The Challenging Ins and Outs of Federal Employee Misclassification

By Michael J. DeBlis III*

Michael J. DeBlis III examines the federal worker classifcation, weaving the 20 factors into the newer three categories.

The cost of paying human capital is among the largest burdens for most businesses. For good companies that value quality employees, this is a solid investment—after all, strong workers can make or break a business. For their less-scrupulous peers, however, paying for employees is an obnoxious pain that simply stands in the way of more necessary spending. This disdain for covering employee costs has, over time, developed into a startling and unfortunate trend: employee misclassification.

A W-2 employee costs a company quite a lot. In many jurisdictions, there are requirements related to benefits and paid vacation time, and employers are required to pay a portion of employee tax obligations. An independent contractor, however, doesn't come with any of these costs. Benefits aren't required, vacation time is rarely provided, and the employee pays all of his own taxes. Win-win, right?

Wrong. Employee classification isn't just a whim left up to an employer; it's based on federal laws that cover aspects of a work environment like scheduling and control over assignments. Despite this, many employers continue to misclassify employees for personal gain—a 2000 study found that 10% to 30% of employers have misclassified workers. Further, the same study found that 95% of workers who believed they were misclassified were, indeed, improperly categorized. Additional examinations have indicated that current rates of misclassification may be even higher than previously suspected; in Ohio, misclassifications increased by 53.3% from 2008 to 2009, while Illinois reported an increase of 21% from 2001 to 2005.

These statistics paint a dire picture, but the government is adamant that they are cracking down on this alarming trend. In 2011, the Department of Labor collected over $5,000,000 in back wages for 7,800 employees. If you think you may be misclassified, or have a client that is misclassified, here's what you need to know—and what you can do about it.

The Importance of Proper Classification

Income tax, Social Security, FICA, and FUTA are among the irrefutable realities of paying employees or earning wages. All W-2 employees are required to have these amounts withheld from their paychecks—but the same is not true

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for independent contractors. While this amount varies from one state to another, this can result in 20% or more of an employees' paycheck in withholdings each payday. Why is this significant? In 2011, the Department of the Treasury estimated that every employee misclassified as an independent contractor saves a company nearly $4,000 in employment taxes and $43,007 in salaries and wages. This trend has likely only risen after the Affordable Care Act was phased in; as employers meeting specific regulations are required to provide insurance for their employees, this only adds to the expenses accrued to keep people on the payroll.

Employers benefit when misclassifying, but the opposite is true for employees. In addition to an increased tax burden, independent contractors also lose the benefits associated with employment, like unemployment insurance, worker's compensation for injuries, minimum wage and overtime protections, coverage under FMLA, and the safeguards of employment equality laws, like the Age Discrimination in Employment Act and the Civil Rights Act.

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Law-abiding businesses are hurt by the negligence of others, as well. Per one study, miscategorizing employees can increase the costs of unemployment taxes and workers' compensation premiums based on the adjustment of participants in the general pool. Part of the costs associated with employee benefits may shift to the general public, too; for example, underpaid contractors not eligible for insurance at work may opt instead for public assistance. And while seemingly insignificant, businesses that save money through illegal classifications gain a competitive advantage, too.

Employees *vs.* Contractors

Under the law, there are four available employment classifications: independent contractor, common-law employee, statutory employee, and statutory non-employee.

While there are similarities and differences in all of these categories, the major difference separating employees from contractors is the element of control. An employer has the ability to dictate the work to be done, who should be doing it, how it is to be done, and what the end result should be. This means that if an employer tells you that you personally must prepare a sales report using the data included in your sales reporting systems to be completed fully and accurately by the end of the workday, this is completely and fully his right. As long as this direction or element of control is present, an employee–employer relationship exists, even if one or both parties wish to classify this relationship as something else. A contract or other signed agreement does not have the power to supersede the law.

Should the shoe be on the other foot and the worker himself be given the right to direct and control the work to be done, the hours during which work can be completed, and who physically performs the work, these aspects are far more indicative of an independent contractor role. This means that an employer can offer a project to a contractor, but the terms on which the project is completed are controlled primarily by the contractor, not the employer.

In order to make this boundary a little clearer, the IRS published 20 factors, weighted in terms of their importance and applicability, that can be used to help businesses and workers understand where they stand. The main points are shown in Table 1.

In general, if the answer to most or all of these questions is "yes," the worker is an employee. If most or all of these questions can be answered with "no," the employee can likely be classified as an independent contractor. It is important to note that most service consumer–worker relationships in the United States are more appropriately categorized as employee–employer connections.

Due to the explicit nature of these questions and the subsequent lack of confusion associated with correct employee classification, misclassification lawsuits are on the rise—and progress has been seen. FedEx, the international shipping carrier, was the subject of one of these cases. The outcome? 2,300 workers previously considered independent contractors were found to be misclassified. FedEx argued that the drivers provide their own trucks and don't have to follow specific routes, but the court determined that by dictating hours, uniforms to be worn, and mandatory company-provided training, FedEx was exerting control inappropriate for contractors. In this case, the court made clear that absolute control isn't required for employee classification, just a certain amount above and beyond what would be expected of an independent contractor.

Employees by Statute

In some cases, a worker may still be considered an employee by title alone, even if the control test questions demonstrate otherwise. The roles are shown in Table 2.

TABLE 1.
• Is the worker required to follow instructions regarding where, when, and how he is supposed to work?
• Is the worker provided with training prior to beginning work, like meetings, seminars, or other correspondence?
• Are the services offered by a worker integral to business operations and ongoing business success?
• Must any services be personally provided?
• Are any assistants hired, supervised, and paid?
• Is there an ongoing relationship between the hiring body and worker?
• Does the service consumer set duty or work hours?
• Is the time committed by the worker performing services roughly equivalent to full-time hours?
• Is work performed on the premises of the service consumer? (While plenty of employees do perform work at third-party sites and can still be considered employees, offsite work often suggests greater freedom. The applicability of this point will largely depend on the work being performed.)
• Must services or jobs be performed in a set order or sequence?
• Are oral or written progress reports required in the course of performing tasks?
• Is the worker being paid on an hourly, weekly, or monthly basis, versus a lump sum or commission payment?
• Are business travel expenses covered by the service consumer?
• Is the worker provided with significant tools and resources to complete work, like a computer or mobile phone?
• Does the service consumer invest in maintaining a workspace for the worker?
• Does the worker have any protection from liability in regards to the realization of profit or loss from his services, separate from the general liability that exists as an employee?
• Does the worker provide services for a single service consumer at a time, rather than piecework for multiple parties? (Note that it is possible for workers to be employees of more than one company simultaneously, and that has no bearing on worker classification.)
• Are any services offered by the worker not available to the general public?
• Does the service consumer have the ability to release or discharge the worker?
• Is the worker able to terminate his labor agreement at any time without consequence?

While statutory employees are considered employees, statutory non-employees are not. Workers who fit into this classification include real estate agents who operate independently and make most income on commission, direct sellers, and companion caregivers not employed by a parent company.

Suspected Misclassification

If you're reading this and thinking "well, this isn't good," either in regards to yourself or a client, there are steps that can be taken to right previous wrongs.

First, it is suggested that those who believe they are improperly classified to first speak candidly with their employer. In some cases, employers do not mean to misclassify workers, are not malicious about their practices, and truly do not realize the issues at hand. However, this step should be taken on a case by case basis, and workers concerned about job security may not be ready to come forward.

The next step is to get the government involved. By filing Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, workers can request a determination by the IRS. This form outlines many of the same principles listed above, and even takes things a step further, categorizing forms of support into three distinct buckets:

- **Behavioral Control:** the presence of rules regarding scheduling, training, tools, equipment, and work performance
- **Financial Control:** issues concerning who pays workers' expenses, like workspaces and equipment, and how workers are paid (lump sum *vs.* a standard paycheck)
- **The relationship between the service consumer and worker:** the presence of advantages like benefits or restrictions like non-compete or non-disclosure agreements

Upon receipt of Form SS-8 from a worker, the IRS will then send the same form to the service consumer to be completed. The case will be assigned a technician, who will review both Forms and determine a ruling based on the law. If a formal determination is issued by the IRS, it

TABLE 2.

- Officers of corporations as well as superintendents, managers, and other supervisory personnel (note that corporate directors are not generally considered employees for their directorial duties).
- Statutory employees, including drivers engaged in food service distribution, employees who work from home according to an employer's specifications, and full-time traveling or city salesmen. FICA taxes must be withheld from statutory employees if the majority of services must be provided by the worker in question, the worker doesn't have a substantial investment in the tools and facilities required to satisfy tasks, and tasks are a part of an ongoing relationship.
- Code Sec. 218 agreements, or workers of the state or local government covered by Code Sec. 218 of the Social Security Act.

is considered binding for all future cases with the same set of facts. If an information letter is sent, this is not binding but rather can be interpreted as advisory.

Note that the statute of limitations for a refund continues to run during this time, regardless of the preparation of From SS-8. If a taxpayer is concerned about this, he is encouraged to file Form 1040X, an amended return, as soon as possible with the words "Protective Claim" at the top and, under Part III, Explanation of Changes, "Filed Form SS-8 with the Internal Revenue Service Office in Holtsville, NY. By filing this protective claim, I reserve the right to file a claim for any refund that may be due after a determination of my employment tax status has been completed."

How a Worker Should Handle an IRS Determination of Worker Misclassification

While it's possible to give the IRS a heads up *via* Form SS-8, it's far more likely for the IRS to note misclassification through a standard business audit. One of the biggest red flags the IRS looks for—and something that can actually trigger an audit—is a substantial number of 1099-MISCs with large numbers in Box 7 (Non-employee compensation).

For those who have found to be miscategorized who have not yet filed taxes, the amount reported on Form 1099 should be included on Line 7 of Form 1040. FICA tax must then be calculated manually using Form 8919, *Uncollected Social Security and Medicare Tax on Wages*. Further, the taxpayer should include Form 4852, *Substitute for Form W-2, Wage and Tax Statement,* to stand in for the W-2 that should have been provided. If taxes were already filed, Form 1040X will be required to amend the original filing and request a refund of any self-employment tax paid. If a W-2 is eventually offered, an additional amendment may be suggested. As FICA taxes are jointly paid, employers who are working to change poor practices should request employees fill out Form 4669, *Statement of Payments Received*, to account for the portion a worker paid on his own behalf.

In some rare and unfortunate circumstances, a change in classification may result in a deficiency if a worker was taking deductions on Schedules A or C that aren't permitted for a W-2 employee to claim. There is no relief for workers in misclassification cases, so these changes will require an amended return and further payment.

Suing the Employer for Additional Penalties

So, you were illegally misclassified and you're mad about it. Now what?

In some cases, a lawsuit may be the appropriate response. Under Code Sec. 7434, there may be recourse for the victims of those who knowingly file a fraudulent information return. Damages can range from $5,000 to the true value of the damage that resulted from the changes in filing status, as well as the cost of bringing legal action, including reasonable legal fees. To win this kind of case, you must be able to prove that:

- An information return (like a 1099-MISC) was issued.
- This return was fraudulent.
- The return was issued willingly and knowingly.

A good faith belief that correct measures were taken isn't enough to qualify a case as fraud, but a lack thereof can qualify. There is a time limit on Code Sec. 7434—six years from the date the return is first filed or one year after the fraudulent return would have been identified through reasonable care—but the IRS has no set limit to bring charges against an employer.

Whistleblower Awards

The IRS has a long history of rewarding whistleblowers who help with the identification of tax fraud, and employee misclassification is no different. Under Code Sec. 7623, rewards may be available for those who provide actionable tips on employee miscategorization. Should the IRS determine that any tips provided contribute to judicial or administrative action, the whistleblower may be eligible to receive 10% to 30% of collected proceeds. Anyone submitting information that could result in a reward should file Form 211, *Application for Award of Original Information*. If the case is personal, this can be included with Form SS-8.

The Ignorance Defense

"But we didn't think we were doing anything wrong!"

It's a common defense for companies classifying workers incorrectly, and in many cases it's true—or, it was true, at one point or another. While some businesses certainly do set out to defraud the government, most had misguided albeit good faith reasons to begin to misclassify workers in the first place. Those who really and truly did not mean to escape the law have protection under Code Sec. 530 of the Revenue Act of 1978, which safeguards those who made an honest mistake in worker classification. To qualify for this protection, the following must be true:

- A reasonable basis for treating employees as contractors, like similar and frequent behavior elsewhere in the industry.
- Consistency in classification among all workers in a similar position.
- Reporting consistency.

Classification Settlement Program

While relief is available under Code Sec. 530, the IRS also offers a Classification Settlement Program, or CSP, to ease the burden. This allows the IRS to support those with potential misclassification issues early in the administrative process to avoid the possibility of appeals or litigation. In some cases, the IRS must offer the option of a CSP for taxpayers to reject or accept.

In the CSP process, the IRS will first determine if misclassification applies, as well as if Code Sec. 530 relief is appropriate. If any basis for miscategorization is found and all 1099 paperwork was filed in accordance with the law, the IRS may offer an adjustment equal to 25% of any deficiency in the most recent tax year under investigation. If there appears to be no sound reasoning for classification and none of the requirements under Code Sec. 530 are met, the service consumer will have to pay 100% of the adjusted amount for the most recent tax year. In both of these situations, employers must be willing to reclassify their employees.

CSP participation is optional, and service consumers have the right to an Appeal or administrative review.

Voluntary Classification Settlement Program

An alternative to the traditional CSP program, the Voluntary Classification Settlement Program is an option for those who voluntarily come forward to report potential misclassification before the IRS or Department of Labor can intervene. The VCSP is a big incentive for those who haven't been targeted yet; through VCSP, companies are permitted to reduce their tax liabilities to just over 1% of the wages paid to reclassified workers while abating all penalties and interest. Further, successful program completion can preclude audits for unpaid employment tax in past years.

TABLE 3.

- The degree of control by the service consumer
- The source of facilities funding
- The opportunity for profit or loss
- The ability to discharge a worker
- Whether the work being performed is a part of the service consumer's regular business
- The permanence of the relationship
- The relationship the parties believed they were entering into

Requesting a Tax Court Determination

When a Code Sec. 530 defense isn't an option and a CSP is rejected, a Tax Court determination under Code Sec. 7436 might be an alternate pathway to consider. Code Sec. 7436 allows the Tax Court to determine employment tax issues including misclassification, as well as the calculation of FICA, FUTA, and income tax. Code Sec. 7436 is only for service consumers; workers are not able to argue status.

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A Code Sec. 7436 filing doesn't have to be the first step; service consumers can start by seeking an Appeal. In this process, the IRS will first send Letter 950-C, *Employment Tax 30 Day Letter-WC*, a notice of adjustment to employment taxes. This can be accompanied by Form 13683, *Statement of Disputed Issues*, for adjustments less than $25,000. Upon receipt, an employer can then submit a letter to Appeals with a statement of any disputed adjustments as well as the background details and explanations to support these assertions. After this, the employer will have a chance to meet with an examiner before proceeding to Appeals.

If no response is filed within 30 days or if the IRS Appeals process goes poorly, the IRS will likely respond with Letter 3523, *Notice of Determination of Worker Classification (NDWC)*, indicating the misclassified employees that need to be recategorized. If a service consumer would still like to fight back, he has until the 91st day following the postmark date on the NDWC to petition the Tax Court. However, things may not get better in Tax Court; similar to the 20-factor test used by the IRS, the Tax Court uses a seven-factor test to determine employee classifications (*see* Table 3).

If the amount being disputed is under $50,000 for each quarter, the taxpayer may be better positioned to conduct a judicial review as an S case, or a small claims case that falls under the umbrella of Code Sec. 7436. These cases are smaller and less expensive, but there's no arguing with the ruling: both sides cede the right to additional appeals by proceeding with an S case.

The Bottom Line on Classifications

Employee misclassification steals billions of dollars from the government every year and hurts countless good employees just trying to earn an honest living. The best situation for everyone—except, perhaps, for unscrupulous employers who plan to go on being unscrupulous, laws be damned—is to classify employees properly the first time around, and to stay up to date on rulings to be sure things don't change to the detriment of you, your clients, or even your company.

ENDNOTE

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