

Independent-contractor law may hinder consultants

Sharon Burger and Stephen Gould

For consultants seeking to work as independent contractors, Massachusetts has become a more complicated place in which to do business.

There are a number of issues that consultants need to consider when forming and operating their businesses that will determine whether they qualify as independent contractors under the state's restrictive statute.

In fact, the growing trend toward structuring new businesses as limited-liability companies (LLCs) rather than corporations may hinder their ability to secure work as self-employed individuals.

In July 2004, Massachusetts revamped its independent-contractor statute. The law creates a presumption that service provider are employees of the service recipient unless they can meet all elements of a rigorous three-factor test. By raising the bar on who can legitimately be classified as an independent contractor, the law may make it more difficult for consultants who previously qualified for treatment as independent contractors to maintain that status.

The three-factor test is designed to determine whether a worker's relationship with another firm is more business-to-business than employee-to-employer in nature. The first criterion is that the individual is free from control and direction in the performance of the service. The Massachusetts attorney general's advisory on this law interprets this provision to mean that "a worker's activities and duties must actually be carried out with independence and autonomy," free from supervisory direction and "using his or her own approach without instruction."

The second test provides that the service to be performed by the worker must be "outside the usual course of business of the employer." According to the advisory, a consultant who performs the same kind of work that is part of the service normally delivered by the company that engages him or her may not be treated as an independent contractor. This provision may be problematic for consultants, such as software programmers who perform contract work for firms—other than computer firms—that have their own IT departments.

The third test is that the worker must routinely work in an "independently established trade, occupation, profession or business." Issues of size and corporate structure become important. In determining whether a consultant qualifies as an independent contractor, the service recipient will want a clear sense that the consultant is a bona fide employee of another company that has the responsibility to withhold income taxes and pay into the Social Security and worker's compensation systems on behalf of that individual.

Increasingly, consultants and other small businesses are choosing to organize as LLCs, which offer a number of advantages over corporations. In Delaware, the number of businesses being formed as LLCs has for several years surpassed the number being organized as corporations. However, for consultants and other small businesses seeking to perform services as independent contractors, the LLC form of organization may actually hinder their ability to secure contracts with other firms.

We have seen instances where service recipients perceive that a service provider will more likely be treated as an employee of his or her own business if that business is organized as a corporation. Thus, while the structure of a consultant's business (whether LLC or corporation) should not be a critical factor in a potential service recipient's decision whether and to whom it should outsource its work, experience has shown that some companies are unwilling to work with consultants that are organized as LLCs unless the consultant reorganizes or converts its business structure into a corporation.

Massachusetts companies face potentially serious criminal and civil penalties for misclassifying workers, including imprisonment, debarment from performing public work and substantial monetary penalties, which are likely to make them more reluctant to hire consultants as independent contractors and ever more vigilant in peeling back appearances to understand the essence of the service provider-service recipient relationship. This means that consultants who seek to perform services as independent contractors must carefully consider their business plan and organizational structure to determine whether they remain viable in light of the important changes in the Massachusetts independent contractor statute.