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# Preventing and Managing Independent Contractor Risks

Innovative Tax and Employment Law Strategies to Address  
Increasing Government and Private Enforcement Threats

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## Overview of Presentation

- Tax and employment law implications for independent contractor classification
- Recent enforcement activity
- Consequences of misclassification
- Factors in evaluating worker classification
- Implementing a successful independent contractor compliance program

# Implications of Independent Contractor Classification

## From an Employment Perspective

- Companies are not required to provide government-mandated or employer-provided benefits to independent contractors
- Companies are not required to comply with Federal employment or workforce protection laws with respect to independent contractors
- Independent contractors often use their own equipment and facilities
- Independent contractors cannot organize and form a union

## From a Tax Perspective

- Companies are not required to pay FICA or FUTA taxes on payments made to independent contractors
- Companies are not required to withhold taxes from independent contractors
- Companies do not pay state unemployment taxes
- Independent contractors pay SECA taxes rather than FICA taxes
- Independent contractors do not pay unemployment taxes

## Recent Increase in Tax Enforcement Activity

- The IRS's Employment Tax Initiative
- Proposed changes in Federal tax laws to mandate reclassifications
- Increased enforcement activity by state taxing authorities

## Section 530 Safe Harbor for Tax Law

- Provides retroactive and prospective relief to taxpayer classifying workers as independent contractors
  - However, is currently being reevaluated by Congress
- Taxpayer must satisfy three requirements:
  - Taxpayer must have treated all workers in a similar position consistently as independent contractors;
  - Taxpayer must have filed all required Federal tax returns; and
  - Taxpayer must have had a reasonable basis for classifying workers as independent contractors

## Section 530 Safe Harbor for Tax Law (cont.)

- To establish Reasonable Basis, taxpayers must have “reasonably relied” on:
  - Judicial precedent;
  - Past audit in which the IRS accepted the classification;
  - Industry standard; or
  - Another reasonable basis
- Industry standard is the most commonly relied upon reasonable basis:
  - A “significant segment” of the industry must classify workers in a similar manner
  - 25% of the industry (excluding taxpayer) is significant
  - Geographic bounds are not defined
- Reliance must exist at the time of classification
- Burden of proof shifts to the IRS if taxpayer establishes a *prima facie* case for reasonable basis and has fully cooperated with the IRS

# Recent Proposed Legislation

- President Obama's Tax Proposal in 2011 Budget
  - Eliminates prospective relief under the Safe Harbor
  - Provides for reduced tax rates only for voluntary reclassifications
  - Instructs IRS to issue guidance that will provide narrowly defined safe harbors
  - Allows workers to require companies to withhold taxes
  - Requires notice to independent contractors
  - Permits cooperation between DOL and IRS
- Proposed Taxpayer Responsibility, Accountability and Consistency Act of 2009 (S.2882 and H.R.3408)
  - Eliminates prospective relief for misclassified workers
  - Eliminates industry practice as a reasonable basis for classification
  - Places the burden of proof on the taxpayer
  - Requires notification of the DOL

## Other Recent Enforcement Activity

- GAO Report
- Obama/DOL “Misclassification Initiative”
- EEOC budget increase
- State legislatures, Attorneys General, task forces



## Ripple Effects of Worker Reclassification

- Investigation by one government agency may trigger investigations by other agencies
- Federal and state agencies share information
- Publicity may lead to tax or employment inquiries
- Audit of an individual worker can lead to audit of the company that hired the worker

# Potential Consequences of an Erroneous Classification

- Liability for additional Federal or state taxes, interest and penalties
- Individual and class-action lawsuits by allegedly misclassified workers
  - Wages (including minimum and OT wages, and missed meal period pay)
  - Employer-provided benefits (*e.g.*, vacation pay, sick pay, medical benefits, life insurance, disability insurance, etc.)
  - Government-mandated benefits (*e.g.*, unemployment insurance and workers' compensation benefits)
- Governmental civil and criminal actions
- Attorneys' fees, expert fees and court costs
- Negative publicity

*The consequences can be significant*

## Lessons from the FedExperience

- In 1999, current and former FedEx drivers filed a class-action lawsuit in CA claiming that they were employees rather than independent contractors
  - CA Court of Appeal ruled in 2007 that FedEx Ground Package Delivery System, Inc. had misclassified 203 California drivers as independent contractors; CA Supreme Court denied review
  - Resulted in \$27 million stipulated judgment in 2008: \$14.5 million in damages and \$12.5 million in attorneys' fees (\$133,000/worker)
- In 2005, driver misclassification actions were filed in 31 states involving 27,000 drivers; consolidated into multi-district action in N.D. Indiana
- In 2007, IRS sought reclassification and \$319 million in taxes and penalties; reduced its assessment to \$14 million and withdrew adjustment in 2009
- In 2009, AGs in 8 states sent letter to FedEx expressing concern regarding its driver classification; New York, New Jersey and Montana have announced intent to sue FedEx for state labor law violations

## Other Noteworthy Misclassification Cases

- Huggins – *respondeat superior*
- Microsoft - paid nearly \$100 million to settle a class action by workers who sued to recover various Microsoft employee benefits. That action was filed following an IRS audit.
- Somers - Massachusetts' highest court held that the state's independent contractor law is a strict liability statute and the measure of damages is the value of the wages and benefits an individual would have been entitled to receive had he been properly classified as an employee.

# Evaluation of Worker Classification

- The determination is a facts-and-circumstances test
- Behavioral Controls
  - Does the company control the manner and means of the work?
  - Does the company provide training and instructions to the worker?
- Financial Controls
  - Does the company pay the worker based on time worked or on a project-by-project basis?
  - Can the worker earn a profit or incur a loss?
- The Relationship of the Parties
  - Was the worker hired for a specific project or indefinitely?
  - What does the worker understand his/her status to be?

## Focus on *Your* Facts and Circumstances

- Different courts and government agencies apply different tests to evaluate worker classification
- However, all of the tests use control over the worker as a core theme
- The main focus should be on the facts and circumstances that support your position

# High-Risk Classifications

- Consultants
  - Individuals who are performing duties that are part of the company's regular business
  - Individuals performing functions as managers and officers (especially at newly formed businesses)
  - Former employees performing duties that are part of the company's regular business
- Drivers
- Sales positions
- Company officers
- Professional positions
- Secretaries

# Key Steps to a Successful Independent Contractor Compliance Program

- Identify independent contractor classification risks
  - Workers in high-risk categories
  - Similar positions held by employees
- Understand the needs and perspective of business units
- Develop compliance solutions that will work with business units
  - *E.g.*, classification of sales workers driven by avoidance of business expense reimbursements
- Use company culture and resources to implement a compliance program



## Understand Your Audience: Assessing Independent Contractor Classification from the Perspective of Business Units

- In-person visit; meet with worker, co-workers and managers to assess propriety of classification
- Develop interview script to assess classification
  - “Smart interviews” – specific questions re control over the work, nature of work, location and timing of work, nature of compensation (see Reference Materials)
- Use of counsel to conduct interviews
- Schedule check-ups of classification
- Consider terminology – *e.g.*, review, not audit

# Increasing Awareness of Independent Contractor Classification in Business Unit

- Training
  - Manager awareness that mere classification not dispositive
- Consider impact of assigning employment costs as business-unit expense
- Create a culture of compliance
- Train HR/management to identify issues regarding independent contractor classification and escalate to legal
- Create central controls over hiring, promotion, compensation, termination, and independent contractor agreements

## Evidence in Evaluating Worker Classification

- Important to consider the evidence the government and/or workers will solicit in the event of a challenge to classification
  - Written materials (*i.e.*, memoranda, emails) that define or describe the workers' responsibility
  - Written contracts, handbooks and codes of conduct
  - Instructions, training materials and evaluations
  - Company promotional materials and websites
  - Related materials for workers classified as employees
  - Interviews and/or depositions of workers and their supervisors
- Any communication can be used as evidence

# Best Practices for Mitigating Independent Contractor Risks

- Understand classification rules in play
- Understand industry standard (also impacts Safe Harbor)
- Develop the facts necessary to support the classification at the time of classification
- Review independent contractor agreements to confirm they support that relationship
  - Existence of agreement is not determinative, but courts and administrative agencies will consider the existence of the agreement among other factors
- Consider impact of reclassification and pending litigation (*e.g.*, may be beneficial to settle case if unfavorable ruling could lead to avalanche of other claims)

# Settlement Options for Tax Claims

- Request a Technical Advice Memorandum from IRS Counsel (Rev. Proc. 2010-2)
  - Can be used to resolve the application of the law to the taxpayer's facts during audit
  - Generally applies to a continuing action until it is withdrawn or modified
- Early Referral To Appeals (Rev. Proc. 99-28)
  - Allows taxpayers to request referral to Appeals before the 30-day letter is issued in order to resolve a case more quickly. *See* § 4.03(1)
- Fast Track Settlement (Rev. Proc. 2003-40)
  - Allows taxpayers and LMSB to mediate their dispute with an Appeals Official acting as a neutral party
- Closing Agreement (I.R.C. § 7121)
  - Final and conclusive absent fraud, malfeasance or misrepresentation regarding a material fact
  - Appeals can enter into a Closing Agreement based upon a settlement
  - Appeals has discretion to include the current year and guidance regarding future years, but will retain the right to audit future years for compliance with such guidance

## The Global Perspective

- The classification of employee versus independent contractor is not an exclusively US issue
- Comparable questions arise in other jurisdictions
- For our clients with international operations, we will be offering an international webinar in the near future with participants from Germany, France, and the United Kingdom

# REFERENCE MATERIALS

## Key Factors to Evaluate Control for Both Tax and Employment Law Purposes

- Control over the means by which the work is performed
- Nature of the worker's services
- Location and timing of the work
- Nature of the compensation for work
- Nature of the relationship and parties' intent



# Questions to Consider in Evaluating Classification

- Control over the means by which the work is performed:
  - Does the worker have the right to control the manner and means of completing the work?
  - Does the worker have the right to use personal judgment and initiative in performing the work?
  - Does the company supervise the worker?
  - Does the company provide training?
  - Does the company provide instructions?
  - Does the company have an evaluation process for workers?
  - Does the company have a code of conduct (*i.e.*, dress code)?
  - Does the company actually exercise control?

# Questions To Consider When Deciding On Worker Classification (cont.)

- Independence of Worker

- Is the worker engaged in an independent business that is separate from the company's business?
- Does the worker perform services for businesses other than the company's business?
- Is the worker in business for him/herself?
- Does the worker claim to be an independent contractor?
- Does the worker have the right to hire, supervise and/or terminate those working for him or her? Does the company have the right to hire, supervise and/or terminate such workers?
- Does the worker have the authority to supervise the company's employees?

# Questions to Consider in Evaluating Classification (cont.)

- Nature of the Worker's Services:
  - Are the services performed an integral part of the company's regular business?
  - Do other workers classified as employees perform similar services?
  - Was similar work previously performed by employees?
  - Does the worker have a high degree of specialized skill?
  - Does the worker have a license or certificate?
  - Does the worker provide services to other businesses?
  - Does the worker hire his/her own employees?
  - Is the worker performing work no other employee can perform?

# Questions to Consider in Evaluating Classification (cont.)

- Location and Timing of the Work
  - Does the company schedule the time and location of the work?
  - Is there a period of time in which the work must be performed?
  - Where does the worker perform the services?
  - Is the worker required to come to the company's premises?  
How often?
  - Does the worker use his/her own equipment or supplies?

# Questions to Consider in Evaluating Classification (cont.)

- Nature of the Compensation

- Is the worker paid by the job or by the time worked?
- Does the worker bill the employer for services through invoices?
- Does the employer charge the amounts incurred for the worker's services to payroll or to other accounts?
- Is the worker listed on the employer's payroll?
- Does the company pay taxes or withhold taxes for the worker?
- Does the company offer any government-mandated or employer-provided benefits?
- Does the worker pay his/her own expenses?
- Can the worker earn a profit or incur a loss?

## Questions to Consider in Evaluating Classification (cont.)

- Nature of the Relationship & Parties' Intent:
  - Was the worker hired for a specific project or indefinitely?
  - Can the worker's services be terminated at will?
  - What does the worker understand his/her status to be?
  - Is there a written contract?
    - If so, is it clear that the worker controls manner and means of completing the work and company only interested in result of work?
  - How was the worker presented to customers?
  - Do other companies in the industry treat similar workers as employees or independent contractors?

## I.R.S. Revenue Ruling 87-41

- Revenue Ruling 87-41 sets out a 20-factor test that the IRS uses when determining whether a worker is an employee
- These factors fall into three broad categories:
  - Behavioral Controls (*e.g.*, whether the company has the right to control details of the worker's work, whether training is provided, whether the work is performed on the company's premises, whether the worker can work for competitors);
  - Financial Controls (*e.g.*, whether payment is based on time worked or commission, whether the company pays for the worker's tools and other expenses, whether the worker bears the risk of profit or loss); and
  - Relationship of the Parties (*e.g.*, the intent of the parties, the integration of the worker's service into business operations, the duration of the relationship, the right to terminate the relationship)
- Helpful guidance on the application of these factors can be found in *Independent Contractor or Employee?: Training Manual*  
[www.irs.gov/pub/irs-utl.emporind.pdf](http://www.irs.gov/pub/irs-utl.emporind.pdf)

# Classification of Corporate Officers for Tax Law

- Corporate Officers: Treated as employees for Federal income tax obligations
  - Corporate officers are treated as employees for purposes of FICA, FUTA, and withholding, even if they would not be employees under the common law test, unless:
    - The officer does not perform any services or performs only minor services;  
*and*
    - The officer is not entitled to receive, directly or indirectly, any remuneration
  - Loans, dividends, or other distributions may be treated as remuneration if they are actually compensation for services
  - A director of a corporation is not an employee for those services



# Classification of Statutory Employees for Tax Law

- For FICA and in some cases FUTA taxes (but not withholding obligations), workers in the following occupational groups may be treated as employees even though they are not common law employees. I.R.C. §§ 3121(a)(10), (d)(3), 3306(i).
  - Agent-drivers or commissioner-drivers
  - Full-time life insurance salesmen (FICA only)
  - Home workers paid more than \$100 in cash during the year (FICA only)
  - Traveling or city salesmen
- Workers in these categories are statutorily treated as employees *only* if:
  - By contract, substantially all of such services are to be performed personally by the workers, *and*
  - The workers do not have a substantial investment in the facilities used in connection with the performance of such services (other than transportation), *and*
  - The services are part of a continuing relationship with the person for whom the services are performed

# Classification of Statutory Non-Employees for Tax Law

- By statute, some workers are not treated as employees for employment tax purposes, even if they would be treated as employees under the common law standards, such as qualifying real estate agents, direct sellers, and companion sitters/babysitters. I.R.C. §§ 3508, 3506
- Real estate agents and direct seller are considered statutory non-employees if:
  - Substantially all of the worker’s remuneration for services is directly related to sales or other output rather than to number of hours worked,
  - A written contract exists between the worker and the business that states that the worker will not be treated as an employee for Federal tax purposes,
  - With respect to real estate agents, the worker is licensed, and
  - With respect to direct sellers, the worker sells consumer products but does not work in a permanent retail establishment
- Statutory non-employees are subject to self-employment tax under the Self-Employment Contributions Act (“SECA”)

## Treatment of Workers Under Different Employment Taxes

| Type of Worker                                    | Income Tax Withholding | FICA   | FUTA    |
|---|------------------------|--|---------|
| Common Law Employee                               | Withhold               | Taxable  | Taxable |
| Corporate Officer                                 | Withhold               | Taxable  | Taxable |
| Statutory Employees                               |                        |  |         |
| Agent and commission driver                       | No Withholding         | Taxable  | Taxable |
| Full-time life insurance salesperson              | No Withholding         | Taxable  | Exempt  |
| Full-time traveling or city salesperson           | No Withholding         | Taxable  | Taxable |
| Home worker                                       | No Withholding         | Taxable if paid \$100 or more in cash during the calendar year | Exempt  |
| Section 218 Employee                              | Withhold               | Taxable  | Exempt  |
| Statutory Non-Employees                           |                        |  |         |
| Qualified real estate agent – I.R.C. § 3508(b)(1) | No Withholding         | Exempt*  | Exempt  |
| Direct seller – I.R.C. § 3508(b)(2)               | No Withholding         | Exempt*  | Exempt  |
| Companion sitter – I.R.C. § 3506                  | No Withholding         | Exempt*  | Exempt  |
| Section 530 Employee                              | No Withholding         | Exempt**   | Exempt  |

\*However, statutory non-employees are subject to SECA.

\*\* Employees owe employee share of FICA.