

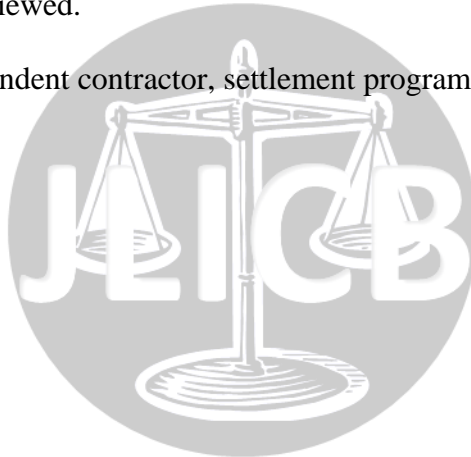
The legal ramifications of classifying employment: Employee v. independent contractor

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ABSTRACT

In an attempt to properly assess taxes and collect penalties for non-compliance, the IRS Chief of Employment has recently indicated that worker classification cases will be elevated to a major IRS focus. Consequently, employers need to comprehend all pertinent laws regarding proper worker classification as either employee or independent contractor. This paper looks at the definition of an employee and what needs to be taken into account to assure proper employment classification. If misclassification occurs employers need to be aware of ways to mitigate the severity of penalties largely through IRS Settlement Programs. In addition provisions of Sec. 530 of the Revenue Act of 1978 offer a safe harbor to nullify penalties altogether if the employer so qualifies. A proactive strategy for minimizing the possibility of improper classification is reviewed.

Keywords: employee, independent contractor, settlement programs, IRC Section 3509, Section 530 relief



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INTRODUCTION

In an attempt to properly assess taxes and collect penalties for non-compliance, the Internal Revenue Service (IRS) Chief of Employment has recently indicated that worker classification cases will be elevated to a major IRS focus (Deloitte, 2012). The IRS is in the process of conducting a three-year research project of 6000 random employment audits (Sheppard, 2012). The weak economy is likely a major factor behind the IRS's enhanced effort to collect unpaid taxes. Employers and workers therefore need to be aware of all pertinent laws and regulations regarding the proper classification of workers as employees or independent contractors. This paper looks at the definition of an employee and what needs to be taken into account in making a proper employment designation. Misclassification penalties under Internal Revenue Code (IRC) Section 3509 are then discussed. The paper then looks at opportunities for employers to mitigate Section 3509 penalties by agreeing to IRS Settlement Programs. Next, the safe-harbor provisions of Section 530 of the Revenue Act of 1978 are reviewed. The paper concludes by offering suggestions to employers on how to avoid making costly errors in employment classification.

EMPLOYMENT DEFINED

Section 3121(d) (2) of the IRC stipulates that an "employee", for social security taxes and Medicare (FICA), is any individual who, under the usual common law rules (discussed below) has the status of an employee (IRC, 2011). In addition, Section 3121(d)(3) mandates that certain workers statutorily qualify as employees without reference to the common law tests. The following four classes of workers are always treated as statutory employees: 1) drivers who distribute non-milk beverages, meat, vegetables or baked goods; or who pickup and deliver laundry, if the driver is an agent of the business or paid a commission 2) life insurance agents who work for one company 3) individuals working at home on material or goods supplied by the employer and the goods must be returned at the employer's request when the work is completed and 4) full-time traveling salespersons who work on the employer's behalf and turns in orders to the business (2011). For these workers, employers must withhold and match FICA taxes but are not required to withhold federal income taxes. Section 3508, on the other hand, classifies real estate agents and direct sellers as independent contractors if their compensation is related to sales or other output (2011). Section 3401, which refers to employers federal income tax withholding obligations, does not define "employee" and thus follows the common law rules.

The IRS applies a three part common-law test that evolved from a 1987 Revenue Ruling (Weissman, 2009). In that ruling twenty factors were delineated that help guide IRS agents in determining employment status (2009). These twenty factors are synthesized into three categories that involve behavior control, financial control and the relationship of the parties. The characteristics of behavioral control include such factors as explicit work instructions, required training and the ability to hire and pay assistants. Financial control involves significant financial investment, reimbursed expenses and the opportunity to generate profit or to incur loss. The relationship of the parties is established by such conditions as the payment of fringe benefits, a contractual agreement between the parties and whether similar services are provided by the worker to other entities (2009). All three conditions need not be met in an IRS agent's determination of worker status. In addition, actual control need not be present. It is the right to control that determines the employment relationship. The IRS and the courts look to the overall body of evidence in making their determination. If desirable either the firm or worker can file

Form SS-8 to (usually) get a binding determination of worker status by the IRS. In most cases it is the worker who desires the ruling to qualify as an employee. Employers may not want to risk tampering with an advantageous (i.e., independent contractor) worker status. On this form the three conditions described above are evaluated and a decision is rendered by an IRS agent. It must be noted that the ruling by an IRS agent only encompasses federal taxes and is not binding for other employment purposes. The Employee Retirement Income Security Act (ERISA) of 1974, Fair Labor Standards Act (FLSA) and the various states can all apply different tests to determine employee status and therefore the same individual can legally be classified differently for different purposes. The balance of the paper discusses the ramifications of proper worker classification for federal tax purposes only.

MISCLASSIFICATION PENALTIES

If an employer makes a misclassification error (even if unintended) in determining worker status the penalties can be substantial. If there is “intentional disregard” (e.g., ‘off-the-books’ transactions) in deducting and withholding of federal taxes, employers are responsible for all unreported taxes for all years under examination (Deloitte). This includes federal income tax with marginal rates as high as 39.6%, employer and employee shares of FICA taxes and federal unemployment compensation taxes (FUTA). In addition penalties for missed deposits (10%) and withholdings (20%) are assessed (Deloitte). These penalties are intended for cases of “intentional disregard” so it is more likely that a company would face the reduced penalties, resulting from negligence as opposed to fraud, under IRC Section 3509.

Classification Settlement Program

Employers can qualify for these reduced rates if, under audit, they agree to the terms of an IRS Classification Settlement Program (CSP). Under this program the employer consents to reclassify workers as employees for the year under audit and prospectively. To qualify for this rate the employer must have previously filed Form 1099 for all affected workers in all previous years as if it was assumed the workers were independent contractors (Deloitte). In return the taxes are reduced to 1.5% for federal income taxes, 20% of the employee’s share of FICA taxes and the full employer share of FICA taxes for the year under audit only (See Table 1). No interest or penalty is assessed. If 1099s were not filed but the employer agrees to the provisions of Section 3509 the tax rates for the withholding taxes are doubled (no change in the employer’s share) and no penalty or interest is owed (See Table 1). It should be noted that employers do not have recourse against the employees for the penalties assessed on the withholding. Employers do, however, have the opportunity to further reduce penalties under a new IRS initiative, the Voluntary Classification Settlement Program (VCSP).

Voluntary Classification Settlement Program

Under the VCSP program, established in 2011, employers must have treated workers as independent contractors for the past three years and filed all 1099s and not be under audit (Deloitte). By voluntarily filing Form 8952, prior to being audited and agreeing to classify workers as employees in the future, companies can pay a penalty of 10% of the already reduced rates under Section 3509. For example, the lowest rate available under Section 3509 would be about 10% of payroll. By preemptively filing Form 8952 the rate would be 10% of the reduced amount or about 1% of payroll (See Table 1). It is an option well worth considering particularly

if the worker classification can potentially be successfully contested. This program has recently been expanded to encompass firms that may currently either be under audit, albeit not an employment audit, or who may not have met the 1099 filing requirement. If so qualified the employer pays a 25% penalty (as opposed to 10%) on the reduced rates of Section 3509 and agrees to pay a graduated penalty on the unfiled 1099s depending on how many were not filed (Perez, 2012). This option expires on June 30, 2013 unless it is extended. Beside these options it is even possible for employers to eliminate all misclassification penalties if they can qualify under the safe-harbor provision of Section 530 of the 1978 Revenue Act.

Section 530 - 1978 Revenue Act

This provision was originally enacted as a temporary fix under the Revenue Act of 1978 but was made permanent by the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 (2009). The employer must meet all three of the following requirements to be relieved of the penalties: 1) have a reasonable basis for independent contractor classification 2) have substantive consistency in reporting workers as independent contractor in the past and 3) have reporting consistency as evidenced by the filing of Form 1099 for each worker earning over \$600. The reasonable basis for independent contractor classification is often the critical factor in the determination of Section 530 relief and can be demonstrated by 1) relying on a court or IRS ruling 2) having not had workers reclassified in a previous IRS audit 3) following industry practice or 4) following advice from an accountant or attorney (2009). It should be noted that having the penalties waived does not change the worker status to an independent contractor but the employer can continue to treat the worker as a non-employee for FICA and FUTA taxes prospectively. The common law rules discussed above would determine the employer's responsibility for withholding federal income tax.

ENSURING COMPLIANCE

Most worker classification situations are routine and without contention. Some, however, are nebulous and require a thorough understanding of tax laws and regulations on the part of employers to avoid costly penalties and interest. This is especially true today now that the IRS has increased its scrutiny of worker classification. If unsure of the employee/independent contractor classification the easiest solution would be to file Form SS-8 and get a binding determination from the IRS. This option may not always be desirable because it gives up control of the decision when it might not be necessary to do so. At the very least employers might want to use the form internally in making their classification decision. Form SS-8 summarizes the three control factors the IRS uses in determining worker classification and should enable the employer to determine worker status without contacting the IRS. Of course employees have the right to submit this form as well. In addition, workers have the right to file Form 8919 and pay uncollected social security taxes if they conclude that they qualify for employee status. This likely would trigger an employer audit and expose the company to substantial penalties. Employers, therefore, need to understand that all employees can act as quasi-auditors for the IRS. Because of this potential liability, if the employer believes that the worker might not qualify for employee status, it is incumbent that all 1099s be filed on a timely basis. This will enable the employer to eliminate or mitigate penalties should the IRS successfully contest the independent contractor classification in the future.

If worker classification is contested employers need to be familiar with the safe-harbor defense provided in Section 530 of the Revenue Act of 1978. This provision enables employers

to eliminate all penalties and interest resulting from improper classification if it meets the three criteria outlined above. In addition, for employer taxes, the employer may continue to follow independent contractor status even though the workers may be common law employees for federal income tax withholding. If Section 530 is not available IRC Section 3509 enables employers to reduce penalties if the employer preemptively concedes employee status for the period currently under audit. To take advantage of this option the employer must have consistently filed Form 1099. Absent the 1099 filings, under similar circumstances, penalties are doubled but it would likely still be in the company's best interest to concede the issue rather than risk the maximum penalties for all years under contention. In addition employers now have the opportunity to participate in a new IRS initiative, the Voluntary Classification Settlement Program (VCSP) established in late 2011 which has recently been expanded to help more employers qualify. The VCSP can substantially reduce the Section 3509 penalties.

If employers want to proactively craft a more solid defense for independent contractor status the twenty criteria involving the three control factors that the IRS uses in its audit determination should be thoroughly reviewed and comprehended. In addition some other factors to consider in determining independent contractor status include the following: 1.) Does the contractor maintain a website? 2.) Does the contractor invoice the business? 3.) Does the contractor have business insurance? 4.) Does the contractor have a state sales tax number? And perhaps most importantly 5.) Is there a contract and did the contractor draft it? All of these factors would substantiate the case that an independent business is intended and independent contractor status is the proper classification (Deloitte).

CONCLUSION

In conclusion, there is an abundance of information available to enable employers to make proper worker classification. Penalties for not doing so can be substantial. Form SS-8 can serve as a convenient document for making the determination even if it is not filed with the IRS. At the very least either a W-2 (employee) or 1099 (independent contractor) should always be filed on a timely basis. Back up documents should be kept for at least three years to support the decision. Workers can assert their rights to be properly classified as employees thus increasing the risk on the employer to make the proper employment classification. If the independent contractor decision is subsequently reversed employers need to be aware of their rights under IRC Section 3509 and Section 530 of the 1978 Revenue Act. Depending on the circumstances negotiated settlements should be strongly considered.

Table 1- Appendix-Illustration of Impact of Employment Penalties

Classification Settlement Program (CSP)- Employer is under audit, reduced penalties, one year's tax, agree to prospective employee treatment, 1099s filed: 1.5% of federal income tax (FIT), employer share of Social Security (6.2% of \$113,700) and Medicare (unlimited 1.45%), 20% of 6.2% withholding for Social Security, 20% of Medicare withholding.

Example: \$1,000,000 taxable income, Employer pays:

FIT penalty-.015 (\$1,000,000) =\$15,000; no 1099s=\$30,000

Employer FICA- .062 (\$1,000,000) =\$62,000

Employer Medicare-.0145 (\$1,000,000) =\$14,500

Employee FICA-.20(.062) (\$1,000,000) =\$12,400; no 1099s=\$24,800

Employee Medicare-.20(.0145) (\$1,000,000) =\$2,900; no 1099s=\$5,800

Total penalty=\$106,800=10.68% of wages, interest waived under IRC Section 6205

If no 1099s filed total penalty is \$137,100=13.71% of wages

Voluntary Classification Settlement Program (VCSP)-(established in 2011) - employer must voluntarily file Form 8952, have filed all 1099s, have all workers in same class treated as employees, not be undergoing audit of any kind:

Reduced penalty in above example-.10 (\$106,800) =\$10,680=1.068% of wages

Expanded VCSP (through 6/30/13)-employer could be undergoing non-employment audit or have unfiled 1099s:

.25 (\$106,800) =\$26,700=2.67% of wages.

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