

WORKER CLASSIFICATION: WILL THE IRS AND OTHERS AGREE WITH YOU?

Employers often face a business decision about how to treat a particular worker or group of workers: Are the individuals independent contractors or employees? Often, the independent contractor classification is attractive to employers because it affords certain flexibility. However, there are a number of factors that must be considered when deciding how to classify workers.

WHY IS WORKER CLASSIFICATION IMPORTANT?

Ensuring proper classification is important for many reasons, not the least of which are substantial tax consequences for the business. Specifically, an employer must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to employees. Also, an employer must provide workers' compensation coverage and may be responsible for the cost of providing employee benefits such as retirement income, health insurance, and life insurance.

An independent contractor classification may be more attractive to an employer because there is no requirement to withhold or pay any taxes on payments to these workers. Similarly, a business is not responsible for workers' compensation or employment benefits for independent contractors.

However, if a business misclassifies a worker as an independent contractor when that individual should be treated as an employee, significant tax and other liabilities can result. The problem grows exponentially if the misclassification occurs with respect to multiple individuals over an extended period of time.

HEIGHTENED GOVERNMENTAL FOCUS

While the Internal Revenue Service and state tax authorities have had enforcement mechanisms regarding worker classification, the IRS recently has developed new tools to identify non-compliance with the Tax Code provisions regarding such classification. It even has initiated publicity and educational efforts targeted to encourage self-compliance. In a recent "IRS Tax Talk Today" presentation, IRS officials stated that compliance levels have decreased, citing a rise in the number of individuals or independent contractors filing Schedule C, Profit or Loss from Business (Sole Proprietorship), instead of filing W-2s as employees.

Importantly, these officials also noted that federal congressional inquiries and proposed legislation have increased the IRS' focus on the worker classification issue. Lawmakers and the IRS believe the tax revenues lost to incorrect worker classification are substantial. Other sources report that the IRS is employing computer audit and additional tools designed to identify potential worker misclassification. Further, the IRS announced an agreement with over half the states to share information regarding worker misclassification. Given this heightened governmental focus, businesses should review the use of independent contractors and develop a business plan targeted at compliance.

WHO SHOULD BE CLASSIFIED AS AN EMPLOYEE?

The Tax Code provides that an "employee" is any officer of a corporation or any individual who, under the usual common law rules applicable in determining the employer-employee

relationship, has the status of an employee. Further, applicable regulations state that an employment relationship exists when the person or business for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is achieved. State tax authorities and governmental entities such as unemployment agencies follow similar rules.

To assess the employer-employee relationship under common law rules, an employer should consider all documentation and information regarding the worker's relationship with the business. The IRS will look for evidence of the degree of control over, and independence of, the worker. The considerations fall into three categories:

- *Behavioral control:* Does the business control or have the right to control what the worker does and how the worker does his or her job?
- *Financial control:* Are the financial aspects of the worker's job controlled by the payer? (These include matters such as how the worker is paid, whether expenses are reimbursed, and who provides tools/supplies.)
- *Type of relationship:* Are there written contracts or employee-type benefits (i.e., pension plan, insurance, or vacation pay)? Will the relationship continue, and is the work performed a key aspect of the business?

The IRS will weigh all these factors when determining whether a worker is an employee or independent contractor. Generally, the greater the control the business exercises over the worker, the more likely the worker should be considered an employee. However, a business must consider that the IRS has no objective formula to assess a work relationship as an employment relationship or as an independent contractor relationship. In any given case, there is a weighing of the factors in light of business practices and prior court rulings. Because there is no set rule to making the determination, each situation should be analyzed on its own merits.

IRS ENFORCEMENT TOOLS

The IRS uses two forms to enforce the Tax Code provisions and assist workers who seek assistance if they believe they have been misclassified.

Form SS-8

IRS Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, may be filed with the IRS by either the business or the worker, though workers file a majority of these forms. The form is designed to gather information and documentation from the business and the worker that is needed to analyze the three common law categories regarding control and relationship that are referenced above. The IRS will review the facts and circumstances and officially determine the worker's status. Any business asked by the IRS to respond to a Form SS-8 inquiry should do so immediately and with knowledge of any consequence resulting from an IRS reclassification.

IRS Form 8919

Since 2007, a worker who believes he or she has been improperly classified as an independent contractor can use IRS Form 8919, Uncollected Social Security and Medicare Tax on Wages, to calculate and report the employee's share of uncollected Social Security and Medicare taxes due on his or her compensation. The worker is required to have filed a Form SS-8 or have other correspondence from the IRS stating the worker is an employee. The taxpayer uses this new IRS form in connection with the filing of his or her annual tax return (IRS Form 1040) to avoid paying self-employment tax on the contractor payments. This new form will likely result in more IRS Form SS-8 ruling requests and IRS inquiries to businesses.

RELIEF PROVISIONS (SECTION 530 RELIEF)

Businesses that have a reasonable basis for not treating a worker as an employee may be relieved from having to pay employment taxes for that worker – even if the IRS determines the worker should have been treated as an employee.

To establish a reasonable basis, the business must be able to show that it relied on a court case or IRS ruling issued to the business; that it was audited by the IRS without reclassification of the worker; that a significant segment of the business' industry treated similar workers as individual contractors; and that it relied on credible advice of a business lawyer or accountant who knew facts about the business.

To be eligible for this relief, the business must: 1) file all required federal information returns on a basis consistent with the business treatment of the worker, and 2) not treat any worker holding a substantially similar position as an employee for any periods beginning after 1977.

CONCLUSION

The IRS is under increasing pressure by lawmakers and taxpayers to “close” the so-called “tax gap” caused by noncompliance. Other governmental agencies, including state income tax and unemployment agencies, are under similar pressures. The governmental bodies believe worker misclassification is an area where their enforcement efforts would produce tax revenues missed by noncompliance. Businesses should take notice of this increased focus and evaluate their current work arrangements because failure to properly classify workers can have significant adverse financial consequences.

This Employment Law Update is published as a service to our clients and friends. It is intended to be informational and does not constitute legal advice regarding any specific situation.

N|P Employment and Labor Law Group

CHARLESTON

843.577.9440

Josh Ellis
Molly Hughes Cherry

CHARLOTTE

704.339.0304

Sean Phelan
Grainger Pierce

COLUMBIA

803.771.8900

Mike Brittingham
Jennie Cluverius
Kristian Cross
David Dubberly
John Emerson
Vickie Eslinger
William Floyd
Joan Hartley
Angus Macaulay
Susi McWilliams
Nikole Mergo
Sue Odom
Sam Painter

GREENSBORO

336.373.1600

Trudy Ennis
Peter Pappas
Bill Wilcox

GREENVILLE

864.370.2211

Grant Burns
Jamie Hedgepath
Leon Harmon
Rusty Infinger
Michael Pitts
Tom Stephenson

HILTON HEAD

843.689.6277

Melissa Azallion

MYRTLE BEACH

843.213.5405

Molly Hughes Cherry

NEXSEN | PRUET

