Agencies To Scrutinize Worker Classification

By Robert W. Wood

Whether to hire someone as an employee or independent contractor may seem to be a decision that makes itself. Who wouldn't prefer to have an independent contractor? With independent contractors, you don't have to withhold taxes or pay any benefits. They are easier to fire too.

Yet if you treat employees as independent contractors and fail to withhold taxes, the Internal Revenue Service can reclassify them and assess potentially crippling retroactive penalties. What's worse, the contractor versus employee decision isn't only about taxes. It involves labor and employment law, employee benefits, worker's compensation, unemployment insurance and more.

The IRS, Department of Labor and state governments are swapping information about minimum wage violations, overtime, benefits and failure to withhold taxes. A U.S. Government Accountability Office report claims the IRS is losing billions on worker misclassification, and a DOL study says up to 30 percent of employers misclassify workers. See GAO-07-859T and GAO-09-717; see also Planmatics, Inc., "Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs" (Feb. 2000). But change is on the way.

Arrangements classifying workers as independent contractors can be scrutinized by numerous government agencies and in the course of private civil lawsuits. Lines between employees and independent contractors often blur. Classically, employees go to work at set hours, while independent contractors determine their own. Employees follow orders, while independent contractors work however they prefer.

Employees receive regular paychecks, while independent contractors are paid by the job. Employees work year-round, while independent contractors are temporary. Employers have control over the actions of employees, while the method, manner and means of production are left to independent contractors.

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Of course, real-life is rarely so clear. The seamless flow of information means one investigation often triggers another. Even a small worker status dispute you think isn't worth fighting may trigger a large one. Like dominos, one can fall after another.

The DOL announced in 2010 that it would issue regulations that would require companies to prepare a written classification analysis for each worker, including independent contractors. The proposed regulations remain unissued but are expected to require companies to explain why they think the worker is or is not covered by the Fair Labor Standards Act. Companies may have to show each worker a copy, leading many to refer to these DOL rules as "Right to Know."

President Barack Obama was unsuccessful in passing the Fair Playing Field Act of 2010 (H.R. 6128, S. 3786), but one of its provisions would have required everyone using independent contractors to give each worker written notice, a kind of *Miranda*-like warning. The Treasury Secretary would develop a form document notifying the independent contractor about: (1) The federal tax obligations of an independent contractor; (2) The labor and employment law protections that *do not apply* to independent contractors; and (3) The right the independent contractor has to ask the IRS for a determination whether he or she is an employee or independent contractor.

Although this *Miranda* warning rule for independent contractors and many other proposals have not yet become law, many expect such bills to advance. The writing is on the wall. Companies of all sizes will faced increased scrutiny and a more savvy government. The IRS has offered an amnesty program that is actually fairly attractive.

Not surprisingly, you must be willing to treat workers as employees prospectively. IRS Announcement 2011-64 unveiled the IRS's Voluntary Classification Settlement Program — VCSP — allowing you to voluntarily reclassify independent contractors as employees for the future. If you qualify, your tax exposure for the past is quite limited.

To be eligible, you must: (1) Have consistently treated the workers as independent contractors; (2) Have filed all required Forms 1099 for the workers for the previous three years; (3) Not currently be under audit by the IRS; (4) Not currently be under audit by the DOL or a state government agency concerning worker classification; and (5) If you were previously audited by the IRS or DOL concerning worker classification, you will only be eligible if you complied with the results of that audit.

The IRS has discretion whether to accept you, but once you're in, you will pay just over 1 percent of the wages paid to the reclassified workers for the past year. Stated differently, your payment will be 10 percent of the employment tax liability that would have been due on what you paid your workers for the most recent year, but determined under the reduced rates of tax code Section 3509(a). Compared to potential exposure for misclassification, that is a small payment. To see how this payment is computed, see VCSP FAQ 16; see also VCSP Instructions to Form 8952.

There are no interest charges or penalties, and the IRS has stated that it will not audit you on payroll taxes related to these workers for prior years. You must prospectively switch them to employee status and agree to a special six-year statute of limitations rather than the three years that usually applies to payroll taxes. You can apply by filing Form 8952 at least 60 days before you want to begin treating the workers as employees. Full details, including FAQs, are *available at* http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Voluntary-Classification-Settlement-Program.

Whether to take advantage of this program or wait isn't an easy question. Some employers worry that the states will make an assessment based on misclassification in the past. The amnesty program is with the IRS not the states. Some employers also worry that workers who are reclassified will seek damages for the past.

When you consider the potential penalties that can truly be catastrophic and the basics of the amnesty deal, it is a good one. In that sense, it is surprising that more companies have not pursued the IRS offer. So far, the IRS indicates that about 690 companies have applied for the program covering nearly 14,000 workers.

Whatever you do, get some advice, be careful, be realistic, and get ready to defend yourself.

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