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REAL ESTATE / TRANSACTIONAL LAW

# Update

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## ***caveat structor* – LET THE BUILDER BEWARE EMPLOYERS MUST MIND THEIR ABC'S WHEN CLASSIFYING THEIR CONSTRUCTION WORKERS**

By Vincent J. Paluzzi, Esq.

Misclassification of employees as independent contractors, intentional or not, has resulted in billions of dollars of lost tax revenues, denies such persons coverage under employee protection laws and Social Security, disability and unemployment compensation, and other benefits programs, and places employers who accurately classify their employees as employees at an unfair competitive disadvantage. While some employers have misclassified their employees unintentionally, due to confusion over different or conflicting definitions and standards embodied in various Federal and state statutory schemes, many have done so intentionally to reduce labor costs and gain an unfair competitive advantage. Not surprisingly, the New Jersey Legislature has acted to stem this practice, and to penalize those employers who knowingly misclassify their employees.

Misclassification typically occurs at hiring, when newly-hired workers are classified either as employees or independent contractors. Typically, employees are misclassified in one of the following two ways: (1) workers who should be classified as an employee and receive a Form W-2 from their employer are instead issued a Form 1099 and treated as if they were self employed; and (2) workers are paid in cash "off the books". In the former instance, the burden is shifted

to the worker to pay for social insurance programs and tax withholding liabilities, which may or may not occur, but a paper trail is created for various enforcement agencies to follow and which has provided evidence of the magnitude of the problem. In the latter instance, typically involving undocumented residents, virtually no records are created or maintained, and insurance or benefits contributions and tax payments usually are not remitted.

The impact of the misclassification of employees is significant. On the Federal level, the Government Accountability Office estimated that the underpayment of Social Security, unemployment insurance and income taxes as a result of misclassification of employees in 2006 amounted to \$2.72 billion. In New Jersey, audits by the Department of Labor and Workforce Development conducted for 2006 found approximately 25,000 workers had been misclassified, resulting in more than half a billion dollars (\$565 million) in unreported wages. Those same audits uncovered a significant number of misclassifications in the construction industry. Out of 871 audits and investigations, 41 percent revealed misclassifications totaling approximately 3,000 construction workers, resulting in \$78.2 million in under-reported wages and \$2.1 million in under-reported contributions<sup>1</sup>.

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## *caveat structor* – LET THE BUILDER BEWARE (*continued*)

### 2006 Amendments to the New Jersey Gross Income Tax Act

The New Jersey Legislature has responded aggressively to address the misclassification of employees and its effects, particularly in the construction industry. On August 21, 2006, the Legislature enacted certain amendments to the employer withholding provisions of the New Jersey Gross Income Tax Act<sup>2</sup>, which are based on the use of a single definition of “employee” for purposes of withholding State income taxes and unemployment insurance and disability insurance taxes—the so-called “ABC test”. Under the ABC test, an individual paid for services under an oral, written or implied contract is **presumed to be an employee**, unless it can be shown that he or she meets all three characteristics of a self-employed, independent contractor. Those characteristics are: (A) that the individual has been and will continue to be free from control or direction over the performance of such services, both contractually and in fact; (B) the service provided is either outside the usual course of business for which the service is performed, or is performed outside all of the places of business of the employer for which the service is performed; and (C) the individual performing the service is customarily engaged in an independently established trade, occupation, profession or business, so that the individual routinely would not become unemployed once

the relationship with the particular employer ended.<sup>(3)</sup> In short, the ABC test creates a presumption of employment and shifts the burden to the employer or employee to show otherwise.

By virtue of the 2006 amendments to the New Jersey Gross Income Tax Act, every employer maintaining an office or transacting business in New Jersey, making payment to any resident or nonresident individual of any wages that are subject to New Jersey personal income tax, or making payment of any remuneration for employment subject to contribution under the New Jersey Unemployment Compensation Law that is subject to New Jersey personal income tax, must deduct and withhold from such wages or remuneration for each payroll period an amount computed to be substantially equivalent, when annualized, to the tax reasonably estimated to be due from the inclusion in the individual’s New Jersey income of such wages or remuneration received during the calendar year (“estimated tax”), giving due regard to the individual’s withholding exemptions<sup>4</sup>. In the case of resident or nonresident unincorporated contractors, unless proof of registration with the Division of Revenue of the Department of the Treasury is provided, every person, other than a governmental entity, homeowner or tenant, maintaining an office or transacting business in New Jersey and making any payment of compensation or

remuneration to such unincorporated contractors for services rendered in this State, must deduct and withhold from the payment a tax equal to 7% of the amount paid, except that such 7% withholding tax is not imposed on payments for which estimated tax withholding is required as discussed above<sup>5</sup>. A person required to deduct and withhold such 7% tax but who fails to do so is liable for the amount of such tax, in the event that the tax is not otherwise paid by the unincorporated contractor, and even if otherwise paid, is not relieved from liability for penalties and interest<sup>6</sup>. Moreover, in the case of an owner or lessor of real property (including developers but not homeowners or tenants) to which construction, improvement, alteration or repair of a building, structure or other improvement is made, such owner or lessor is required to deduct and withhold the 7% tax from an unincorporated contractor with whom there is direct privity of contract, **and also is liable for that contractor’s withholding of the 7% tax from its subcontractors and for such subcontractors’ withholding of the 7% tax from lower tier subcontractors**<sup>7</sup>. The 2006 amendments apply to all payments subject to withholding of estimated tax or the 7% tax made on or after January 1, 2007<sup>8</sup>.

## *caveat structor* – LET THE BUILDER BEWARE (*continued*)

### 2007 Construction Industry Independent Contractor Act

The Legislature also enacted the Construction Industry Independent Contractor Act (the “CIICA”), which became effective on July 13, 2007<sup>9</sup>. The CIICA incorporates and applies the ABC test and its presumption of employment to all “services performed in the making of improvements to real property by an individual for remuneration.”<sup>10</sup> The CIICA regulates “employers” and provides various remedies and penalties, including civil fines, debarment from public projects and criminal prosecution for knowing violations, in the event that an employer fails to properly classify a construction worker as an employee and/or fails to pay wages, taxes, benefits or other contributions required by certain other statutory schemes if the worker is properly classified as an employee. The CIICA defines “employer” to include a partnership, association, joint stock company, trust, corporation, or other legal business entity or the successor thereof “who is primarily engaged in the business of, or enters into a contract for, making improvements to real property and includes a subcontractor or lower tier contractor.”<sup>11</sup> The specific reference to subcontractors and lower tier contractors in the definition of “employer” appears to be intended to apply to and protect construction workers at all levels of the project, and not to

connote that a developer or general contractor is exempt from the definition of “employer” with respect to any construction workers engaged by them.

The CIICA specifically regulates the following conduct:

(1) Failure by an employer, or any officer, agent, superintendent, foreman or employee of the employer, to properly classify an individual as an employee for purposes of the New Jersey Prevailing Wage Act, the New Jersey Unemployment Compensation Law, the New Jersey Temporary Disability Benefits Law, the New Jersey Gross Income Tax Act or other applicable State tax laws and the New Jersey State Wage and Hour Law, **who also fails to pay wages, benefits, taxes or other contributions required by any of those acts**<sup>12</sup>;

(2) **Knowing** failure by an employer, or any officer, agent, superintendent, foreman or employee of the employer, to properly classify an individual as an employee for purposes of the said acts, **who also fails to pay wages, benefits, taxes or other contributions required by any of the said acts**<sup>13</sup>;

(3) Failure by an employer to properly classify an individual as an employee for purposes of the said acts<sup>14</sup>;

(4) Employer requires or requests an individual to enter into an agreement or sign a document which results in the misclassification of the individual as an independent contractor or otherwise does not accurately

reflect the employment relationship with the employer<sup>15</sup>; and

(5) Employer or any other party discriminates in any manner or takes adverse action against any person in retaliation for exercising any rights protected under the CIICA<sup>16</sup>.

The CIICA imposes specific penalties for specific violations, as well as general penalties applicable to violations of any of its provisions. An employer violating “any provision” of the CIICA is subject to: (i) discretionary administrative penalties up to a maximum of \$2,500 for a first violation and up to a maximum of \$5,000 for each subsequent violation<sup>17</sup>; (ii) discretionary referral of the violation to investigation and civil or criminal prosecution by the Attorney General or his designee<sup>18</sup>; and/or (iii) mandatory stop work orders requiring the cessation of all business operations at every site at which the violation occurred, or the cessation of all business operations of the violator, for second violations or third or subsequent violations, respectively<sup>19</sup>. **In addition to** these generally applicable penalties, the CIICA imposes specific penalties for specific violations. An employer who fails to properly classify an individual as an employee may be subjected to a civil penalty of \$5,000 for each individual misclassified<sup>20</sup>, and suspension of its registration to bid on or engage in public works projects in New Jersey<sup>21</sup>. An employer, or

## ***caveat structor* – LET THE BUILDER BEWARE (continued)**

any officer, agent, superintendent, foreman or employee of the employer who fails to properly classify an individual and also fails to pay wages, taxes or other contributions required by any of the statutory schemes mentioned above is guilty of a disorderly persons offense, if such failure was not “knowing”<sup>22</sup>, but if such failure was “knowing”, is guilty of a second, third or fourth degree crime depending on the contract amount<sup>23</sup> and is also subject to debarment from bidding on or engaging, directly or indirectly, in public building and/or works projects for a period of three years<sup>24</sup>.

An individual employed as a construction worker who has not been properly classified as an employee, or a representative of such individual, including a labor organization, acting on behalf of the misclassified individual, has a private right of action for damages under the CIICA against the employer, or any other employer who was in contract

with the employee, if the employer had knowledge of the misclassification<sup>25</sup>. Other than provisions expressly making an employer liable for the acts of its **own** officers, agents, superintendents, foremen or employees, as discussed above, **this is the only section of the CIICA that suggests that there may be multiple employers of the same construction worker for purposes of the same violation and/or that there may be vicarious liability of a developer or contractor for violations of the CIICA solely by a subcontractor, sub subcontractor or their respective officers, agents, superintendents, foremen or employees.** Such vicarious liability would appear to be antithetical to the legislative history and purpose of the CIICA, which is based on the misclassification of construction workers by the issuance of a “1099” instead of a “W-2” and/or the payment of

construction workers in cash “off the books”, as well as the failure to remit wages, taxes, benefits or other contributions required under the statutory schemes mentioned above, involving the affirmative acts, or omissions, **of the party engaging the subject construction worker.** This is not to say that a developer or contractor that directs or controls such actions by subcontractors or sub subcontractors is beyond the purview of the CIICA, but only that if the Legislature had intended to impose vicarious liability, it would have been a simple matter to do so clearly and expressly and not by implication. In any event, even assuming arguendo that such vicarious liability exists, the statutory language still requires that the employer who is not in contract with the misclassified individual have “knowledge” of the misclassification in order to be subject to an action for damages by the misclassified individual.

<sup>1</sup> See, Testimony of David J. Socolow, Commissioner, New Jersey Department of

If you would like more information about the CIICA, have any questions about this article, or would like to discuss any other construction law related issues or matters, please contact Vincent J. Paluzzi at 609.989.5033 or [vpaluzzi@sternslaw.com](mailto:vpaluzzi@sternslaw.com).

## ***caveat structor – LET THE BUILDER BEWARE (continued)***

### ***Footnotes***

Labor and Workforce Development “The Misclassification of Employees as Independent Contractors” Before the U.S. House of Representatives, Committee on Education and Labor At a Joint Hearing of the Subcommittees on Workforce Protections and Health, Employment, Labor and Pensions, July 24, 2007.

<sup>2</sup> N.J.S.A. 54A:1-1 et seq.

<sup>3</sup> The ABC test is derived from the common law definition of “servant”. It was first adopted in New Jersey in 1936, upon enactment of the New Jersey Unemployment Compensation Law, N.J.S.A. 43:21-1 et seq., and is codified at N.J.S.A. 43:21-19(i)(6)(A),(B),(C). See generally, Carpet Remnant Warehouse v. Dep’t of Labor, 125 N.J. 567 (1991).

<sup>4</sup> N.J.S.A. 54A:7-1(a).

<sup>5</sup> N.J.S.A. 54A:7-1.2(a),(b). “Contractor” is defined as a person entering into a contract for services to construct, improve, alter, or repair a building, structure or improvement to real property, including a subcontractor, but not including professional services such as rendered by an architect, engineer or other licensed professional. N.J.S.A. 54A:7-1.2(i). Developers and home improvement contractors are encompassed by this definition.

<sup>6</sup> N.J.S.A. 54A:7-1.2(g)(1), (h).

<sup>7</sup> N.J.S.A. 54A:7-1.2(g)(2). “Subcontractor” is defined as a person entering into a contract with a contractor to construct, improve, alter, or repair a building, structure, or improvement to real property, not including professional services such as rendered by an architect, engineer or other licensed professional. N.J.S.A. 54A:7-1.2(i).

<sup>8</sup> N.J.S.A. 54A:7-1.2 (Historical and Statutory Notes).

<sup>9</sup> N.J.S.A. 34:20-1 et seq.

<sup>10</sup> N.J.S.A. 34:20-4.

<sup>11</sup> N.J.S.A. 34:20-3.

<sup>12</sup> N.J.S.A. 34:20-5a.

<sup>13</sup> N.J.S.A. 34:20-5a(2); N.J.S.A. 34:20-6.

<sup>14</sup> N.J.S.A. 34:20-7a, g; N.J.S.A. 34:20-8b.

<sup>15</sup> N.J.S.A. 34:20-8a.

<sup>16</sup> N.J.S.A. 34:20-9. Rights protected under the CIICA include, without limitation, the right to file a complaint or inform any person about an employer’s noncompliance, the right to inform any person of his potential rights under the CIICA, and the right to assist any person in the assertion of those rights. Any person who in good faith alleges noncompliance with the CIICA is afforded the rights provided by the act, “notwithstanding his failure or the merits.” (As in original— “on the merits” may have been intended). The taking of any adverse action against a person within 90 days of the person’s exercise of any rights protected under the CIICA raises a rebuttable presumption of retaliation. Ibid.

<sup>17</sup> N.J.S.A. 34:20-5b. In determining the amount of any administrative penalty, the CIICA requires the Commissioner of Labor and Workforce Development to consider, inter alia, the history of previous violations by the employer, the seriousness of the violation, the employer’s good faith vel non, and the size of the employer’s business; provided, however, that no administrative penalty may be assessed prior to giving the employer notice of the violation and proposed penalty and an opportunity to request a hearing. Ibid.

<sup>18</sup> N.J.S.A. 34:20-5d. Notwithstanding referral of a violation of the CIICA by the Commissioner, and even in the absence of a referral, the Attorney General independently may investigate and prosecute violations of the New Jersey Code of Criminal Justice. Ibid.

<sup>19</sup> N.J.S.A. 34:20-7c,d. **Note that the site-centric stop work orders may affect the rights of property owners and/or developers other than the employer (eg, a subcontractor or sub subcontractor) who violated any provision of the CIICA.** Whether intended or not, this may give rise to constitutional or other challenges to such orders.

<sup>20</sup> N.J.S.A. 34:20-7g. An employer denying that a misclassification occurred has the right to an expedited hearing before the Commissioner, which must be conducted and a decision rendered within 48 hours of the request. Ibid.

<sup>21</sup> N.J.S.A. 34:20-7a. If the Commissioner determines that it is in the public interest to do so, such registration may be suspended immediately, and in advance of any hearing.

<sup>22</sup> N.J.S.A. 34:20-5a(1). If convicted, the violator is subject to a fine between \$100 and \$1,000 and/or imprisonment for between 10 and 90 days. **Each week for which an individual is misclassified for even one day, and each individual misclassified, constitutes a separate offense.** Ibid.

<sup>23</sup> N.J.S.A. 34:20-5a(2). In addition, the violator shall be deemed to have caused a loss to the misclassified employees in any amount by which the employees were underpaid as a consequence of the misclassification, and is subjected to those provisions of the New Jersey Code of Criminal Justice regarding fines and restitution to victims. Ibid.

<sup>24</sup> N.J.S.A. 34:20-6. An employer denying that a violation occurred has the right to an expedited hearing before the Commissioner, which must be conducted and a decision rendered within 48 hours of the request. Ibid.

<sup>25</sup> N.J.S.A. 34:20-8b. Such an action also may be maintained as a class action. Ibid. In the case of undocumented workers, one would imagine that it might prove difficult to find any individual representatives of the putative class to satisfy Federal and/or New Jersey court rules applicable to class actions.