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IRS Inspector Urges Crackdown On Mislabeled 'Independent Contractors'

The IRS isn't the only government agency worried about workers mislabeled as "independent contractors." When you pay independent contractors, there's no income tax withholding and no employment taxes. Even assuming that the "contractor" files a tax return, the IRS won't collect as much and will get it much later. Wage withholding is much, much better for the IRS.

State tax authorities care too, as do insurance companies, unemployment departments and worker's compensation carriers. The classification also matters for pension and benefit laws. And under ObamaCare, many rules hinge on who are your **employees**—independent contractors aren't covered.

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 has just issued a report saying that despite IRS efforts, employers are still getting it wrong.

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 workers are misclassified as independent contractors instead of employees. These employers are dramatically underpaying employment taxes, and that hurts everyone, the report claims.

“This problem adversely affects employees because the employer’s share of taxes is not paid and the employee’s share is not withheld,” said J. Russell George, Treasury Inspector General for Tax Administration. “If left unchecked, the problem will continue to deprive the Federal Government, and the American people, of millions of dollars in lost revenue every year,” he added. See [Watchdog: IRS losing \\$1.2M per year from workers improperly classified as contractors](#).

How do you get a ruling? Either the company or the worker can ask for an IRS ruling. An [IRS Form SS-8](#) is a streamlined ruling form. Any worker or company can fill one out. And unlike most other rulings from the IRS where there’s a fee, this one is free.

Most forms are submitted by workers—about 90%. And most forms produce an IRS ruling that the worker is an employee. In fact, for one year, 72% of all Form SS-8 requests produced rulings the workers were employees. The overwhelming penchant of the IRS is to come out in favor of withholding and employment tax.

For its report, TIGTA analyzed 5,325 rulings in which the conclusion was “employee.” But many employers don’t comply. Seventeen percent of employers appeared to comply with the ruling by issuing the appropriate forms to their workers; 19% appeared not to comply; and 65% of employers did not issue correct forms. TIGTA made four recommendations to improve program performance and increase employer compliance, and the IRS agreed to implement all four.

Meanwhile, the IRS is also still offering its Voluntary Compliance Settlement Program (VCSP). See [IRS Expands Independent Contractor Amnesty](#). To be eligible, an employer must:

- Currently be treating the workers as independent contractors;
- Consistently have treated the workers as independent contractors in the past, including filing [Forms 1099](#);
- Not be under IRS audit on payroll tax issues;
- Not be under audit by the Department of Labor or state agencies for the classification of these workers; and
- Not be contesting the classification of the workers in court.

Employers apply by filing [Form 8952](#), at least 60 days before they want to start treating workers as employees. Employers in the program generally pay just over 1% 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's an employee and who isn't is a real minefield. It is very fact-intensive, and small nuances can spell the difference between success and failure. And the stakes are getting bigger and bigger.

You can reach me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.