

# SMAC

# SMAC Legislative Report

Of CALIFORNIA

News from the Small Manufacturers Association of California

*A compilation of news and commentary on the recent actions of California Legislators and bureaucrats in Sacramento*

## EDD AUDITORS FIND 98,000 “OBSTRUCTED UI CLAIMS” FOR MISCLASSIFIED EMPLOYEES IN FY 2013-14 AUDITS

“California has the largest Unemployment Insurance (UI) program in the nation and the EDD is upgrading its 30-year-old UI payment processing system in order to bring greater conveniences to their customers and greater efficiencies in internal operations. The internal upgrades of the payment processing system launched in September of 2013. Additional upgrades that will allow customers to access their UI claim online, called UI Online, will launch in the spring of 2015. The UI program is an eligibility-based system where regular unemployment benefits are paid by employers”

Employment Development Department

By Tom Martin  
SMAC Executive Director  
& Legislative Chairman

California Employee Development Department auditors define employee misclassification as the practice of employers labeling workers as independent contractors, rather than identifying them as employees. The practice allows employers to avoid paying and or collecting unemployment insurance, disability insurance, employment training tax, and federal and state personal income tax withholdings on workers, and from covering them on workers compensation

The practice reduces labor costs for the employer but creates an unlevel playing field when misleading businesses are able to underbid in competitive bidding on projects.

### EMPLOYEE OR INDEPENDENT CONTRACTOR?

Defining an employee is a complex issue, involving laws, rules, court cases and myriad state and federal agencies. The simplest standard is that if an employer has the right to control the work, the worker is an employee, not an independent contractor. More complicated standards require that an employer exercise behavioral and financial control over the worker for the worker to be considered an employee. Factors include the amount of direction provided over the means and results of the work, the possibility of profit or loss for the worker, and whether the worker is free to provide similar services to other businesses.

Sometimes referred to as the "underground economy," employee misclassification also has negative

consequences for state and federal governments, which are being shorted millions of dollars in tax revenue.

Employers pay taxes on employees, but not on independent contractors, so misclassification of workers may result in tax evasion. For an employee, a business must withhold income, Social Security and Medicare taxes from the employee’s wages plus pay the employer’s share of Social Security and Medicare taxes, pay unemployment taxes, and provide workers compensation insurance coverage.

If a worker qualifies as an independent contractor, the worker is responsible for paying their own income and self-employment taxes, which can result in underpayment of taxes if a worker does not understand or comply with these obligations.

Workers who are misclassified as independent contractors work without the legal protections typically afforded to employees, such as wage and hour laws, workers compensation and unemployment benefits.

### SECOND LARGEST TAX COLLECTING AGENCY

The EDD is one of the largest tax collection agencies in the United States, collecting Unemployment Insurance, Disability Insurance, Employment Training Tax, and State Personal Income Tax withholdings. Only the federal Internal Revenue Service collects more payroll tax dollars than EDD.

During 2013, EDD collected more than \$66.1 billion in California personnel income taxes from more than 1.3 million employers.

Some workers, classified by employers as independent contractors, believe they are employees, and will, if terminated or placed on lay-off, file for unemployment benefits.

This filing will cause EDD to investigate the filing employee’s status, and audit the status of other similarly situated employees at that employer.

EDD says claims from employees who are misclassified are “obstructed benefit claims” and in fiscal 2013-14 EDD auditors found 98,000 misclassified.

The tax branch within EDD has a multi-level approach to employment tax fraud detection and deterrence which involves a payroll tax audit program and participation in the **Joint Enforcement Strike Force (JESF)**. The tax branch also works to deter tax fraud by

educating employers on the risks of participating in the underground economy through seminars and employer assistance programs offered through its Taxpayer Education and Assistance program.

The EDD tax audit program reviews business entities' records to determine compliance with state payroll tax laws and works with employers to gain long-term voluntary compliance. Audit leads are obtained from a variety of sources including but not limited to employee UI and DI *obstructed* benefit claims and lead development programs. The Tax Audit Program issues assessments for noncompliance and applies penalties when appropriate.

The Tax Branch as a whole in 2012 conducted 4,290 audits and investigations, resulting in assessments totaling \$230,674,122, and identified 89,063 unreported (obstructed claim) employees.

## COMBATING THE UNDERGROUND ECONOMY

The "JESF on the Underground Economy" combats the underground economy by pooling resources and sharing data among the state agencies that enforce licensing, labor, and tax laws. The members of JESF include the EDD (lead agency), the Department of Consumer Affairs, the Department of Industrial Relations, and the California Department of Insurance. The Internal Revenue Service, the Franchise Tax Board, the California Department of Justice, and the Board of Equalization are not members of JESF but are active participants.

The **Compliance Development Operations (CDO)** within the EDD, Tax Branch, Field Audit and Compliance Division serves as the primary lead development organization for EDD's Employment Tax Audit Program. The various CDO programs that concentrate on underground economy lead development are as follows:

The **Employment Enforcement Task Force (EETF)** works with JESF partner agencies to conduct joint on-site business inspections to identify employers operating in the underground economy. The goal of EETF is to identify and bring into compliance those individuals and businesses participating in the underground economy that are in violation of payroll tax, labor, and licensing laws.

The **Tax Enforcement Group (TEG)** conducts desk investigations of businesses in a variety of industries using various databases and income tax return analysis to detect noncompliance and fraud.

The **Labor Enforcement Task Force (LETF)** headed by the Department of Industrial Relations was established in January 2012 as a joint effort by state and federal agencies to combat the underground economy. The LETF replaced the Economic and Employment Enforcement Coalition (EEEC) and consists of investigators from EDD, the Department of Industrial

Relations (Division of Labor Standards Enforcement and California Occupational Safety and Health), the Contractors State Licensing Board, and the United States Department of Labor (DOL).

The **Lead Development and Program Support Group (LDPSG)** captures allegations of non-compliance submitted via the Underground Economy Fraud Hot Line, correspondence, and electronic mail. The allegations are screened and forwarded to LETF, EETF, TEG, or the Tax Audit program. The Out-of-State Audit Lead Development Process within the LDPSG provides audit leads on out-of-state employers that have operations in California to EDD's Tax Audit Program.

A **Questionable Employment Tax Practices Program (QETP)** Memorandum of Understanding allows for exchange of case information between EDD and the Internal Revenue Service. During CYs 2010 and 2011, EDD had a pilot program under which they used Internal Revenue Service QETP case information to issue assessments for amounts owed to EDD. In 2012, the pilot program ended and EDD began referring these cases to their Tax Audit Program as audit leads.

The **UI Rate Equity Group (UIREG)** makes assessments of UI rate differences when reserve accounts are transferred by employers attempting to circumvent the UI experience rating system to inappropriately gain a favorable UI rate.

## SIGNIFICANT PENALTIES FOR MISCLASSIFYING

California state law imposes significant tax penalties for of misclassifying employees as independent contractors, including repayment of back payroll taxes, subject to interest and a 10% penalty on the unpaid taxes, and possible out-of-pocket liability for workplace injuries due to the lack of a workers' compensation insurance coverage. Failure to withhold and pay payroll taxes can also result in a misdemeanor charge, and the employer can be fined up to \$1,000 or sentenced to jail for up to one year, or both.

Employers should become familiar with the criteria for distinguishing between employees and independent contractors and consult with their labor counsel for advice and assistance in making proper classifications.

## KNOW THE LAW

### Labor Commissioner Releases New Paid Sick Leave Poster Required January 1

Shane Peterson of the California Chamber of Commerce reports the Labor Commissioner has released the new paid sick leave poster advising employees of their sick leave rights.

California recently passed the Healthy Workplaces, Healthy Families Act of 2014 which mandates paid sick

leave for workers in California. Although the benefit does not need to be provided until July 1, 2015, employers should be aware that other requirements, such as posting and notice requirements must be posted by January 1, 2015, according to the chamber.

In addition, the Chamber reports, the Labor Commissioner updated the wage notice to employees (Labor Code section 2810.5). Employers have been required to provide this notice to nonexempt employees since 2012. The notice has been updated for 2015 to contain information about an employee's right to accrue and use paid sick leave and about employee protections under the paid sick leave law.

The revised notices available on the Commissioner's website at:

<http://www.dir.ca.gov/dlse/dlse-publications.htm>

They include:

- Notice to Employee, Labor Code Section 2810.5;
- Paid sick days poster template; and
- Revised Notice to Employee, Labor Code Section 2810.5.

## **EX-EMPLOYEES ACCESSING COMPANIES' PRIVATE AND CONFIDENTIAL DATA FILES**

Security Magazine reports that ex-employees are leaving with the keys to company data, suggesting they still have access to private and confidential information.

The magazine reports that in July, 2014 alone, 940,000 people in the Professional and Business Service industry left their jobs according to the federal bureau of Labor Statistics. That leads to the question of how much power and access do those people still have over company data.

A study by Intermedia and Osterman Research found that 89 percent of former employees retained access (i.e. valid login and password) to corporate applications such as Salesforce, PayPal and email and 45 percent retained access to "confidential" or even "highly confidential" data after leaving the company. Almost half had logged into a company account after departing.

The problem is, the report notes, there is often no clear responsibility for decommissioning and revoking access. Email might be overseen by IT. While payroll apps reside in HR or Payroll and business apps are provisioned by department managers. In most small businesses IT has one master and if that employee leaves management is in the dark and slow to react.

Sixty percent of survey respondents were not asked for their cloud logins prior to leaving their former companies, possibly because no one knew which department should ask.

Rogue access also creates loopholes through which data can escape an enterprise, possibly fostering legal

quagmires, including trying to track down sensitive information on employees' or former employees' personal devices in order to fulfill an eDiscovery request. Consider that 68 percent of former employees surveyed stored work files in personal cloud storage, and 88 percent retained access to the file sharing services they used at their old job.

The report suggests that companies must implement rigorous access management and IT offboarding processes; deploy a cloud storage service that is easier and more useful than vulnerable third-party solutions; and utilize single sign-on portals to manage access.

## **STATE PURCHASING MANAGERS SAY MANUFACTURING GROWTH SLOWING**

Dr. Raymond Sfeir, Chapman University, Argyros School of Business and Economics Professor of Economics and Research Fellow, in October, issued a report showing the California manufacturing economy is expected to grow at a slightly slower rate in the fourth quarter compared to the third quarter of 2014.

According to the survey of purchasing managers, the Composite Index, measuring overall manufacturing activity, decreased from 61.3 in the third quarter to 59.9 in the fourth quarter, indicating growth, albeit at a lower rate.

Production and new orders are expected to grow at a slower pace compared to the third quarter. On the other hand, the purchasing managers are expecting employment to continue to improve in the fourth quarter as the index reached a higher level than the third quarter reading.

In San Diego a textile mill's purchasing manager said they are raising the (city) minimum wage. Although incremental this will have a domino effect. I only have two or three new employees at minimum but if they receive a raise all employees expect a "raise" too.

The San Diego based manager said "I currently offer healthcare insurance and retirement. Our healthcare went up 30% so more than likely I will have to just raise pay and drop benefits - I am assuming this is what they wanted anyway. It is getting almost impossible to have any manufacturing in CA- We will more than likely sell our business in the next 5 years... I suppose it would be advantageous to move it to Texas."

A primary metals purchasing manager said, "We currently have a solid backlog of work that will take us into the and thru the 4th Quarter. We will need additional workers but qualified welders and fitters are at a premium and commanding higher wages than before."

"Our overall feedback from our customers is very good with increases coming in for almost all customer types," an Aerospace Products & Parts purchasing manager said.

A Computer and Electronic Products manager said, "Though this might be related to CA only. Workers comp this year has increased again though my "Experience Mods" have decreased. This increase brings an increase of over 100% in the last 5 years. Medical insurance is up, Liability insurance based on decreased sales are up. My extremely negative view is based on the above increased costs. It might be hitting my industry now. Eventually, I will not be only company dealing with these issues."

The study showed the manufacturing sector's Composite Index for Orange County increased from 62.2 in the third quarter to 62.6 in the fourth quarter, indicating that the county's manufacturing economy is expected to grow at a minimally faster rate in the fourth quarter of this year. With a California Composite index reading of 59.9, the Orange County manufacturing economy is expected to grow at a higher rate of growth compared to California's.

## OBAMA ADMINISTRATION EPA SETS STRICTER SMOG STANDARDS

Associated Press Reporter Dina Cappiello reports "The Obama administration took steps November 26 to cut levels of smog-forming pollution linked to asthma, lung damage and other health problems, making good on one of President Barack Obama's original campaign promises while setting up a fresh confrontation with Republicans and the energy industry.

In a long-awaited announcement, the Environmental Protection Agency said it prefers a new, lower threshold for ozone pollution of 65 to 70 parts per billion, but said it would take public comments on an even lower standard of 60 parts per billion sought by environmental groups. The current standard is 75 parts per billion, put in place by President George W. Bush in 2008. The EPA was under a court-ordered Dec. 1 deadline to issue a new smog standard.

Pushing back on criticism that new regulations will damage the economy, EPA Administrator Gina McCarthy said lower ozone standards would actually spur more businesses, investment and jobs by making communities healthier. She said states would be given time to carefully design plans to meet the new standard over the coming decades.

"Critics play a dangerous game when they denounce the science and law EPA has used to defend clean air for more than 40 years," McCarthy wrote in an op-ed for CNN's website. "The American people know better."

But business groups like the National Association of Manufacturers painted the government's move as a roadblock that threatens to jeopardize manufacturing's comeback in the U.S. They accused the administration of moving the goalposts, since states are still working to implement the previous standard put in place in 2008.

"Tightening these standards could be the most expensive regulation ever imposed on the American public, with potentially enormous costs to the economy, jobs, and consumers," said Jack Gerard, president of the American Petroleum Institute.

Under the Obama administration, the EPA has issued or proposed the first regulations to control heat-trapping carbon dioxide, mercury and air toxins from power plants. The administration also has doubled fuel-efficiency standards for cars and trucks and clamped down on industrial pollution that blows downwind and contaminates other states.

The initial range of 60 to 70 parts per billion proposed by the EPA in January 2010 would have made it one of the most expensive regulations ever issued, with an estimated \$19 billion to \$90 billion price tag, and would have doubled the number of counties in violation. The agency will seek comment on 60 parts per billion as well as the current standard of 75 parts per billion.

## OBAMA OPPORTUNITY TO "RIGHT A WRONG"

"Seldom do presidents get an opportunity to right a wrong," said Bill Becker of the National Association of Clean Air Agencies, one of numerous advocacy groups that were enraged by the White House's decision to table the first proposal.

In response to the new proposal, Becker said Tuesday night that Obama "has walked the walk on air."

Under the initial proposal, smog cities such as Los Angeles and Houston would have been joined by California's Napa Valley and a county in Kansas with a population of 3,000. The higher range now sought would mean fewer counties would be out of compliance.

Also, other air pollution rules will likely ease the burden on counties and states by reducing smog-forming ground-level ozone as a side effect. Ground-level ozone is created when pollutants from power plants, factories and automobiles react in sunlight.

States would have up to 20 years to meet the new limits, or could face federal penalties.



Thanks and a tip of the hat to:

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