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## **Worker Classification: Federal Tax Considerations**

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# Agenda

- Who are Independent Contractors?
- Why is Employee/Independent Contractor Status Relevant?
- What are the Financial Stakes?
- What are the Applicable Tests?
- Traditional Payroll Tax Audits
- The IRS “National Research Program” Audits
- The Relief Provisions
- Next Webcasts

# Types of “Contingent Workers”

- Independent Contractors
- Leased Employees
- Terminated/Rehired Workers
- Dual Status Workers (Rev. Rul. 58-505)
- Corporate Officers
- Other Statutory Employees
- Statutory Nonemployees
- Employees covered by Section 218 Agreement

# Employee Misclassification: What's at Stake?

## Key Federal and State Agencies Affected by Employee Misclassification

Agency	Areas potentially affected by employee misclassification
DOL	<ul style="list-style-type: none"><li>• Minimum wage, overtime, and child labor provisions</li><li>• Job protection and unpaid leave</li><li>• Safety and health protections</li></ul>
IRS	<ul style="list-style-type: none"><li>• Federal income and employment (payroll) taxes</li></ul>
Department of Health and Human Services	<ul style="list-style-type: none"><li>• Medicare benefit payments</li></ul>
DOL, IRS and PBGC	<ul style="list-style-type: none"><li>• Pension, health, and other employee benefit plans</li></ul>
EEOC	<ul style="list-style-type: none"><li>• Prohibitions of employment discrimination based on factors such as race, gender, disability, or age</li></ul>
NLRB	<ul style="list-style-type: none"><li>• The right to organize and bargain collectively</li></ul>
SSA	<ul style="list-style-type: none"><li>• Retirement and disability coverage and payments</li></ul>
State Agencies	<ul style="list-style-type: none"><li>• Unemployment insurance benefit payments</li><li>• State income and employment taxes</li><li>• Workers' compensation benefit payments</li></ul>

# Employee Misclassification: Payroll Taxes

## Differences Between General Tax Responsibilities of Employees and Independent Contractors

Type of Tax	Individuals classified as employees		Individuals classified as independent contractors	
	Businesses' general responsibilities	Workers' general responsibilities	Businesses' general responsibilities	Workers' general responsibilities
Federal income tax	Withhold tax from employees' pay	Pay full amounts owed, generally through withholding	Generally, none	Pay full amounts owed, generally through estimated tax payments
Social Security and Medicare taxes	Withhold one half of taxes from employees' pay and pay other half	Pay half of total amounts owed, generally through withholding	None	Pay full amounts owed, generally through estimated tax payments
Federal unemployment tax	Pay full amount	None	None	None
State unemployment tax	Pay full amount, except in certain states	None, except pay partial amount in certain states	None	None

# Employee Misclassification: Benefits and Business Expenses

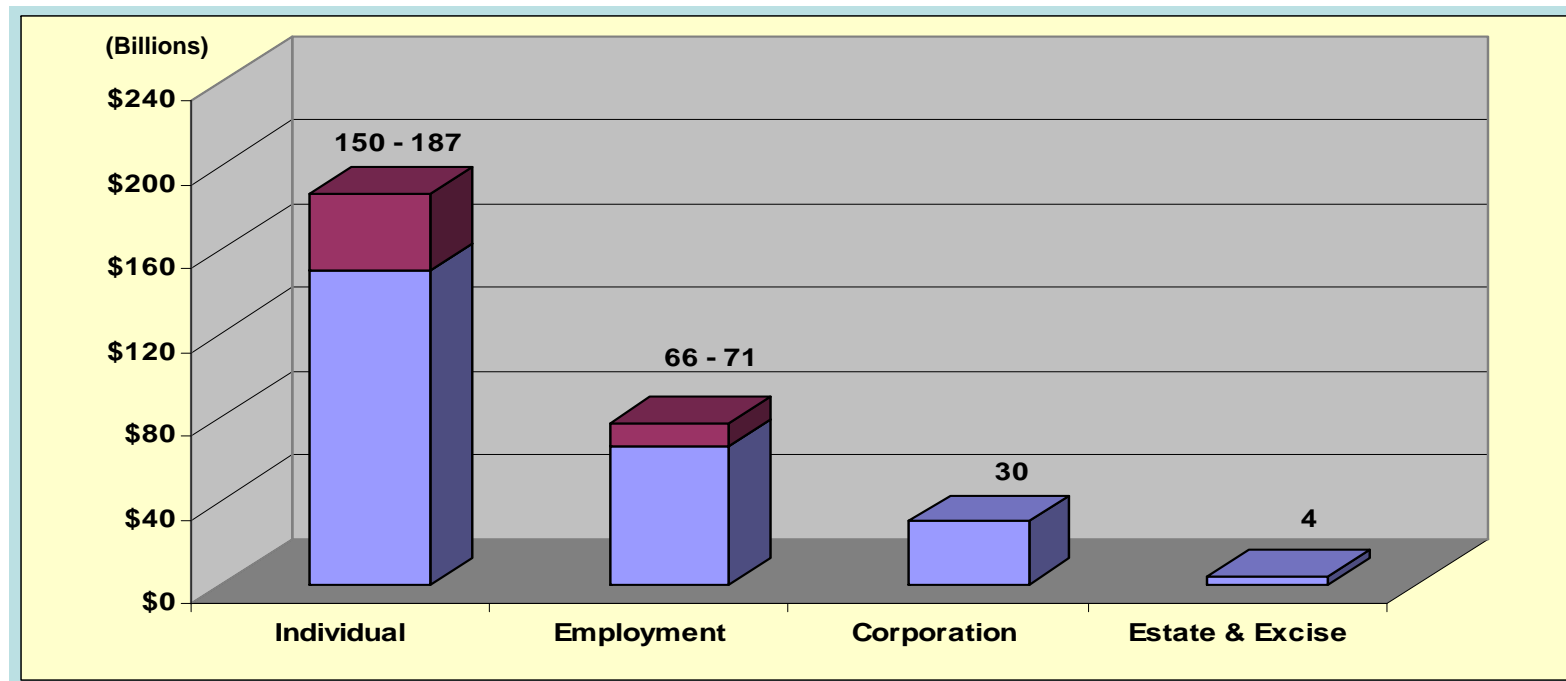
## Differences Between General Benefits Responsibilities of Employees and Independent Contractors

Type of benefits	Individuals classified as employees		Individuals classified as independent contractors	
Retirement Plans	Employers sponsor benefit plans	Employers and employees contribute	Contractors sponsor plans	Contractors bear the full financial cost of the plans
Healthcare	Employers sponsor on a tax-free basis	Employers and employees contribute	Contractors obtain coverage	Contractors bear the full financial cost, but receive tax deduction
Reimbursed Expenses/ Accountable Plans	Employers can reimburse	Nontaxable to extent paid under an accountable plan	Service recipient can reimburse, although generally expenses are unreimbursed	Reimbursed expenses are nontaxable if under an accountable plan
Unreimbursed Expenses	Many employers don't fully reimburse expenses	Unreimbursed expenses subject to 2% floor and AMT	Businesses don't generally reimburse expenses	Not subject to 2% floor or to AMT

# Financial Exposure: Federal Payroll Taxes

- Federal Income Tax Withholding (FITW)
- Federal Insurance Contributions Act (FICA)
  - Social Security (OASDI)
  - Medicare (HI)
- Federal Unemployment Tax Act (FUTA)
- Self-Employment Contributions Act (SECA)
- Railroad Retirement Tax Act (RRTA)

# Financial Exposure: Relationship to the Tax Gap



\$5 billion associated with FICA/FUTA

\$51-56 billion associated with SECA

Other estimates place the annual "Employment Tax Gap" at \$15 billion (IRS, in introduction of NRP program), \$54 billion (Treasury Study issued 9/26/06), or up to \$78 billion.



# Federal Exposure: Federal Payroll Taxes

- Full-rate statutory liability equal to at least 40% of compensation payments to independent contractors
  - 25% Federal Income Tax Withholding exposure
  - 15.3% Employer and Employee FICA (Social Security and Medicare)
  - Social Security Taxable Wage Base (\$106,800 for 2011)
- Example of “full rate” exposure: the annual “full rate” federal tax exposure for 60 misclassified independent contractors earning \$50,000 is approximately \$1,200,000

# Financial Exposure: Federal Tax Penalties

Additional exposure for:

- Information reporting penalties
  - *Failure to file*
  - *Failure to furnish*
- Negligence
- Failure to deposit
- Failure to pay
- Interest

# Independent Contractor Tests: The Common Law Test

## 20 Factors

- |                                |  |
|--------------------------------|--|
| • instructions                 | • order or sequences set                 |
| • integration                  | • reports                                |
| • payments                     | • expenses                               |
| • training                     | • investment                             |
| • services rendered personally | • tools and materials                    |
| • hiring assistants            | • profit or loss                         |
| • continuing relationship      | • works for more than one person or firm |
| • set hours of work            | • offers services to general public      |
| • full-time work               | • right to discharge                     |
| • work done on premises        | • right to quit                          |

# Independent Contractor Tests: IRS Three-Factor Test

- For audit purposes, IRS auditors use a modified version of the 20-Factor Test that focuses on three factors:
  - Behavioral Control Factors
  - Financial Control Factors
  - Relationship of the Parties Factors
- IRS Three-Factor Test considers the work that is being performed and the business context in which it is being performed

# Independent Contractor Tests: Economic Reality Test

- Used by the DOL
- Examines primarily
  - the extent to which the services rendered are an integral part of the employer's business;
  - the permanency of the relationship;
  - the amount of the worker's investment in facilities and equipment;
  - the nature and degree of control by the employer;
  - the worker's opportunities for profit and loss;
  - the amount of initiative, judgment, or foresight in open-market competition with others required for the success of the claimed independent contractor; and
  - the degree of independent business organization and operation.

# Independent Contractor Tests: *Darden* Test

- Similar to 20-Factor Common Law Test
- Based on common law of agency
- All factors considered
- No one factor is determinative

# IRS Payroll Tax Audits: General Approach

- Generic Payroll Tax Issues—The three-part test
  - Are the amounts “wages”
  - Employer and employee relationship
  - “Employment”
- Withholding, Deposit, and Reporting Issues
  - Employer liable for employee taxes
  - Penalty exposure
- Wage Characterization
  - Fringe benefits (excludable, cash and noncash)
  - Employer reimbursements
- Payments to Employees, Independent Contractors, and “Others”

# IRS Payroll Tax Audits: Samples of Affected Industries

- Transportation
- Brokers
- Insurance Agents
- Healthcare Workers
- Sales Forces
- Consultants
- Home Services

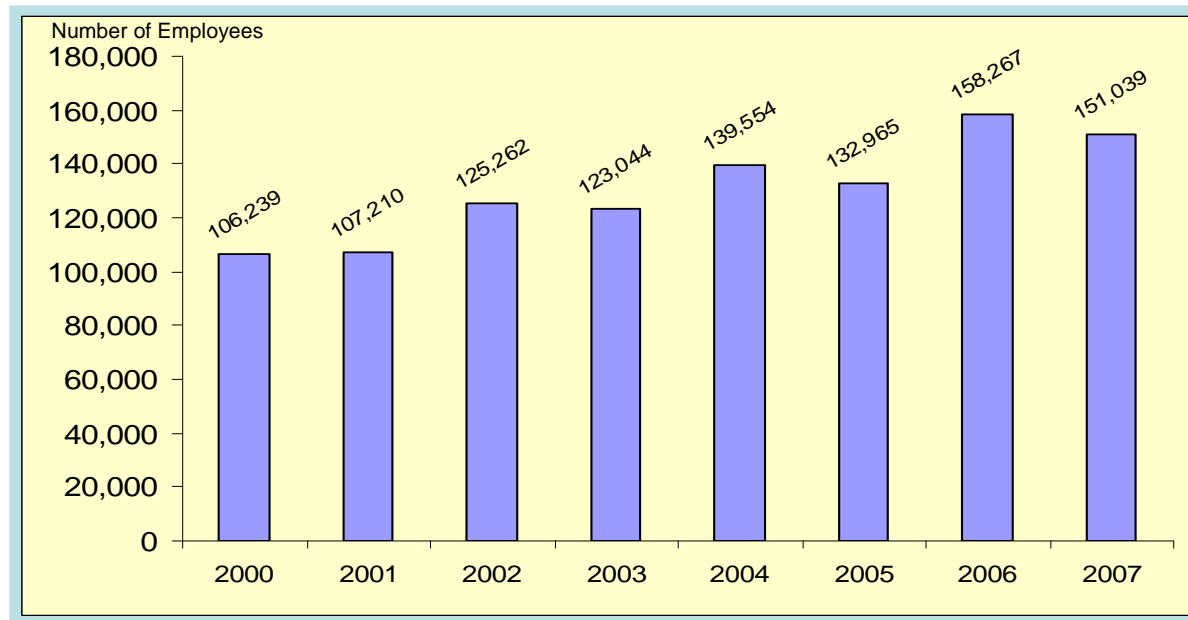


# IRS Payroll Tax Audits: State Coordination

- Coordinating on prefiling and filing efforts
  - e.g., Coordinated EIN filing
- IRS and approximately 40 states share information on worker classification-related audits
- Uniform employment tax and wage reporting law
- FUTA/SUTA coordination
- Joint initiatives focusing on abusive tax transaction
- Database sharing for transcript deliveries
- State Income Tax Levy Program
- State statutes of limitation are often open one year (or more) beyond federal statute of limitation (plus extensions), and some states (e.g., CA) require taxpayers to notify the state of federal settlements

# IRS Payroll Tax Audits: State Audit Efforts

Figure 1: Number of Misclassified Employees Identified by State Audits of Employers, 2000 to 2007



Source: GAO analysis of DOL data.

# IRS Payroll Tax Audits: The National Research Program

- What – Detailed-study audits of compliant and noncompliant taxpayers
- Who – 6,000 taxpayers  
Randomly selected  
Mostly small business employers  
Some large- and midsized  
Tax-exempt and government employers
- When – The 2008 to 2010 tax years conducted from 2010 through?
- Where – Geographically dispersed area

# IRS Payroll Tax Audits: The NRP Audits

- Replace regular payroll audits for 2010 to 2012 cycle
- Throwback to the “Taxpayer Compliance Measurement Program” (TCMP) audits from the 1970s
- The Five Primary Audit Topics:
  - Payroll Tax/Compliance Overview
  - Fringe Benefits
  - Reimbursed Expenses
  - Executive Compensation
  - Worker Classification/Independent Contractors

# IRS Payroll Tax Audits: The NRP Audits

- Why Conduct Such Detailed Audits?
  - to gather data “to improve our tax system”
  - to determine how employers satisfy tax liabilities
  - to reduce the size of the “tax gap”
  - to use data to set Tier 1 and Tier 2 issues for future audits
- How Will It Achieve Goals?
  - changing forms and publications
  - changing tax laws
  - enhancing enforcement techniques
  - educating taxpayers
  - enhancing voluntary compliance
  - improving overall fairness of our tax system

# Federal Payroll Tax Relief

- Significant Statutory and Administrative Payroll Tax Relief Exists:
  1. Section 530 Relief
  2. Section 3509 Relief
  3. Classification Settlement Program Relief

# Federal Payroll Tax Relief: Section 530 Relief

- “Off-Code” relief provision
- If applicable, reduces the employer’s federal employment tax exposure to zero for all past and future years
- If applicable, business can continue to treat the workers as independent contractors for payroll tax purposes
- Must have reasonable basis for that independent contractor treatment
- IRS bears burden of proof
- Under attack by Congress, Administration and the IRS

# Federal Payroll Tax Relief: Section 530 Relief

## Statutory Relief: Section 530

- Provides employer-only relief
- Provides complete relief both retroactively and prospectively
- Three Tests
  - Reporting Consistency
  - Substantive Consistency
  - Reasonable Basis (prior audit, industry practice, “judicial” precedent, or any other reasonable basis)



# Federal Payroll Tax Relief: Section 3509 Mandatory Rates

## Statutory Relief: Section 3509

- Provides an opportunity for reduced employment tax assessments if service recipient issued Forms 1099
- Section 3509 does not provide any relief regarding the employer's portion of FICA taxes or the FUTA tax
- Effective Section 3509 rate is 10.68% for both FICA and FITW for the compensation paid to reclassified worker

# Federal Payroll Tax Relief: CSP Relief Program

## IRS Classification Settlement Program Relief

- Optional settlement program available if previously issued Forms 1099 *and* service recipient agrees to reclassify the independent contractors as employees on a prospective basis for all future years
- Service recipient will be assessed with employment tax liability based on a percentage of Section 3509 liability as low as 25% of the employment tax liability for the most recent year under audit if service recipient has a “colorable” claim

# Example: Tax Exposure and Tax Relief

- The annual “full rate” federal tax exposure for 60 misclassified ICs earning \$50,000 is approximately \$1,200,000.
- Relief provisions can reduce the \$4.8 million four-year liability:

<u>Relief Provision</u>	<u>2010 Exposure*</u>	<u>Total Four-Year Exposure</u>
Statutory relief	320,400	1,281,600
100% CSP Offer	320,400	320,400
25% CSP Offer	80,100	80,100
Section 530 “Off-Code” Relief	0	0

\*Calculations do not include FUTA, SUTA, and SITW liabilities

- Facilitate full relief with no federal taxes paid.

# Steps to Minimize Risks and Exposure

## Do's and Don'ts

If possible, when implementing:

- Do develop standardized independent contractor agreements
- Do limit services to less than full-time
- Do limit services to a short-term nature
- Do avoid hourly fees
- Do limit expense reimbursements to nonroutine expenses
- Do encourage contractors to provide services as an incorporated entity
- Do require verification of tax payments
- Do remove all references of the contractor from the organizational charts
- Do require a waiver of all employee benefits

# Steps to Minimize Risks and Exposure

## Do's and Don'ts

If possible, when implementing:

- Don't retain any rights to direct or control the contractor
- Don't impose restrictions on the methods or means for the performance of the services
- Don't allow the consultant to direct/control/supervise your employees
- Don't require reports from or provide reviews to the contractor
- Don't provide equity compensation
- Don't pay hourly fees
- Don't extend privileges/benefits of a type provided to employees
- Don't provide a profits guarantee

# Steps to Minimize Risks and Exposure

- Do not rely solely on the Common Law test
- Conduct compliance reviews
- Conduct internal training to raise awareness
- Audit the positions to ensure that you know what work contractors are performing
- Review your contracts with independent contractors
- Use incorporated independent contractors
- Monitor length of relationships and hours worked
- Review agreements/indemnification from vendors providing independent contractors
- Separately assess tax, benefits, and employment law exposure
- Determine risk tolerance in each area

# Methods to Reduce Audit Exposure

1. Undertake Section 530/Independent Contractor/CSP reviews
2. Identify a reasonable basis that can extend relief for payroll tax, worker classification, and fringe benefits issues
  - *Section 530/CSP relief for worker classification issues*
  - *“Reasonable to Believe” relief for payroll taxes/fringes*
  - *Interest-free adjustments*
  - *Central Illinois Doctrine*
  - *Penalty abatement for reasonable cause*

# Methods to Reduce Audit Exposure

## 3. Reducing Independent Contractor Exposure

- *Always issue Forms 1099*
- *Obtain services from ICs who have incorporated or are provided by third parties*
- *Avoid issuing Forms W-2 and 1099 during the same year*
- *Neutralize employee benefits considerations by adopting “Microsoft Language”*
- *Seek consistency*
- *Written contracts*
- *Payrolling companies*

## 4. Adopt and implement best practices



# Inside the Beltway: Options to Address Misclassification

<b>Options</b>	<b>Labor groups</b>	<b>Independent contractor groups</b>	<b>Other groups</b>
1. Clarify the distinction between employees and independent contractors within federal law		Support	Support
2. Allow workers to challenge determinations in Tax Court	Support	Oppose	Support
3. Ensure that workers have protection for filing Forms SS-8	Support	Support	Support
4. Determine misclassification as a violation under FLSA	Support	Oppose	
5. Narrow the definition of “a long-standing recognized practice of a significant segment of the industry”		Oppose	Support
6. Lift the ban on IRS clarifying employment status		Support	Support
7. Require service recipients to give workers documents that explain classification	Support	Support	
8. Expand IRS outreach		Support	Support

# Inside the Beltway: Options to Address Misclassification

<b>Options</b>	<b>Labor groups</b>	<b>Independent contractor groups</b>	<b>Other groups</b>
9. Create an online classification system		Oppose	Support
10. Increase the use of IRS notices	Support	Support	Support
11. Require service recipients to withhold taxes for certain independent contractors	Neutral	Oppose	Support
12. Require universal tax withholding for payments made to independent contractors		Oppose	Support
13. Require service recipients to withhold taxes at independent contractor request		Neutral	Support
14. Measure the extent of misclassification at the national level	Support	Neutral	

# Inside the Beltway: Options to Address Misclassification

<b>Options</b>	<b>Labor groups</b>	<b>Independent contractor groups</b>	<b>Other groups</b>
15. Require each independent contractor to apply for a separate business TIN		Support	
16. Expand IRS's CSP		Support	
17. Require service recipients to submit Forms SS-8 for newly retained independent contractors		Oppose	Support
18. Enhance coordination between IRS, DOL, and other federal agencies	Support	Neutral	
19. Enhance coordination between IRS, states, and selected local governments	Support	Neutral	

Questions?

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**David R. Fuller is a partner in Morgan Lewis's Employee Benefits and Executive Compensation Practice.** Mr. Fuller focuses his practice on tax planning and tax controversy matters involving employment taxes, fringe benefits, and contingent workforces, and he regularly advises Fortune 500 companies on these matters. He is recognized as an authority on matters involving payroll taxes, including worker classification, Section 530 relief, Section 3121(v), Social Security taxes, independent contractors, income tax withholding, supplemental unemployment compensation benefit plans (SUB pay), employee outsourcing, and information reporting. Mr. Fuller also has a background in fringe benefits, qualified transportation fringes, executive fringe benefits, working condition fringes, employer-provided jet aircraft and automobiles, no-additional-cost fringes, meals/lodging, accountable plans, and income minimization techniques.

Mr. Fuller has dealt with a range of compliance, planning, and litigation matters. He has worked on many employment tax, employee-independent contractor, and fringe benefits planning strategies and has handled numerous tax controversy matters both with and against IRS agents and appeals officers. Mr. Fuller has worked on a wide array of nonlitigation issues with attorneys, agents, and officials at all levels of the IRS.

## Education

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**Claudia L. Hinsch is an associate in Morgan Lewis's Employee Benefits and Executive Compensation Practice.** Ms. Hinsch provides advice and counseling to clients on all aspects of employee benefits and compensation, including compliance with ERISA, the Internal Revenue Code, and securities laws, as well as benefits issues arising in the context of mergers, acquisitions, divestitures, and corporate restructuring. She also assists clients with the design, drafting, termination, and day-to-day administration of qualified plans, nonqualified plans, equity-based plans, severance and other welfare plans, and other compensation arrangements.

Ms. Hinsch also assists nonprofit organizations with benefits issues and compensation arrangements, including the design, drafting, and operation of 403(b) plans, 457(b) plans, and 457(f) arrangements, and the negotiation and drafting of employment agreements.

## Education

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