

USING INDEPENDENT CONTRACTORS: INCREASED RISKS FOR MASSACHUSETTS EMPLOYERS

Many employers use "independent contractors" to supplement their regular workforce. There are distinct advantages to using trained, non-employee workers with specialized skills, but there are also significant risks. Recent legal developments in Massachusetts make this area more perilous than ever. This edition of the Employment Law Advisor focuses on the risks associated with using independent contractors and the steps employers can take in response.

WHY USE INDEPENDENT CONTRACTORS?

Independent contractors can provide flexibility and cost savings. Because they are usually engaged on a short term or project basis, independent contractors permit many businesses to react nimbly to marketplace demands, adding or subtracting workers as needed. Contract workers also often possess specialized knowledge and skills. They also may possess a desirable entrepreneurial spirit and sense of responsibility that derives from running one's own business.

More important for many businesses are significant potential cost savings. Businesses generally do not spend substantial time and money training contract workers because those workers usually have experience in the work they are hired to do. Further, businesses experience significant tax savings, including avoiding the payment of the employer's share of Federal Insurance Contribution Act tax ("FICA") and Federal Unemployment Tax Act ("FUTA") excise tax. Businesses also avoid payments toward state unemployment and worker's compensation insurance, and substantial costs associated with employee benefits plans. In addition, there are often administrative and overhead savings, including the reduction of costs associated with payroll tax compliance and employee supervision and management.

THE RISK OF MISCLASSIFICATION

Inherent in the use of independent contractors is the risk that the Internal Revenue Service (the "IRS") or other government authority will determine that a business should have treated particular independent contractors (or an entire class of contract workers) as employees for tax, wage-hour, unemployment, workers compensation and/or employee benefit plan purposes. Misclassifying employees as independent contractors may subject businesses to (1) income tax liability and penalties for amounts that should have been withheld from the "wages" of the "employees," (2) employer FICA and FUTA contributions, (3) potential overtime pay and other wage claim liability, (4) unemployment insurance payments, (5) workers compensation insurance premiums (and

potential liability for workplace injuries), and (6) other civil and criminal liability.

DETERMINING WORKER STATUS

Under Federal Law

The IRS is the government agency responsible for determining whether a worker is an employee or independent contractor for purposes of federal employment taxes. While the term "employee" is defined slightly differently for FICA, FUTA and federal income tax withholding purposes, the principal test that the IRS applies in determining worker status is called the "common law test". This test examines the extent that the business retains the right to direct and control the worker with respect to when, where and how work is performed.

The IRS has developed a list of twenty factors to be used as an analytical aid in applying the common law test. Examples of the factors include whether workers must comply with employers instructions about the work, must follow set hours of work, and do not offer their services to the general public. Many employers have become familiar with the twenty factors in evaluating whether particular workers are properly classified as independent contractors. No one factor is decisive and the degree of importance of each depends on the occupation and factual context in which services are being performed.

Under Massachusetts Law

Many Massachusetts employers are surprised to learn that the Commonwealth has a different test for determining worker status for purposes of state income tax withholding, state wage-hour laws, worker's compensation, and the maintenance of payroll records. The Massachusetts Independent Contractor Law, amended in 2004, creates a **presumption** that a work arrangement is an employer-employee relationship. To overcome this presumption, the employer receiving services must establish that:

- 1) the worker is free from the employer's control and direction in performing the service, both under a contract and in fact;
- 2) the service provided by the worker is outside the employer's usual course of business; and
- 3) the worker is customarily engaged in an independent trade, occupation, profession or business of the same type.

The Massachusetts Attorney General enforces the Massachusetts Independent Contractor Law. The Attorney General declared in a recent "advisory" that the Massachusetts law "excludes far more workers from independent contractor status than are disqualified under the IRS common law test." The Attorney General noted that, while the twenty factors considered by the IRS are considered flexible and can be adjusted to the circumstances of the work arrangement,

Massachusetts law establishes a rigid, three-part test that must be met for a business to overcome the law's presumption of an employment relationship.

There are several other noteworthy aspects to the Massachusetts law: (1) according to the Attorney General, a **contract** or **job description** indicating that a worker is free from supervisory direction or control **is required** to establish independent contractor status; (2) a worker who performs the same type of work that is part of the normal service delivered by the business **may not** be treated as an independent contractor; (3) an independent contractor **must** represent him or herself to the public as being in business to perform the same or similar services; (4) an employer's failure to withhold taxes, contribute to unemployment compensation, or provide worker's compensation **may not** be considered when determining worker status, thus suggesting that an employer's subjective belief that a worker is an independent contractor has little relevance under the law; and (5) the law creates broad liability for both business entities and individuals, including corporate officers and those with management responsibility over affected workers.

The Attorney General can issue civil citations and institute criminal prosecution for both intentional and unintentional violations of the Independent Contractor Law. Willful violations can result in fines up to \$25,000 or imprisonment for up to one year for a first offense, and fines up to \$50,000 or imprisonment for up to two years for subsequent violations. Non-willful violations can result in fines up to \$10,000 or imprisonment for up to six months for a first offense, and fines up to \$25,000 or imprisonment for up to one year for subsequent violations.

Employees also may file civil actions for themselves and others similarly situated seeking treble damages, attorney's fees and costs. This is a fertile area for claims and recoverable money damages can be substantial. For example, if a group of workers treated as independent contractors worked over forty hours per week without receiving one and one-half times their regular rate of pay, damages may include three times the owed overtime pay for a period going back as far as three years.

WHAT SHOULD EMPLOYERS DO?

Businesses using independent contractors should evaluate these relationships carefully to determine whether the classification is proper under both federal and state law. Classifications that have passed muster under federal law may not meet the three-

part Massachusetts law test, particularly given the Attorney General's recent strict interpretation.

All written independent contractor agreements should be reviewed carefully and modified where appropriate. According to the Attorney General, Massachusetts law requires that independent contractor relationships be reflected in written agreements or job descriptions. These documents should be drafted in a manner that accurately describes the relationship and the parties' respective obligations. Although government agencies and courts will look beyond the agreements in determining worker status, a well written agreement is nevertheless critical in defending independent contractor status.

Applying the federal and state tests may not result in a clear answer as to proper worker status. Fortunately, there are also published IRS opinions and court decisions that can provide guidance. In many situations, after seeing how the IRS and courts have classified workers under similar circumstances, changes can be made to relationships to make independent contractor classifications more defensible. In other situations it may be appropriate to seek an advisory opinion from the IRS or other government agency with respect to the classification of certain workers (or positions). Opinions can be requested through counsel without identifying the employer in question.

After evaluating an independent contractor relationship it may become clear that a worker is misclassified and should be treated as an employee. One option then is to "let sleeping dogs lie" and do nothing. However, in our view, the better approach usually is to correct the misclassification and take appropriate steps to limit liability. To that end, the employer may attempt to change the relationship substantially enough to make the independent contractor classification proper (if that is possible), offer the worker employment, or terminate the worker and consider whether to replace him/her with an employee or some other type of service provider. How the employer deals with the effects of the past misclassification (such as the failure to withhold taxes and make employer FICA and FUTA contributions) is a more difficult issue and will depend on the particular circumstances.

The bottom line is that businesses need to be very careful. Although there are clear advantages to using independent contractors, the potential adverse consequences of misclassification are significant and should not be ignored.

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