



WORKER CLASSIFICATION: A PERILOUS CHALLENGE

The proper classification of workers as employees or independent contractors is complex and often poses a challenge for business owners. Over the past couple years, the perils of misclassification have been underscored as agencies at both the federal and state levels have ratcheted up their enforcement activities. In the current climate, a company's management must conduct itself prudently as it attempts to comply with the classification rules of the relevant agencies. This newsletter gives an overview of the method of analysis performed by federal and certain state enforcement agencies and the consequences for failure to classify workers properly.

FEDERAL LAW

The IRS Test

The Internal Revenue Service ("IRS") examines the "degree of control" and "independence" evident in each relationship between a business owner and its workers. The IRS breaks this evidence down into three categories: (1) **behavioral control**: does the company control or have the right to control what the worker does and how the worker does the job?; (2) **financial control**: are the business aspects of the worker's job controlled by the business owner, including how the worker is paid, whether expenses are reimbursed, who provides supplies, etc?; and (3) **type of relationship**: are there employee-type benefits, such as retirement plans, insurance benefits, and vacation pay, and is the work performed a key aspect of the business?

None of these factors is determinative on its own, but combined they convey a unified impression to the IRS about the relationship. The weight of any particular factor will vary depending on the circumstances of each relationship.

Under the Internal Revenue Code ("Code"), if an employer misclassifies an employee as an independent contractor and fails to withhold payroll taxes, the employer is subject to a penalty equal to 1.5% of the employee's wages and an additional penalty equal to 20% of the employee's share of FICA taxes. In the event a company fails to issue a Form 1099 to a worker without reasonable cause, these penalties are increased to 3% and 40% respectively. If an employer intentionally disregards the withholding requirement, it can be liable for the full amount of the employee's taxes. Other penalties, relating to failure to file and late filing of proper tax and information returns, may apply as well.

The DOL Test

The United States Department of Labor ("DOL") applies a different but significantly overlapping worker classification analysis, sometimes referred to as the "economic realities test." This test likewise focuses on the degree of control the business owner maintains over the worker and pays particular

attention to the extent to which the worker is economically dependent on the business owner.

Under the Fair Labor Standards Act ("FLSA"), DOL can fine an employer up to \$1,100 for each employee who receives less than the remuneration for services required under the FLSA, including by reason of misclassification. DOL can also bring suit for back pay for unpaid overtime wages and liquidated damages in the same amount. A bill recently proposed in the United States Senate would increase the fine to \$5,000 per employee for the second and each subsequent violation and require employers to notify workers in writing of their classification as employees or independent contractors, among other things.

CONNECTICUT LAW

The Connecticut Department of Revenue Services ("DRS") follows the same basic approach as the IRS in examining the classification of workers, i.e., DRS considers behavioral control, financial control, and the relationship of the parties.

The Connecticut Department of Labor's Unemployment Compensation Division employs a more rigid test, commonly referred to as the "ABC Test." To be considered an independent contractor as opposed to an employee, a worker's status must meet all the following criteria:

- A. The worker must be **free from control and direction** in the performance of the services, both under any contract and in fact;
- B. The services must be performed **outside the usual course** of the business owner's business or outside of all the business owner'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 services he or she is providing to the business owner.

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On May 5, 2010, Connecticut Governor Jodi Rell signed a new law increasing the state's civil penalty for independent contractor misclassification. The old penalty of \$300 per violation has been increased to \$300 per day per violation. The new law also gives the Connecticut Department of Labor the authority to issue a stop work order to an employer who knowingly misclassified employees as independent contractors for the purpose of defrauding its workers' compensation insurer. Significant fines and penalties also may be levied directly against company management for violation of the state's minimum wage laws, including by failure to pay overtime. For example, if the total amount of unpaid wages to a single employee exceeds \$2,000, an employer or any officer of the employer who agrees to pay less than minimum wage may be fined up to \$10,000 and face up to five years in prison. All this is in addition to a business owner's liability for back pay for overtime, benefits, tax assessments and other damages in the event it is found to have misclassified a worker.

OTHER STATE LAW

The taxation and withholding requirements, as well as the labor laws, of other states may apply to workers who are not Connecticut residents or perform their services outside of Connecticut. In these cases, the business owner needs to look to the employee/independent contractor tests of the relevant state. Several states follow the common law approach embodied in the IRS test, while others employ an analysis akin to the ABC Test.

Awuah v. Coverall North America, Inc.

A recent case in Massachusetts has garnered significant attention for its strict application of a worker classification test nearly identical to Connecticut's "ABC Test" cited above. Under the so-called "Independent Contractor Statute" of the Massachusetts General Laws, a worker is considered an employee unless he or she: (a) is free from the business owner's control and direction; (b) performs the service outside the usual course of the business owner's business; and (c) is customarily engaged in an independent business of the same nature as that involved in the service performed.

In *Awuah v. Coverall North America, Inc.*, several franchisees of a large, national cleaning company brought an action against the franchisor-company, alleging they had been misclassified as independent contractors. The United States District Court for the District of Massachusetts ruled in favor of the franchisees, because the franchisor could not show that the franchisees were engaged in an "independent, separate and distinct business" from the franchisor, failing the second part of the three part Massachusetts test. Rather, the franchisor and franchisees were engaged in the same business, cleaning services. So, the court held, the franchisees had to be classified as employees under Massachusetts law.

This ruling has caused considerable consternation among franchising companies nationwide, because many states, including Connecticut, have statutes quite similar to the Massachusetts Independent Contractor Statute. Reclassifying franchisees around the country as employees would, no doubt, subject franchisors to significant employment-related costs, including minimum wage, overtime, unemployment, workers' compensation and health care costs, among others, that franchisors had formerly avoided.

In the wake of *Awuah*, Massachusetts is considering legislation that would render its Independent Contractor Statute more flexible. If a worker met *just one* of the factors above (as opposed to having to meet all three), he or she could be deemed an independent contractor under the proposed legislation. In the meantime, this case serves as an important illustration of the potentially severe consequences of worker misclassification and the heightened focus on this issue at the state and federal levels.

CONCLUSION

Distinguishing between employees and independent contractors is a critical, yet complicated and uncertain challenge. A business owner faces the difficult task of satisfying the various state and federal standards applicable to each of its worker relationships.

Although there is important variation among the different tests, a list has evolved over the years of twenty common factors that all enforcement agencies are likely to consider as they evaluate whether a particular worker has been properly classified.

We have compiled these factors in checklist form for you to work through as you assess each of your worker relationships. Considering each of these factors in turn and documenting their application should provide a basis on which to predict the treatment of these relationships by the various federal and state enforcement agencies.

In particularly questionable situations, you may ask the IRS to make the determination for you, with respect to liability under the Code, by filing IRS Form SS-8.

In the event you have any questions concerning the matters addressed in this overview, or in applying the relevant factors to a specific relationship to determine the risk involved in treating a particular service provider as an independent contractor, please contact Cheryl Johnson, Pat Weitzman, or Chris Librandi of our office at (203) 222-0885.

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TWENTY FACTOR CHECKLIST

BOX A: “YES” answers are indicative of an employer/employee relationship. “NO” answers suggest an independent contractor relationship.

FACTOR	YES	NO
1. Right to Control Manner/Mode of Performance – Do you require the worker to comply with your instructions as to when, where, and how to perform certain services?		
2. Training – Does the worker receive training from another employee or do you require the worker to attend training meetings?		
3. Integration – Are the services performed by the worker – an integral part as opposed to an ancillary part of your business? Is the worker performing the same services as a documented employee?		
4. Services Required to be Rendered Personally – Must the services be rendered personally by the worker?		
5. Hiring, Supervising and Paying Assistants – Do you hire and pay the worker’s assistants as opposed to the worker hiring and paying his or her own assistants?		
6. Continuing Relationship – Do you have a continuous relationship with the worker as opposed to the worker providing services only infrequently?		
7. Set Hours of Work – Does the worker have set work hours?		
8. Full Time Required – Do you require the worker to devote substantially full time to your business?		
9. Working on Employer’s Premises – Is the work performed on your premises?		
10. Order or Sequence – Do you require the worker to perform the services in a set order or sequence?		
11. Oral or Written Reports – Do you require the worker to submit regular oral or written reports to you?		
12. Payment by Hour, Week, Month – Do you pay the worker hourly, weekly or monthly as opposed to on a commission basis?		
13. Payment of Business, Traveling Expenses – Do you pay the worker’s business and/or traveling expenses?		
14. Furnishing of Tools, Materials – Do you furnish the tools or materials to the worker required to perform the services?		
15. Right to Discharge – Do you have the right to discharge the worker?		
16. Right to Terminate – Does the worker have a right to terminate his or her relationship with you at any time without incurring liability?		

BOX B: “YES” answers are indicative of an independent contractor relationship. “NO” answers suggest an employer/employee relationship.

FACTOR	YES	NO
17. Significant Investment – Does the worker invest in its own facilities for the performance of services?		
18. Realization of Profit or Loss – Can the worker realize a profit or loss as a result of services (other than not receiving payment for services)?		
19. Working for More than One Firm at a Time – Does the worker perform services for a few unrelated parties at the same time?		
20. Making Services Available to General Public – Does the worker make his or her services available to the general public on a regular and consistent basis?		

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