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MIS-CLASSIFICATION LAWS:
The Dangers Of Calling An Employee An Independent Contractor

By Deborah I. Hollander, Esq.

New Jersey, New York and Pennsylvania have all recently enacted statutes to prevent and, in some cases, punish employers for "misclassifying" employees as independent contractors. The punishment may include fines, civil liability, debarment from publication and even incarceration.

Moreover, the punishments may not be limited to liability to a state agency. The Internal Revenue Service recently announced the "Questionable Employment Tax Practice" (QETP) initiative, wherein it has agreed with at least twenty-nine states "to exchange data, thereby leveraging resources and encouraging businesses to comply with federal and state employment tax requirements." Thus, a finding of liability under one of these state laws is likely to be reported to the IRS, which would then seek payment of the employer share of federal payroll taxes.

THE IRS MIS-CLASSIFICATION REGULATION STANDARDS

Mis-classification has long had the potential for additional federal tax liability. Even if a firm has conformed to all the filing requirements for reporting income to a contractor, as opposed to an employee, the IRS still requires a "reasonable basis" for not treating the individual as a true employee. The IRS requires three "factors" as indicating whether the firm exercises the degree of control over an invidual which would render them to be, in fact, an employee, and the degree of independence that individual exercises to be deemed a true independent contractor. These three major catagories are:

1. "Behavioral": Does the company control or have the right to control what the worker does and how the worker does his or her job? The IRS will, in particular, look at the type of instructions given to the individual; the degree of instruction (such as whether the individual is told when and where to work), what sequence, tools, and personal vehicle to use; whether the individual is subject to an evaluation systems typical of an employer review of employee progress and whether the firm provides training.

2. "Financial": Are the business aspects of the worker's job controlled by the payer? (these include things like how the worker is paid, whether expenses are reimbursed, who provides tools, supplies, etc.)

3. "Type of Relationship": Are there written contracts or employee type benefits (*i.e.* pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?

The IRS does not recognize any "magic" or set number of factors that "makes" the worker an employee or an independent contractor, and no one factor stands alone in making this determination. Businesses must weigh all these factors when determining whether a worker is an employee or independent contractor.

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IRS Penalty and Enforcement

Workers who believe they have been improperly classified as independent contractors by an employer can use Form 8919 (Uncollected Social Security and Medicare Tax on Wages) to figure and report the employee's share of uncollected Social Security and Medicare taxes due on their compensation. If a firm has mis-classified an employee as an independent contractor and had no reasonable basis for doing so, it may be held liable for employment taxes for that worker. There may be an opportunity to pay these taxes without interest if an employer settles quickly, so an employer in this situation should promptly consult a tax professional.

NEW JERSEY, PENNSYLVANIA AND NEW YORK MIS-CLASSIFICATION STATUTES

As noted, each of the above States has, within the past two years, passed "mis-classification" statutes. There are fundamental similarities to the statutes. Each statute is aimed specifically at the construction industry; each contains similar, but not identical, tests for whether an individual is an employee or independent contractor, based upon principles similar to those found in the IRS regulation. Each statute creates stiff civil penalties and potential criminal liability for mis-classification. Each is designed to invite and protect complaints of alleged mis-classification.

"New Jersey Construction Industry Independent Contractor Act."

This Act applies exclusively to employers within the Construction Industry and presumes, regardless of whether payroll taxes were withheld, that an individual who performs services in the making of improvements to real property by an individual for remuneration paid by an employer, shall be deemed to be employed, "unless and until it is shown to the satisfaction of the Department of Labor and Workforce Development that:

a. the individual has been and will continue to be free from control or direction over the performance of that service, both under his contract of service and, in fact; and

b. the service is either outside the usual course of the business for which the service is performed, or the service is performed outside of all the places of business of the employer for which the service is performed; and

c. the individual is customarily engaged in an independently established trade, occupation, profession or business."

Penalties

The New Jersey statute provides substantial penalties against the "employer", particularly employers who operate in the public works sector. The Department of Labor may assess fines, up to a maximum of $2,500 for a first violation, and up to a maximum of $5,000 for each subsequent violation.

There are also potential criminal sanctions. An employer who fails to properly classify an individual as an employee and fails to pay compensation, wages or benefits as required for employees under the "New Jersey Prevailing Wage Act", the unemployment compensation law, the "Temporary Disability Benefits Law," the "New Jersey Gross Income Tax Act", or the "New Jersey State Wage and Hour Law," is guilty of a misdemeanor, and can be fined not less than $100 or more than $1,000, or be imprisoned for not less than 10 or more than 90 days, or both.

Each week, in any day of which an employee is mis-classified and each employee

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so mis-classified, is a separate offense. A reasonable belief as to the validity of the actions is not a complete defense.

If the failure is done "knowingly," the "employer" is deemed guilty of a crime of the second degree, if the contract amount is for $75,000 or above, he is guilty of a crime of the third degree if the contract amount exceeds $2,500, but is less than $75,000; and guilty of a crime of the fourth degree if the contract amount is for $2,500 or less. In addition, the violator shall be subject to the criminal restitution liability for the amounts underpaid to the employee.

Debarment Penalties

Another penalty is debarment from public contracting. If the Department of Labor determines that an employer or any officer, agent, superintendent, foreman, or employee of the employer has knowingly failed to properly classify an individual as an employee and failed to pay prevailing wages (on a public project) and/or full benefits under various statutes, then the commissioner shall debar the employer from contracting, directly or indirectly, with any public body for the construction of any public building or other public work projects, or from performing any work on the same for a period of three years.

The Power To Issue A Stop Work Order

For a third or any subsequent violation, the Department of Labor has the power to issue a stop-work order requiring the cessation of all business operations of the violator within 72 hours of that determination. The order shall take effect when served upon the employer. The order remains in effect until the commissioner issues an order releasing the stop-work order, upon finding that the employer has properly classified the individual as an employee and has paid any penalty assessed under this section. The alleged violator has the right to request a hearing in forty eight hours in which to contest the charges. Otherwise, if the violator's challenge is unsuccessful, as a condition of release from a stop-work order, the commissioner may require an employer, who is found to have failed to properly classify an individual as an employee, to file with the Department of Labor periodic reports for a probationary period of up to two years.

Private Suits Against Employers Authorized

The statute has generous provisions for private enforcement. An individual who believes himself or herself to have been mis-classified, may sue his own "employer" or another company which has a contract with that employer for knowingly mis-classifying. In other words, both the immediate "employer" and a general contractor in direct privity is vulnerable to the suit. A suit may also be brought as a class action or for a group of mis-classified individuals. “An individual employed as a construction worker, who has not been properly classified as an employee, may bring a civil action for damages against the employer” or any other employer who was in contract with the employee for failing to properly classify the employee, if the employer had knowledge of the mis-classification." In other words, a worker who was "mis-classified" may sue his direct employer and the general contractor.

In addition, an individual representative, including a labor organization, may bring the action on behalf of an individual or as a class action. The court may award attorneys fees and other costs of the action, in addition to damages to an individual or class of individuals who have not been properly classified. Furthermore, the sums collected as fines by the Department of Labor do not go to the individuals mis-classified and, therefore, would not reduce the amount actually payable to compensate for lost wage and benefits. Therefore, any civil damages owed would be in addition to the Department of Labor fines.

Anti-Retaliation Provisions

The anti-retaliation provisions are quite broad. It is unlawful and "discriminatory" to retaliate against anyone who either files a

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claim for enforcement, or tells "any person" (which would include "any government or entity" about an employers' non-conformance. The allegations need not be accurate, merely in good faith, to justify protection. It is also improper to retaliate against someone for informing others of their rights under the acts, or assisting an employee in seeking to enforce his rights. An adverse action within 90 days of a person's exercise of these rights, will be presumed to be retaliatory, and the employer must present evidence to rebut that presumption.

Extended Liability

The statutory definition of construction "employer" subject to the law explicitly includes subcontractors and "lower tier" contractors, as well as successor corporations. However, this does not necessarily mean that a contractor is subject to fines for its subcontractors' violations. On the other hand, the private enforcement actions may be brought against firms other than the immediate employer of the plaintiff, as noted above.

The Pennsylvania "Construction Workplace Mis-classification Act"

On June 14, 2011, the Pennsylvania "Construction Workplace Mis-classification Act" became effective. It is one of the most aggressive laws on the subject in the country. Section 4 of the new law provides that a company or its "officer or agent" is in violation of the Act if the business "fails to properly classify" an individual as an employee under the Pennsylvania Workers Compensation Act or Unemployment Compensation Act, or fails to provide coverage or make contributions on behalf of an individual who should be classified as an "employee" under those laws. Each individual mis-classified by an employer is a separate violation of the law.

Under the law, no individual can be classified as an independent contractor, unless he/she:

a. has a written contract to perform services with the construction industry business,

b. is free from control or direction over the performance of such services under the contract and, in fact,

c. is customarily engaged in an independently established trade, occupation, profession or business.

Penalties

The Pennsylvania Department of Labor may assess penalties of up to $1,000 for the first violation and up to $2,500 for each subsequent violation, and/or refer intentional or negligent violations of the Act to the Attorney General for criminal prosecution. An intentional violation of the law is a criminal misdemeanor; a negligent mis-classification is a criminal summary offense. Unlike New Jersey, Pennsylvania's new law provides that it "shall be a defense to an alleged violation. . . if the person for whom the services are performed in good faith believed that the individual who performed the services, qualified as an independent contractor at the time the services were performed."

The Power To Issue A Stop Work Order

The Pennsylvania Secretary of Labor may seek a stop-work order from a court to issue a stop-work order requiring the cessation of work by individuals who are improperly classified within 24 hours of the effective date of the order. In the event that a majority of individuals working at a site are improperly classified, the order can require the cessation of <u>all</u> business operations of that employer at each site at which a violation occurred within 24 hours of the effective date of the order which may apply to an entire "site." It is unclear whether this was

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intended to require all work to stop at a construction project because one subcontractor (or sub-subcontractor) violated the terms, even though all of the other contractors may be in compliance and other contractors may not even be in the same contractual chain as the violator. Even if a shut down is limited to a particular firm at that site, if that firm was carrying out critical path work, then even a stop order limited to that firm could project wide impacts. However, unlike the New Jersey statute, Pennsylvania does not explicitly provide that a contractor may be disbarred from public work for violations.

Private Suits

The statute, as passed, does not explicitly authorize private suits. During its enactment, the Pennsylvania Legislature rejected a proposed version which would have authorized an individual or representative of an individual to bring an action against an employer for knowingly and intentionally failing to classify the individual.

Anti-Retaliation Provisions:

Pennsylvania's statute makes it a violation of the Act for a business to require or demand that an individual enter into an agreement, or sign a document which results in the improper classification of that individual as an independent contractor. It also prohibits retaliatory action against employees or individuals who file complaints under the Act, regardless of whether those complaints are valid. If a firm takes an "adverse action" against a complainant within 90 days, it will be "presumed" the action was retaliatory, and the firm will have to justify the steps it took.

Extended Liability

In an unusual provision, Pennsylvania's statute extends the potential liability to firms which try to avoid the mis-classification statutes through using a subcontractor. If a firm "intentionally contracts with an employer knowing the employer intends to mis-classify employees," it is subject to the same penalties and remedies as an employer found to be in violation of the new law. This provision may cover employment agencies and other providers of labor for the construction industry.

New York Construction Industry Fair Play Act

The New York Construction Industry Fair Play Act legislates a "presumption of employment in the construction industry" that "any person performing services for a contractor shall be classified as an employee unless the person is a separate business entity," as defined in the act, or unless three prescribed criteria are all met, "in which case the individual shall be an independent contractor." Those criteria are: (A) the individual is free from control and direction in performing the job, both under his or her contract and in fact; (B) the service must be performed outside the usual course of business for which the service is performed; and (C) the individual is customarily engaged in an independently established trade, occupation, profession, or business that is similar to the service at issue.

The definition of "independent entity" does not depend solely upon the existence of a trade name or formal corporation. Rather, the business entity must:

(1) perform services free from the direction or control over the manner and means of performing service, subject to the contractor's right to specify the desired result; (2) not be subject to "cancellation or destruction" upon termination of the relationship with the contractor; (3) make a substantial capital investment in the business beyond ordinary tools, equipment or a personal vehicle; (4) own the capital goods and reaps the profits or bears the entity's losses; (5) makes its services

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available to the public or the business community on a continuing basis; (6) includes the services rendered on a federal income tax schedule as an independent business or profession; (7) performs services under the entity's own name; (8) pays for its own license or permit if a license or permit is required; (9) furnishes the necessary tools and equipment; (10) hires, if necessary, its own employees, without the contractor's approval, pays its employees without reimbursement from the contractor, and reports its employees' income to the IRS; (11) is free to perform similar services for others on terms of its own choosing; and (12) does not represent to its customers that the entity is an employee of the contractor.

Penalties

The New York Fair Play Act carries both civil and criminal penalties for "any contractor who willfully fails to classify an individual as an employee." The civil penalty for a first violation of the Fair Play Act is a $2,500 fine per mis-classified employee with fines increasing up to $5,000 per mis-classified employee for subsequent violations.

In addition to civil penalties, the statute allows misdemeanor criminal penalties for willful violations. A first violation may be punished by a fine of up to $25,000.00 or up to thirty days by imprisonment and for a subsequent offense by imprisonment for not more than sixty days or a fine not to exceed fifty thousand dollars. The words “willfully violates” means a contractor knew or should have known that his or her conduct was prohibited.

The law states that violators "shall" be subject to a one year debarment from public bidding for a first offense and a five year debarment for a second offense.

The law also explicitly expands the liability and potential debarment from the legal entity which violated the statute to any officer of a corporation or shareholder owning 10 percent or more of the corporation, who knowingly permits a willful violation of the Fair Play Act subject to all of the civil and criminal penalties as the employing entity, as well as debarment and ineligibility to bid on public works contracts upon conviction. A corporation cannot escape the accumulation of offenses by re-forming as a new legal entity.

Finally, the above penalties and liabilities are expressly allowed to be in addition to those which may be assessed under unemployment compensation and worker compensation statutes. Indeed, a violation under one of these laws will be reported to the enforcement arm of other agencies. Violators may be subject to additional penalties for the mis-classification of a worker with regard to unemployment compensation insurance, workers’ compensation insurance or business, corporate, or personal income taxes.

As in Pennsylvania, the Department of Labor is required to issue a Notice to Employees to be posted. New York's posting requirements are more detailed; specifying that the posting must be able to withstand adverse weather and must be in specific languages designated by the Department of Labor. A failure to post this notice itself can result in fines up to $1500.00 for the first violation and up to $5000.00 for a second violation in five years.

Private Cause of Action and Anti-Retaliation Provisions

The statute also includes an anti-retaliation provision. Retaliating by terminating or changing the conditions of someone for making or threatening to complain, even to the employer, will itself constitute a violation of the statute. In addition, the statute explicitly gives the victim of retaliation a right to sue. It does not however, explicitly, create a cause of action for the underlying mis-classification.

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Extended Liability

If the employer is a corporation, any officer or shareholder who owns or controls 10% or more of the corporation and who knowingly allows a violation of the law, may also be subject to civil and/or criminal liability.

Tips For Contractors

Because these new state laws redefine how construction workers are classified and imposes stiff penalties for independent contractor mis-classification, construction firms should immediately review their existing worker classifications. Those that have, in the past, relied heavily upon individual independent contractors (whether retained directly or through a labor supplying subcontractor), and presumed that their compliance with IRS regulations would be suffcient for state labor laws, need to rethink their strategies. Potential risks include inconsistencies with federal and state tax laws that could lead to increased risk of tax penalties for failure to comply with appropriate federal and state tax withholding requirements and related obligations.

On public projects, contractors and subcontractors are often already required to submit prevailing wage certifications, as well as lien releases and certified payrolls from subcontractors.

Tips For Sureties

The statutes make no specific mention of sureties or obligations under public bonds. The re-classification statutes essentially make it unlawful to "underpay" someone by calling them an independent contractor and failing to pay the full lawful benefits (workers compensation, unemployment insurance, etc. prevailing wages) due. In most states, sureties have been liable for under-payments that result from classifying a skilled worker as a laborer, for instance, under the prevailing wage laws. Therefore, although there is no language which obviously makes a surety liable for penalties and fines, they may receive claims on their bonds for the additional prevailing wages etc. In addition, the levying of fines (and potential incarceration sentences on corporate principals), obviously, may have a severe impact upon principals. Inquiry into a firm's compliance with these laws, or reliance upon unincorporated individuals as independent subcontractors chiefly supplying labor, may be considered as part of the underwriting process. Businesses that routinely contract with construction firms should consider requiring their contractors to certify, in writing, that workers classified as independent contractors meet the requirements for such classification to safeguard against any penalties under the Act.

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