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Massachusetts: entering a market with independent contractors – the perils of misclassification

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## MASSACHUSETTS

# Massachusetts: entering a market with independent contractors – the perils of misclassification

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Businesses exploring entering the United States market must consider whether the persons who will perform services for them will be employees or independent contractors. Put briefly, an employee generally works under the company's direction and control and typically has no independent business relationship with other clients or customers, while an independent contractor provides his or her services as an independent business and is responsible for the results of the services but not the manner of performance. Moving beyond those generalities involves many, often unclear factors. Designating the relationship appropriately requires an understanding of Federal laws as well as the often stricter requirements of state laws regarding independent contractors. Massachusetts, home to one of the strictest tests for classifying independent contractors, presumes that individuals providing services are employees until the contrary can be shown and takes a very narrow view of who can be an independent contractor. Under both Federal and Massachusetts law, the consequences of misclassifying an individual as an independent contractor can be severe.

A conscientious business that wants to properly determine whether an individual should be retained as an employee or independent contractor is faced with disparate sets of rules and tests. For example, Federal tax laws use one set of ambiguous guidelines – currently requiring the evaluation of many factors that relate to behavioural control, financial control, and type of relationship between the parties – while labour regulations use somewhat different sets of rules. A common theme focuses on the amount of direction and control the company exercises over the service-providing individual. At one end of the spectrum is the employee who works solely for one company, following direction as to how to perform services, using company-supplied resources (such as an office and equipment), and subject to all of the company's rules. At the other end is the independent contractor who clearly operates a business of his or her own, provides services to a number of companies, maintains a separate office and equipment, and provides a result using his or her own expertise with little supervision or direction. In between lie

most situations that raise questions for companies attempting to determine at which end of the spectrum a particular relationship will fall. For companies engaging individuals in Massachusetts, however, the question is even more perilous, with an explicit presumption that the individual is an employee and a strict test for determining whether an individual is properly classified as an independent contractor.

To establish independent contractor status under the Massachusetts independent contractor statute, M.G.L. c.149, § 148B, Massachusetts uses a three-prong test. First, an individual must be free from control and direction in performing services, both by contract and in fact. Second, the service must be 'outside the usual course of business of the employer'. Third, the individual must customarily be engaged in an independently established trade, occupation, profession, or business of the same nature as that involved with the services. How a company wishes to – or actually does – classify the relationship is irrelevant. Further, although documenting a true independent contractor arrangement with an appropriate agreement is critical, an arrangement that is truly an employment relationship will not be upheld as anything else, regardless of what type of contract the parties use.

The risks of determining after the fact that an individual designated as an independent contractor was actually an employee can be quite costly. An independent contractor typically receives no benefits and will work with few restrictions and little oversight. Companies rarely provide contractors with equity compensation (because of securities law complications and adverse accounting), and while a company will have to report to the government what it pays the independent contractor, it will rarely have to withhold taxes. Workers' compensation programs do not cover a contractor's injuries, and no unemployment benefits are available when the relationship ends. By contrast, workplace injuries for employees are covered by a system of workers' compensation insurance in which there are pre-determined arrangements for compensating such injuries, and employees who are fired are often able to receive unemployment benefits. Employees will often have access to other employee ben-

efits, including health insurance, and are protected by Federal and state minimum wage and overtime laws. Therefore, a company found to have misclassified as an independent contractor someone truly an employee may be liable for taxes that were not withheld (particularly if the individual has not paid such taxes), and subject to claims by the individual (or his or her estate) for benefits that he or she should have received as an employee but that are extremely expensive and sometimes impossible to provide to someone improperly omitted from the regular company benefit plans. (As just one example, a successful claim by a misclassified individual for the costs of long-term disability coverage could result in a company's out-of-pocket liability for the costs of what otherwise would have been many years of coverage under an insurance policy.) The government may also determine that the individual was not paid in compliance with applicable minimum wage laws and/or that the individual should have received overtime compensation based on hours worked. Under these laws, there can be personal liability for directors, officers and others involved in decision-making at the management level and, in Massachusetts, mandatory triple damages will be awarded for wage and hour law violations, as well as attorneys' fees. These penalties apply even where an employer has acted in good faith, e.g., in a situation where a company incorrectly believed it had properly classified its independent contractors.

Businesses entering the US are often concerned about the difficulties perceived in hiring employees in compliance with US laws, and have an initial preference to retain independent contractors, desiring to avoid involving their companies in regulatory oversight, requirements to collect taxes and to make other withholdings, reporting obligations, etc. In addition, and importantly, the individuals may wish to perform services as independent contractors, sometimes for tax reasons, or because this has been their prior practice. Yet even if the parties agree on the classification at the start, there are a number of ways agreement can collapse. The government may audit the workplace and reclassify the workers, the individual (or his or her surviving spouse or credi- ►►

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tors) may decide that he or she should have had some payment or benefit available only to employees, or other workers may complain about their own status, dragging this individual into a reclassification. And if it is determined that the relationship was improperly classified, the initial agreement of the parties will not be a defence.

Not only is it dangerous to proceed with an independent contractor designation without a thorough understanding of the pitfalls, but many of the concerns prompting an erroneous designation may be misplaced, arising from the assumption that the strictures of many non-US labour laws on hiring and firing also apply in the United States. Therefore, it is important

for non-US businesses to understand that, while Massachusetts and Federal law do heavily regulate many aspects of the employment relationship, it is permissible and relatively easy to hire a transitional or temporary workforce by hiring employees on an at-will basis (permitting both parties to end the relationship at any time for any lawful reason), hiring them part-time (if fewer hours suffice), or retaining employees on short, fixed-term contracts. It is also generally easier for a company to protect intellectual property created by an employee and to provide incentives through equity compensation. Moreover, many companies find that they wish to exercise more control over the manner of an individual's work than is

permissible for an independent contractor relationship.

Balancing these concerns should push a business entering the US in the direction of treating workers as employees, even if on a temporary or part-time basis, rather than as independent contractors. This is not to say that there are no true independent contractors (even in Massachusetts they exist!) but that a company that decides to designate its workers as independent contractors, particularly if the reason for doing so is to attempt to avoid regulations or liability, must be very careful to create a relationship that in fact, as well as on paper, is what it claims to be. ■



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