DOMINION FINANCIAL
CONSULTANTS

To: The Dominion Files/The Dominion Advisory

From: Christy Mistr

Date: January 31, 2014

RE: Cautions in Worker Classification: Why You Should Carefully Analyze Whether Your Workers are Properly Characterized as Employees or Independent Contractors

What You Should Know

In recent years, the Internal Revenue Service (IRS), the Department of Labor (DOL) and State Governments have increased their enforcement efforts with respect to worker misclassification and are increasingly collaborating and information-sharing in their respective enforcement initiatives. The Department of Labor believes that thirty percent (30%) of workers are misclassified while the IRS believes the number hovers around twenty percent (20%). The General Accounting Office (GAO) has estimated that the IRS is losing billions and employment advocacy groups believe that workers are being denied employment benefits to which they are entitled such as wage and discrimination protections, unemployment insurance, workers compensation and other benefits. As a result, IRS, DOL and State Governments have launched a full court press.

The recent recession was a large impetus for increased enforcement by States over worker classification practices as State governments. States found themselves with smaller budgets and larger service demands and thus have attempted to collect millions of dollars in unpaid taxes and unemployment-insurance and contributions to workers compensation funds.

Federal agencies have also followed suit. In 2010, DOL announced that it would issue regulations requiring companies to write a classification analysis for all workers, including independent contractors. These regulations are expected to require companies to explain why any worker is not covered by the Fair Labor Standards Act. The DOL also increased enforcement efforts around the same time and since 2011, has collected almost half a billion dollars in back wages for almost 20,000 workers improperly classified.

45 East Boscawen Street, 3rd Floor
Winchester, VA 22601
540.535.0505

1701 Pennsylvania Avenue, NW
Washington, DC 20006
202.580.6511

877.547.7430
dominionconsult.com

In September of 2011, IRS and DOL announced that they would be collaborating in their enforcement efforts in an effort to stem the tide of worker misclassification. Specifically, DOL signed an inter-agency memorandum of understanding ("MOU") with IRS to share enforcement information and coordinate law enforcement efforts in an effort to end the business practice of misclassifying employees and avoid providing associated employment protections. At the outset, seven States joined the multi-agency collaboration: Connecticut, Maryland, Massachusetts, Minnesota, Missouri, Utah and Washington. Four states signed limited agreements at that time: Hawaii, Illinois, Montana and New York. Since then, four more states joined the collaboration: California, Colorado, Iowa and Louisiana. Most recently, in November of 2013, New York became the 15th state to become a full partner with DOL in a collaborative initiative to crackdown on workplace misclassifications of independent contractors.

Federal and state government agencies are increasing audits to determine if workers have been misclassified as independent contractors, in an effort to circumvent paying payroll taxes, employee benefits (including retirement plan contributions), unemployment insurance, and overtime pay. The stakes will grow in 2015 when health care reform requires businesses with 50 or more employees to provide health insurance to them, or face a penalty of as much as $3,000 per worker.

The IRS recently announced it is concluding 6,000 random audits over the next year as part of a three-year project on payroll tax compliance. The IRS believes that around 20% of all workers are incorrectly classified, allowing employers to save $3,710 per worker in payroll taxes annually, and costing the IRS $1.6 billion.

On a more limited basis, Congress has begun to focus on the issue. For example, in the Fair Playing Field Act of 201 (H.R. 6128 and S. 3876), legislation has been offered in the House and Senate that would require employers to give independent contractors a type of Miranda warning regarding federal tax obligations, the labor and employment law protections inapplicable to independent contractors and the right of each contactor to ask the IRS to determine whether he or she is an employee or an independent contractor.

What You Should Do: Planning Considerations

As you are hiring, you should take a significant pause to consider the correct classification of workers that you hire. The financial consequences of misclassifying workers can be substantial. If an independent contractor is reclassified as an employee, payroll taxes, interest, and penalties will be assessed on the employer for failure to withhold and remit taxes, and the employer must also pay the cost of the audit. Employers may be able to limit penalties if they have a reasonable basis for treating the worker as a contractor, or if the worker misclassification is found to be unintentional. In addition to any State taxes and penalties, employers will have to pay payroll taxes of 7.65% and penalties of 20% of those taxes and 1.5% of wages (if unintentional—i.e., 1099s were filed) and 40% of payroll taxes and 3% of wages (if intentional). In addition, the IRS can also go after all business owners and officers personally for 100% of the penalty. Because these are fiduciary taxes (deemed to be held for another's benefit), each owner and officer is deemed a "responsible person"

by IRS and each is jointly and severally liable. Although the taxes will be assessed on each person, they are usually only collected once.

Misclassified workers can also be adversely impacted by subsequent characterizations. For example, in *Karagozian v. Commissioner*, the Tax Court recently determined that the worker should have been treated as an employee, requiring the employer to make payroll contributions but disallowing a refund of overpaid self-employment taxes by the worker. Similarly, the Ninth Circuit has found that retirement plan contributions made by a presumed self-employed worker who is later classed an employee to be disallowed, resulting in failed contributions, additional income tax and a penalty for excess contributions. See *Rosenfeld* (9th Circuit, 2013).

It is recommended that you consult with the guidelines offered by your State as well as those offered by the Internal Revenue Service. In 1987, the IRS published a 20-factor test it uses to determine whether a worker is an employee or independent contractor. Many states rely upon this guidance. The factors are listed below; however the primary factor is the degree of control that the employer exerts over the worker in dictating job responsibilities and how those are performed.

- **Instructions**.
- **Training**.
- **Integration**.
- **Services Rendered Personally.**
- **Hiring assistants.**
- **Continuing Relationship**.
- **Set Hours of Work**.
- **Full Time Required**.
- **Work Done on Premises**.
- **Order or Sequence.**
- **Reports.**
- **Payment Method.**
- **Expenses.**
- **Tools and Materials.**
- **Investment.**
- **Profit or Loss.**
- **Works for more than 1 Person at a Time.**
- **Services Available to Public.**
- **Right to Fire.**
- **Right to Quit.**

More recently, the IRS has begun to divide these into three principal groups:

- **Behavioral Control**. Does the business or the employee have the right to direct the way the work is done in the following respects:

    - **Types of Instructions Given**. Who controls when and where the work is done, what equipment is used, who is hired to assist with the work, where supplies are purchased, what work must be done by a particular person and in what order the work occurs.
    - **Degree of Instruction**. More detailed instruction indicates more control and that a worker is an employee.
    - **Evaluation System**. Methods of evaluating workers suggest employment while performance measures could go either way.
    - **Training**. Training on process or procedures is strong evidence that the worker is an employee. Independent contractors typically do not need this.
- **Financial Control**. Does the business control the following economic aspects of the worker's job:
    - **Significant Investment**. An investment in equipment can indicate independent contractor status but is not determinative and not necessary as some types of work do not require such expenditures.
    - **Unreimbursed Expenses**. Contractors are more likely to have these.
    - **Opportunity for Profit or Loss**. Have the possibility of incurring a loss indicates that the worker is a contractor.
    - **Services Available to the Market**. Contractors are free to pursue other work and usually do, often advertise and maintain a business location.
    - **Method of Payment**. Employees are typically paid a regular wage for a period of time. Contractors typically bill by the job or on an hourly basis through an invoicing system.
- **Type of Relationship**. These are designed to show how the worker and business perceive their relationship to each other.
    - **Written Contracts**. The IRS does not regard the characterization of the parties in a contract but looks to how the parties interact with one another.
    - **Employee Benefits**. Businesses typically do not grant employee benefits such as insurance, pensions, and paid time off to contractors. Provision of these types of benefits suggests employment.
    - **Permanency of the Relationship**. If the relationship is intended to continue indefinitely rather than for a term of years or for a project, the IRS considers this to be evidence of the intent to create employment.
    - **Services Provided as Key Activity of the Business**. The more integral the services are to the core mission of an organization, the more likely the IRS is to regard the workers as an employee. For example, the IRS believes that attorneys hired by a law firm would be subject to direction and control of the firm which is indicative of an employment relationship.

Businesses must weigh all of the factors when making a determination. No one factor is determinative. The IRS will look to the entire relationship and consider the degree and extent to which the business is permitted to control the worker. You should document your analysis in making the determination. If, after reviewing the evidence, it is still unclear whether a worker is an employee or independent contractor, you may request a determination from IRS using Form SS-8, "Determination of Worker Status for Purposes of

Federal Employment Taxes and Income Tax Withholding." This form may be filed by the business or by the worker. IRS will review the facts and circumstances and make an official determination regarding the worker's status. It can take up to six months to get a determination. Since 2007, workers who believe they have been improperly classified are as independent contractors by an employer may, in limited circumstances, use IRS Form 8919 to petition IRS to figure and report the employee's share of uncollected social security and Medicare taxes due on their compensation.

What You Should Do If You Have a Potential Misclassification

If you think you have a potential misclassification, review the issue with your CPA or attorney. The IRS has not been lenient in this area historically; that said, the IRS is aware that the recent economic downturn caused many businesses and start-ups to increase worker misclassification. To remedy this problem, the IRS has initiated an amnesty program called the Voluntary Classification Settlement Program (VCSP) to give businesses a chance to voluntarily correct worker misclassifications prospectively. To qualify, you must have filed Form 1099 for the independent contractor for any of the relevant past three years and not be under employment tax audit by IRS, DOL or a state government agency. The taxpayer will agree to pay 10% of employment tax for the prior year but will not be subject to interest and penalties and will not be subjected to an audit for those workers. To participate, a taxpayer may apply using Form 8952, Application for Voluntary Classification Settlement Program. The application should be filed at least 60 days prior to when the taxpayer wants to begin treating its workers as employees.