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Ten Consequences of Reclassifying Independent Contractors as Employees

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Most business people have some familiarity with the differences between independent contractors and employees; most obviously, you pay wages to employees and you must withhold taxes, while independent contractors handle their own taxes.

You have vicarious liability for the acts of your employees, so if your employee driver causes an accident, you have liability. If an independent contractor driver causes the accident, you do not.

Your relationships with employees are also regulated as to wage and hour laws, nondiscrimination, the provision of benefits, and so on. Not so for independent contractors. You have unemployment insurance and workers' compensation insurance obligations for employees. In contrast, companies have nearly unfettered discretion in how they treat independent contractors.

Of course, this belies 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. If you were not already confused about the nature of such disputes, you would quickly become so by reading some of the cases in this burgeoning field.

Many businesses use a combination of employees and independent contractors, and there is nothing wrong with this. Yet there are associated risks, and one of them is possible reclassification. To a large extent, if you use independent contractors, and if someone chal-

lenges you about your classification decisions or methodology, you will fight. You will defend your characterization of the relationship, and do your best to hang on to independent contractor treatment.

Fight Versus Flight

Such a dispute may be with the Internal Revenue Service or a state tax department, with a labor agency, or with the workers themselves. The last can be particularly frightening. The workers themselves may assert rights as putative employees, despite the independent contractor label to which they may have agreed.

A dispute over characterization may even arise with third parties. For example, a third party who is injured by one of your independent contractors may pursue you too. The injured third party would assert that you have vicarious liability for the actions of the worker because he is really your employee, not a true independent contractor.

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This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

As this mere scratching of the surface should make clear, the problems can be myriad and far-reaching. If you face one of these nasty disputes, you will need to bone up thoroughly on the nomenclature and substance of these skirmishes. That is a separate subject, and it is one about which much has been written. In fact, there are volumes written about the contractor versus employee divide in all its nuances.

Moreover, most people (including this author) spend considerable time talking about how to fight one of these fights, and the substantive and procedural law that is implicated. Oddly, however, most of us take relatively little time to analyze what the stakes are in the dispute, and how the relationships will need to change

in the event the workers (who were previously treated as independent contractors) are recharacterized and treated as employees. To look at this question from another angle, many workers facing or requesting recharacterization to employee status may also be ignorant of the costs and types of benefits they may receive.

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. We will assume that this reclassification decision has been made or ordered, either consensually (as in a settlement) or by a court or administrative order.

To keep matters simple, we will assume that wholesale independent contractor treatment (for all purposes of federal and state law) will be replaced by wholesale employee treatment (again, for all purposes under federal and state law). Thus, we will not deal with hybrid workers who are independent contractors for some purposes and employees for others.

If a court, body, or agreement concludes that workers are employees rather than independent contractors and recharacterizes them as such, here are 10 things to consider.

1. Federal Income Tax Withholding

Perhaps one's biggest duty as an employer is to withhold taxes. You act as the government's agent, and that is no laughing matter. In fact, one of the biggest employer liabilities is for failure to withhold income and employment taxes. There are usually state tax withholding obligations as well.

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If workers are recharacterized from contractor to employee, there may be big liabilities for failure to withhold in the past.

As far as the income tax is concerned, 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. A retroactive determination that payments to a worker were in fact wages paid to an employee can have serious consequences, in terms of potential taxes, interest, and penalties to the government. Prospectively, of course, you also have to observe the usual formalities of withholding, getting the workers to submit IRS Forms W-4, and so on.

2. Social Security Tax

Social Security or Federal Insurance Contributions Act (FICA) withholding is required on all wages up to an annual limit. This limit is called the Social Security wage base, and it is adjusted upward for inflation each

year. For 2008, the wage base was \$102,000 for the component of Social Security known as Old-Age, Survivors, and Disability Insurance (OASDI). For 2009, it is \$106,800. There is no cap for Medicare. The employer and the employee each pay half of the FICA tax.

Someone who is properly treated as an independent contractor is responsible for all his own self-employment taxes. The mandatory contribution to OASDI for self-employed individuals is 12.4 percent 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 percent of the worker's wages.

Medicare payments are similar to OASDI contributions. Self-employed individuals contribute 2.9 percent of their earnings toward Medicare. There is no earnings limitation. As an employer, the company would be responsible for one-half (1.45 percent) 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, the past employment tax liability, plus interest and penalties, can be huge. Prospectively, the obligation is not too onerous, but there is an employer portion that is not passed along to employees.

3. Federal Unemployment Taxes

The Federal Unemployment Tax Act (FUTA) allows for the collection of a federal employer tax used to fund state workforce agencies. Unemployment insurance rates are set by the federal and state governments. The maximum FUTA tax rate is 6.2 percent. However, for most firms paying state unemployment taxes, the maximum tax rate is 0.8 percent. The earnings limit for FUTA is \$7,000.

If workers are ruled to be employees, the company would be responsible for paying past FUTA taxes (plus interest and penalties), and would need to collect them prospectively too.

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 latter 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 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, the employer would have liability for the past. Plus, the company would need to begin making premium payments for the future.

6. Health and Welfare Benefits

This number may be the big elephant in the room. To a large extent, how much and what type of benefits are required is going to depend on what plans the company has in place for employees.

In general, if the company provides great benefits for employees (and nothing for independent contractors), recharacterization will really, really smart. The “independent contractors” who are recharacterized as employees may have to be provided all the same benefits, since most of these plans are subject to comprehensive nondiscrimination rules.

The employer may get an idea of average benefits based on a national average of employee benefits as a fraction of wages. The U.S. Bureau of Labor Statistics reports such data. Benefits in private industry, including paid leave, supplemental pay, insurance, retirement, and legally required benefits, average nearly 30 percent of total compensation.

7. Pension Plans

Qualified pension and other employee benefit plans involve enormously complex qualification, compliance, and nondiscrimination rules. Of course, such plans are usually only for employees. That means if putative independent contractors are reclassified as employees, watch out.

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

It may well be a huge liability if an employer must treat certain workers as participants in one or more such plans. A recharacterization of independent contractors can require the employer to make retroactive participation and funding changes. In extreme cases, the employer may face disqualification of the plans, negatively impacting both the company and all plan participants. Again, this one can be a biggie.

8. Unreimbursed Business Expenses

This can be an unanticipated category of consequences of a recharacterization from independent contractor to employee. There are statutory rights to expenses of employment. Employees have these rights and independent contractors do not.

There can be line-drawing about what is or is not reimbursable, and how far back in time you can or should go. Still, this consequence of recharacterization can be large for the past, and involve fundamental changes in operating costs for the future.

9. IRS Penalty Assessments

IRS penalties can be significant enough to be considered a separate category. The penalty IRS assesses de-

pends on its interpretation of the employer’s intention in misclassification.

If IRS believes the employer did not deliberately misclassify the workers, it can apply a 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 percent of the FICA that should have been withheld and 1.5 percent of wages.

Lack of intent to misclassify hinges largely on the filing of all necessary Forms 1099 for the workers. If all the necessary forms have not been filed, the employer can be assessed a larger penalty under Section 3509(b)—40 percent of FICA and 3 percent of wages.

The employer is entitled to a credit (under Section 3402(d)) 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. However, this credit does not apply in Section 3509 reduced rate cases. Besides, it can be tough to track former employees down and prove they are paid up.

If IRS 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 (see Section 3509(c)).

Plus, it can go after the business owners and/or officers personally. That potential liability is a whopper—a 100 percent penalty on each responsible person.

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The amount of the company’s tax (and also the 100 percent 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.

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.” (Section 530 was never added to the Internal Revenue Code; it is a section in the Revenue Act of 1978). Perhaps because of the existence of Section 530 relief, IRS is often interested in getting an employer to agree to prospectively treat the workers as employees, even if 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 is worth mentioning. 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, they 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, he 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. 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. Of course, taxpayers are obligated to file complete and accurate returns under tax code Section 6011. 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.

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 Section 1.461-1(a)(3) states that the taxpayer “should” file an amended return to correct the error. However, neither the Internal Rev-

enue Code nor Treasury Regulations impose an affirmative duty on a taxpayer to file an amended return.

Conclusion

Worker status disputes are messy, expensive, and upsetting from almost any angle. Whether you are seeking employee treatment or trying to avoid it, and whether you are aligned with a worker, company, agency, or third party, the stakes can be high. All too often, though, you may not thoroughly quantify 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 workers’ 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 you look at only one issue, however, that can be shortsighted. Do not fail 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 re-characterization 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. Whatever your role, you will be glad you did.