IRS Still Hunting For Misclassified Workers

By Robert W. Wood

The Internal Revenue Service is like an awkward and disaffected teenager these days, with all the baggage that goes with it. For that reason, the inspector general of the IRS is now much in the news. He has reported on targeting of conservative groups applying for tax-exempt status, excessive conference and travel expenses, and more. Some of the inspector general's nips at the heels of the IRS are likely to impact many wallets.

When you consider the dollars involved, some of those wallets may even be emptied. The inspector general's latest report says the IRS needs to do more to go after employers who pay workers as independent contractors when they are really employees. Of course, companies and workers can sign binding agreements that say the workers are independent contractors.

That hasn't changed. But the IRS isn't bound by this, no matter what. And no other government agencies are bound by it either. That also hasn't changed.

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When you pay independent contractors, there's no income tax withholding and no employment taxes. Even assuming that every independent contractor files a tax return, the IRS won't collect as much and will get it much later. Statistics bear that out.

In fact, just one piece of the puzzle is the self-employment tax. That is supposed to equal both the employer and employee shares of Social Security taxes on wages paid to employees. It turns out the self-employment tax is one of the most notoriously under-collected taxes there is.

There's no question that in timing and amount, wage withholding is much, much better for the IRS. Of course, the IRS isn't the only government agency worried about workers who are mislabeled as "independent contractors." California's tax authorities care too, as do insurance companies, unemployment departments and worker's compensation carriers.

The classification also matters for pension and benefit laws. Many lawyers and law firms must deal with the panoply of nondiscrimination rules in their own pension and benefit plans. Those rules are all geared to who is an employee. If some or all of your independent contractors are reclassified as employees, would your plans still qualify? Similarly, under Obamacare, many rules hinge on who are your employees — independent contractors are not covered.

When you consider all the tentacles encircling one's legal relationship with employees, a recharacterization battle can be almost overwhelming in scope. And one reclassification usually leads to others. This fundamental worker status issue has become one of the most consequential legal determinations around.

If you're in business and guess wrong, the liability for past years can be crushing. And the IRS inspector general's report says that despite IRS efforts, employers are still getting it wrong. The IRS quickly agreed. In this report, the inspector notes that employers and workers alike can seek determinations about worker status from the IRS. See TIGTA Report No. 2013-30-058, "Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings."

Nevertheless, the report says *millions* of employees are misclassified as independent contractors. These employers are dramatically underpaying employment taxes. That hurts everyone, the report claims. And the figures are significant.

The rulings that the report says are underutilized are not the employer's best friend. Either the company or worker can ask for an IRS ruling by completing a streamlined ruling form, IRS Form SS-8. And unlike most other rulings from the IRS where there's a fee, this one is free.

The vast majority of the forms — about 90 percent — are submitted by workers. What's more, most requests produce an IRS ruling that the worker is an employee. In fact, for one recent year for which statistics are available, 72 percent of all Form SS-8 requests produced rulings that the workers were employees.

Only about 5 percent were rulings that the worker is an independent contractor. The rest were withdrawn or no ruling was issued. The overwhelming penchant of the IRS is to come out in favor of withholding and employment tax.

For its report, the treasury inspector general for Tax Administration analyzed 5,325 rulings in which the conclusion was "employee." But many employers do not comply. Seventeen percent of employers appeared to comply with the ruling by issuing the appropriate forms to their workers; 19 percent appeared not to comply; and 65 percent of employers did not issue correct forms. TIGTA made four recommendations to improve program performance and increase employer compliance. The IRS agreed to implement all four.

Meanwhile, the IRS is still offering its Voluntary Compliance Settlement Program (VCSP). To be eligible, an employer must: (1) currently be treating the workers as independent contractors; (2) consistently have treated the workers as independent contractors in the past, including filing Forms 1099; (3) not be under IRS audit on payroll tax issues; (4) not be under audit by the Department of Labor or state agencies for the classification of these workers; and (5) not be contesting the classification of the workers in court.

Employers apply by submitting Form 8952 at least 60 days before they want to start treating workers as employees. Employers in the program generally pay just over 1 percent of the wages paid to the reclassified workers for the past year. There are no penalties and no interest, and employers will not be audited on payroll taxes related to these workers for prior years.

Determining who is an employee and who is not is a real minefield. It is fact-intensive, and small nuances can spell the difference between success and failure. And as the inspector general's report perceives, the stakes are getting bigger and bigger.

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