

Who is an Independent Contractor?

By Michael R. Brown, Esq.

Many employers perceive that hiring “independent contractors” instead of “employees” can have many economic advantages, such as saving on unemployment and workers’ compensation premiums and other payroll taxes, as well as benefits available only to employees such as overtime, health coverage and stock options. However, misclassifying workers as independent contractors may result in legal exposure, substantial civil fines or criminal sanctions for the employer.

Unfortunately, there are not uniform state and federal definitions of independent contractor status. Indeed, within a single state, a different definition may be applied to payroll taxes and to unemployment and workers’ compensation coverages. This article reviews how the Internal Revenue Service of Massachusetts, Rhode Island and New Hampshire define “independent contractor” for purposes of these coverages, and suggests means for employers to limit their liability.

I. FEDERAL TAX LAW

The IRS requires employers to withhold income taxes from employee wages

and pay various other payroll taxes for employees – but not for independent contractors. To reach the important determination as to whether a person is an employee or an independent contractor, the IRS applies common law factors using the so-called “Twenty-Factor Test.” The analysis is fact-specific and none of these factors is considered dispositive; rather, it focuses on the right of control – whether the employer has the right to dictate not only the result, but also the process (or methods) the worker uses to produce the result. A worker is an employee if the employer has the right to control that which is done by the worker, whether or not the employer

actually exercises that right. The 20 factors may be divided generally into three broad categories: behavioral control, financial control and the continuing relationship of the parties.

The behavioral control category looks at factors such as what type of training the business gave the worker, whether the worker must render services personally, and the level of control over when, where and how the individual must work. The financial control category includes factors such as whether the worker is reimbursed for business expenses, whether the worker can realize a profit or suffer a loss, and whether the worker makes his services available on the open market. Finally, when looking at the type of relationship that exists, the IRS will consider factors such as whether there was a written contract describing the parties’ relationship and whether employee benefits were provided to the worker.

If an employer misclassifies an employee as an independent contractor, the company will be liable for back taxes owed with interest. Additionally, the IRS may assess a penalty of 12 percent to 35 percent of the tax bill.

II. STATE LAWS

States are free to use a different definition of “employee” to determine an employer’s obligations under state law. Therefore, employers need to be familiar with all relevant state laws and to keep in mind that in a majority of the states there is a presumption in favor of finding that a worker is an employee. Like the IRS’s Twenty Factor Test, a key common factor among the states is whether the employer has the right to control the manner and means by which



the work is performed. The more control the employer has over the way the worker does his or her job, the more likely an employer/employee relationship will be found.

TAX WITHHOLDING AND PAYROLL TAXES

For payroll tax withholding purposes, Rhode Island applies the IRS's common law rules to determine if state taxes need to be withheld. New Hampshire does not have a personal income tax, so employers there do not have a problem with any different test to be applied. On July 19, 2004, Massachusetts amended its independent contractor law and created a strong presumption that work arrangements are an employer/employee relationship. To overcome this presumption, the employer must satisfy a three-part test that is narrower than previous Massachusetts law, which applied the so-called "ABC Test" (discussed below under Unemployment Insurance). Under the new law, the fact that the worker performs the service out-



side the company's premises is now irrelevant. It is important to remember that under this new law, unlike other tests discussed here, the "right of control" factor, while it continues to be very important, is not dispositive. Thus, even if that factor is met, the other two prongs of the new test must be met. Unless all three factors are satisfied, the worker will be considered an employee under the new law.

The state attorney general has issued a guidance indicating that the amended law applies in all employment contexts, although the text of the statute itself appears to limit its effects to minimum wage, overtime and a variety of working conditions such as holidays, days of rest, Sunday work, workplace safety, personnel records, maternity leave and timely payment of wages (but not unemployment or workers' compensation coverage). The Massachusetts Commissioner of Revenue has taken the position and has proposed a regulation clarifying that Massachusetts law using the Twenty Factor Test will continue to apply in

determining whether a worker must be treated as an employee for tax withholding purposes.

UNEMPLOYMENT INSURANCE

As noted, Rhode Island uses the Twenty Factor Test. However, New Hampshire and Massachusetts employ the so-called "ABC Test" to determine whether unemployment taxes have to be paid. Under the ABC Test, an employer must demonstrate that the worker meets all three of the following requirements to be classified as an independent contractor:

- A. The worker must be free from direction and control in the performance of the service, both under the contract to hire and in fact; and
- B. The worker's services must be performed either 1) outside the usual course of the employer's business; or 2) outside all of the employer's places of business; and
- C. The worker must be customarily engaged in an independently established trade, occupation, profession or business of the same nature as the service being provided.

If any of these three requirements are not met, the worker is deemed to be an employee and unemployment taxes must be paid.

WORKERS' COMPENSATION INSURANCE

Each of these three states continues to apply different rules. To avoid the requirement for workers' compensation coverage in Rhode Island, the worker in question must file a notice of designation as an independent contractor with the state. The notice creates a presumption of status as an independent contractor. If the individual fails to file a notice, it will be very difficult for the employer to avoid the obligation to provide coverage.

In New Hampshire, for worker's compensation purposes, an individual must meet all of the following criteria to be classified as an independent contractor:

1. The individual must have a Federal Employer Identification Number;
2. He must have control or discretion over the means of performance of the work;

3. He must have control over the time when the work is performed;
4. The person must hold himself out to be in business for himself; and
5. The person cannot be required to work exclusively for the employer.

If all five of these requirements are satisfied, the individual may be classified as an independent contractor and need not be covered by workers' compensation in New Hampshire.

Massachusetts follows a right of control test much like the ABC Test. The importance of proper classification in this area cannot be overstated. If a worker is injured, but was not covered by his employer's workers' compensation policy because of an independent contractor classification, the employer may have opened itself to a variety of unpleasant results, including state sanctions and the ability of the worker to sue the employer privately.

III. REDUCING LIABILITY

All employers, particularly those in Massachusetts where the new law is still being analyzed, should evaluate carefully

whether a worker is an independent contractor or not. In addition, employers should review any written agreements with so-called independent contractors to determine whether they reflect the relationship accurately, and whether they still meet muster under either the new Massachusetts law or other states' laws. Employers should seek the advice of an experienced employment lawyer in reaching this important decision. In so doing, employers should ask themselves why is it important to their organization to treat certain individuals as independent contractors rather than employees. Employers should further consider whether the risks discussed above in making the wrong call on classification should help drive the best answer to that basic question. While some employers may be reluctant to do anything, the legal liability will only continue and increase. ■

Michael R. Brown, Esq., is a partner at Seyfarth Shaw LLP. He is NEHRA's legal advisor and can be reached at mrbrown@seyfarth.com.