The Massachusetts Independent Contractor Law

Serious Problems and Difficult Choices for Businesses in Massachusetts

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Many businesses use "independent contractors" to augment their regular workforce. They see advantages to using trained, non-employee workers with specialized skills who can provided needed services on an a short-term or long-term basis. Indeed, some companies have developed their business models based upon the use of such non-employee workers.

However, the ability of businesses to classify workers as independent contractors is not unchecked. Businesses cannot avoid employer obligations simply by designating certain workers as independent contractors. The Internal Revenue Service ("IRS") often examines independent contractor relationships to determine whether, in fact, the relationships are really employment relationships because businesses have retained the right to direct and control the workers with respect to when, where and how work is performed. A determination that a company misclassified employees as independent contractors can have serious consequences both for the company and for those determined to be "responsible persons."

States also have an interest in seeing that employees are not misclassified as independent contractors, as it affects state tax revenues, workers' compensation, and unemployment compensation. To the surprise of many businesses, some states apply different tests than the IRS for determining worker status (at least for purposes of determining worker unemployment benefits). Massachusetts is one of those states and has gone even further; it has enacted an independent contractor law that creates a "presumption" of employee status for purposes of the Commonwealth's wage laws and requires businesses to meet a strict three-part test to overcome this presumption. Recent amendments to the Massachusetts law make the test essentially **impossible** to meet for a company with workers providing services that are within the company's usual course of business. The amendments also broaden the law's applicability, increase its penalties for noncompliance, and make it a more attractive vehicle for private lawsuits, including class actions.

The Massachusetts Independent Contractor Law presents serious problems for many companies that rely upon independent contractors to meet business needs. Companies operating in Massachusetts need to understand the law and evaluate the risks involved. Some companies then may need to make some difficult choices about how they operate their businesses. This article is intended to assist businesses in understanding the legal issues and risks involved in this evolving area of employment law.

Why Use Independent Contractors?

Why do businesses 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. Further, contract workers often possess specialized knowledge and skills. Moreover, many possess a desirable entrepreneurial spirit and sense of responsibility that derives from running one's own business.

For some companies the use of independent contractors is central to the companies' business models. Many courier companies, for example, use "owner-operator" independent contractors to handle the pick-up and delivery part of their businesses. Various types of consulting firms use independent contractors to provide the actual consulting work performed at client locations. Many home health care businesses use independent contractor physical therapists and occupational therapists to provide services to clients in their homes.

Some companies use independent contractors "as needed" to supplement their workforces during busy periods. An accounting firm, for example, may use an independent contractor accountant to perform audits or handle overflow work during tax season. The accountants might perform the work at client locations or at their own offices. Similarly, a law firm may use independent contractor lawyers or paralegals to assist on big trials.

For many businesses the primary motivation for using independent contractors rather than employees is the cost savings. Businesses generally do not spend substantial time and money training contract workers because, presumably, the workers are already trained to perform the tasks for which they are engaged. 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 workers 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 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 a business to (1) income tax liability for monies 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) state unemployment insurance payments, (5) workers' compensation insurance premiums (and potential liability for workplace injuries), (6) other civil and criminal liability. Additionally, workers may be entitled to coverage (and benefits) under existing employee benefit plans.

Determining Worker Status: Employee vs. Independent Contractor

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 applied by the IRS in determining worker status is called the "common law test." This test examines the extent to which 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. Workers are generally employees if they: (1) must comply with employer's instructions about the work; (2) receive training from or at the direction of the employer; (3) provide services that are integrated into the business; (4) provide services that must be rendered personally; (5) hire, supervise, and pay assistants for the employer; (6) have a continuing working relationship with the employer; (7) must follow set hours of work; (8) work full time for an employer; (9) do their work on the employer's premises; (10) must do their work in a sequence set by the employer; (11) must submit regular reports to the employer; (12)

receive payments of regular amounts at set intervals; (13) receive payments for business and/or traveling expenses; (14) rely on the employer to furnish tools and materials; (15) lack a major investment in facilities used to perform the service; (16) cannot make a profit or suffer a loss from their services; (17) work for one employer at a time; (18) do not offer their services to the general public; (19) can be fired at any time by the employer; and (20) may quit work at any time without incurring liability.

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. Many businesses have become familiar with these twenty factors in evaluating whether particular workers are properly classified as independent contractors.

The common law test and its twenty factors may be the most well-known test for determining worker status. However, in enforcing the Fair Labor Standards Act ("FLSA"), which contains federal minimum wage and overtime requirements, the U.S. Department of Labor ("DOL") looks instead to the "economic reality" of the relationship and considers the following factors to be significant: (1) the extent to which the services rendered are an integral part of the employer's business; (2) the permanency of the relationship; (3) the amount of the worker's investment in facilities and equipment; (4) the nature and degree of control by the employer; (5) the worker's opportunities for profit and loss; (6) the amount of initiative, judgment, or foresight in open market competition with others required for the success of the claimed independent contractor; and (7) the degree of independent business organization and operation.

The different tests and many factors considered in determining worker status create uncertainty for businesses. However, this uncertainty is mitigated to some degree by the many published federal court decisions and IRS and DOL opinion letters and rulings over the years. Many companies take some comfort in knowing that federal courts and agencies have examined and accepted similar independent contractor relationships. For federal law purposes at least, businesses are often able to model their independent contractor relationships based upon what upon courts, the IRS and/or DOL have said is correct. Moreover, businesses can go further and request formal determinations from the IRS concerning worker status by submitting an IRS Form SS-8 (Determination of Employee Work Status for Purposes of Federal Employment Tax Obligations).

Unfortunately, the situation gets more complicated and problematic for businesses when different states in which they operate establish their own tests for determining worker status. This is what has happened in Massachusetts.

Worker Status under Massachusetts Law

The Unemployment Compensation Law Test

Massachusetts is among nineteen states that have a three-part test for determining worker status **for unemployment compensation purposes**. This test is often referred to as the "ABC test." For many years Massachusetts law (M.G.L. c. 151A, § 2) has required an employer that contests an individual's entitlement to unemployment benefits based upon independent contractor status to establish:

> "(a) such individual has been and will continue to be free from control and direction in connection with the performance of such services, both under his contract for the performance of service and in fact; and
>
> (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 or the same nature as that involved in the service performed."

The presumption of employee status and the strict three-part test makes establishing an independent contractor relationship (for unemployment compensation purposes) more difficult than the IRS common law test or the FLSA "economic reality" test. While the test in the Massachusetts unemployment compensation law creates problems for some businesses, at least it is consistent with the law of nineteen other states and the law's broad social purpose, which is "to lighten the burden which now falls on the unemployed worker and his family." M.G.L. c. 151A, §74.

The Massachusetts Independent Contractor Law

Massachusetts, however, set itself apart from other states in 1990 when it enacted the Independent Contractor Law, M.G.L. c. 149, §148B ("the MICL"). In doing so, the Commonwealth took the ABC test, which is generally only contained in unemployment compensation laws, and made it part of to the wage law requirements of M.G.L. c. 149. This was a significant development in Massachusetts law. Nonetheless, for almost fifteen years the MICL remained somewhat unnoticed. Many businesses using independent contractors continued to view the federal law tests, and especially the twenty factors used by the IRS, as the standard for determining worker status.

The MICL was amended on July 19, 2004, and now is getting plenty of attention. The 2004 amendments expanded the application of the MICL to M.G.L. c. 151 (which contains minimum wage and overtime requirements), increased the penalties for misclassification, and changed the second part of the ABC test in a very significant way.

As before the 2004 amendments, the MICL creates a presumption that "an individual performing any service" is an employee. To overcome this presumption, the party receiving services must now establish:

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

Prior to the 2004 amendments, the second part of this three-part test stated that a business must establish that "such service is performed either outside the usual course of the business for which the service is performed or is performed outside of all places of business of the enterprise." The deletion of the "or is performed outside of all places of business of the enterprise" language is very significant and impacts a broad range of businesses that use independent contractors to perform certain work at home, at the contractor's own place of business, or at client locations.

The 2004 amendments to the MICL were initiated by Massachusetts construction industry trade unions who view the use of independent contractors by construction companies as a major problem. Companies can save significant costs, including workers' compensation costs, by classifying workers as independent contractors. The deletion of the "or is performed outside of all places of business of the enterprise" was viewed, essentially, as closing a loophole in the MICL. The amendments were part of a public construction-related bill ("An Act Further Regulating Public Construction in the Commonwealth," Chapter 193 of the Acts of 2004), and

passed at the end of the legislative session, in the middle of summer, with little, if any, opposition or debate. It seems fair to say that most legislators did not recognize the impact the amendments would have on non-construction industry businesses. Most business groups outside the construction industry were unaware of the legislation before it passed and never weighed in on it.

Business groups believe that the broad impact of the deletion of the "or is performed outside of all places of business of the enterprise" language was **not** intended. But unintended impact or not, that fact is that, as a result of the amendments to the MICL, many types of businesses can no longer properly classify workers as independent contractors. Affected businesses include accounting firms, law firms, engineering firms, various consulting firms, and home health care businesses, among many others.

The Massachusetts Attorney General enforces the Massachusetts Independent Contractor Law. In December 2004 the Attorney General issued an "advisory" which declared that **the MICL, as amended, "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 to overcome the law's presumption of an employment relationship.

The MICL has other significant provisions. A written contract or job description indicating that a worker is free from supervisory direction or control **is required** to establish independent contractor status (at least according to the Attorney General). 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. The law also 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 MICL. 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, attorneys' 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.

Uncertainty and Difficult Choices: What Should Businesses Do?

Since the publication of the Attorney General's advisory this past December, when news of the amended MICL finally began to spread, many Massachusetts businesses have been struggling with how to react. There are businesses that have been using independent contractors for years and now must consider whether they have to change the way they do business. Some of these businesses have multi-state operations and have determined that Massachusetts is the only state where they are in trouble because Massachusetts now applies an independent contractor test that is different and much more difficult than the ones applied by the federal government and every other state in which they do business.

Many individuals are also adversely impacted. Persons who choose to operate as independent contractors face the prospect of losing clients who are now afraid to use them. Others face a decrease in the demand for their work and/or the amount paid for their services because businesses are now required to pay FICA, FUTA, state unemployment insurance and worker's compensation premiums. Some predict that businesses will terminate relationships with individual contractors and turn instead to professional staffing firms.

What should businesses do? All companies using independent contractors need to evaluate these relationships carefully to determine whether the classification is proper under the MICL. (Of course, in the process some businesses will learn that their independent contractors are misclassified even under federal law and/or the pre-amended MICL.) All written independent contractor agreements should be reviewed carefully and modified where appropriate. According to the Attorney General, the MICL requires that all independent contractor relationships be reflected in written agreements or job descriptions. These documents should be drafted in a manner that correctly describes the relationship and the parties' respective obligations. Although federal and state 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.

After evaluating independent contractor relationships it may become clear that certain workers are misclassified under the MICL test and should be treated as employees. One option is to do nothing and hope that no worker complains, the Attorney General's Office does not come knocking, and maybe the legislature will recognize the problems created by the amended MICL and do something about it. Indeed, there is some hope among business groups that corrective legislation will be enacted to eliminate the "unintended impact" of the amendments. This hope was strengthened somewhat by a draft Technical Information Release issued by the Massachusetts Department of Revenue ("DOR") on March 8, 2005.

DOR stated that the 2004 amendments to the MICL do not change DOR rules for determining whether a person is an employee or independent contractor **for purposes of Massachusetts tax withholdings**. DOR said that for wage withholding purposes under M.G.L. c. 62B it would continue to accept IRS determinations concerning the status of workers and DOR would be guided by the IRS twenty factor test and common law elements of direction and control. So, where a worker is determined to be correctly classified as an independent contractor for state tax withholding purposes (applying the IRS standard) but incorrectly classified under the MICL, liability should not extend to the failure of the business to withhold state taxes.

Now there are different tests applied for tax withholding purposes (M.G.L. c. 62B), for unemployment compensation purposes (M.G.L. c. 151A), and for wage and hour law purposes (M.G.L. c. 149 and c. 151). It is not entirely clear what test now applies for workers' compensation purposes (M.G.L. c. 152), though the Attorney General and the Massachusetts Department of Industrial Accidents have stated that it is the MICL test. Some hope that the confusion and uncertainty created by the differing tests under Massachusetts law, on top of the wide scale problems created by the MICL, will prompt legislative action.

Doing nothing, of course, has its risks. The MICL gives the Attorney General and private litigants potent ammunition in the form of stiff penalties (civil **and criminal**), treble damages, and the right to recover attorneys' fees and costs. The Attorney General's approach to enforcing the amended MICL is not yet clear. Will it be more aggressive as a result of the amendments, perhaps targeting particular industries for non-compliance? Only time will tell. Regardless, though, private civil actions may pose the greater danger for businesses. As word of the MICL spreads, more and more workers and attorneys will recognize it as a relatively easy way to recover money from non-compliant businesses, particularly those businesses that use many independent contractors.

As a result, many businesses will decide to stop using certain (or all) independent contractors, or to change the status of these workers to employees. Where workers are reclassified, businesses

will have to consider whether the reclassifications will be retroactive or just prospective. What are the legal ramifications? What effect will the reclassifications have on employee benefits? Businesses will need to examine employee handbooks, policies and benefit plan documents to ensure that no unintended extension of employer obligations or employee benefits results from reclassification. Employer plans and policies may need to be amended.

Another alternative is to maintain the independent contractor relationships but take steps to limit potential exposure. For example, a business can take measures to ensure that no independent contractor works more than forty hours per week, so that the business does not face potential overtime liability. A business also can pay unemployment compensation contributions and workers' compensation premiums on behalf of its independent contractors, and thus limit legal exposure in these areas. (Of course, paying these costs may defeat a principal reason for using independent contractors in the first place.) The bottom line is that a company's response to the MICL needs to be considered very carefully, with all of the risks and ramifications thought out and addressed.

Summary

The use of independent contractors is extremely important to many businesses, but it is an area with inherent risks and uncertainty. The amended MICL takes the risks and uncertainty to a new and more dangerous level for businesses operating in Massachusetts. Businesses need to examine their independent contractor relationships in light of the MICL, to understand the risks, and to consider taking appropriate steps to reclassify or restructure their relationships

For more information on the topic of independent contractors and the Massachusetts independent contractor statute, contact our **Employment Law Group**.