

TRAPS TO AVOID IN CUTTING PAYROLL COSTS

No Such Thing as a Free Ride: How Employers Get Into Trouble Trying to Cut Payroll Costs¹

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INTRODUCTION

In a soft economy, employers look for ways to reduce overhead and payroll costs. The typical payroll costs include not only an employee's salary or hourly wage, but also federal income tax and Medicare, unemployment tax and the cost of fringe benefits. When companies reduce their workforces to trim the bottom line, they sometimes look to alternative, less expensive forms of labor to fill the gap in the workforce. Examples include independent contractors, unpaid interns and volunteers. Each of these poses its own special set of considerations with which an employer should be thoroughly familiar before entering into relationships with such individuals.

I. INDEPENDENT CONTRACTORS

Independent contractors, sometimes known by the relatively benign term "consultants," are a seemingly attractive option for employers seeking to fill short-term requirements or cut costs. After all, an independent contractor gets paid a fixed amount documented by a 1099 with no taxes withheld or matched and receives no fringe benefits. What better way to cut costs and still get the work done? Unfortunately, many companies find themselves in deep trouble with the New Hampshire Department of Employment Security (DES), the New Hampshire Department of Labor (NHDOL) or the Internal Revenue Service (IRS) after engaging individuals to perform services as independent contractors. Each of these entities has a reason to make a determination of whether or not someone has properly been identified as an independent contractor, and each employs a very different test to do so.

Under state law, the distinction between an employee and independent contractor is of great importance. Employees are entitled to many rights and protections not available to independent contractors, such as workers' compensation benefits, and coverage under state wage and hour and discrimination laws, including whistleblower protections. Misclassification under state law can result in significant liability for employers including penalties, employment taxes, workers' compensation and unemployment

compensation liability, claims for unpaid overtime, minimum wage claims, and employee benefit claims.²

For many years New Hampshire employers have both battled with and taken advantage of gray areas of the law relating to proper classification of workers. Effective January 1, 2008, however, the definition of "employee" was amended for purposes of state wage and hour, worker's compensation and whistleblower laws in the legislature's attempt to clarify the criteria for exempting workers from employment status under state workers' compensation as well as wage and discrimination laws.³ While the amended law provides employers a higher degree of certainty, there are still areas fraught with ambiguity, making it somewhat challenging to make correct classification decisions.

II. NEW HAMPSHIRE DEPARTMENT OF LABOR

The NHDOL monitors employers to make certain that they are in compliance with the state's labor laws, including minimum wage, overtime, safety issues and worker's compensation. Each year, the New Hampshire Department of Labor ("NHDOL") publishes a Fact Sheet of the "Top 10 New Hampshire Labor Law Violations." The most recent list published by the NHDOL says that the number one labor violation is misclassification of employees as independent contractors and the related failure to secure workers' compensation insurance pursuant to RSA 275:42, I & II and RSA 281-A:5.⁴ It remains unclear whether these violations are a result of willful misclassification on the part of employers to avoid expenses associated with employees (unemployment compensation, workers compensation, minimum/overtime pay requirements, etc.) or simply mistakes due to the challenging standards of the law. RSA 275:4 provides that, to be classified as an independent contractor, a worker must meet *ALL* of the following criteria:

1. The worker must possess or have applied for a federal employer identification number or social security number; or in the alternative, have agreed in writing to carry out the responsibilities imposed on employers;
2. The worker must have control and discretion over the means and manner of performance of the work, in that the result of the work, rather than the means or manner by which the work is performed, is the primary element bargained for by the employer;

3. The worker must have control over the time when the work is performed, and the time of performance is not dictated by the employer. However, this does not prohibit the employer from reaching an agreement with the worker as to completion schedule, range of work hours, and maximum number of work hours to be provided by the person, and in the case of entertainment, the time such entertainment is to be presented;
4. The worker hires and pays the person's assistants, if any, and to the extent such assistants are employees, supervises the details of the assistants' work;
5. The worker holds himself or herself out to be in business for himself or herself;
6. The worker has continuing or recurring business liabilities or obligations;
7. The success or failure of the worker's business depends on the relationship of business receipts to expenditures;
8. The worker receives compensation for work or services performed and remuneration is not determined unilaterally by the hiring party;
9. The worker is responsible in the first instance for the main expenses related to the service or work performed. However, this does not prohibit the employer or worker from providing the supplies or materials necessary to perform the work;
10. The worker is responsible for satisfactory completion of work and may be held contractually responsible for failure to complete the work;
11. The worker supplies the principal tools and instrumentalities used in the work, except that the employer may furnish tools or instrumentalities that are unique to the employer's special requirements or are located on the employer's premises;
12. The worker is not required to work exclusively for the employer.

Employers are further required to post these factors in a conspicuous place in the workplace.⁵ Unless a worker meets *all* of the above criteria, that worker *must* be classified as an employee. As a result of this change in the law, it has become increasingly difficult to characterize workers as independent contractors.

Companies can use a written agreement as *prima facie* evidence of meeting the aforementioned criteria. However, employers should be mindful of payment arrangements, supervision of duties, and exclusivity. Further, not only must the worker hold him/herself out to be in business for themselves, they need to have recurring business obligations and liabilities. This may be a difficult factor to meet if the employer is supplying tools or instrumentalities for the work to be completed, reimbursing the worker for business expenses or providing insurance.

Under New Hampshire discrimination, wage and hour, and workers' compensation laws, liability associated with misclassification can be significant. The Department of Labor can assess civil penalties of up to \$2,500 if they find an employer used a written agreement intended to misrepresent an employment relationship. In addition, employers can be assessed a civil penalty of \$100 per employee for each day of noncompliance (for up to a year). Employers who fail to obtain workers' compensation insurance are likewise subject to a civil penalty of up to \$2,500 and \$100 per day per viola-

tion. It is important to note that "any person with control or responsibility over decisions to disburse funds and salaries and who knowingly failed to secure payment of workers' compensation" can be *personally liable* for the payment of penalties."⁶ Among other consequences, if an employee is injured on the job and is not covered by workers' compensation insurance, the employer will be held liable for damages incurred by the worker.

Further, employers will also be responsible to compensate otherwise eligible workers for contributions it should have been making during the period of misclassification under fringe benefit plans such as 401(k) contributions, disability benefits, etc. If the employee's position is classified as non-exempt under federal and state law, the employer will face penalties in addition to back-pay requirements for overtime and/or minimum wage violations.

III. DEPARTMENT OF EMPLOYMENT SECURITY

The state Department of Employment Security ("DES") is charged with the responsibility to collect unemployment taxes from the state's employers and then make determinations as to whether or not individuals are entitled to collect benefits under the state's unemployment law, RSA 282-A. DES has its own test for purposes of the unemployment statute, RSA 282-A:9, III (a), (b) and (c), known as the "ABC Test."

The ABC Test provides that services performed by an individual for wages shall be deemed to be employment subject to unemployment coverage unless and until it is shown to the satisfaction of the Commissioner of the Department of Employment Security that:

- A. The individual has been and will continue to be free from control or direction over the performance of such services;
- B. Such service is either outside the usual course of 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; and
- C. Such individual is customarily engaged in an independently established trade, occupation, profession or business.⁷

In essence, this test imposes a rebuttable presumption that all workers are employees. The employer bears the burden to establish each part of the tripartite test and "failure to establish any of them is proof of employment for purposes of RSA chapter 282-A."⁸ While the purpose of the unemployment statute is to prevent the spread of unemployment and to lighten the burden on involuntarily unemployed individuals, even in times of recession "not every case of unemployment entitles an unemployed person to benefits."⁹

One can imagine circumstances where an employer may engage a contractor to perform duties in a manner that meets all of the criteria established under the Department of Labor test, yet fails to meet the second tier requirement that the service be outside the usual course of business for which such service is performed. For example, a computer programming company may engage a computer programmer to perform work, or a not-for-profit may engage a consultant to help raise money. In these two scenarios, the "consultants" would not be performing work outside the usual course of business of the company. These types of scenarios can place employers in an interesting bind.

IV. NEW HAMPSHIRE CASE LAW

The New Hampshire Supreme Court has had occasion to interpret part (a) of RSA 282-A:9 a limited number of times in the past twenty-five years. In *Appeal of Lakes Region Community Services Council*, the Court determined that Lakes Region Community Services Council (the "Council") was not the employer of temporary respite care providers.¹⁰ The Council kept a roster of respite care providers who gave temporary care to disabled persons as a form of relief to the regular care providers. The Council trained the providers, matched them with the care recipient on an as-needed basis, and verified the providers' hourly work logs for payment. The Council also evaluated the replacement providers' services. The Council did not otherwise "monitor the provision of services or instruct" the respite care providers on what to do. The Court held that "[t]he only reasonable conclusions from this evidence are that the respite care providers are free from control or supervision by" the Council, and the Council accordingly passed part (a) of the ABC test.¹¹

On the other hand the Court in *Appeal of John Hancock Distributors, Inc.* ("Distributors") concluded that a securities seller directed and controlled the performance of its brokers' services.¹² The Court found that Distributors failed part (a) because it required the brokers to use specific literature in selling securities, controlled the commission they received for their work, required minimum educational standards, sanctioned non-compliance with internal rules, controlled the manner in which sales were consummated, and retained the right to refuse to process any sale made.¹³ Moreover, the book of business created by the broker remained the property of Distributors along with customer files, transaction logs, correspondence and any other records, all of which had to be returned to Distributors at the end of the relationship. Unlike the Council in *Lakes Region*, Distributors "directly monitor[ed] the provision of services and instruct[ed] brokers what to do and how to do it."¹⁴

Appeal of Boudreault involved a logging contractor who was found to have directed and controlled the performance of services by loggers he engaged to perform services.¹⁵ Boudreault solicited and arranged all logging contracts between the workers and the client landowners; decided when and where work would be done; could hire and fire the workers; provided the major pieces of equipment used on the job and paid workers weekly by the hour eliminating any risk of loss involved with the job.¹⁶ The loggers were therefore considered to be his employees and not independent.

Parts (b) and (c) of the ABC test can also be problematic for companies. The New Hampshire Supreme Court has also looked at whether individuals treated as independent contractors were indeed engaged in an independently established trade or business. In *Weiss-Lawrence Co. v. Riley* the individuals at issue performed piecework, which was part of the process of manufacturing shoes, in their homes. In that matter it was clear that the workers were performing services for the business of the manufacturer; that they were not engaged in an established trade or business and that they were not prepared or available to perform similar service for others.¹⁷

Similarly, *Appeal of Work-A-Day of Nashua* involved the placement of unskilled workers in temporary positions within various client companies of Work-A-Day. These individuals were not involved in independent businesses, were paid by the hour for their work, and their work was directed by the companies who retained their services.¹⁸ In order to be deemed to be in an independently established business, a worker should be in a position to per-

form the same or similar services for others, and his or her business should be able to survive the demise of the company for whom services are being provided. For example, one who provides cleaning services to companies or individuals for a contracted rate would still have a going business if his or her best customer went out of business and no longer needed cleaning services. He or she might have to find other customers, but they would still have the tools of their trade, motor vehicles, a business name and business cards and a telephone number that prospective customers could call for services. Contrasted with the custodian of a building who has no tools or equipment and simply works the hours determined by the owner, doing the tasks to which he was assigned during the hours established by the owner for an hourly rate; the difference between one who is engaged in his own business and one who is not becomes clearer.

Since the case law on point in New Hampshire is limited, one can look to other states to see how they have come down on this point. In *Athol Daily News v. Bd. of Review of the Div. of Empl. & Training*, the Massachusetts Supreme Judicial Court concluded adult newspaper carriers are not covered by G.L. c. 151A (Massachusetts unemployment compensation benefit statute) and directed that a judgment be entered reversing the board's decision that the Athol Daily News ("News") did not pass the ABC Test.¹⁹ The News is a small newspaper publisher that distributed its papers to subscribers by using carriers who picked up the newspapers either at the News's circulation room or at bundled drop points near the carriers' homes.

The Massachusetts Supreme Judicial Court analyzed Massachusetts' ABC Test, G.L. c. 151A, §2, which is nearly identical to New Hampshire's RSA 282-A:9. Focusing here on part (b) of the ABC Test, the Court acknowledged that the record demonstrated, "although carriers may pick up newspapers at the company's distribution center, most newspapers are delivered from house to house on a public route within one or more local communities. Other newspapers are delivered to bundle drops, stores, and vending machines. It is clear that all of the carriers make deliveries outside of premises owned by the News or which could fairly be deemed its 'places of business.'"²⁰

V. INTERNAL REVENUE SERVICE

The test used by the IRS to evaluate whether a person is an employee or an independent contractor may also provide helpful guidance in this area. The IRS formerly used what has become known as the "Twenty Factor" test. Under pressure from Congress and from representatives of labor and business, it attempted to simplify and refine the test, consolidating the twenty factors into eleven main tests, and organizing them into three main groups: behavioral control, financial control, and the type of relationship of the parties. They are described below.

A. Behavioral Control

Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of—

Instructions the business gives the worker. An employee is generally subject to the business' instructions about when, where, and how to work:

When and where to do the work

- What tools or equipment to use
- What workers to hire or to assist with the work
- Where to purchase supplies and services
- What work must be performed by a specified individual
- What order or sequence to follow

The amount of instruction needed varies among different jobs. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. A business may lack the knowledge to instruct some highly specialized professionals; in other cases, the task may require little or no instruction. The key consideration is whether the business has retained the right to control the details of a worker's performance or instead has given up that right.

Training the business gives the worker. An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

B. 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 business expenses.** Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services they perform for their business.
- **The extent of the worker's investment.** An employee usually has no investment in the work other than his or her own time. An independent contractor often has a significant investment in the facilities he or she uses in performing services for someone else. However, a significant investment is not necessary for independent contractor status.
- **The extent to which the worker makes services available to the relevant market.** An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.
- **How the business pays the worker.** An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is usually paid by a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.
- **The extent to which the worker can realize a profit or loss.** Since an employer usually provides employees a workplace, tools, materials, equipment, and supplies needed for the work, and generally pays the costs of doing business, employees do not have an opportunity to make a profit or loss. An independent contractor can make a profit or loss.

C. Type of Relationship

Facts that show the parties' type of relationship include:

- **Written contracts describing the relationship the parties intended to create.** This is probably the least important of the criteria, since what really matters is the nature of the underlying work relationship, not what the parties choose to call it. However, in close cases, the written contract can make a difference.
- **Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.** The power to grant benefits carries with it the power to take them away, which is a power generally exercised by employers over employees. A true independent contractor will finance his or her own benefits out of the overall profits of the enterprise.
- **The permanency of the relationship.** If the company engages a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that the intent was to create an employer-employee relationship.
- **The extent to which services performed by the worker are a key aspect of the regular business of the company.** If a worker provides services that are a key aspect of the company's regular business activity, it is more likely that the company will have the right to direct and control his or her activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

Using the above tests, people such as lawyers, contractors, subcontractors, public stenographers and auctioneers who have an independent business in which they offer services to the public are generally not employees. However, whether such people are employees or independent contractors will depend on the facts in each case. The general rule is that an individual is an independent contractor if the person for whom the services are performed has the right to control or direct only the result of the work and not the means and methods of accomplishing the result.

VI. UNPAID INTERNS

The temptation especially during summer months and school vacations is to use college or even high school students as "interns" who might perform work previously done by paid employees. The Department of Labor has established rules by which a company may apply for authorization to pay a sub-minimum wage rate or no rate at all for "students working for practical experience."²¹ Without the necessary approval by the NHDOL, an employer is prohibited from using an unpaid intern to perform services.

Either the employer or a school representative may submit the application for approval when the prospective intern is either a high school or post-secondary school student. The application must state the name and nature of the school, the course of study, whether credit will be received by the student for the work along with many other details concerning the nature of the program and how it relates to the student's educational goals.²²

The statute is very clear that an intern may not be used to replace an existing or laid off worker.²³ The Department is careful to make certain

not only that the students are safe in performing the duties assigned to them but also in assuring that the internship is an educational experience and not simply a means for an employer to get free labor, and certainly not to allow for displacement of a paid employee. There is no place in the workforce for students to perform tasks for free or in exchange for minimal compensation in order to fulfill the needs of employers. Employers who use interns in this manner are in danger of being cited for violations of the minimum wage law and even the youth employment law if the workers are under the age of 18.

VII. VOLUNTEERS

When the workforce is lean and the needs are great, employers sometimes turn to those who would like to volunteer their time to fill the void. It is often a serious mistake for employers to allow this. The definition of employment under federal law is very broad, "to suffer or permit to work." The term employee as it applies to RSA 275:42 by definition does not apply to bona fide volunteers. However, one is only considered a bona fide volunteer under certain limited circumstances:

- A. When such volunteers are performing work for public, charitable or religious facilities;
- B. When such activities are exempt under 29 CFR Ch.V, §553:100-106, WH Publication 1297 "Employment Relationship" of the Fair Labor Standards Act;
- C. Where such bona fide volunteers do not replace a paid employee; and
- D. Where such volunteer duties do not necessarily or traditionally lead to paid employment.²⁴

This effectively eliminates the construction company employer from having his neighbor fill in for the laid off receptionist who used to answer the phone. Where volunteers are welcome and free to read to the elderly in nursing homes, to work at a blood drive for the Red Cross, to play the organ for the church choir or to clean up the city parks, no for-profit company is allowed to use a volunteer to perform services or to allow an employee to work off the clock in order to avoid payroll costs or payment of overtime.

CONCLUSION

Employers who attempt to replace laid-off workers with independent contractors, consultants, interns and volunteers must structure their arrangements with these individuals carefully. Independent contractors or

consultants should work only pursuant to the terms of a written contract and should be treated like a vendor rather than an employee. Internship programs should be carefully constructed in conjunction with a school, college or university with proper NHDOL approval. Volunteers' services should be confined to civic and charitable organizations and be limited to the types of tasks that do not normally lead to paid employment.

Failing to adhere to these principles can result in significant liability to the employer for injured workers not covered by worker's compensation, unpaid wages and overtime, and unpaid payroll and unemployment taxes. Each of the enforcing authorities, the NHDOL, DES and IRS all have significant power to bring actions against employers to collect back taxes and wages, to make the worker whole and to impose fines and penalties. The savings enjoyed by cutting corners may in the long run end up costing the employer far more than he or she could have dreamed.

ENDNOTES

- 1 The authors extend their thanks to Elizabeth A. Lahey for her assistance in research for this article.
- 2 RSA 275:4
- 3 *Id.*
- 4 As revised July 1, 2008
- 5 This mandatory poster is available from the Department of Labor at http://www.labor.state.nh.us/mandatory_posters.asp.
- 6 RSA 281-A:7
- 7 RSA 282-A:9, III, a, b and c.
- 8 *John Hancock*, 146 N.H. at 128.
- 9 *Wellman v. Riley*, 95 N.H. 507, 510 (1949)
- 10 127 N.H. 386, 387 (1985).
- 11 *Id.*
- 12 146 N.H. 124 (2001).
- 13 *Id.* at 128.
- 14 *Id.*
- 15 123 N.H. 332 (1983).
- 16 *Id.* at 333.
- 17 100 N.H. 41 (1955).
- 18 132 N.H. 289 (1989).
- 19 439 Mass. 171, 786 N.E.2d 365 (2003).
- 20 786 N.E.2d at 372.
- 21 RSA 279:2-aa, Lab 805.01.
- 22 Lab 805.02.
- 23 RSA 279:22-aa.
- 24 Lab 803.05.



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