

## In This Issue:

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New Connecticut legislation will drastically increase civil penalties and expand criminal liability for companies that misclassify workers as independent contractors.

## Stiffer Penalties on the Horizon for Independent Contractor Misclassification in Connecticut?

By GJ Stillson MacDonnell and Stephen P. Rosenberg

On May 5, 2010, Connecticut Governor Jodi Rell signed into law *An Act Implementing the Recommendations of the Joint Enforcement Commission on Employee Misclassification*.<sup>1</sup> The new law increases the state's civil penalty for independent contractor misclassification from the current \$300 per violation to \$300 **per day** per violation. It also expands criminal liability for employers who knowingly misclassify workers with the intent to injure, defraud or deceive the state because of their failure to pay workers' compensation or second injury fund assessments.<sup>2</sup> The new law is scheduled to become effective on October 1, 2010. Nothing in the legislation reconciles the conflicting interpretations of independent contractor status that currently exist under state and federal law.

### The New Law's Scope and Purpose

The Connecticut legislature established the Joint Enforcement Commission on Employee Misclassification in July 2008 to "review the problem of employee misclassification by employers for the purpose of avoiding their obligations under state and federal labor, employment and tax laws."<sup>3</sup> The Commission is co-chaired by Connecticut's Attorney General, and current Senatorial candidate, Richard Blumenthal and Acting Labor Commissioner Linda Agnew. Other Commission members are the Commissioner of Revenue Services, the chairperson of the Workers' Compensation Commission, and the Chief State's Attorney.

Under current Connecticut law, companies found to have misclassified workers as independent contractors are fined \$300 per violation.<sup>4</sup> They also may be liable for back wages, tax assessments, and other damages. The Connecticut Department of Labor can also issue a stop work order to an employer found to have knowingly misclassified employees as independent contractors for the purpose of defrauding its workers' compensation insurer.<sup>5</sup> In certain situations, a knowing violation may be prosecuted as a Class D felony.<sup>6</sup>

According to a Joint Enforcement Commission report, the Connecticut Department of Labor has collected approximately \$90,000 in civil penalties and issued more than 300 stop work orders since July 2008. Between October 2008 and September 2009, the Connecticut Department of Labor's Unemployment Field Audit Unit audited 2,020 employers and reclassified 6,700 workers, resulting in \$53 million in back wages and \$750,000 in additional unemployment taxes. Between July 2008 and February 2010, the Department of Revenue Services audited 100 employers and assessed more than \$2 million in additional taxes related to the alleged misclassification of independent contractors.<sup>7</sup>

Civil penalties will increase substantially under the new legislation. According to a report prepared by the state's Office of Fiscal Analysis, increasing the penalty from \$300 per violation to \$300 a day per violation will result in a "significant" potential revenue gain. Attorney General Blumenthal had advocated for penalties as high as \$1,000 a day per violation. In the wake of recent budget shortfalls, and with strong support for the legislation by labor unions and their political allies, both houses of the state legislature voted unanimously to pass the bill.

## Increased Scrutiny of Independent Contractor Classifications

The new law is emblematic of an increasingly hostile environment in Connecticut toward the classification of workers as independent contractors. In the past year, the Joint Enforcement Commission has developed a complaint/referral form and a database to track complaints of independent contractor misclassification more consistently and methodically. Currently, the Commission is developing a website to publicize the issue of worker misclassification and to provide information for individuals who believe they have been misclassified as independent contractors.

The legislative history and the Commission's report are clearly focused on perceived abuses—particularly in the construction industry—and the public statements of federal agencies that there is widespread misclassification and, consequently, loss of tax revenue. This legislation is premised on the notion that it will raise revenue for the cash-strapped state. While it is difficult to predict the financial benefit to Connecticut, if the law causes employers to curtail the use of contractors in favor of employees, payroll tax-related revenue such as income and unemployment taxes would increase, as such taxes are withheld at the source or paid by the employers. Enhanced compliance would reduce the extent of violations, but the significantly increased penalties may still increase revenue to the state from penalties and interest.

By way of comparison, in 2004, Congress enacted the SUTA (State Unemployment Tax Act) Dumping Prevention Act, which was aimed at discouraging employers from avoiding higher unemployment compensation tax rates by shifting employees to another entity.<sup>8</sup> States responded by enacting their own SUTA dumping laws to maintain their eligibility for federal funding for state agencies. By the time the federal and state governments enacted these laws, business behavior had changed and the projected revenue stream slowed to a trickle.

## Different Tests for Determining Independent Contractor Status

The new Connecticut legislation targets entities that use independent contractors by attempting to force them to assume workers' compensation and unemployment compensation obligations under state law. The Act does this, however, without reconciling the various tests of independent contractor and employee status. The Connecticut Departments of Labor and Revenue Services utilize two very different and conflicting tests. For example, the Department of Labor's Unemployment Division applies the "ABC" test, which is a difficult standard to satisfy. Under the ABC test, an individual is an independent contractor if he or she: (A) has been and will continue to be free from control and direction in the performance of services; (B) performs services outside of the company's usual course of business or outside of its places of business; and (C) is customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the services performed.<sup>9</sup>

In contrast, the Department of Revenue Services uses the more traditional common law test. By executive directive, these two state

agencies are to exchange information and, potentially, may conduct joint audits with federal agencies. The counterpart tests used by the federal Internal Revenue Service and Department of Labor are in turn different from either of the state tests. Taken together, these state and federal tests can be expected to whipsaw a business that operates on an independent contractor model.

## What Employers Can Do

In response to this new legislation, some businesses that legitimately engage the services of independent contractors will have to consider altering their staffing arrangements or cutting back on the number of individuals they retain in Connecticut, rather than run the risk of overwhelmingly expensive penalties. Classifying an individual who could legitimately be treated as an independent contractor as an employee is a conservative approach that will increase the employer's costs and may create problems from ERISA (Employee Retirement Income Security Act) benefits perspective. Companies that use independent contractors in Connecticut, or are considering retaining an independent contractor in the state, should keep the following points in mind.

- State and federal courts and government agencies apply varying tests to determine whether an individual is properly classified as an independent contractor. The same individual, performing the same services, may be deemed an independent contractor under one test and an employee under another test.
- Audits of contractor status in Connecticut by state and federal agencies will increase under the new law; sometimes by separate agencies acting together, and sometimes one after the other.
- Given the increase in audits and the potentially disastrous financial penalties that could result from the new enforcement tools, all organizations that use the services of independent contractors in Connecticut should consider conducting their own compliance audits with the assistance of legal counsel..

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<sup>1</sup> Conn. Public Act No. 10-12.

<sup>2</sup> *Id.*

<sup>3</sup> Conn. Gen. Stat. § 31-57h.

<sup>4</sup> Conn. Gen. Stat. § 31-69a(a).

<sup>5</sup> *Id.*; Conn. Gen. Stat. § 31-288(g).

<sup>6</sup> Conn. Gen. Stat. § 31-288(g).

<sup>7</sup> State of Connecticut, Joint Enforcement Commission on Employee Misclassification, Annual Report, Feb. 2010, at 12-13.

<sup>8</sup> See Pub. L. 108-295.

<sup>9</sup> Conn. Gen. Stat. § 31-222(a)(1)(B).