All Lawyers Need to Know: Independent Contractor Basics

Robert W. Wood

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Mr. Wood practices law with Wood & Porter, in San Francisco (www.woodporter.com), and is the author of Legal Guide to Independent Contractor Status (4th Ed. Tax Institute 2007) available at www.taxinstitute.com.

Most lawyers have at least passing familiarity with the differences between independent contractors and employees. Most obviously, employers pay wages to employees and must withhold taxes, while independent contractors are obligated to pay their own payroll and other employment taxes. Employers have vicarious liability for the acts of employees, so if an employee driver causes an accident, the employer is liable. If the same individual were an independent contractor, the employer would not be liable. An employer must comply with wage and hour laws, nondiscrimination, the provision of benefits, and other employment laws with respect to its employees, but in many cases is not required to do so for independent contractors. An employer has unemployment insurance and worker's compensation insurance obligations for employees. In contrast, companies have great discretion in how they treat independent contractors.

Of course, these differences do not address the overall characterization question of how one classifies workers as employees or independent contractors. A whole host of federal and state laws can bear on this question. Moreover, one can reach different determinations for different purposes—for example, a determination that a worker is an employee for tax purposes would not, in all cases, have bearing on whether the worker is an employee for liability purposes. Moreover, this is a burgeoning field which encourages confusing conclusions.

Among the risks that employers and their counsel must consider is the possibility that a worker may be reclassified as an employee or as an independent contractor, particularly for businesses that use a combination of employees and independent contractors. If the company is wrong, it may be subject to a variety of penalties and other costs.

This article focuses on the primary issues that may need to be addressed if workers who were treated as independent contractors are reclassified as employees. Such a reclassification decision may be ordered by a court or administrative body, or it may be the subject of a settlement. For purposes of simplifying the discussion, this article also assumes that any reclassification is made as a whole—that is, workers are not treated as employees for some purposes and independent contractors for others.

If a client's workers are recharacterized (by an agency, court, mutual agreement, or other means) as employees rather than independent contractors, the client should consider ten immediate issues:

1. Income Tax Withholding

One of the most significant employer liabilities arises out of the failure to withhold income and employment taxes.[1] Witholding obligations also arise under California and most other state laws. If workers are recharacterized from contractor to employee, an employer may be subject to significant liability for failure to withhold income taxes.

If the employer cannot prove that the workers paid their own income taxes, the employer can be required to pay the tax it should have withheld from the payments to the workers.[2] A retroactive determination that payments to a worker were in fact wages paid to an employee can result in significant liability to the employer for taxes, interest, and penalties. Prospectively, of course, the employer must observe the usual formalities of withholding by getting the workers to submit IRS Forms W-4.[3]

2. Social Security Tax

Federal Insurance Contributions Act (FICA) (commonly referred to as Social Security) withholding is required on all wages up to an annual limit—the Social Security Wage Base—and is adjusted upward for inflation each year. For 2009, the wage base is $106,800 for the component of Social Security known as Old-Age, Survivors, and Disability Insurance (OASDI).[4] There is no similar income cap for Medicare. The employer and the employee each pay half of the FICA tax.

A worker who is properly treated as an independent contractor is responsible for all his own self-employment taxes.[5] The mandatory contribution to OASDI for self-employed individuals is 12.4% of all wages up to the wage base. If workers are recharacterized from contractor to employee, the company would be responsible for paying half of the OASDI contribution, or 6.2% of the worker's wages.[6]

Medicare payments are similar to OASDI contributions. Self-employed individuals contribute 2.9% of their earnings toward Medicare. There is no earnings limitation. As an employer, the company would be responsible for one half (1.45 %) of the Medicare tax for all

employees. Again, there is no limit on the amount of compensation subject to the Medicare tax.

If workers are recharacterized as employees, the past employment tax liability, plus interest and penalties, can be significant. Prospectively, this obligation may not seem too onerous. However, employers should remember that the employer portion of these taxes is not passed along or borne by the employees. If your client's payroll is large, the client's share of the employment taxes will also be large and may have a significant impact on the client's business.

3. Federal Unemployment Taxes

The Federal Unemployment Tax Act (FUTA) provides for the establishment of a federal employer tax, funded by employers, to fund state workforce agencies. Unemployment insurance rates are set by the federal and state governments. The maximum FUTA tax rate is 6.2%. However, for most firms paying state unemployment taxes, the maximum tax rate is 0.8%. The earnings limit for FUTA is $7,000.[7] FUTA deductions are paid solely by employers based on their internal workforce. If workers are determined to be employees instead of independent contractors, the employer would be responsible for paying past FUTA taxes (plus interest and penalties) and would need to collect them prospectively.

4. State Unemployment Taxes

Most states have an unemployment insurance system that complements the FUTA taxes paid by employers. These taxes are paid to provide partial-wage replacement to unemployed workers undergoing an active search for a new job. The state portion of this tax is determined by the state agency and depends on the unemployment experience of each company.

Because of the experience rating feature, the tax rate can vary over time for the same employer. If a company's independent contractors are recharacterized as employees, the company would be responsible for paying applicable state unemployment insurance for the past (plus interest and penalties) and for the future too.

5. Workers' Compensation Insurance

Employers are responsible for paying workers' compensation insurance premiums for their employees. As with unemployment insurance, this amount will vary from state to state, and it may even vary from employer to employer. In some states the employers obtain private insurance. In other states, employers must contribute to a state-operated fund.

If workers are recharacterized as employees, the employer would have liability for the contributions that should have, but were not, made in the past. In addition, the employer would be obligated to make premium payments in the future.

6. Health and Welfare Benefits

While income tax withholding, Social Security and Medicare payments, unemployment taxes, and workers compensation payments are generally predictable—the rates are set and the amount of any interest, penalties, and other costs can be estimated—health and welfare benefits are subject to greater variation, and the impact of recharacterizing independent contractors as employees may be more difficult to predict. This uncertainty is exacerbated by the national debate over health care, which may result in greater burdens placed on either individuals or employers, as well as the skyrocketing costs associated with health benefits. Thus, at least on a prospective basis, the cost of health and welfare benefits may have the biggest financial impact on the recharacterization of worker status.

To a large extent, the type and cost of benefits afforded to workers will depend on the benefit plans an employer has established for its employees. In general, if the company provides significant benefits for employees (and nothing for independent contractors), recharacterization can have a substantial and negative financial impact on the employer, primarily because the comprehensive nondiscrimination rules applicable to employee benefits will require the employer to offer the same benefits to all employees, including recharacterized employees.[8]

In order to gain a sense of the magnitude of the impact, the employer may begin by applying the average benefits based on a national average of employee benefits as a fraction of wages as reported by the U.S. Bureau of Labor Statistics.[9] Benefits in private industry, including paid leave, supplemental pay, insurance, retirement, and legally required benefits, average nearly 30% of total compensation; thus, recharacterization of independent contractors as employees could result in an increase in employment costs of nearly one third.

7. Pension Plans

Qualified pension and other employee benefit plans involve enormously complex qualification, compliance, and nondiscrimination rules. These plans are usually only for employees and are often one of the key rationale for differentiating between independent contractors and employees.

A retroactive (or even prospective) change can have enormous implications for a company's pension and other qualified plans. If the employer cannot legitimately exclude the workers from participation, those workers may be entitled to retroactive coverage, vesting, and contributions in one or more plans.[10]

If an employer must treat certain workers as participants in one or more such plans, the resulting liability may be huge and impact the viability of the plans. A recharacterization of independent contractors can require the employer to make retroactive participation and funding changes to existing plans. In extreme cases, the employer may face disqualification of the plans, negatively impacting both the company and all plan participants. As with health and welfare benefits, pension plan exposure on recharacterization can be quite significant.

8. Unreimbursed Business Expenses

Another consequence of a recharacterization from independent contractor to employee is the reimbursement of business expenses. While independent contractors can agree to bear their own business expenses, there are statutory rights to expenses of employment.[11] Consequently, while an employer may have established clear and rational lines limiting reimbursement for expenses (including amount, timing, and business purpose), a recharacterized employee may seek to change those rules. As with employment based taxes and other benefits, employers need to consider not only the costs of remediating the failure to comply in the past, but also the ongoing additional costs associated with expanding categories of reimbursable expenses.

9. IRS Penalty Assessments

IRS penalties are significant and should be considered as a separate category of the costs of recharacterization. The penalty the IRS assesses depends on their interpretation of the employer's intention in misclassification. If the IRS believes the employer did not deliberately misclassify the workers, it can apply a more modest penalty under Internal Revenue Code section 3509(a). Under this provision, in addition to paying the employer's share of FICA and FUTA, the employer may have to pay a penalty of 20% of the FICA that should have been withheld and 1.5% of wages.[12]

If your client seeks to show that it had no intent to misclassify the workers, it will usually need to show, at a minimum, that it filed all necessary Form 1099s for the workers. If all the necessary forms have not been filed, the employer can be assessed a larger penalty: 40% of FICA and 3% of wages.[13] The employer is entitled to a credit against the retroactive assessment of federal income tax withholding if the employer can prove that the workers reported the correct income and paid their tax.[14] However, this credit does not apply where the Service applies the reduced rates for noncompliance under Internal Revenue Code section 3509. Moreover, as a practical matter, an employer may find it difficult to locate former employees and prove they reported their income and paid their taxes correctly.

If the Service decides that the employer has *deliberately* misclassified workers, it can hold the employer responsible for all employment taxes that should have been paid, including income tax and the employee's share of FICA and FUTA.[15] Most significantly, the Service is not limited to seeking recourse from the employer as an entity; it can go after the business owners and/or officers *personally,* effectively eliminating the limited liability of corporate and limited liability company owners. Moreover, the potential liability to the owners is extreme: a 100% penalty on each responsible person.[16]

This 100% penalty is often assessed against each and every owner and officer of the company. Although the IRS can collect it only once, and while owners and officers may seek equitable contribution for the penalties, the possibility of personal liability for all the payroll tax deficiencies can be frightening. The amount of the company's tax (and also the 100% penalty) can be reduced if the employer can show that the employee paid the proper amount of income tax. However, the employer is not allowed to recover any amount assessed from employees or former employees or to credit any amount paid against income tax.[17]

With all the IRS liabilities, it is worth noting that many employers who are determined to have misclassified workers attempt to qualify for a penalty protection known as "Section 530 relief."[18] While this provision was never incorporated into the Internal Revenue Code, a business can seek to be relieved of certain federal employment tax obligations if it had a reasonable basis for not treating workers as employees, was consistent in its treatment of any similar workers as contractors, and consistently filed required information returns with the IRS. Perhaps because of the existence of Section 530 relief, the IRS is often interested in getting an employer to agree to *prospectively* treat the workers as employees, even if the IRS is not able to collect back taxes and penalties from a retroactive reclassification.

10. Relevance of Tax Treatment

The way in which workers filed their income tax returns in the past should also be considered. Some employers may insist that the workers received tax benefits as a result of their independent contractor treatment. If those workers are then reclassified, the employer may argue that the workers should be required to offset those tax benefits against what they receive via recharacterization. If a worker has filed federal income tax returns as a self-employed individual and filed Schedule C to his IRS Form 1040 individual income tax returns, the worker is claiming the tax benefits of operating his own business.

These expenses are more likely to be claimed where the reclassification dispute is between the company and the workers themselves. These could include the cost of materials or supplies, automobile expenses, equipment, meals, lodging, travel, entertainment, and other expenses associated with the business.[19] Interestingly, employers commonly claim that workers are "double-dipping" when they claim these expenses.

In fact, workers who are retroactively recharacterized from independent contractors to employees rarely file amended income tax returns.[20] Of course, taxpayers are obligated to file complete and accurate returns.[21] Federal income tax regulations state that a taxpayer who becomes aware of errors on his federal income tax return "should" file an amended tax return correcting such errors.[22]

Yet surprisingly, there is no mandatory obligation to file such an amended return. If a taxpayer determines there was unreported income on a previously filed return, Treasury Regulations state that the taxpayer "should" file an amended return to correct the error.[23] However, neither the Internal Revenue Code nor Treasury Regulations impose an affirmative duty on a taxpayer to file an amended return.

Interestingly, the mandatory or permissive nature of this amended return filing matter has been called into question. In fact, the IRS issueda notice in July of 2009 (Notice 989, Rev. 7-2009) specifies that workers who filed tax returns as independent contractors but who have subsequently been ruled to be employees "must" file amended income tax returns. Some have questioned whether an IRS Notice can possibly supersede a Treasury Regulation, but it is at least clear that the IRS is enhancing its presence in this area.

Conclusion

If you have a client whose workers were treated as independent contractors, but are suddenly ruled to be employees, your client will need help. As a lawyer, you may need to triage the issues and agencies involved and even reach out to other lawyers (including employment, employee benefits, and tax) to assess the situation and help your client. Worker status disputes are messy, expensive, and upsetting to your client from almost any angle.

Whether your client is seeking employee treatment or trying to avoid it, and whether your client is aligned with a worker, company, agency, or third party, the stakes can be high. All too often, however, your client may not have thoroughly quantified the costs of recharacterization. Any such quantification efforts should begin with the temporal element. That is, at what point in time will the recharacterization from independent contractor to employee be effected?

Often, particularly with government agencies, recognition of employee status will be prospective only, as part of a negotiated compromise. Plus, it is common for companies and workers to deal with only the issue directly in front of them. Thus, despite the points made in this article, you may be dealing *only with* the status of workers for purposes of worker compensation insurance, for unemployment insurance, or for some other specific purpose or incident. If so, you may not want to think about many other issues, at least not right away.

If your client only considers one issue, however, that can be shortsighted. Help your client to consider the domino effect that is so prevalent in worker characterization disputes. That domino effect is the tendency for one agency or one lawsuit ruling on employee status (for ostensibly one discrete purpose) to turn into a many tentacled recharacterization beast.

That is perhaps the biggest lesson here. Step back and consider the landscape and the interrelationships between one recharacterization battle and the overall war. Doing so will provide the greatest benefit to the client. ■

Endnotes

1 See I.R.C. §§ 6651(a), 6662, & 6672.

2 See I.R.C. § 3509.

3 For a summary of these rules, see *Employer's Tax Guide*, I.R.S. Pub. 15 (rev. Jan. 2007).

4 See http://www.ssa.gov/OACT/COLA/cbb.html.

5 See I.R.C. § 1401.

6 See I.R.C. § 3101(a).

7 See I.R.C. § 3306(b).

8 See 42 U.S.C. § 2000(e)-2000(h)(6) (Supp. 1994); 29 U.S.C. §§ 621 et seq.; 29 U.S.C. §§ 701 et seq.; 29 U.S.C. §§ 201-219; 29 U.S.C. §§ 151-168; 33 U.S.C. §§ 901-9150; and 8 U.S.C. §§ 1324(a) & (b).

9 See http://www.bls.gov/ebs

10 *Vizcaino v. Microsoft Corp.*, 97 F.3d 1193 (9th Cir. 1996).

11 See CAL. LAB. CODE § 2802.

12 See I.R.C. § 3509(a).

13 See I.R.C. § 3509(b).

14 See I.R.C. § 3402(d).

15 See I.R.C. § 3509(c).

16 See I.R.C. § 6672.

17 See *Duncan v. Commissioner*, 68 F.3d 315 (9th Cir. 1995).

18 Section 530 was never added to the Internal Revenue Code; it is a section in the Revenue Act of 1978.

19 See I.R.C. § 162.

20 See however, IRS Notice 989, which requires workers who are recharacterized to file amended returns.

21 See I.R.C. § 6011.

22 Treas. Reg. § 1.461-1(a)(3).

23 Treas. Reg. § 1.461-1(a)(3).