STAY CLASSY: THE TAX CONSEQUENCES OF WORKER CLASSIFICATION

I. WORKER CLASSIFICATION: THE BASICS

A. Persons who are retained to render services can meet any number of classifications: employees, contractors, subcontractors, agents, and brokers. An important distinction is made between "employees" and "independent contractors".

B. Definitions: "employee" vs. "independent contractor".

1. An employee is a person retained to render services for another person or an entity in exchange for wages or salary.

2. An independent contractor is a person or entity contracted to perform work for – or provide services to – another person or entity as a nonemployee.

C. There is no single test or criteria for determining whether a worker is an employee or an independent contractor.

1. In fact, a worker may be classified as an employee for one purpose and as an independent contractor for another.

2. Different governmental agencies and the laws and regulations governing employees and independent contractors use different and sometimes (but not always) overlapping standards for determining worker classification. For example, the criteria and tests used by the IRS to determine worker classification for tax purposes differs from the criteria and tests used for purposes of coverage under the Fair Labor Standards Act.

3. Contractual agreements and labeling of workers as “independent contractors” are not sufficient to establish that the workers are, in fact, independent contractors as opposed to employees.

D. There are many tax obligations of employers of employees.

1. For workers classified as employees, the employer must withhold and/or pay:

a. Federal Income Tax Withholding (FITW), as well as State income tax withholding.

b. Social Security and Medicare Taxes (FICA).

c. Federal Unemployment Tax (FUTA) (employer only).

d. State Unemployment (employer only).

2. Conversely, workers classified as independent contractors, employer is not required to collect or remit employment taxes. Independent contractors are paid lump sums and are responsible for paying their own income and, if applicable, self-employment taxes.

E. Over the years, the IRS has utilized various tests and criteria for worker classification for tax purposes.

1. In 1987, the IRS published Revenue Ruling 87-41 which included a “20-Factor Test” for determining worker classification. The 20 factors are:

a. Instructions – Does the worker have to comply with instructions about when, where, and how to conduct the work?

b. Training – Is the worker required to be trained as directed by the employer?

c. Integration – Does the worker's work constitute an integral part of the employer's business?

d. Services Rendered Personally – Are the services to be rendered by the worker required to be rendered personally?

e. Hiring, Supervising and Paying Assistants – Does the employer hire, supervise and pay assistants?

f. Continuing Relationship – Is the relationship between the worker and the employer ongoing or a one-off engagement?

g. Set Hours of Work – Is the worker required to work specific hours?

h. Full-Time Required – Is the worker required to devote substantially all of his or her time to the business of the employer?

i. Work Done on Premises – Is worker required to perform the work on the employer's premises?

j. Order or Sequence Set – Is the worker required to perform the work in an order or sequence determined by the employer?

k. Oral or Written Reports – Is the worker required to submit regular oral or written reports to the employer?

l. Payment by Hour, Week, Month – Is the worker paid at a regular interval?

m. Payment of Expenses – Does the employer ordinarily pay for the worker's business and/or traveling expenses?

n. Furnishing of Tools and Materials – Does the employer furnish tools and materials to worker?

o. Significant Investment – Does the worker invest in and/or maintain the facilities used by the worker in performing the work?

p. Profit or Loss – Does the worker share in the profit or suffer loss as a result of the work performed?

q. Integration – Are the worker's services integral or essential to the employer's operations, as opposed to merely incidental thereto?

r. Working for More Than One Firm at a Time – Does the worker perform more than de minimis work for multiple, unrelated employers at the same time?

s. Making Service Available to General Public – Does the worker make his or her services available to the general public on a regular and consistent basis?

t. Right to Discharge – Does the employer retain the right to discharge the worker?

u. Right to Terminate – Does the worker retain the right to end the relationship with the employer?

2. Simplified Three-Factor Test groups the 20 factors above into three general categories: Behavioral Control, Financial Control, and Relationship Factors.

   a. Behavioral Control:

      i. Instructions.

      ii. Training.

      iii. Services Rendered Personally.

      iv. Hiring, Supervising and Paying Assistants.

      v. Continuing Relationship.

      vi. Set Hours of Work.

      vii. Full-Time Required.

      viii. Work Done on Premises.

      ix. Order or Sequence Set.

      x. Oral or Written Reports.

   b. Financial Control:

      i. Payments by Hour, Week or Month.

      ii. Payment of Expenses.

      iii. Furnishing of Tools and Materials.

      iv. Significant Investment.

      v. Profit or Loss.

c. Relationship Factors:

i. Integration.

ii. Working for More Than One Firm at a Time.

iii. Making Services Available to General Public.

iv. Right to Discharge.

v. Right to Terminate.

3. Statutory Employees.

a. Workers in certain occupations are considered "statutory employees" for FICA purposes regardless of whether they are classified as independent contractors under the Three-Factor Test:

i. Compensated corporate officers.

ii. Agent drivers or commission drivers engaged in distributing meat, vegetable, fruit or bakery products; beverages (other than milk); or who picks up laundry or dry cleaning, if the driver is an agent and is paid on commission.

iii. Full-time life insurance salespersons whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.

iv. Full-time traveling or city salespersons soliciting orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be

merchandise for resale or supplies for use in the buyer's business operation. The work performed must be the salesperson's principal business activity.

v. An individual who works at home on materials or goods supplied by employer and must be returned to employer.

b. For FUTA, workers who fall into i. thru iv., above, are statutory workers.

c. Statutory employees for FICA purposes must be in one of the four specified occupations and satisfy the following requirements:

i. Contract must specify that the worker will perform substantially all of the services.

ii. Worker shall have no substantial investment in the facilities.

iii. There is a continuing relationship between employer and worker.

4. Section 530 Relief. Employers may be relieved from employment tax obligations in some instances if it can meet three statutory criteria:

a. Reporting Consistency – The taxpayer must have timely filed the requisite information returns consistent with its treatment of the worker as a non-employee. (For example, if the taxpayer claims the worker is an independent contractor, Forms 1099 must have been filed for the taxable years at issue.)

b. Substantive Consistency – If the taxpayer or predecessor treated the worker, or any worker holding a substantially similar position, as an employee at any time after December 31, 1977, the taxpayer will not be eligible for relief.

c. Reasonable Basis – The taxpayer must have relied on one of the following for purposes of treating the worker as a non-employee: 1) prior audit; 2) judicial precedent; 3) industry practice; or 4) other reasonable basis. Reasonable basis requirement is to be liberally construed.

II. THE CONSEQUENCES OF WORKER MISCLASSIFICATION

A. Federal Tax Liabilities – If an employer misclassifies a worker as an independent contractor, the tax consequences can include substantial interest and penalties in addition to the principal amounts of the tax.

1. Section 3509 – Failure to Withhold. If an employer fails to deduct and withhold, then the employer is liable for:

a. 1.5% of wages paid to employees.

b. 40% of employee's share of FICA (Social Security tax).

c. 100% of employer's share of FICA.

d. 100% of federal unemployment tax.

e. NOTE: If employer fails to file 1099-MISC and other reports, the amounts in a. and b., above, are doubled. Also, if an employer intentionally disregards the reporting rules, the IRS will attempt to collect 20% of wages paid to employees and 100% of the FICA due, both the employer's and employee's shares.

2. Failure to Pay. 0.5% of unpaid tax liability for each month up to 25% of total tax liability.

3. Penalties for Failure to File W-2s or 1099s:

   a. $50 for each W-2 employer failed to file.

   b. Between $50 and $550 for each 1099 employer failed to file. NOTE: Different upper limits will apply depending on the tax year the failure occurred in.

4. Section 7202. Any person who willfully fails to collect, account for, and pay over any tax shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution.

B. State Tax Liabilities.

1. MCL § 205.23 imposes interest and the following penalties for failure to pay:

   a. If due to negligence, greater of $10 or 10% of unpaid tax.

   b. If due to intentional disregard of the law, greater of $25 or 25% of unpaid tax.

   c. If due to fraudulent intent to evade tax, 100% of unpaid tax.

C. How do misclassification issues arise?

1. Routine audit of employer's W-2s or 1099s.

2. Worker receives 1099 and fails to pay any income taxes.

3. Worker applies for unemployment or Social Security benefits.

4. Worker that is misclassified contacts IRS or other state or federal agency.

D. To avoid misclassification issues, employers should:

1. Determine whether worker classifies as a "statutory employee" under FITW, FICA, and FUTA statutes.

2. Analyze the worker's proper classification under the Three-Factor Test.

3. Determine whether Section 530 relief is available.

III. LATEST DEVELOPMENTS IN WORKER CLASSIFICATION CASES

A. Gig Economy – A labor market characterized by the prevalence of short-term contracts or freelance work as opposed to permanent jobs.

B. By their nature, workers in gig economy will be mostly classified as independent contractors. Examples are Uber drivers, delivery drivers for Grubhub, movers for Bellhops, babysitters on Care.com.

C. Uber and Lyft drivers are engaged as independent contractors. In Uber's IPO filings, it stated that its drivers are properly classified as independent contractors because:

1. Drivers can choose whether, when, and where to provide services.

2. Drivers are free to provide services for Uber's competitors.

3. Drivers provide their own vehicle to perform services.

D. Certain states like California and New Jersey are examining and confronting worker classification issues in the gig economy.

1. *Dynamex Operations West, Inc. v. Superior Court of Los Angeles*.

a. The California Supreme Court examined the issue of whether truck drivers were properly classified as employees or independent contractors.

b. The Court applied the ABC Test, under which a worker will be deemed an employee unless:

i. The worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact.

ii. The worker performs work that is outside the usual course of the hiring entity's business.

iii. The worker is customarily engaged in an independently established trade, occupation or business of the same nature as the work performed.

c. The Court found that the employer retained sufficient control over the drivers, that the drivers performed work that was central to the employer's business, and that the drivers were not customarily engaged in the type of work being performed outside of their role with the employer. As such, the drivers were deemed employees and not contractors.

d. Ninth Circuit Court of Appeals issued opinion on May 2, 2019, that would make the *Dynamex* standard for worker classification be retroactively applicable.

2. CA Assembly Bill 5 makes the ABC Test used in *Dynamex* mandatory for worker classification in California. It does, however, exempt a number of professions, like doctors, dentists, lawyers, architects, accountants, engineers, insurance agents, investment advisers, direct sellers, real estate agents, hairstylists and barbers who rent booths at salons, as well as marketers and human-resources professionals.

3. Lawsuits have been filed in New Jersey, New York, and Massachusetts by Uber and Lyft drivers arguing they have been misclassified as independent contractors.

E. DOL Opinion Letter (FLSA2019-6).

1. Letter arose from request for determination on service providers in "gig" economy like Uber and Lyft.

2. Uber and Lyft provide a virtual marketplace, whereby the company acts as a referral business and links the drivers to new business opportunities. Therefore, the drivers are best classified as independent contractors.

3. Drivers have virtually complete control of their cars, work schedules, and log-in locations, together with their freedom to work for competitors.