these contracts was uniform in most of its clauses, indicating that to the extent that services contracts pass through the Office of Contract Administration,⁹ they are uniform. Unique to each of these contracts was a brief narrative describing the services of the vendor (for example, Appendix A of City form P 501, entitled “Services to be Provided by Contractor”). However, these individualized “scope of services” clauses in no way contained clear indications that the City’s intended treatment of the vendor as an independent contractor was proper. At best the scope of service indicated the vendor was to perform services that would not typically be provided by a city worker and the contract was silent, ambiguous or sketchy about the methods and manner that the services would be rendered.

We further noted that each of these contracts had a “standard” clause¹⁰ regarding “independent contractor” status. Essentially this clause recites that both the City and the Contractor agree that the vendor should be classified as an independent contractor and each shall be responsible for legal requirements that flow from such a relationship. While we think that the inclusion of this clause is better than nothing being said, we note that legally this clause will not govern a decision in the event the City is challenged either by another governmental entity or in court.¹¹ In fact, although comprehensive documentation may assist the City if a government agency were to do a random audit, it will not control the outcome of any litigation were an individual with whom the City entered into a contract to claim he or she is entitled retroactively to employee type benefits because of the manner in which the “contract work” was actually performed. In the words of one tax attorney, “One common misconception that many people have is that if there is a contract signed by the worker agreeing to independent contractor status, that creates such a relationship. This is not in fact the case. The common-law test controls even if the worker has agreed to be an independent contractor.”¹² And, as we have indicated, the common law test looks to the facts describing the method, manner and tools involved in the individual’s rendering of services.

We also note with a bit of irony that the a standardized grant agreement used by some city departments (see Appendix B: Article 4, Form G100) attempts to more broadly exculpate the City from liability for misclassification of the grantee than does the standard services contract agreement (see report of the 2004-2005 Grand Jury issued May 24, 2005 attempting to discern why the City does not treat a grantee as a vendor providing services under contract). Given that the City’s standard grant agreement spells out consequences for the City and the vendor that should follow if there has been a misclassification of the vendor as an independent contractor, we make the recommendation that this language (see Appendix B) should also appear in the City’s standardized services contract forms.

⁹ To the extent that the Office of Contract Administration could not locate a significant number of contracts for vendors whose names we supplied from the Controller’s list, and to the extent that the Controller’s list had about 700 sole proprietor names and the Office of Contract Administration’s list had only 70 sole proprietor names, we question whether all services contracts that are required to be reviewed by the Contract Administration are passing through that Office or whether the documentation for vendors receiving minimal payments is not a contract but rather a purchase order which provides no scope of services or other documentation to support an independent contractor classification.

¹⁰ City Contract Form PSC 501, Clause 8.

¹¹ Vizcaino v. Microsoft, *supra*.

¹² Robert E. McKenzie, Esq., Austin & Lehr, www.mckenzielaw.com/INDEPEND.html

Concurrent with reviewing the City's standard services contract we also interviewed several departments identified as heavily utilizing sole proprietor vendors or identified as knowledgeable about the use of sole proprietor vendors. We spoke with contracting personnel from the Department of Public Health, the Department of Human Services, the Department of Human Resources, the Department of Children, Youth and Families and the Office of Contract Administration, as well as with representatives of the Mayor's Office, the Controller's Office, the City Attorney's Office and the Civil Service Commission. Most of the people with whom we spoke had very limited familiarity with the distinctions between an employee and an independent contractor. Further, none had knowledge of any systematic city-wide approach to making such a determination. In regard to knowledge of the issues, neither the Controller nor the Department of Human Resources is responsible for making a distinction between employee and independent contractor. The City Attorney's Office advised us that in reviewing contracts its Office gives attention to the issue of employee or independent contractor. However, the City Attorney's Office, while knowledgeable about the legal distinctions and requirements, could not present us with any existing documentation that would support past determinations.

Absent any uniform documentation, the City would have to rely on a hope that each department has retained adequate documentation if there were a challenge to the propriety of classification of a sole proprietor vendor. And absent departmental documentation, the City would have to attempt to re-create whatever facts existed for the City Attorney to have concurred in approval of the vendor as appropriately classified as an independent contractor. This retroactive approach has a major flaw: if the department lacks documentation both at the time of entering into contract and during the course of the working relationship between the vendor and the City to support the propriety of the independent contractor classification, the City will have to rely on stale memory of individuals involved (if such individuals still work for the City or can be located) to defend itself in a legal challenge. And, in fact, when we sampled documentation maintained by several departments regarding the classification issue, we found that the documentation might very well lead to a conclusion that the vendor should have been an employee.¹³

Given that the determination of whether a vendor should be an independent contractor or an employee is fact-intensive, the facts of the relationship between the City and the vendor should be recorded. A simple form, which could then be approved or rejected by a knowledgeable authority such as the City Attorney, could constitute adequate documentation at the time of contract to show the intent of the City to meet the common law tests in its treatment of the vendor. In addition, the City should document how the City has actually treated the sole proprietor vendor throughout the course of performance under the contract. This documentation can be as simple as a certification by the manager that the City Attorney or Contract Administration will be notified if there is a change of any of the conditions attested to on the initial documentation form. Or, the documentation can be a periodic re-submission of the initial

¹³ For example, we found that some contractors not only received dollars as compensation, but also health insurance (the latter fact suggests that a determination of independent contractor status may not be correct). Several contractors performed services "full time" for the City and the services were of a nature typically performed by employees (these vendors were retained "to teach children" and there was no indication these vendors had a private practice or enterprise as a trainer). In one instance a department's file regarding the vendor contained a draft of a document that appeared as if it was intended to transmit the job duties to the Civil Service Commission for inclusion in the civil service classification scheme, but in a change of mind, the classification of independent contractor was the mechanism the department chose to obtain services.

documentation to both attest to the propriety of the classification and as a training-reminder to the manager about how an independent contractor differs from an employee. All documentation developed to address the issues raised in this report should be permanently stored with the contract itself and maintained by the Office of Contract Administration. We append to this report several sample checklist forms that have been used by other employers to aid classification determination (Appendix C, Forms 1 to 3). In fact, the I.R.S. has generated a form for use when the employer wants the I.R.S. to make the classification determination. That form itself – designated SS-8 – can be the City’s established documentation without actually forwarding the form to the I.R.S.

In the case of borderline calls at the time of entry into the contract as to whether the vendor is going to function as an employee or independent contractor, the City should have available a job classification that is temporary and exempt from the requirements of civil service into which that vendor can be placed as a salaried employee for purposes of the City’s compliance with all tax obligations. Further, if in the creation of such a classification the Civil Service Commission limits the hours worked by the temporary professional services employee, the employee need not be paid benefits. The Civil Service Commission has the power to create such an exempt classification if such a classification does not currently exist.¹⁴ The City Charter Section 10.104 provides:

The following positions shall be exempt from competitive civil service selection, appointment and removal procedures, and the person serving in the position shall serve at the pleasure of the appointing authority:

12. Persons employed in positions in any department for expert professional temporary services, when such positions are exempted from said classified civil service for a specified period of said temporary service by order of the civil service commission.

However, we recommend that if the Civil Service Commission creates such a classification, it condition that any appointment to a position in such a class be approved by the Department of Human Resources lest agencies interpret the existence of such classification as a vehicle for avoiding the civil service process.

The Civil Service Commission should also create an exempt classification for professional services positions where the services will be needed for a longer period of time that will mandate the payment of fringe benefits. The Commission has the authority exempt such positions under City Charter Section 10.104, subsection 18. However, in this instance we again recommend that if the Civil Service Commission creates such a classifications, it condition that any appointment to a position in the classification be approved by the Department of Human Resources.

¹⁴ A practice of the City agencies and the Civil Service Commission for which we find no statutory, charter or code authority is the practice of agencies seeking approval and the Civil Service Commission approving or disapproving services of the City to be contracted out to vendors who are independent contractors.

FINDINGS

1. The City lacks systemic documentation to support its decisions to classify individual sole proprietor service vendors as independent contractors and to support its treatment of the individual as an independent contractor.
2. Misclassification may subject the City to significant monetary liability.
3. The City Attorney's Office is currently the most knowledgeable agent in the City for making a determination as to whether a vendor should be an employee or an independent contractor.
4. The Civil Service Commission has the authority to permit professional service vendors to be hired as employees outside the civil service system.
5. Simple forms or checklists currently exist and have been used in other jurisdictions to document independent contractor status.

RECOMMENDATIONS

1. The City should identify and adapt legal standards into a form that can then serve as documentation for the City Attorney's approval or disapproval of independent contractor status of the vendor. Completed forms such as any appended hereto as Appendix C Forms 1-5 could well serve as that documentation.
2. The language in Article 14 of the City grant agreement form G100 (see Appendix B) should be incorporated into City contract agreement form P 500 and P501.
3. The City Attorney's Office should either approve or reject each contract for services of individual vendors based on the submitted documentation described in the first recommendation.
4. The City should designate a department with expertise to formulate a method of monitoring the classification treatment of the sole proprietor vendor to insure that the contracting department has not, in practice, altered the terms and conditions under which contract services are being rendered. Possible tools for ongoing monitoring are continuing use by periodic re-submission of the initial form referenced in recommendation number 1, above, or a prospective written certification by departmental contract administrators that the monitoring department or the City Attorney will be notified if any of the responses given to the initial checklist change.
5. All documentation to support an independent contractor determination should be permanently appended to each contract with a sole proprietor vendor and maintained by the Office of Contract Administration for the length of the longest statute of limitations.
6. If there is currently no civil service exempt classification in which a vendor whose classification is questionable can be hired as an employee, the Civil Service Commission should create such a classification. Appointment to such a classification should be approved by the Department of Human Resources.

REQUIRED RESPONSES TO FINDINGS AND RECOMMENDATIONS - -60 days

FINDINGS: Responses required as noted below

City Attorney (Findings 1-5)

Civil Service Commission (Finding 4)

Department of Human Resources (Finding 4)

Office of Contract Administration (Findings 1, 3 and 5)

RECOMMENDATIONS: Responses required as noted below

City Attorney (Recommendations 1-5)

Mayor (Recommendations 1, 4 and 5)

Controller (Recommendations 1 and 4)

Office of Contract Administration (Recommendations 1, 4 and 5)

Civil Service Commission (Recommendation 6)

Department of Human Resources (Recommendation 6)