

BEWARE, THE INDEPENDENT CONTRACTOR TRAP

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For many businesses, hiring independent contractors seems like a perfect cost-saving solution during a start-up phase or in a sluggish economy. Because independent contractors are considered to be in business for themselves, the IRS does not consider them to be “employees.” As a result, companies do not have to pay state or federal payroll taxes for independent contractors, and can avoid providing the usual employee benefits, such as worker’s compensation, retirement benefits and health insurance. In addition, laws intended to protect the rights of employees and which form the basis of employment litigation (wage claims, whistleblower actions, discrimination and wrongful termination actions) are not available to independent contractors.

However, employers can face significant and costly legal problems from this supposed “cost-saving solution” if they do not know the legal complexities involved in determining who is, and who is not, properly classified as an independent contractor. A business that misclassifies an employee as an independent contractor can be liable for payment of payroll and income taxes, as well as interest and penalties; back wages, including overtime pay; and benefits, including reimbursement for out of pocket expenses that would have been covered by a benefit program if the employee had been properly classified. Further, an investigation of one independent contractor arrangement can pique an investigator’s interest—and inspire an investigation into all of a businesses’ independent contractor arrangements. There is also the possibility of criminal penalties, if the employer is found to be acting “willfully” in misclassifying an employee.

What makes this area of employment law especially difficult is that governmental agencies and state statutes have different tests for determining whether a worker must be classified as an “employee” rather than an “independent contractor.” Given the same facts, one agency or statute might classify a worker to be an employee, while

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another may find the same worker to be an independent contractor. Additionally, all of these tests require a fact intense and case specific inquiry which can make it difficult to predict the outcome of marginal or novel cases.

In general, employers in New Hampshire and Massachusetts need to be aware of three separate “independent contractor” tests: i) the IRS test; (ii) the separate tests used by the New Hampshire Department of Employment Security and its counterpart in Massachusetts, the Division of Employment Assistance; and (iii) the tests used by New Hampshire Department of Labor, or in Massachusetts, the Office of the Attorney General, which is tasked with enforcing the Commonwealth’s laws regarding independent contractor status.

Overview of Three Tests in NH and MA: In general, the IRS requires that employers withhold federal income taxes, pay social security and Medicare taxes, and pay unemployment taxes on wages paid to an employee. An employer does not generally have to withhold or pay any taxes on payments to independent contractors. The IRS has recently revised its independent contractor test. The IRS will consider all information that provides evidence of the degree of control and the degree of independence between the parties. Facts that provide evidence of the degree of control and independence fall into three categories for purposes of the IRS test: behavioral control, financial control, and the nature of the relationship between the parties. (See <http://www.irs.gov/pub/irs-pdf/p15a.pdf>).

The state agencies charged with overseeing unemployment compensation laws in both NH and MA follow the so-called “ABC” test. In New Hampshire, the “ABC” test creates a presumption that *all* workers are employees unless and until it is shown to the satisfaction of the Commissioner of the Department of Employment Security that:

- A. Such individual has been and will continue to be free from control or direction over the performance of such services, both under his contract of service and in fact; and
- B. In **New Hampshire:** Such service is either outside the usual course of the business for which such service is performed or that such service is performed outside of all the places of business of the enterprise for which such service is performed;

In **Massachusetts:** Such service is performed outside the usual course of the business of the employer; and

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C. Such individual is customarily engaged in an independently established trade, occupation, profession, or business.

See [N.H. RSA 282-A:9](#), III; see also [Mass.Gen.Law 151A s.2](#)

In New Hampshire, when the state Department of Labor assesses whether a worker qualifies as an “independent contractor” for purposes of the state’s employment laws, it applies a twelve part test. All twelve parts must be met for a worker to be qualified as an independent contractor by the Department of Labor. See [N.H. R.S.A. 275:4](#).¹ In contrast, Massachusetts’ classification issues are analyzed under a special “independent contractor” law, which while different than NH’s 12 part-test, is virtually identical to the Massachusetts’ Division for Unemployment Assistance test referenced above. See [Mass.Gen.Law c.149 s.148B](#).

Recent Caselaw: The importance of these tests can best be highlighted by a recent ruling out of the Massachusetts Superior Court. In *Chaves v. King Arthur’s Lounge*, the Court ruled in favor of an exotic dancer’s claim that she had been misclassified by her former employer – a local strip club -- as an independent contractor rather than as an employee. The Court expressly rejected the defendant’s claim that it was primarily in the business of selling food and alcohol and that its use of the topless dancers was a form of entertainment it provided for its patrons, “akin to the televisions and pool tables in a sports bar.” The judge quickly rejected that attempt, ruling that “a court would need to be blind to human instinct to decide that live nude entertainment was equivalent to the wallpaper of routinely-televised matches, games, tournaments and sports talk.” The judge also concluded that “the dancers were an integral part of the company’s business and were therefore more likely to be employees than independent contractors.” The court concluded that the plaintiff was entitled to receive the applicable minimum wage and overtime compensation from her employer. The court further certified the lawsuit as a class action. There are approximately 70 King Arthur’s dancers who will be eligible for inclusion in this class action. As a result, the employer faces the potential of a significant financial liability.

Implications for Employers: Employers must realize that in deciding whether an individual is an employee or an independent contractor, the individual’s title is largely irrelevant. Further, the existence of an independent contractor agreement, by itself, does not determine a worker’s status. There are multiple factors, as referenced above, which dictate whether a worker can qualify as an “independent contractor.” Because there is no single test, employers should strive to satisfy as many conditions as possible of each of the

¹Due to considerations of space, a hyperlink to the 12 part test is provided in lieu of the actual language for each of the twelve parts.



applicable tests. Also, employers are encouraged to audit their existing employment classifications to guard against the possible risk of costly litigation and damages for a misclassification of the “independent contractor” relationship.

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