Worker Classification – “Building” a Case for Independent Contractor Status

Over the past few years, the topic of independent contractor vs. employee status has been a focus of both federal and state taxing authorities, as well as the subject of high-profile lawsuits – in some instances brought by workers who were treated as independent contractors in an attempt to receive employment-related or unemployment benefits.

The IRS, U.S. Department of Labor (DOL), and a number of state taxing authorities have been increasing their audit, information-sharing, and legislative activity in order to challenge the treatment of workers as independent contractors – and increase tax revenues.

The construction industry is one that the IRS has long recognized as ripe for employment tax audits. According to the IRS, “The use of subcontractors is common within the construction industry. Many taxpayers treat employees as subcontractors to avoid paying employment taxes.”

This article focuses on worker classification issues and provides strategies that may help reduce the risk of exposure to employment tax penalties. We will illustrate why the IRS and state taxing authorities feel the construction industry is particularly vulnerable to employment tax audits.

Most importantly, we will offer some insight into how to strengthen the independent nature of contractor relationships while ensuring compliance with the various employment tax rules, as well as outline certain remedies that the IRS has made available. Finally, we will note some of the high-profile issues related to the incorrect treatment of workers as independent contractors.

Independent Contractors Play a Vital Role in the Construction Industry

It is no secret that the use of independent contractors is prevalent in the construction industry. A report from the U.S. Bureau of Labor Statistics (BLS) a few years ago noted that more than 20% of all construction industry workers were independent contractors. Many independent contractors also hire their own employees or subcontractors (which is generally a good factor in determining the independent relationship).

From an employment tax audit perspective, this large pool of “potential employees” presents an opportunity for the IRS and state unemployment taxing authorities to impose penalties for prior noncompliance and collect employment taxes prospectively for any worker reclassified from independent contractor to employee status.

A Trend Toward Increased Enforcement

As previously mentioned, IRS and DOL enforcement of worker classification rules is on the rise, particularly in the construction industry. For example, the IRS and DOL recently signed a Memorandum of Understanding (MOU) with respect to information sharing, specifically in the area of worker classification. Those who are knowledgeable about the construction industry have indicated that middle-market construction companies have recently seen a significant uptick in audits for potential employee classification errors.

In addition, the Obama administration has made it a priority to crack down on employers that intentionally misclassify employees in order to save costs and avoid taxes, as indicated in both the 2011 and 2012 budget proposals submitted to Congress. Since 2010, the IRS has been conducting a National Research Program in conjunction with a three-year audit initiative that has targeted an additional 6,000 employers, mainly focusing on worker classification.

This trend also exists at the state level, with a number of “punitive-based” actions regarding employee/independent contractor classification. For example, the Colorado Department of Labor and Employment recently signed a memorandum of understanding with the U.S. DOL’s Wage and Hour Division to coordinate enforcement of laws, exchange information, and reduce “the practice conducted by some businesses of misclassifying employees.” The U.S. DOL has entered into similar agreements with Connecticut, Hawaii, Illinois, Maryland, Massachusetts, Minnesota, Missouri, Montana, Utah, and Washington.
Effective January 2008, Illinois enacted the Employee Classification Act, which is specific to the construction industry and imposes strict criteria for independent contractor treatment, as well as fines and penalties for employee misclassification.8

More recently, California passed legislation targeting independent contractors and worker misclassification. California Senate Bill 459 (referred to by critics as the “Job Killer Act”) adds two new law sections to the California Labor Code and imposes civil penalties of $5,000 to $15,000 per violation for misclassifying workers, with increased penalties for engaging in a pattern of violations. It also imposes “joint and severable” liability for an individual who, for money, “knowingly advises an employer to treat an individual as an independent contractor to avoid employee status for that individual.”9

As state unemployment funds have been depleted from the poor economy, auditors are becoming more aggressive in conducting their audits. Since worker classification is the largest potential revenue raiser – both retroactively for back taxes, interest, and penalties and prospectively for future compliance – it is the largest area of focus in state unemployment tax audits.

According to recent data issued by McGraw-Hill Construction, new construction starts (unadjusted) were slowly but steadily increasing during the latter half of 2011, reaching their highest level since late 2008. (However, these numbers are cumulatively lower than the first 10-month period in 2010 due to the sluggish start to 2011!)10 If the recent upward trend continues through the balance of 2012, then the increased need for workers could raise the industry’s profile even further with respect to audit activity.

Strengthening the Independent Contractor Relationship
There are a number of actions that can be taken to strengthen existing independent contractor relationships and reduce the risk of employment tax audit exposure.

Since proving the independent relationship between a worker and a company is heavily dependent on providing as much documentation as possible, it is critical to establish and document detailed policies, procedures, and systems that are easily understandable to the employees responsible for hiring independent contractors.

While not an exhaustive list, the following are several methods and procedures to assist in establishing a solid foundation for classifying workers as independent contractors:

- **Develop a checklist** of items that must be compiled and completed prior to the hiring of an independent contractor (e.g., business cards, letterhead, sample invoices, website, sample list of other clients, or LinkedIn profile).
- **Develop a questionnaire** that must be completed prior to the hiring of an independent contractor. These questions would relate to the various factors indicative of employment or independent contractor relationships (discussed below) and can be used to supplement the information contained in the checklist noted above.
- **Use a contract** that contains specific language related to the independent contractor relationship (e.g., the worker “will comply with all applicable federal, state, and local tax reporting requirements for independent contractors”).
- **Refrain from using contract language** that establishes the “right of direction and control,” including noncompete agreements; restrictions on hiring subcontractors, helpers, or other employees; or the payment of the contractor’s liability or workers’ comp insurance.
- **Establish a centralized storage location** for all independent contractor files. This not only would help in the event of an examination by a taxing authority, but also would strengthen future procedures when working with independent contractors.
- **Create a formal internal policy document** that clearly defines the required documentation, procedures, departments responsible for implementing the procedures, and applicable contact information for questions.

**Worker Classification Tax Laws**
The IRS and other taxing authorities offer little formal (and sometimes differing) guidance as to how a worker is classified for employment tax purposes. In the late 1990s, the IRS began using the “categories of evidence” methodology to determine a worker’s status.

Essentially, the IRS incorporated many of the original 20 common law control factors from IRS Revenue Ruling 87-4111 into three categories:

1) Behavioral control (i.e., who has the right of control and direction),
2) Financial control (i.e., who controls how the worker conducts his/her business activities), and
3) Relationship of the parties (i.e., how the parties perceive their relationship).12

All three tests employ multiple factors that the IRS would weigh to determine how it would classify an employment
relationship. An employer may consider asking the following in order to address each of these factors:

**Behavioral Control**
- Will the employer instruct the contractor on how the work is to be completed?
- Will the contractor be required to work specific hours and/or days?
- Will the employer provide the contractor with a formal evaluation system or training?
- Must the work be performed by a specified individual?

**Financial Control**
- Will the employer reimburse the contractor for expenses incurred?
- Does the contractor have a significant financial investment in his/her own business?
- Will the employer pay the contractor at regular amounts and at pre-established intervals (e.g., weekly, biweekly, monthly, etc.)?
- Did the contractor negotiate or establish the rate of pay? Is there documentation of this negotiation (e.g., e-mails, written notes from meetings or calls, etc.)?

**Relationship of the Parties**
- Did the contractor sign a written agreement indicating “independent contractor” status?
- Will the employer provide the contractor with any type of benefit that it typically offers to other employees?
- Will the contractor perform services for a specified time, project, or event?
- Does the contractor work with other companies?

**Remedies Offered by the IRS**
In addition to taking the internal steps previously discussed, the IRS offers two opportunities for employers to protect themselves and/or lessen the penalties: 1) §530 safe harbor provision and 2) the IRS’ new Voluntary Classification Settlement Program.

**Section 530 Safe Harbor Provision**
Section 530 protection is a defense that an employer can only raise under audit, and allows businesses to continue independent contractor treatment without regard to the common law test as long as substantive consistency, reporting consistency, and reasonable basis exist.

In layman’s terms, “substantive consistency” is treating all workers who are similarly situated (i.e., who hold related or similar jobs) as independent contractors, and “reporting consistency” is filing all required federal employment tax returns (i.e., 1099-MISC) on a basis consistent with this treatment. Any of the following will meet the “reasonable basis” requirement:
- Judicial precedent, a published ruling, private letter ruling, or technical advice memorandum issued directly to the taxpayer;
- Past IRS examination of the taxpayer in which the classification of the particular workers was considered and left unchanged; or
- A long-standing, recognized practice of a significant segment (at least 25%) of the industry.

If §530 protection exists, the IRS cannot reclassify independent contractors as employees for federal employment tax purposes. However, §530 protection is generally not accepted for either state income tax withholding or unemployment tax purposes.

Therefore, it is conceivable that the same individual could be classified as an employee for state unemployment tax purposes, yet treated as an independent contractor for federal employment tax purposes by virtue of the §530 rules.

**Voluntary Classification Settlement Program**
In late September 2011, the IRS announced the Voluntary Classification Settlement Program (VCSP), which allows employers to voluntarily reclassify independent contractors as employees and pay significantly reduced amounts (approximately 1% of the most recent year’s pay to the voluntarily reclassified workers) in exchange for prospective treatment of these workers as employees. CCH recently indicated that more than 500 employers signed up for this program after its initial offering.

From a strictly employment tax perspective, this program may be a good idea for companies that believe they may have exposure for misclassifying workers as independent contractors.

However, since this is a new program and only addresses federal employment taxes, it is too soon to determine the impact that participation could have on other areas (such as labor laws and state unemployment tax), and companies that consider participating in this program should discuss the various implications with their tax and legal advisors.
Once an employer chooses to reclassify some of its workers as employees under the VCSP, it must also reclassify all workers in the same job class as employees. In other words, the employer should treat those who do a job similar to, or related to, the job of the individual being “reclassified” as an employee for employment tax purposes.15

To be eligible for the VCSP, employers must be able to demonstrate the following:

1) Consistently have treated the workers as nonemployees;

2) Have filed all the required Forms 1099 for the workers for the previous three years; and

3) Not currently be under any IRS audit (regardless if the audit has identified worker classification as an issue) or under a worker classification audit by the DOL or a state agency. (This condition effectively locks many large companies out of participation in VCSP if they continually are under an IRS audit.)

To participate in this program, employers must file Form 8952, Application for Voluntary Classification Settlement Program, at least 60 days before the employer wants to begin treating the workers as employees. Once the IRS accepts the employer into the VCSP, it will contact the employer to enter into a VCSP closing agreement.

Under the closing agreement, the taxpayer must agree to extend the statute of limitations by three years for the first three calendar years beginning after the parties sign the closing agreement. The taxpayer must also agree to treat as employees the workers within the same job class as the reclassified worker for future tax periods.

If the IRS determines that the taxpayer is not eligible for the VCSP, then it will contact the employer to notify it that it has rejected the VCSP application.

Penalties for Misclassification

Misclassification of workers can be substantial and can expose a contractor to:

- Required payment of prior tax obligations;
- Potential penalties for failure to withhold and remit taxes;
- Retroactive reinstatement of employee benefits; and
- Potential fines imposed by state agencies, as well as state unemployment tax.

There are both tax and non-tax exposures related to the misclassification of workers. In addition to state unemployment taxes (as well as interest or penalties imposed by states), IRC §3509 provides the following federal employment tax penalties for worker misclassification:

- Federal income tax withholding penalty calculated at 1.5% of total payments made to the misclassified worker(s).
- Employer Social Security calculated at 6.2% of total payments up to the applicable wage limit ($106,800 for 2009, 2010, and 2011; and $110,100 for 2012).
- Employer Medicare tax calculated at 1.45% of total payments.
- Employee Social Security calculated at 20% of the total employee liability.
- Employee Medicare tax calculated at 20% of total employee liability.16

Based on the above, a reclassification of 10 workers who earned $50,000 could result in almost $55,000 in federal employment tax exposure per year.

Non-employment tax issues and risks could include:

- The added cost of coverage under employee benefit plans, including retirement, medical, dental, etc.
- Employee bonus, wage and hour, and overtime rules.
- State disability insurance. Note: Only a few states impose this, including California, Hawaii, New Jersey, New York, and Rhode Island.
- Workers’ comp insurance, which is generally administered by state agencies but covered through a private insurance carrier.

Conclusion

The IRS, DOL, and state taxing authorities have made it clear that they are targeting worker misclassification as something they believe is not only a wrong to be righted, but also a source of revenue. The construction industry has historically been a targeted industry, and if it continues to experience growth along with new construction activity, then it will be even more of a target for audit activity.

There are a number of areas where companies can act with respect to the hiring of independent contractors in order to establish protocols, consistency, and procedures to minimize the potential for exposure.
In addition, certain defenses and information can be provided under IRS or state audit in order to challenge the taxing authorities’ positions. Further, if an employer believes it has exposure in the worker classification area, then the new VCSP may be an option to address those issues and provide a level of safety in future audits.

While following the information presented in this article will not necessarily guarantee protection against IRS penalties for worker misclassification, it does provide some guidance that contractors can apply toward minimizing their employment tax risk in this area. Given the current economy, ensuring compliance is certainly worth the upfront administrative burden if it helps avoid substantial employment tax, interest, and penalties down the road.

Endnotes:
1. IRS Construction Industry Audit Technique Guide (ATG), Chapter 8.
4. Budget of the U.S. Government, Fiscal Year 2011 (pg. 100) and 2012 (pg. 112).
5. It should be noted that for the vast majority of the state laws passed over the last few years, there has been little focus on the determination of employee or independent contractor status. The main focus of these laws has been the imposition of penalties and fines for noncompliance.
7. Id.
11. IRS Rev. Rul. 87-41.

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