Advisory

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Employee Misclassification: Avoid the Looming Crackdown.

Connecticut Attorney General, Richard Blumenthal, recently called for stiffer penalties against employers who misclassify employees as independent contractors. Specifically, Attorney General Blumenthal is seeking a dramatic increase of the current penalty for misclassifying employees of $300 per violation to at least $300 per day for each worker misclassified as an independent contractor. The Connecticut General Assembly is expected to take up Attorney General Blumenthal's proposal during its current session.

Attorney General Blumenthal's call to arms is just the most recent evidence of a looming crackdown on employee misclassification. In July of 2008, the General Assembly created a joint enforcement commission on employee misclassification, which reviews employee misclassification and coordinates civil prosecutions of state and federal laws as a result of employee misclassification. Beginning on February 1, 2010, the commission began reporting to the governor and legislature on employee misclassification including recommendations for legislative and administrative action. The commission is expected to launch its website later this month. The website is designed to educate workers about misclassification and will allow them to file complaints in their names or anonymously.

These recent efforts on the State level are part of a larger nationwide initiative to stamp out employee misclassification. In August 2009, the United States Government Accountability Office issued a report calling for the U.S. Department of Labor and the Internal Revenue Service to take significant steps to combat employee misclassification. In response, in February 2010, the IRS began an anticipated three-year long audit of 6,000 employers in an effort to uncover occurrences of misclassification and to recover lost tax revenue. Similarly the U.S. DOL has announced that it intends to step up its enforcement activity with a new initiative targeting employee misclassification.

On December 15, 2009, just four months after the issuance of the GAO report, Senator John Kerry introduced the Taxpayer Responsibility, Accountability and Consistency Act of 2009, which targets misclassification by allowing workers classified as independent contractors to directly petition the IRS for a determination as to the accuracy of the classification. The proposed Act also includes a steep increase in the penalties for employee misclassification and strips an existing safe harbor provision that currently protects employers who have mistakenly misclassified workers so long as the employer has a "reasonable basis" for the classification.

The increasing state and federal attention on employee misclassification means it is more important than ever for employers to ensure they are properly classifying employees and independent contractors. Only through proper classification can employers sidestep potentially significant liability.

Who is an Independent Contractor?

Simply labeling a worker as an independent contractor does not make him or her one, even if the employee has accepted that status in writing. Generally, workers are considered employees if they are subject to another's right to control the manner and means of performing the work. Independent contractors are individuals who obtain customers on their own to provide services.

continued next page

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They may have other employees working for them and they are not subject to close control over the manner by which they perform their services.

Complicating matters is the fact that while most employment laws apply only to employees (and not independent contractors), there are at least six different tests for determining whether a worker is an employee or independent contractor. Which test applies depends on the statutory provision in question, the enforcement authority and/or the jurisdiction.

The Common Law Test

State and federal discrimination statutes, as well as ERISA, most workers' compensation statutes, and certain common law torts (such as wrongful discharge) rely on the common law principles of agency to classify workers. Whether a worker is an employee or independent contractor under the common law of agency depends on a fact-specific balancing test which requires analysis of thirteen factors:

- the hiring party's right to control the manner and means by which the product is accomplished;
- the skill required to perform the job;
- the source of the worker's instrumentalities and tools;
- the location of the work (i.e., at the hiring party's premises or on the property of a third party);
- the duration of the relationship between the parties (i.e., indefinite or for a defined period);
- whether the hiring party has the right to assign additional projects to the worker;
- the extent of the worker's discretion over when and how long to work;
- the method of payment;
- the worker's role in hiring and paying assistants;
- whether the work is part of the regular business of the hiring party;
- whether the hiring party is in business;
- the provision of employee benefits;
- and the tax treatment of the worker.

While application of a thirteen-factor test may seem daunting, Connecticut and federal courts applying this test tend to focus principally on whether the employer has the right to control how the individual performs his/her job. For example, if the hiring entity retains the right to instruct a worker specifically how to perform the job, the worker is more likely to be deemed an employee. However, if the individual determines how to perform the job without oversight from the hiring entity, then the worker is more likely to be an independent contractor.

The Labor Relations Test

Determining whether a worker is an employee entitled to the protections of the National Labor Relations Act requires the application of a modified common law test. Although all thirteen factors remain in play, rather than focusing on the hiring party's right to control workers, this test centers on whether the workers have significant entrepreneurial opportunity for gain or loss. In other words, this test depends on whether the worker or the hiring party stands to gain or lose as a result of the work performed. If the hiring party bears the risk of profit or loss, the worker is most likely an employee.

Federal Payroll Taxes

To ensure that employers are properly paying the requisite payroll taxes, the IRS has historically applied a 20-factor analysis based on the common law test to determine

whether workers are employees. Recently, however, the IRS has attempted to simplify its 20-factor test by instructing the hiring party to hone in on three aspects of the hiring party's relationship with the worker to determine the degree of control or independence present. According to the IRS the three critical aspects are:

- Behavioral: Does the hiring party control or have the right to control what the worker does and how the worker does his or her job?
- Financial: Are the business aspects of the worker's job controlled by the hiring party? (These include factors like how the worker is paid, whether expenses are reimbursed, who provides tools/ supplies, etc.)
- Type of Relationship: Are there written contracts or employee type benefits (i.e. pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?

Like the common law and labor relations test, the IRS test is a balancing test. However, unlike those tests, the IRS test lacks a dominant factor which takes primacy in close cases. Thus, the IRS test can be difficult to apply, and exposes employers to the risk of misclassification.

Currently, Section 530 of the Revenue Act of 1978 mitigates that risk by creating a safe harbor in the event of misclassification unless the employer has "no reasonable basis" for its classification of the worker. However, as noted above, the recently proposed Taxpayer Responsibility, Accountability and Consistency Act of 2009 seeks to abolish that safe harbor. If that bill passes, employers could find themselves liable for all back taxes and penalties stemming from misclassification of employees even if the misclassification was justified by, for example, industry practice.

The ABC Test (Conn. Gen. Stat. § 31-222(a)(1)(B))

Connecticut's Department of Labor uses its own test to determine whether workers are employees for purposes of State unemployment taxes. Dubbed the ABC Test, the Department will consider a worker to be an independent contractor if:

- [A] such individual has been and will continue to be free from control and direction in connection with the performance of such service, both under his contract for the performance of service and in fact;
- [B] such service is performed either outside the usual course of the business for which the service is performed or is performed outside of all the places of business of the enterprise for which the service is performed; and
- [C] such individual is customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service performed.

Unlike the common law test, labor relations test, or IRS test, a worker must satisfy all three prongs of the ABC Test to be considered an independent contractor by the Connecticut Department of Labor. Thus, applied properly, only a small minority of workers will be independent contractors under the ABC Test. To aid entities in the proper application of the ABC Test, the Department of Labor offers a self assessment worksheet on its website at http://www.ctdol.state.ct.us/uitax/abctest.doc.

Economic Reality Test

Finally, the United States Department of Labor applies a different test to cases arising under the federal Fair Labor Standards Act and FMLA. This "Economic Reality test" focuses on:

- the degree of control exercised by the employer over the worker;
- the worker's opportunity for profit or loss and their investment in the business;
- the degree of skill and independent initiative required to perform the work;
- the permanence or duration of the working relationship;
- the extent to which the work is an integral part of the employer's business

The economic reality test is broader than the common law test, but like that test no one factor is dispositive. The ultimate concern is whether, as a matter of economic reality, the worker is in business for him or herself or depends upon the hiring party's business for the opportunity to work.

Navigating the Road Ahead

Given the looming crackdown on employee misclassification and the possibility of significantly increased penalties, it is imperative that employers begin self-auditing their workforces to ensure compliance with each test. At the same time, employers should review internal treatment of independent contractors to make sure it is consistent (i.e. employers must not treat workers as employees by providing benefits but as an independent contractor for purposes of payroll taxes).

Knowing which test to apply is only the first step. Successfully determining whether a worker is an independent contractor depends on the proper application of these divergent tests. While some workers will fit cleanly into one category or another, others will require nuanced analysis. Employers are well-advised not to ignore the remaining factors of the common law test, and to seek legal advice if they have any questions about how to classify a particular worker or workers.

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