PUBLICATION

Worker Reclassification: Potentially Dire Consequences When Converting to Employee Status

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In prior Alerts, we have addressed both the IRS' employment tax audit initiative that is currently underway and the worker classification issues that will play a key role in those audits. Because any company having service providers (regardless of size or industry) is an audit candidate, every such company should consider conducting a self-examination regarding worker classification. If classification issues are identified in the self-examination, the company should consider taking certain steps, possibly including either a reclassification of the individual or a change in the facts and circumstances under which such individual provides services to the company.

The perils are generally known in those situations where the service provider is treated as an employee by the company and then converted to an independent contractor. The conversion, whether voluntary or required, of a service provider treated as an independent contractor to an employee status may be equally perilous. This Alert will discuss the circumstances, risks and consequences of such a conversion to an employee status.

Tax Reporting and Withholding Issues

How the Misclassification Comes to Light. There are numerous ways in which a company will discover or be told that its service providers who have been treated as independent contractors are more appropriately classified as employees. For instance, the company may learn of this misclassification through self-examination or other internal inquiry. Further, the IRS can assert a required change to the company as a result of an audit in which the classification issue is addressed.

Apart from such self-examinations or IRS audits, disgruntled workers can raise the issue. For example, if a worker is not happy with paying the full self-employment taxes or with being denied participation in employee benefit programs, that worker may challenge their status in discussions with the company. Where those discussions do not resolve the issue, the disgruntled worker may ask the IRS to intervene. If the IRS concludes that the worker is not properly classified as an employee, the Service may expand its review to include the company's entire workforce for other instances of misclassification.

Similarly, an unhappy worker may file a complaint with the Department of Labor's Employee Benefit Security Administration (DOL/EBSA) regarding issues which may arise under the Employee Retirement Income Security Act of 1974, as amended (ERISA), as discussed below. The IRS and DOL/EBSA share information, so an issue arising with either agency may ultimately result in audits or other actions by both agencies.

Lastly, but very importantly, state revenue and workforce agencies can also become involved, either through audits or worker complaints.

What the Company Can Do. As discussed in our March 9, 2010 Alert, proper worker classification is a fact and circumstance determination. In some cases, a change in one factor can make the difference between an individual being considered either an employee or an independent contractor.

1. Modify the Circumstances. Since the consequences of improper classification can be dramatic, a company may prefer not simply to change the classification of a worker, but rather to modify prospectively the facts and circumstances, to support either retention of the existing classification or a change in classification. For example, decreasing the types or levels of required job reporting may be enough of a changed circumstance to support the continued independent contractor classification. On the other hand, if the worker should be classified as an employee given all the facts and circumstances, then to help defend the prior classification as an independent contractor and highlight the reason for the change in classification, the company may wish, for example, to prospectively increase the types and/or levels of required reporting.
2. Voluntary Tax Contributions. Other options may also be available to a company faced with reclassifying an independent contractor as an employee. For example, if a company becomes aware of a classification defect before an IRS audit, that company may consider voluntarily correcting any income tax reporting and withholding problems. Under this approach, the company must revise Forms 1099 and W-2 for the misclassified workers and, where necessary, pay back taxes for the years of correction. The company will usually be eligible for Internal Revenue Code (the Code) Section 3509 reduced assessment rates for employment taxes, provided that the failures were unintentional.
3. Section 530 Relief. A further option, dependent upon the particular facts, may be to continue the independent contractor classification and, in the event of an audit which results in retroactive status as an employee, argue that the company is entitled to relief under Section 530 of the Code. Section 530 relief is significant when applicable, as it can absolve the company of all back employment taxes due to misclassification. However, the relief is only available on audit, and only if the company has a reasonable basis for the independent contractor classification. A reasonable basis is normally based upon case law, published IRS rulings, prior audit or long-standing industry practice.

Proposed Developments. Companies should be aware of certain legislative and administrative developments which are proposed.

4. Legislation. Rules and options may change for companies as a result of legislation currently proposed both in the U.S. Senate and House of Representatives. The proposed Employee Misclassification Prevention Act (S. 3254; H.R. 5107) would require the company to keep specific records for all workers, whether classified as employees or independent contractors, with required notices to each worker regarding their status. A worker would be presumed to be an employee if these requirements are not met. If a worker is misclassified as an independent contractor or the employer does not maintain proper records and issue notices, the employer would face civil penalties under this proposed act of up to $1,100 per employee, or $5,000 per employee for repeat or willful violations. This proposed legislation also contains audit provisions, including a requirement that DOL/EBSA perform targeted audits of industries which are considered to be prone to worker classification issues.
5. Tax “Transparency”. Further, the IRS revealed in Announcement 2010-9 that it intends to improve “transparency” regarding business tax issues by requiring a new schedule to be attached to many business federal income tax returns which would disclose "uncertain tax positions." Whether an uncertain worker classification issue will be one of the types of disclosure issues required by this new schedule is not yet known. However, this transparency initiative has not been finalized and the Service is considering public comments regarding various aspects of this proposal.

Employee Benefits and ERISA

How the Issue Arises. In addition to tax reporting and withholding issues which can arise regarding worker classification, issues regarding benefit plans and benefit liabilities can also arise. The economic implications for benefit responsibility have the potential to far exceed any ultimate tax withholding liabilities.

ERISA Benefits. When workers are reclassified or employee status is otherwise raised as an issue, the question of employer liability for current and prior benefits is often raised. For benefits which are subject to ERISA, such as participation in retirement plans, medical and dental coverage, life insurance, long-term disability coverage, etc., worker complaints challenging exclusion from coverage may be raised with DOL/EBSA, which aggressively acts on behalf of workers. In these cases, the workers may obtain active DOL/EBSA representation for their ERISA claims, at little or no personal expense. For example, DOL/EBSA sued Time Warner for denying pension and health plan coverage to individuals who Time Warner considered to be independent contractors. *Herman, Sec'ty. U. S. Dept. of Labor v. Time Warner* (New York Federal District Court, 1998). Even if DOL/EBSA does not sue the employer, the workers may file their own lawsuit, as occurred when misclassified programmers sued Microsoft, resulting in a reported $97 million settlement. Vizcaino v. Microsoft (Ninth Circuit Court of Appeals, 1996).

Fiduciary Duty and Plan Qualification Issues. In addition to claims raised by reclassified (or simply misclassified) workers for retroactive benefits, the DOL/ESBA may assert a breach of fiduciary duty for improperly including or excluding employees from ERISA plans, and the IRS may separately challenge a plan's tax-qualified status. For example, for certain types of benefit plans (retirement or Code Section 125), to maintain a tax-qualified status only an employee or a “leased employee” as defined in Code Section 414(n) is permitted to participate, and tax-qualified status is technically lost if any independent contractor or other leased individual participates. If tax-qualified status of a retirement plan is lost, all vested benefits and the trust are taxable immediately, the accounts cannot be rolled to IRAs, and corporate deductions for contributions in prior years can be reversed.

What the Company can do. As evident from the foregoing, significant penalties and other costs may be required to correct the results of worker misclassification. However, at least for retirement plans, if the problem and a proposed correction are submitted to the IRS voluntarily before notice of an audit, a lesser penalty can be applied -- but a full correction will still be required. In limited circumstances, a full “self correction” without payment of an IRS penalty or active IRS involvement is possible. A correction sometimes involves significant employer contributions to the plan, in addition to the penalties and/or excise taxes payable to the IRS. The DOL/EBSA has a similar voluntary correction program for addressing certain fiduciary breaches, though issues arising from misclassification will be addressed only at the discretion of DOL/EBSA.

Health Care Reform Act. Additional problems may arise under the new health reform legislation. Issues remain to be resolved through regulatory guidance which may significantly affect the liability of a company in situations involving worker misclassification. With effective dates for penalties beginning in 2014, hopefully, regulatory guidance will be issued well in advance.

Summary

Proper worker classification, whether as an employees or independent contractor, remains very important. If an internal self-examination concludes that workers may have been misclassified, then the various possible legal, tax, benefit plan, and fiduciary violations must be considered to adequately assess the risks, exposures, and available courses of action. When a worker is reclassified, the new facts and circumstances should be sufficiently different from those previously existing so as to not only support the reclassification, but also, hopefully, reduce the company's exposure for past taxes, benefits and similar responsibilities.

With careful planning and assistance from professionals familiar with these employment, labor, tax and other issues, companies can proceed through the reclassification process and be well prepared to defend their positions if later challenged by the IRS, DOL/EBSA or the workers.

Should your company wish to discuss any of the issues addressed in this or prior Alerts regarding worker classification, please contact any of the attorneys in the Firm's Tax Department.