

Tax Court Applies Its Own Factors for Employee/Independent Contractor Issues

Many college and university officials are quite familiar with the problem of determining whether a person hired to provide certain designated services for the institution (e.g., researcher, continuing education teacher, etc.) should be classified as an employee or an independent contractor, too often because it tends to be an audit issue. The IRS has issued guidelines in this regard, including the infamous “20-factor test” set forth in Rev. Rul 87-41. In 1996, the IRS set forth additional employee/independent contractor guidelines in an internal training manual. These guidelines look to elements of behavioral and financial control over the worker and how the parties view their own working relationship. (A copy of this training manual is posted on the IRS Web site at www.irs.gov/pub/irs-utl/emporind.pdf)

The courts, of course, are not bound by the IRS tests or guidelines. A recent case in the Tax Court (*Levine v. Commissioner*, T.C. Memo. 1005-86) sets forth an entirely different set of factors that the court believed should be applied in making employee/independent contractor determinations.

Colleges and universities struggling with the IRS guidelines might want instead to adopt the eleven factors used by the Tax Court: (1) The hiring party’s right to control the manner and means by which the work is accomplished; (2) the skill required of the worker; (3) which party furnishes the equipment used and the place of work; (4) whether the work is part of the hiring party’s regular business; (5) the worker’s opportunity for profit or loss; (6) the manner in which the work relationship may be terminated; i.e., by one or both parties, with or without notice or explanation; (7) the permanency of the relationship; (8) the method of payment, whether by time or by the job; (9) whether the hiring party pays Social Security taxes; (10) whether the worker receives employee benefits; and (11) the relationship the parties believe they are creating.

The court said that, while the degree of control exercised by the person for whom the work is performed over the person rendering the services is generally considered to be “fundamental” in resolving the employee/independent contractor question, it is not exclusive, and all of the other factors should be taken into account with no one factor being determinative in and of itself.

Source:

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Employee or Independent Contractor?

<http://www.irs.gov/govt/fslg/article/0,,id=110344,00.html>

Whether someone who works for you is an employee or an independent contractor is an important question. The answer determines your liability to pay and withhold Federal income tax, social security and Medicare taxes, and Federal unemployment tax.

In general, someone who performs services for you is your employee if you can control what will be done and how it will be done.

The courts have considered many facts in deciding whether a worker is an independent contractor or an employee. These facts fall into three main categories:

- Behavioral Control – Facts that show whether the business has a right to direct and control. These include:
 - Instructions - an employee is generally told:
 1. when, where, and how to work
 2. what tools or equipment to use
 3. what workers to hire or to assist with the work
 4. where to purchase supplies and services
 5. what work must be performed by a specified individual
 6. what order or sequence to follow
 - Training – an employee may be trained to perform services in a particular manner.
- Financial Control – Facts that show whether the business has a right to control the business aspects of the worker’s job include:
 - The extent to which the worker has unreimbursed expenses
 - The extent of the worker’s investment
 - The extent to which the worker makes services available to the relevant market
 - How the business pays the worker
 - The extent to which the worker can realize a profit or loss
- Type of Relationship – Facts that show the type of relationship include:
 - Written contracts describing the relationship the parties intended to create
 - Whether the worker is provided with employee-type benefits
 - The permanency of the relationship
 - How integral the services are to the principal activity

For a worker who is considered your employee, you are responsible for:

- Withholding Federal income tax,
- Withholding and paying the employer social security and Medicare tax,
- Paying Federal unemployment tax (FUTA)
- Issuing Form W-2, Wage and Tax Statement, annually,
- Reporting wages on Form 941, Employer’s Quarterly Federal Tax Return.

For a worker who is considered an independent contractor, you may be responsible for issuing Form 1099-MISC, Miscellaneous Income, to report compensation paid.

The status of certain workers is specifically determined by law; these workers are known as statutory employees and statutory non-employees. See Publication 15-A, Employer’s Supplemental Tax Guide, for more information.

If you would like for the IRS to determine whether or not a worker is considered an employee, please submit Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.

Salient excerpts from the AG advisory – full text below

1. Freedom from Control

First, a worker must be free from “control and direction” in the execution of his or her job. M.G.L. c. 149, § 148B (a) (1).

2. Service Outside the Usual Course of Employer's Business

To qualify as an independent contractor, the worker's job or service also must be performed "outside the usual course of business of the employer." M.G.L. c. 149, § 148B (a) (2). Hence, a worker who performs the same type of work that is part of the normal service delivered by the employer may not be treated as an independent contractor. Cf. Canning's Case, 283 Mass. 196 (1933) (pipe fitter hired to install steam pipes in factory was engaged in the usual course of the employer's business, therefore, he was an employee entitled to worker's compensation coverage). (Note that state unemployment statutes permit independent contractors to work either outside of the employer's normal course of business or away from the worksite, unlike the Independent Contractor Law. M.G.L. c. 151A, § 2 (b).)

3. Independent Trade, Occupation or Business

The worker must work routinely in an "independently established trade, occupation, profession or business." M.G.L. c. 149, § 148B (a) (3). The particular service in question must be "similar in nature" to the "independently established trade, occupation, profession or business" of the worker. M.G.L. c. 149, § 148B (a) (3). An independent contractor must represent him or herself to the public as "being in business to perform the same or similar services." I.R.S. Revenue Ruling 87-41, Factor 12(c). Furthermore, an independent contractor often has a financial investment in a business that is related to the service he or she is currently performing for the employer. I.R.S. Revenue Ruling 87-41, Factor 14. Ordinarily, an independent contractor has characteristics of an independent business enterprise. See Fair Labor Standards Handbook, Tab 200 ¶ 217, August 1998.

**An Advisory from the Attorney General
Chapter 193 of the Acts of 2004
Amendments to Massachusetts
Independent Contractor Law, M.G.L. c. 149 sec. 148
2004/2**

Pursuant to G.L. c. 23, § 1 (b), the Office of the Attorney General issues the following Advisory:

INTRODUCTION

On July 19, 2004, "An Act Further Regulating Public Construction in the Commonwealth" ("The Act") was signed into law. Chapter 193 of the Acts of 2004. Because the bill contained an emergency preamble, it became effective immediately. The Act replaces the existing law regulating the use of independent contractors. G.L. c. 149, § 148B.

Employers that improperly classify employees as independent contractors deprive these workers of proper Social Security contributions, worker's compensation insurance and other benefits, while also unfairly reducing employers' state and federal tax withholding, and related obligations. ¹This practice disadvantages those businesses that bear higher costs in complying

¹ State and federal law regulate employers' payroll tax obligations. See *M.G.L. c. 62B, ' 2; 26 U.S.C. ' 3102*. Employers transacting business in Massachusetts who pay wages taxable to a resident or nonresident individual shall deduct and withhold a tax from such wages for each payroll period. @ *830 CMR 62B.2.1(4)(a)(1)*. Such employers shall withhold amounts determined according to tables prepared by the Commissioner. *830 CMR 62B.2.1(4)(a)(3)*. Massachusetts Department of Revenue, *Massachusetts Circular M*. Employers must deduct taxes from their employees and are liable for the payment of such tax. *26 U.S.C ' 3102(a), (b)*. In addition, state unemployment and worker's compensation law require employer payment. *M.G.L. c. 151A, ' 14* (requiring employers to make contributions for employee unemployment insurance); *M.G.L. c. 152, ' 25A* (requiring employers to provide worker's compensation insurance).

with the law. In this way, independent contractor misclassification undermines fair market competition.

Massachusetts' legislature has manifested its interest in preventing independent contractor misclassification by amending the law, first enacted in 1990, which creates the presumption of employment in Massachusetts. M.G.L. c. 149, § 148B (the "Independent Contractor Law"). See St. 1990 c. 464. The amendments are contained in An Act Further Regulating Public Construction in the Commonwealth, Chapter 193 of the Acts of 2004, effective July 19, 2004. The Act to Protect the Tips and Wages of Certain Workers, Chapter 125 of the Acts of 2004, effective September 8, 2004, increases the potential sanctions for violations of the Independent Contractor Law.

The Attorney General is authorized under the law to issue a civil citation or institute criminal prosecution for both intentional and unintentional violations of the Independent Contractor Law. M.G.L. c. 149, § 27C (a) (1), et seq. Upon criminal conviction, or following three civil citations for intentional violations, employers may be debarred from public works projects for up to two years. M.G.L. c. 149, § 27C (b) (3). Employees also may institute private actions for themselves and others similarly situated for treble damages, attorneys' fees and costs. M.G.L. c. 149, § 150.

The Independent Contractor Law excludes far more workers from independent contractor status than are disqualified under the traditional state and federal law tests, including the 20 Factors Test set forth in Internal Revenue Service ("IRS") Revenue Ruling 87-41, the Fair Labor Standards Act ("FLSA") and the Massachusetts common law. As a result, Massachusetts employers will need to reexamine many of their work relationships to ensure that they are complying with the law.

I. Distinguishing Employees from Independent Contractors Under State Wage and Worker's Compensation Law

The Independent Contractor Law creates a presumption that a work arrangement is an employer-employee relationship unless the party receiving the services can overcome the legal presumption of employment by establishing that three factors are present. First, the worker must be free from the presumed employer's control and direction in performing the service, both under a contract and in fact. Second, the service provided by the worker must be outside the employer's usual course of business. And, third, the worker must be customarily engaged in an independent trade, occupation, profession or business of the same type.²

M.G.L. c. 149, § 148B.

This rigid, three-part test is unlike the well-established IRS, FLSA, National Labor Relations Act ("NLRA") and state law tests, which have flexible criteria that must be balanced according to the circumstances of the work arrangement. Since the independent contractor tests contain "no shorthand formula or magic phrase that can be applied to find the answer, . . . all the incidents of the relationship must be assessed and weighed with no one factor being decisive." *NLRB v. United Insurance Co. of America*, 390 U.S. 254, 258 (1968); *Chase v. Independent Practice Association*, 31 Mass. App. Ct. 661, 665 (1991) ("In the employment context, a master-servant relationship is determined by a number of factors"); *Dykes v. DePuy, Inc.*, 140 F.3d 31,

² Historically, Massachusetts courts relied on many of the same factors used by the IRS in its "20 factors test" to distinguish independent contractors from employees in the wage and hour context. See *Commonwealth v. Savage*, 31 Mass. App. Ct. 714 (1991) (real estate broker who scheduled her own work hours, bought her own supplies and worked from home deemed an independent contractor). Note, however, that because the broker worked in the employer's normal trade, *Savage* likely would not have overcome presumption of employment set forth in M.G.L. c. 149, § 148B.

A similar, but not identical test exists in the unemployment insurance statutes. M.G.L. c. 151A, § 2, et seq. See *Athol Daily News v. Bd. of Review of Div. Of Employment & Training*, 439 Mass. 171 (2003) (newspaper deliverer who bought papers from company, worked for different employers and worked away from the business was independent contractor); *Boston Bicycle Couriers, Inc. v. Dep. Dir. of Div. of Employment & Training*, 56 Mass. App. Ct. 473 (2002) (bike messengers were not independent contractors). As noted below, the factors in 151A, § 2 differ from the Independent Contractor Law.

37 (1st Cir. 1998). In contrast, the Independent Contractor Law requires proof that the worker meets all three of its requirements. Otherwise the worker is deemed an employee for purposes of Massachusetts' worker's compensation and wage laws.

1. Freedom from Control

First, a worker must be free from "control and direction" in the execution of his or her job. M.G.L. c. 149, § 148B (a) (1). The analysis of this factor is similar to the common law, IRS and FLSA control and economic realities tests. An employment contract or job description indicating that a worker is free from supervisory direction or control is a prerequisite, but is insufficient by itself under the Independent Contractor Law. To be free from an employer's direction and control, a worker's activities and duties must actually be carried out with independence and autonomy. For example, an independent contractor completes the job using his or her own approach without instruction and also dictates the hours that he or she will work on the job. *Savage*, 31 Mass. App. Ct. at 717-18 ; *Brigham's Case*, 348 Mass. 140 (1964) (worker was employee under the worker's compensation law because the employer "had the right to control employee in the performance of the details of his work."); I.R.S. Revenue Ruling 87-4, 1987-1 C.B.; IRS Publication 15-A, Employer's Supplemental Tax Guide.

2. Service Outside the Usual Course of Employer's Business

To qualify as an independent contractor, the worker's job or service also must be performed "outside the usual course of business of the employer." M.G.L. c. 149, § 148B (a) (2). Hence, a worker who performs the same type of work that is part of the normal service delivered by the employer may not be treated as an independent contractor. Cf. *Canning's Case*, 283 Mass. 196 (1933) (pipe fitter hired to install steam pipes in factory was engaged in the usual course of the employer's business, therefore, he was an employee entitled to worker's compensation coverage).³

3. Independent Trade, Occupation or Business

The worker must work routinely in an "independently established trade, occupation, profession or business." M.G.L. c. 149, § 148B (a) (3). The particular service in question must be "similar in nature" to the "independently established trade, occupation, profession or business" of the worker. M.G.L. c. 149, § 148B (a) (3). An independent contractor must represent him or herself to the public as "being in business to perform the same or similar services." I.R.S. Revenue Ruling 87-41, Factor 12(c). Furthermore, an independent contractor often has a financial investment in a business that is related to the service he or she is currently performing for the employer. I.R.S. Revenue Ruling 87-41, Factor 14. Ordinarily, an independent contractor has characteristics of an independent business enterprise. See *Fair Labor Standards Handbook*, Tab 200 ¶ 217, August 1998.

An employer's failure to withhold taxes, contribute to unemployment compensation, or provide worker's compensation may not be considered when analyzing whether an employee has been appropriately classified as an employee or independent contractor. M.G.L. c. 149, § 148B (b). Hence, an employer's subjective belief that a worker should be an independent contractor may have limited relevance under the Independent Contractor Law. Similarly, the amendments to the Independent Contractor Law deem irrelevant the status of a worker as a "sole proprietor or partnership," for the purpose of obtaining worker's compensation insurance. M.G.L. c. 149, § 148B (c).

³ Note that state unemployment statutes permit independent contractors to work either outside of the employer's normal course of business or away from the worksite, unlike the Independent Contractor Law. M.G.L. c. 151A, § 2 (b).

II. Violations of the Presumption of Employment Statute

An employer violates the statute when two acts occur. First, the employer must classify or treat a worker as an independent contractor although the worker does not meet each of the criteria in the three-factor test identified on pages 2-5, *supra*.

Second, in receiving services from the worker, the employer must violate one or more of the laws enumerated in the Independent Contractor Law, including several of the following wage and hour, taxation, and worker's compensation statutes:

- Any of the wage and hour laws set forth in M.G.L. c. 149
- The minimum wage law set out in M.G.L. c. 151, §§ 1A, 1B and 19; 455 CMR 2.01, et seq.
- The state overtime law set forth in M.G.L. c. 151, §§ 1, 1A, 1B and 19
- The law requiring employers to keep true and accurate employee payroll records, and to furnish the records to the Attorney General upon request as required by M.G.L. c. 151, § 15
- Provisions requiring employers to take and pay over withholding taxes on employee wages. M.G.L. c. 62B
- The worker's compensation provisions punishing knowing misclassification of an employee. See M.G.L. c. 152, § 14.⁴

In addition to providing for imposition of substantial civil and criminal penalties, the law permits the Attorney General to debar from public works certain violators of the Independent Contractor Law. M.G.L. c. 149, § 27C (a) (3). The length of debarment depends upon the nature and number of violations.

Debarment Resulting from a Criminal Conviction

First Offense Subsequent Offense

Violation without intent: 6-month debarment 3-year debarment
Willful violation: 5-year debarment 5-year debarment

Debarment Resulting from a Civil Citation

Three intentional citations 2 year debarment
Failure to comply with civil citation or administrative order 1 year debarment
M.G.L. c. 149, § 27C(a)(3).⁵

Violations also carry a potential maximum penalty of up to \$50,000 per civil violation, as well as prison time and criminal fines for criminal violations. The Independent Contractor Law creates broad liability for both business entities and individuals, including corporate officers, and those with management responsibility over affected workers.⁶

The Attorney General views the misclassification of employees as a serious violation of state law. Where appropriate, the Attorney General will enforce aggressively the provisions of the Independent Contractor Law.

⁴ Compare M.G.L. c. 152, § 14(3) (requiring an employer to "knowingly" misclassify an employee in order to violate the worker's compensation provision) with M.G.L. c. 149, §§ 27C(a)(1) & (2), (b)(1) & (2) (providing penalties for both intentional and unintentional employee misclassifications). A criminal conviction for intentionally misclassifying an employee in order to avoid worker's compensation premiums carries a state prison sentence of up to five years, a jail sentence between six months to two and a half years and/or a fine between \$1,000 and \$10,000. M.G.L. c. 152, § 14(3).

⁵ A willful violation occurs when an employer either knew or showed reckless disregard for whether its conduct is prohibited. *Secretary of Labor v. Richland Shoe Co.*, 486 U.S. 128, 133-35 (1988). See *Commonwealth v. Armand*, 411 Mass. 167, 170 (1991); *Commonwealth v. Redmond*, 53 Mass. App. Ct. 1, 4 (2001).

⁶ Compare *Commonwealth v. Cintolo*, 415 Mass 358 (1993) (permitting only "persons" to be charged).