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Employee or Independent Contractor?

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Classifying a worker as an employee or an independent contractor has a significant effect on the cost of employing that individual. For this reason, the IRS and Department of Labor pay close attention to worker classification issues to ensure that employers are making the right determinations. This article details the relevant regulatory guidance and case law, the possible penalties for offenders, and the tests used to determine whether a classification is correct.

Intentionally or not, many workers in the United States are classified as independent contractors (IC). In classifying a worker as an IC instead of an employee, putative employers can eliminate the following expenses:

- The employer's share of Social Security (FICA) and Medicare taxes
- Overtime and minimum wage payments
- Employee health insurance premiums
- Employee retirement benefits, vacation, holiday, and sick pay
- Other employee fringe benefits, such as stock options
- Federal and state unemployment compensation taxes (FUTA and SUTA)
- Workers' compensation insurance premiums.

Federal and state regulators take this issue very seriously and have recently re-energized their efforts to challenge worker classification. Unreported or underreported employment taxes contribute to the overall federal tax gap (*Tax Gap Estimates for Tax Years 2008–2010*, IRS publication, http://bit.ly/2Lza1BM). Federal employment withholding taxes represent nearly 70% of all federal tax revenue to be paid to the IRS, which seeks back taxes and penalties from employers that wrongly treat workers as self-employed contractors. At the same time, and sometimes in partnership, the U.S. Departments of Labor and Justice and their counterparts at the state level are involved in ensuring that workers are properly classified by their employers, as is most recently evident in the rapidly growing "sharing" or "gig" economy created by various freelance service opportunities such as Uber, Lyft, and Grubhub.

Another relatively recent development is the increased interest in these issues by plaintiffs' attorneys. Not a week goes by without a published report of a newly filed class action suit, or the certification or settlement of such a suit, against a putative employer by individuals who were classified as ICs but who believe they should have been classified otherwise (an excellent

resource on these developments can be found at https://independentcontractorcompliance.com). Indeed, a new type of legal challenge has surfaced: a class action filed by one or more employers classifying their workers as employees against one or more *competitors* classifying their workers as ICs, unfairly or not [*Diva Limousine Inc. v. Uber Technologies, Inc.*, Case No. 18-CV-05546 (N.D. Cal. Sept. 10, 2018)].

Filing a Complaint

Any worker who thinks he has been misclassified as an IC can file a complaint with either the U.S. Department of Labor (DOL) or the applicable state department of labor or unemployment agency. Some states will handle individual complaints, but the DOL normally only handles cases where there is the possibility that many workers have been misclassified and there has been a substantial loss to the federal or state government in terms of taxes or contributions to unemployment or worker compensation funds. A DOL investigation can include all employees and independent contractors for a three-year period.

Employees or former employees can also anonymously report suspected tax fraud (an employer's intentional failure to withhold taxes) to the IRS by using Form 3949-A as a whistleblower. Workers may also file a Form SS-8 with the IRS requesting a determination of the worker's employment status, although a ruling in favor of the employment status is the norm (see below). The IRS may also choose to audit an employer for underreporting of payroll taxes resulting from a possible worker misclassification.

Federal Ramifications

Federal penalties for worker misclassification can be severe. Ramifications vary depending on the DOL or the IRS's determination of whether the misclassification was unintentional, intentional (willful), or even fraudulent. If the mis-classification was unintentional, the employer faces penalties based on the fact that all payments to misclassified ICs are reclassified as wages. If the IRS suspects intentional misconduct or fraud, however, it can impose additional fines and penalties; for example, penalties that include 20% of all the wages paid, plus 100% of the FICA taxes—both the employee and employer's share. Criminal penalties are assessed for each misclassified worker, and the court can impose a prison sentence as well. In addition, the persons responsible for withholding payroll taxes may be held personally liable for any uncollected or unremitted tax under the responsible person penalty statute [Internal Revenue Code (IRC) section 6672] and its state counterparts. The IRS administers tax-related violations, while the DOL enforces federal and sometimes state labor laws, typically pursuant to the Fair Labor Standards Act (FLSA). Willful violators may be prosecuted criminally and fined up to $10,000 by the DOL, or imprisoned for a second conviction (http://bit.ly/2Vb5c64). A summary of the penalties that could be proposed by the IRS is found in *Exhibit 1.*

Exhibit 1

Internal Revenue Code Penalties

Exhibit 1
Internal Revenue Code Penalties

Civil Penalties	
IRC Section	
6651	***Failure to file:*** 5% per month during the period of failure to file employment tax returns, up to a maximum of 25%.
6656	***Failure to make timely deposits of taxes:*** 10% if tax deposit is past due more than 15 days, and increases to 15% is not paid within 10 days of a delinquency notice.
6662	***Underpayment of tax:*** 20% of the underpayment of tax attributable to a substantial understatement of tax or negligence.
6663	***Civil fraud:*** 75% of the underpayment that is attributable to fraud.
6672	***Willful failure to collect and pay tax:*** 100% of total tax not collected and paid.
6721	***Failure to file correct information returns:*** $50 per return, up to a maximum of $250,000 per year.
6722	***Failure to furnish correct payee statements:*** $50 per failure to provide Forms W-2 and 1099 employees and independent contractors, respectively.
6723	***Failure to comply with other information reporting requirements:*** $50 per failure, with an aggregate maximum of $100,000 per year.
Criminal Penalties	
7202	***Willful failure to collect or pay tax:*** maximum of $10,000 and imprisonment for not more than 5 years.
7204	***Willful failure to provide statement to employees:*** maximum of $10,000 and imprisonment for not more than 1 year.

Recent Examples

A recently announced plea agreement involving a Tennessee-based slaughterhouse and meat packing plant illustrates how the DOL and Department of Justice (DOJ) currently view worker misclassification, especially if many workers are involved. The owner of the business had used over 100 undocumented immigrants for a decade, paying them cash wages, and was only discovered by an FBI raid. The owner will spend several years in federal prison, even with his plea agreement, and is also liable for over $1.4 million in restitution for unpaid payroll taxes, interest, and penalties, not counting penalties for wire fraud and for each individual who was hired illegally (Tiffany Hu, "Slaughterhouse Owner Owes $1.4M For Immigration Violations," Law360 Tax Authority, Sept. 17, 2018, http://bit.ly/2Rli620).

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In some cases, however, an employer can resolve a misclassification issue without being forced to pay the back taxes and continue to treat the worker as an IC or, as explained below, may instead agree to reclassify the worker or group of workers, on a prospective basis, as employees. In the former situation, section 530 of the Revenue Act of 1978 provides relief from liability for back payroll taxes, interest, and penalties; this is detailed further below. Unfortunately, there is no similar safe harbor in dealing with the DOL, which can require employers to pay back wages, overtime, and benefits, as well as impose other statutory penalties; the authors are also not aware of any state counterpart to section 530. In addition, there is no such safe harbor from liability for Affordable Care Act insurance premiums or penalties if ICs are reclassified as employees.

Under the FLSA, each worker who has been misclassified as an IC may be awarded wages, overtime, and additional compensation for the previous three years, with a possibility of double the amount as "liquidated damages."

As implied above, even after an employer is charged at the federal level, the matter may be referred to state tax or labor authorities, who have the ability to impose their own back taxes, interest, fines, and penalties. In addition, employers could also face individual lawsuits from workers claiming they were denied benefits because of an improper classification. Indeed, as mentioned above, the current trend in worker misclassification litigation often involves the filing of a class action lawsuit against the putative employer, especially in the courts of an employee-friendly state such as California. Plaintiffs' attorneys are increasingly tax savvy and shop for the best forum to file their case.

There have been some large awards recently in cases involving unpaid over-time wages and FICA taxes that were the result of worker misclassification, amidst increased scrutiny by both federal and state authorities. A Missouri federal court recently granted conditional class certification in a proposed nationwide FLSA action brought by a cable TV installation technician who alleged that she and similarly-situated cable installers in 10 states were improperly

classified as ICs and thus denied overtime compensation, etc. [*Fair v. Communications Unlimited Inc.,* Case No. 4:17-CV-2391 RWS (E.D. Mo. Sept. 19, 2018].

Similarly, drivers of hearses and similar vehicles were granted class certification in their suit against their putative employer, Serenity Transportation, which they allege required them to follow detailed and restrictive policies when they were hired to transport a body from hospital to mortuary. As above, the case revolves not around payroll taxes—although that will undoubtedly come next—but around misclassification under state and federal wage and hour laws. The potential liability is in the millions [*Johnson v. Serenity Transportation, Inc.,* No. 15-CV-02004-JSC (N.D. Calif. Aug. 1, 2018)].

States are also making more effort to closely monitor these issues. On August 10, 2018, the state of New Jersey and the DOL announced their new three-year partnership to enhance enforcement of IC misclassification laws by conducting coordinated investigations and sharing information. The news release mentioned that in New Jersey alone, auditors have identified more than $80 million in under-reported employer contributions in the past seven years. Similarly, Virginia governor Ralph Northam issued an executive order on August 13, 2018, establishing an interagency task force to combat worker misclassification and payroll fraud.

What Are the Tests for Independent Contractors?

Many tests defining IC status apply across federal and state jurisdictions, making it possible for a worker to be classified as an IC under one law, or even in one state, but as an employee under another law or in another state. The DOL and the IRS have their own distinct yet overlapping tests for determining worker misclassification; however, some experts caution that the IRS typically classifies workers as employees whenever their status is not immediately apparent.

As is readily apparent from the above, one of the major challenges for employers is determining whether a worker should be classified as an employee or an IC. Most CPAs are comfortable discussing this with clients under the standard "common law" 20-factor test; however, many are unaware that myriad other recent tests have been generated by various agency rulings and court cases. Both the IRS and the DOL have ramped up their policing of this issue, especially the latter.

At the federal payroll tax level alone, there are several tests to examine:

- Common law 20-factor test
- Newer IRS three-factor test
- Overriding federal statutory provisions.

Common Law Test

The common law test, originally developed by the IRS, uses 20 factors to evaluate right of control and the resulting validity of the independent contractor classification. These factors are listed in *Exhibit 2.*

Exhibit 2

IRS 20-Factor Test

Exhibit 2
IRS 20-Factor Test

Level of instruction	If the company directs when, where, and how the work is done, this control indicates an employment relationship.
Amount of training	Requesting workers to undergo company-provided training suggests an employment relationship since the company is directing the methods by which work is accomplished.
Degree of business integration	Workers whose services are integrated into the business operations or significantly affect business success are likely to be considered employees.
Extent of personal services	Companies that insist on a particular person performing the work assert a degree of control that suggests an employment relationship. In contrast, independent contractors typically are free to assign work to anyone.
Control of assistants	If a company hires, supervises, and pays a worker's assistants, this control indicates a possible employment relationship. If the worker retains control over hiring, supervising, and paying helpers, this arrangement suggests an independent contractor relationship.
Continuity of relationship	A continuous relationship between a company and a worker indicates a possible employment relationship; however, an independent contractor arrangement can involve an ongoing relationship for multiple, sequential projects.
Flexibility of schedule	People whose hours or days of work are dictated by a company are likely to qualify as employees.
Demands for full-time work	Full-time work gives a company control over most of a person's time, which supports a finding of an employment relationship.
Need for onsite services	Requiring someone to work on company premises—particularly if the work can be performed elsewhere—indicates an employment relationship.
Sequence of work	If a company requires work to be performed in a specific order or sequence, this control suggests an employment relationship.
Requirements for reports	If a worker regularly must provide written or oral reports on the status of a project, this arrangement indicates an employment relationship.
Method of payment	Hourly, weekly, or monthly pay schedules are characteristic of employment relationships, unless the payments simply are a convenient way of distributing a lump-sum fee. Payment on commission or project completion is more characteristic of independent contractor relationships.
Payment of business or travel expenses	Independent contractors typically bear the cost of travel or business expenses, and most contractors set their fees high enough to cover these costs. Direct reimbursement of travel and other business costs by a company suggests an employment relationship.
Provision of tools and materials	Workers who perform most of their work using company-provided equipment, tools, and materials are more likely to be considered employees. Work largely done using independently obtained supplies or tools supports an independent contractor finding.
Investment in facilities	Independent contractors typically invest in and maintain their own work facilities. In contrast, most employees rely on their employer to provide work facilities.
Realization of profit or loss	Workers who receive predetermined earnings and have little chance to realize significant profit or loss through their work generally are found to be employees.
Work for multiple companies	People who simultaneously provide services for several unrelated companies are likely to qualify as independent contractors.
Availability to public	If a worker regularly makes services available to the general public, this supports an independent contractor determination.
Control over discharge	A company's unilateral right to discharge a worker suggests an employment relationship. In contrast, a company's ability to terminate an independent contractor relationship generally depends on contract terms.
Right of termination	Most employees can unilaterally terminate their work for a company without liability. Independent contractors cannot terminate services without liability, except as allowed under contract terms.

Newer Three-Factor Test

Although the IRS has long used the 20-factor test to determine the relationship of a worker and employer, it now groups those factors into three broad categories. According to the Internal Revenue Manual (IRM), the 20-factor test may still be used for reference purposes, but the primary (or at least preferred) method is to consider every piece of information in a case that helps to decide the extent to which the taxpayer does or does not retain the right to control the worker (section 4.23.5.7.1, http://bit.ly/2EMMPhZ). The evidence tends to fall into three main categories: behavioral control, financial control, and relationship control.

Behavioral control

The behavioral control test focuses on whether the company controls or has the right to control what the worker does and how the job is done. Behavioral control factors include types of instruction given, degree of instruction, evaluation systems, and training.

Financial control

The financial control test looks at who controls the economics of the worker's job. Being able to work for multiple employers and providing one's own tools may indicate IC status. Factors pointing to employee status are eligibility for reimbursement of travel costs and payment based on hours worked. The financial control factors are significant investment, unreimbursed expenses, opportunity for profit or loss, availability of the services to the market, and method of payment.

Relationship control.

The relationship control test examines how the parties perceive each other. Providing paid vacation and retirement benefits indicates a worker is an employee, as does hiring to provide services indefinitely rather than for a specific time period. Written language stating the worker is an IC is not determinative. The factors include the existence of written contracts, offering of employee benefits, permanency of the relationship, and services provided as a key activity of the business.

Employers must weigh all of the above factors when determining whether a worker is an employee or an IC. Some factors may indicate that the worker is an employee, while other factors indicate that the worker is an IC; there is no set number of factors that makes the worker an employee or an IC, and no one factor stands alone in making this determination. Also, factors that are relevant in one situation may not be relevant in another. The key is to look at the entire relationship, consider the degree or extent of the right to direct and control, and to document each of the factors used in coming up with the determination.

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Preemptive Federal Statutory Provisions

As indicated above, a worker classification audit by the IRS or a state department of revenue often results from an investigation by the DOL or its state counterpart; the DOL test is more likely to find employee status than the 20-factor test. The DOL often applies an "economic realities test" under the FLSA, which uses the following six factors to determine if a worker is an employee or an independent contractor:

- The degree to which the functions of the worker are essential to the business operations
- The ongoing nature (i.e., permanency) of the relationship between the worker and the employer
- The extent to which the worker has invested in her own materials and supplies
- The control the employer has over the worker
- The degree to which the employer affects the profit and loss opportunities of the worker
- The level of skill, judgment, and initiative required for the functions performed by the worker.

In July 2015, the Wage and Hour Division of the DOL issued Administrator's Interpretation 2015-1 (http://bit.ly/2Rnc5Su) to include a more detailed analysis and critical facts to develop, including the following clarifications:

- Whether the work is performed away from the employer's premises, in the worker's home, or at the employer's customer's premises can still be integral to the employer's business.
- If a worker is truly in business, the worker should be at some risk of loss due to his managerial decisions. Working more hours is not considered a managerial skill that affects the opportunity for profit or loss.
- In evaluating the relative investments of the employer and worker, courts should consider whether the worker has made investments in the employer's ability to expand, reduce its cost structure, or extend its business plan. Courts should also consider how that investment compares to the employer's overall investment, not just to the work performed by the worker.
- Having specialized skills does not mean that the worker is an IC; there is a difference between providing skilled labor and demonstrating the skill and initiative of an IC. According to the interpretation, "Only carpenters, construction workers, electricians, and other workers who operate as independent businesses, as opposed to being economically dependent on their employer, are independent contractors."
- Courts should also consider whether the lack of permanence in the worker's relationship with the employer is the result of operational characteristics of the business (i.e., whether the work is typically transient or seasonal) or the result of the worker's own independent business initiatives.
- Control in the nature of the business, regulatory requirements, or customer satisfaction are indicative of an employee/employer relationship. The major issue is how much control is exercised by the employer, not why the employer is exerting it (Rachel Ziolkowski Ullrich, "DOL Interpretation Says 'Most Workers are Employees' Under the FLSA's Broad Definitions,'" Ford Harrison, Jul. 15, 2015, http://bit.ly/2LESIPO).

Although the IRS's common law and three-factor tests and federal labor law's economic realties test are the most commonly used, they are not the only tests to determine worker status. That status can also be evaluated under many other federal laws, including the Civil Rights Act, the National Labor Relations Act, the Americans with Disabilities Act, and the Age Discrimination in Employment Act, all of which borrow concepts from the various tests described above. Court

decisions must also be studied since they often place greater or lesser importance on some of the same facts regulatory agencies will focus on.

IRS Form SS-8

By using Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, putative employers or their workers can request an IRS status determination. The worker generally submits the request for determination and typically answers the questions in a manner that will elicit that response from the IRS. The putative employer is then given an opportunity to respond by filing its own Form SS-8, but the IRS will not ordinarily share the worker's answers with the putative employer or its CPA, at least not until litigation or possibly in response to a Freedom of Information Act (FOIA) request.

An employer in receipt of notice that a worker has filed Form SS-8, as well as any CPA with such an employer for a client, should understand the following:

- The odds are good that the worker's Form SS-8 will skew the facts in favor of employee status, because the worker understands that such status is usually more beneficial. For example, workers may claim employee status to gain health, retirement, and other fringe benefits and to eliminate self-employment tax liabilities.
- The IRS technician may discount the employer's Form SS-8 responses and decide the worker is an employee.
- The Form SS-8 instructions state that the IRS's determination letter applies only to the worker (or class of workers) who requested a determination.
- The employer can safely disregard the IRS's determination letter if it is entitled to relief under section 530 of the Revenue Act of 1978, as detailed below. When section 530 relief is available, the IRS cannot force the employer to reclassify affected workers as employees. CPAs or qualified tax attorneys can help the employer determine if it qualifies for section 530 relief, and should do so far ahead of any IRS or other audit or investigation. Charging a tax attorney with this role may allow the attorney's investigation to be protected by the attorney-client privilege.
- Neither the Form SS-8 determination process nor the review of any records in connection with the determination constitutes an official IRS audit. While there is no procedure to appeal a Form SS-8 determination, the employer should ask its tax advisor if it can simply disregard the determination ("Form SS-8: How should you Handle Worker Classification?," Peterson Whitaker & Bjork, Jul. 31, 2015, http://bit.ly/2T6q50m).

Employers should think carefully about entering into IC relationships that last long-term or indefinitely.

The employer may want to continue to treat the worker as an IC, regardless of what the IRS determination letter says. If so, however, the employer should be prepared for an employment tax audit.

A recent report from the Treasury Inspector General for Tax Administration (TIGTA) noted several findings of interest. Several cases related to gig economy workers were mishandled due to lack of guidance, and there were no referrals from the SS-8 program for investigation for

over three years (*Improvements to the SS-8 Program Are Needed to Help Workers and Improve Employment Tax Compliance,* Sept. 19. 2018, http://bit.ly/2LCoz3t).

Section 530 Relief

Section 530 of the Revenue Act of 1978 generally allows an employer to treat a worker as not being an employee for employment tax purposes (but not income tax purposes), regardless of the worker's actual status under the common-law test, unless the taxpayer has no "reasonable basis" for such treatment or fails to meet certain other requirements.

Under section 530, a reasonable basis for treating a worker as an IC is considered to exist if the employer reasonably relied on 1) past IRS audit practice with respect to the taxpayer, 2) published rulings or judicial precedent, 3) longstanding recognized practice in the industry of which the taxpayer is a member, or 4) if the taxpayer has any "other reasonable basis" for treating a worker as an IC (*Worker Reclassification—Section 530 Relief,* IRS publication, http://bit.ly/2Q6tmLn).

The relief under section 530 is available with respect to a worker only if certain additional requirements are satisfied. The employer must not have treated the worker as an employee for any period, and for periods after 1978, all federal tax returns—including information returns—must have been filed on a timely basis (with some grace) consistent with treating the worker as an IC. Furthermore, the employer (or a predecessor) must not have treated any worker holding a substantially similar position as an employee for purposes of employment taxes for any period beginning after 1977 (the "similar worker consistency requirement").

Section 530 also prohibits the Department of Treasury and the IRS from publishing regulations and revenue rulings with respect to the employment status of any individual for purposes of employment taxes. An employer may, however, obtain a written determination from the IRS regarding the status of a particular worker for purposes of federal employment taxes and income tax withholding.

Voluntary Classification Settlement Program

As mentioned above, there is an option for an employer to reclassify certain classes of its workers as employees, but on a prospective (going forward) basis. The VCSP provides an opportunity for employers to reclassify their workers as employees for employment tax purposes for future tax periods with partial relief from federal employment taxes. To participate in this program, an employer must meet certain eligibility requirements; file Form 8952, Application for Voluntary Classification Settlement Program (VCSP); and enter into a closing agreement with the IRS.

The VCSP, originally released in Announcement 2011-64, has been modified in Announcement 2012-45 to—

- permit a taxpayer under IRS audit, other than an employment tax audit, to be eligible to participate in the VCSP;
- clarify the current eligibility requirement that an employer who is a member of an affiliated group within the meaning of IRC section 1504(a) is not eligible to participate in the VCSP if any member of the affiliated group is under employment tax audit;
- clarify that an employer is not eligible to participate if it is contesting in court the classification of the class or classes of workers from a previous audit by the IRS or DOL; and
- eliminate the requirement that an employer agree to extend the period of limitations on assessment of employment taxes as part of the closing agreement with the IRS.

Form 8952 requires the employer to attach a list of the names and Social Security numbers (SSN) of the target group members. The latter requirement could be problematic (as one of the coauthors has witnessed on more than one occasion) if two or more workers are sharing the same SSN (e.g., potential undocumented immigrants).

Recommended Action for CPAs and Employers

When it comes to worker classification issues, CPAs should be proactive. Start reviewing existing contractor relationships immediately, including the paperwork. The IC agreement must be consistent, both internally and externally; for example, in most states only employees are bound by a covenant not to compete, so inserting this provision into an IC agreement will raise a red flag with an IRS auditor. Seek a competent tax attorney with experience in these issues to assist in the review and, if necessary, redrafting of the agreement. CPA firms should also consider engaging under a *Kovel* agreement in order to protect any research and conversations conducted under the attorney-client privilege.

Employers should think carefully about entering into IC relationships that last long-term or indefinitely. They should periodically conduct audits of all positions and review the requirements for an employee versus an IC; in some cases, the relationship between a contractor and employer may change over time. For example, an employer may hire a contractor to complete a specified project with a set deadline, but find the project has become more of a long-term activity. As a result, it may be more appropriate for the contractor to be reclassified as an employee. Another best practice is executing a separate contract with an IC for each project completed so as to emphasize the independent nature of the relationship. Outside counsel (or a CPA under a *Kovel* agreement) should consider recommending that potential employers use IRS Form SS-8 as an informal checklist for determining whether a particular worker or class of workers should properly be classified as contractors or employees.

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