IRS Offers Employers a Worker Classification Do-Over

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Compliance Week

A new program from the Internal Revenue Service and stepped up enforcement activity by the Department of Labor is putting renewed focus on how employers classify their workers.


Gousman

The temptation to put the independent contractor label on those who are really employees is always there, says Rosemary Gousman, managing partner at law firm Fisher & Phillips. By doing so, employers skirt obligations to provide benefits, such as healthcare and pensions, and avoid paying all the necessary taxes, which can be significant. “Some spillover effects need to be addressed, such as employers using the independent contractor category to avoid paying unemployment and disability tax to federal and state governments,” she says.


Ray

But not all employers with misclassified workers are purposely trying to rig the system. The rules can be confusing and leave plenty of areas of interpretation. “There are a number of different tests to determine employee status. Further confounding that analysis are unique state laws. The results may differ depending upon the exact law for which the analysis is conducted,” says Michael Ray, an associate at law firm Ogletree Deakins.

How widespread is the problem? A spokesperson for the Department of Labor says since January of 2009, the Wage and Hour Division has collected more than $9 million in back wages for more than 15,000 employees in 1,339 investigations related to employee misclassification.

The IRS recently provided an incentive to fix such problems, when it announced its Voluntary Classification Settlement Program in September—an amnesty program that lets companies pay back taxes on misclassified workers without fines or interest. The IRS says the program is part of its “Fresh Start” initiative, to help businesses and tax payers address their tax responsibilities. Employers that are not currently being audited by the IRS or other state agencies for misclassification issues but have treated some workers as non-employees are eligible to apply.

An employer that voluntarily joins the classification settlement program will have to pay 10 percent of its employment tax liability, which amounts to 1 percent of the wages paid to the employee for the most recent tax year, without any interest or penalties. That's a significant

reduction from what companies need to pay if classification problems are found during an audit. If the IRS finds misclassified employees, it typically forces companies to pay 100 percent of their employment tax liability for the previous 3 years, plus a 1.5 percent penalty and interest on top of that. The IRS is also offering a special six-year statute of limitations, as opposed to the standard three years generally applied to payroll taxes, and promised that employers will not be audited on payroll taxes related to the misclassified workers for prior years.


Reinfeld

"Misclassification is like sitting on a ticking time bomb. The faster employers resolve the issue, the better it will be for them," says Keith Reinfeld, an associate at law firm Fox Rothschild. "Essentially, the IRS is giving companies a 90 percent discount off their employment tax liability for the previous year and wiping out penalties and interest."

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The IRS volunteer program doesn't mean, however, that misclassification scofflaws will get off scot free. They could still be subject to penalties from the Labor Department or individual states. In fact, two days before announcing its new program the IRS signed an agreement with the Labor Department, who in turn recruited representatives from 11 states to enable information sharing and to coordinate law enforcement actions in combating worker misclassification practices. Connecticut, Maryland, Massachusetts, Minnesota, Missouri, Utah, and Washington have all signed the agreement with the Labor Department. Other states, including Hawaii, Illinois, Montana, and New York, are expected to sign similar agreements in the near future.

An IRS spokesperson clarified that the memorandum of understanding signed with the Labor Department is only to provide non-specific statistical data to them, some of which are already available on the IRS Website. "The IRS is not going to share any specific information with the Department of Labor. We cannot turn over someone's tax return to them or to the states," the spokesperson says. "They can refer information to us but the IRS cannot [refer specific information to them]," says the spokesperson.

IRS 20 FACTOR TEST

Below is a list of the 20 factors used to evaluate right to control and the validity of independent contractor classifications:

- *Level of instruction*. If the company directs when, where, and how work is done, this control indicates a possible employment relationship.

- *Amount of training*. Requesting workers to undergo company-provided training suggests an employment relationship since the company is directing the methods by which work is accomplished.
- *Degree of business integration*. Workers whose services are integrated into business operations or significantly affect business success are likely to be considered employees.
- *Extent of personal services*. Companies that insist on a particular person performing the work assert a degree of control that suggests an employment relationship. In contrast, independent contractors typically are free to assign work to anyone.
- *Control of assistants*. If a company hires, supervises, and pays a worker's assistants, this control indicates a possible employment relationship. If the worker retains control over hiring, supervising, and paying helpers, this arrangement suggests an independent contractor relationship.
- *Continuity of relationship*. A continuous relationship between a company and a worker indicates a possible employment relationship. However, an independent contractor arrangement can involve an ongoing relationship for multiple, sequential projects.
- *Flexibility of schedule*. People whose hours or days of work are dictated by a company are apt to qualify as its employees.
- *Demands for full-time work*. Full-time work gives a company control over most of a person's time, which supports a finding of an employment relationship.
- *Need for on-site services*. Requiring someone to work on company premises—particularly if the work can be performed elsewhere—indicates a possible employment relationship.
- *Sequence of work*. If a company requires work to be performed in specific order or sequence, this control suggests an employment relationship.
- *Requirements for reports*. If a worker regularly must provide written or oral reports on the status of a project, this arrangement indicates a possible employment relationship.
- *Method of payment*. Hourly, weekly, or monthly pay schedules are characteristic of employment relationships, unless the payments simply are a convenient way of distributing a lump-sum fee. Payment on commission or project completion is more characteristic of independent contractor relationships.
- *Payment of business or travel expenses*. Independent contractors typically bear the cost of travel or business expenses, and most contractors set their fees high enough to cover these costs. Direct reimbursement of travel and other business costs by a company suggests an employment relationship.
- *Provision of tools and materials*. Workers who perform most of their work using company-provided equipment, tools, and materials are more likely to be considered employees. Work largely done using independently obtained supplies or tools supports an independent contractor finding.
- *Investment in facilities*. Independent contractors typically invest in and maintain their own work facilities. In contrast, most employees rely on their employer to provide work facilities.
- *Realization of profit or loss*. Workers who receive predetermined earnings and have little chance to realize significant profit or loss through their work generally are employees.
- *Work for multiple companies*. People who simultaneously provide services for several unrelated companies are likely to qualify as independent contractors.

- *Availability to public*. If a worker regularly makes services available to the general public, this supports an independent contractor determination.
- *Control over discharge*. A company's unilateral right to discharge a worker suggests an employment relationship. In contrast, a company's ability to terminate independent contractor relationships generally depends on contract terms.
- *Right of termination*. Most employees unilaterally can terminate their work for a company without liability. Independent contractors cannot terminate services without liability, except as allowed under their contracts.

Source: IRS 20 Factor Test for Independent Contractor.

Beware the DoL

While the IRS may not be sharing specific information, the Labor Department is still pursuing cases vigorously. "The misclassification of employees may result in the violation of multiple laws, and a Labor Department investigation does not preclude other agencies from investigating their own laws," says the Labor Department spokesperson.

Earlier this month, the Labor Department announced its victory in pursuing a worker misclassification case against telephone and internet service installation contractor, Cascom. The labor department filed the lawsuit back in 2009, seeking to recover back wages and damages including health benefits coverage for 250 workers totaling $1.6 million. The lawsuit was pursued based on an investigation conducted by the agency's Wage and Hour Division in the Columbus, Ohio district.


Etter

And there may be exceptions to the rule barring the IRS from proving specific information to other agencies, meaning companies will want to use caution when entering the IRS's volunteer program. "If a state agency requests specific information from the IRS, Section 6103(d) provides an exception for them to get the information," says Craig Etter, shareholder at law firm Greenberg Traurig. He said the IRS may not tell the Labor Department the specific name of a company but can disclose data collected to point them in the right direction.

Lawyers familiar with the subject said all the efforts by the IRS and the Labor Department are focused on revenue. "On one hand, one will think that the government is looking at fairness of how companies treat workers. A more cynical view is on tax collection," said Brian Hall, a partner at law firm Porter Wright.


Hall He adds that by subscribing to the amnesty program, employers are saying we are doing it right this time. “But the action can also imply that employers have not done it right before,” he says, which may lead to other liabilities such as lawsuits from the Labor Department.

All About Control

Many companies have difficulties when classifying workers, as there is no single bright line test to determine whether an individual is an independent contractor or an employee.

The IRS's 20 factors or right-to-control test is designed to assess who controls how work is implemented. The rules state that employers are eligible to label workers as independent contractors if the workers have full control to dictate their work hours, decide how work should be carried out, have no limitation to work for other companies simultaneously, and other criteria.

Meanwhile, the Labor Department adopted the economic reality test, an assessment on the degree of control by the company on the relationship with employees, ability to determine profit and loss of workers, the skill and initiative required to perform the job, and the relationship permanency. At the state level, a multitude of different state laws apply.

“It is all about determining how much control the employer has on workers. The more control employers have, it is more likely the worker should be treated as an employee,” says Reinfeld.

Lawyers advise employers that if they have the slightest doubt, they should classify workers as employees, since the penalties and litigation can far outweigh any potential savings.