

US Worker Classification

The correct classification of a worker as an employee or an independent contractor is becoming increasingly important in the United States. The responsible federal and state government agencies are aggressively investigating and enforcing related compliance and are sharing information about identified non-compliance under initiatives such as the “questionable employment tax practices” initiative. The crackdown on worker misclassification is partly driven by revenue pressures: published statistics reveal that worker misclassification accounts for a significant portion of the US tax gap—the difference between the tax actually collected and what should have been collected. Proposed legislation (the Taxpayer Responsibility, Accountability, and Consistency Act of 2009, HR 3408) limits the relief now potentially available for federal tax matters if a business misclassifies a worker. Given the costs associated with misclassification, a business that uses the services of workers in the United States should review its workers’ classifications under the various US laws before changes in the law make corrections more costly and onerous. Even if a business believes that its classifications are correct, it should monitor its policies because a change in the status of even one worker may eliminate potential relief due to inconsistent treatment.

The financial risks of misclassification include unpaid taxes, penalties, and interest. Relevant taxes include the employee’s federal and state income tax liability (plus interest) on wages that he or she did not report previously; federal unemployment tax; state unemployment insurance tax; and the employee and employer portions of social security and Medicare taxes. For 2010, the rate applicable to both the employer and the employee for social security and hospital insurance (Medicare) taxes is 7.65 percent—6.2 percent for old-age, survivors’, and disability insurance on a specified wage base up to \$106,800 in 2010, plus 1.45 percent for Medicare.

Failure by a business to secure workers’ compensation and disability insurance can result in monetary penalties and non-monetary penalties such as debarment from government contracting and a stop-work order. An uninsured business is liable for the Workers’ Compensation Board award that an employee receives, and significant medical costs can arise if an employee is severely injured. Hiring an employee also involves wage and hour risks such as documentation issues, minimum wages, overtime, and other wage liabilities. An individual misclassified as an independent contractor may be entitled to benefits under various employee benefit plans; moreover, his or her consequent exclusion from participation in a qualified plan may result in the plan’s operational failure because it was not operated in accordance with its terms. Other misclassification risks include potential violations of discrimination law and health and safety laws, and exposure to tort liability under workers’ compensation law.

Criminal penalties may also apply for failure to comply with the classification and reporting rules, including monetary penalties and—for certain owners, officers, and employees—criminal prosecution under federal and state laws leading to imprisonment. If those individuals have authority over a business’s financial affairs and willfully fail to collect and pay taxes, they may be held personally liable for the uncollected taxes in non-criminal cases, and they may also be personally liable for failure to obtain workers’ compensation insurance.

To complicate matters, there is no uniform test to determine a worker’s classification. Even at the federal level, the standard varies for the purposes of federal income tax, the minimum wage and overtime law, the law granting employees the right to form and join unions, and various civil rights laws. For federal tax purposes, a common-law test determines a worker’s status. The cases focus primarily on whether the person providing the services is subject to the direction and control of the business with respect to what must be done and how it is done. In 1987, the IRS issued its list of 20 factors based on case law for use in determining whether a worker is an employee or an independent contractor. The factors fall into three general categories: (1) behavioural control (direction and control of what must be done and how); (2) financial control (do the services represent the worker’s own business?); and (3) the relationship between the worker and the recipient of the services. Examples of behavioural control indicating employee status

include requirements for worker training and compliance with instructions. Financial control factors indicating independent contractor status include the potential to realize a profit or loss from the services and significant investment in facilities that the worker uses. Relationship factors that suggest employee status include the right to hire and fire the worker and a continuing relationship between the worker and the person for whom the services are performed.

Some exceptions to the federal tax common-law tests exist, including statutory classifications such as that of a full-time life insurance salesperson as an employee for social security tax and employee benefit purposes. A significant exception to the common-law test may apply in some circumstances when a worker is classified as an employee. Section 530 of the Revenue Act of 1978 allows a worker's misclassification as an independent contractor to stand if substantive consistency and reporting requirements are met and the business had a reasonable basis for treating the individual as an independent contractor. Substantive consistency is achieved if the business has always treated that worker, and every worker in a substantially similar position, as an independent contractor. Federal reporting requirements are met if IRS form 1099-MISC is filed for each worker consistent with his or her treatment as an independent contractor. A reasonable basis for treating the worker as an independent contractor includes certain legal authority, a prior IRS audit, and a longstanding and recognized practice of a significant industry segment in which the worker was engaged. However, section 530 relief is limited to federal employment tax liability and does not affect the status of a worker under state unemployment insurance, workers' compensation, or disability coverage, or under other areas of compliance.

If a business does not qualify for relief under section 530, an IRS classification settlement program designed to reflect the hazards of litigating the classification is available, but only if the business consistently issued IRS form 1099 to the individuals. If a business clearly fails either the "substantive consistency" test or the "reasonable basis" test, the settlement offer is an assessment of 100 percent of the employment tax liability for only one taxable year. In contrast, if a business has plausible arguments to pass both tests, the offer is a reduced assessment of 25 percent of the employment tax liability for one year. Proposed legislation repeals section 530 in favour of a more limited safe harbour for businesses.

Code section 3509 also offers potential relief to businesses that have unintentionally misclassified workers, even if IRS form 1099 was not issued. It reduces the FICA/Medicare withholding rate for the employee share and the income tax withholding rate; the reduction depends on whether form 1099 was issued. President Obama has proposed limiting section 3509 relief to situations in which a business voluntarily reclassifies its workers, a proposal projected to increase revenue by more than \$7 billion over the next 10 years. The rule currently applies if an employer reclassifies due to an IRS examination.

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