Independent Contractor vs. Employee: Tax vs. Labor Law

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The “Parade of Horribles”

What can happen when a worker formerly classified as an independent contractor is reclassified as an employee?

FLSA Minimum Wage & Overtime Requirements

- Unless an exemption applies, FLSA requires that workers classified as "employees" be paid at least the federal minimum wage ($7.25) for all hours worked.
- Additionally, "employees" must be paid overtime pay of not less than time and one-half the regular rate of pay for all hours worked over 40 hours in a workweek.
- FLSA Section 13(a)(1) contains some exemptions from these requirements[1]:
  - ❑Employees employed as bona fide executive, administrative, or professional employees
  - ❑Computer Employees
  - ❑Outside Sales Employees

[1]Fair Labor Standards Act of 1938 § 13(a)(1); *see Fact Sheet #17A: Exemption for Executive, Administrative, Professional, Computer & Outside Sales Employees Under the Fair Labor Standards Act (FLSA),* U.S. DEPARTMENT OF LABOR, WAGE & HOUR DIVISION (Rev. September 2019) for more information on qualification requirements for 13(a)(1) exemptions.

State Minimum Wage & Overtime Requirements

- Minimum wage varies from state to state, and sometimes from city to city
- Typically time-and-a-half when over 40 hours in any week
- Mandatory paid breaks each day
- Lack of time records may leave employer unable to challenge hours claimed by employee
- At termination, final paycheck due quickly. For example, Oregon requires all compensation owed to be paid by end of next business day. Failure causes normal rate of pay to accrue until earlier of payment or 30 days, as a penalty

Potential for Class Action Lawsuits

- Misclassifying workers as independent contractors can expose employers to potential class action lawsuits, often resulting in millions of dollars in liability when misclassified workers sue to recover the value of the compensation and benefits they were denied.
- For example, in 2015 FedEx settled a class action lawsuit for $228 million after the 9th Circuit found that it had mistakenly classified 2,300 truck drivers as independent contractors[2].
  - By the end of 2016, FedEx had paid more than $500 million in misclassification settlement payments.

[2]*See Alexander v. FedEx Ground Package System, Inc.*, 765 F.3d 981 (2014).

Employer Liability for Federal Payroll Taxes, Social Security, and Medicare Taxes

- Employers are required to withhold and pay taxes on federal payroll, Social Security, and Medicare taxes for all workers classified as employees[3].
- However, workers classified as independent contractors are responsible for their own federal payroll taxes, also known as self-employment taxes[4].
- When an employee is misclassified as an independent contractor, the employer may fail to withhold and pay the employer's portion of payroll, Social Security, and Medicare taxes for the misclassified worker.
  - If the employer does not fall within the Section 530 safe harbor, they may be held liable for employment taxes with regard to these misclassified workers[5].

[3] *See Understanding Employment Taxes,* INTERNAL REVENUE SERVICE (Rev. May 30, 2024).
[4] *See Forms and Associated Taxes for Independent Contractors,* INTERNAL REVENUE SERVICE (Rev. May 23, 2024).
[5] *See* IRS News Release, *Payments to Independent Contractors*, INTERNAL REVENUE SERVICE (August 2015).

Employer Liability for State Payroll Taxes

- Obligations and penalties are similar as for federal taxes
- But note that there can be many more types of taxes and withholding obligations at the state and local level

Penalties for Failure to Deposit Payroll Taxes

- When an employee is misclassified as an independent contractor, federal and local governments lose out on tax and payroll revenue from these misclassified workers.
  - Accordingly, penalties can be imposed on employers for failure to deposit payroll taxes for misclassified employees.
- The IRS imposes a Failure to Deposit Penalty on employers who fail to make correct deposits with regard to payroll, Social Security and Medicare taxes, and federal unemployment taxes[6].
- The Failure to Deposit Penalty ranges from 2%-10% of the unpaid deposit (with interest) depending on the lateness of the deposit[7].
  - Where a delinquency notice has been given to the employer, the penalty will rise to 15% of the unpaid deposit[8].

[6]*See Failure to Deposit Penalty,* INTERNAL REVENUE SERVICE (Rev. February 27, 2024).
[7]I.R.C. § 6656(b)(1)(A).
[8]§ 6656(b)(1)(B).

Back Payments for Missed Benefits

- Misclassified workers can file complaints with the Department of Labor or with their state to claim employee benefits that were missed out on during the period of misclassification[9].
- If these claims are validated, employers may be on the hook for back payments with regard to benefits normally afforded to employees, including 401(k), health care, equity compensation, paid time off, and family and medical leave[10]
  - Employers may seek to mitigate these risks with plan language that denies eligibility for any workers classified or treated by the employer as an independent contractor, even if later reclassified as an employee
  - But reclassified workers may seek to recover the value of lost benefits, even if ineligible for cover under the benefit plan itself[10A]

[9] *See Compliance Bulletin,* SULLIVAN BENEFITS (2024).
[10] *See Top 5 Employee Misclassification Penalties to Avoid,* MBO PARTNERS (May 17, 2024); *Vizcaino v. Microsoft*, 120 F.3d 1006 (9th Cir. 1997).
[10A] *See, e.g., Gray v. Fedex Ground Package Sys., Inc.*, 2014 WL 4386741 (E.D. Mo. 2014). *But see Remington v. J.B. Hunt Transp., Inc.*, 2017 WL 1552316 (D. Mass. 2017).

Fines and Penalties for Misclassification

- In addition to back payments, employers may also be subject to additional fines and penalties for missed benefits.
- For employers subject to the ACA employer shared responsibility requirements (generally employers with 50 or more FTEs), failure to property classify workers can result in penalties under:
  - Code Section 4980H(a) or (b), due to failure to offer coverage to a worker who is a “full-time employee”’ within the meaning of Section 4980H
  - Code Sections 6721 and 6722, due to failure to file and furnish Form 1095-C to workers who qualified as “full-time employees”
- Reclassification may cause problems with nondiscrimination and coverage testing under benefit plans, that can lead to excise taxes or additional contribution obligations

Failure to Keep I-9s

- U.S. Citizenship and Immigration Services (USCIS) holds that independent contractors are one of the categories of workers for which employers are not required to complete and retain I-9 documentation[11].
- However, employers must complete and retain I-9 documentation with respect to all workers who are classified as employees for as long as the employee continues to work for the employer and for a specific period of time after employment ends.[12]
- This can lead to potential issues in the event of the reclassification of a worker from independent contractor to employee, as the employer may be missing important I-9 documentation authorizing these misclassified employees to work in the United States. The employer will be required to complete and retain an I-9, with the conversion date as the "start" of employment. Because the employee must participate in the I-9 process and provide documentation evidencing status and ability to work legally, employers should allow ample time for this process to be completed.
- A failure to complete and retain I-9 documentation for these misclassified employees may lead to civil fines for the employer[13].

[11] *See I-9 Central: Exceptions,* U.S. CITIZENSHIP AND IMMIGRATION SERVICES (Rev. September 27, 2022).
[12] *See Handbook for Employers: 10.0 Retaining Form I-9,* U.S. CITIZENSHIP AND IMMIGRATION SERVICES (Rev. July 18, 2023).
[13] *See I-9 Central: Penalties,* U.S. CITIZENSHIP AND IMMIGRATION SERVICES (Rev. July 10, 2020).

Denial of Trade or Business Deductions at the Employee Level

- Workers who are misclassified may not be able to properly deduct their work expenses as trade or business expenses[14].
- As a result, misclassified workers may come up short on their actual tax liability.
- This can lead to several negative outcomes at the individual level, including[15]:
  - ❑Exposure to unpaid tax liability
  - ❑Tax penalties
  - ❑Interest

[14]*See, e.g.,* I.R.C. § 162.
[15]*See Accuracy-Related Penalty*, INTERNAL REVENUE SERVICE (Rev. February 14, 2024).

State Law Effects may differ

- For example, the Oregon statute provides (in relevant part):

“Independent contractor” means a person who provides services for remuneration and who, in the provision of the services:

(a) Is free from direction and control over the means and manner of providing the services, subject only to the right of the person for whom the services are provided to specify the desired results;

(b) Except as provided in subsection (4) of this section, is customarily engaged in an independently established business;

State Law Effects may differ: Oregon Statute Continued

A person is considered to be customarily engaged in an independently established business if any three of the following requirements are met:

(a) The person maintains a business location:

(A) That is separate from the business or work location of the person for whom the services are provided; or

(B) That is in a portion of the person’s residence and that portion is used primarily for the business.

(b) The person bears the risk of loss related to the business or the provision of services as shown by factors such as:

(A) The person enters into fixed-price contracts;

(B) The person is required to correct defective work;

(C) The person warrants the services provided; or

(D) The person negotiates indemnification agreements or purchases liability insurance, performance bonds or errors and omissions insurance.

(c) The person provides contracted services for two or more different persons within a 12-month period, or the person routinely engages in business advertising, solicitation or other marketing efforts reasonably calculated to obtain new contracts to provide similar services.

(d) The person makes a significant investment in the business, through means such as:

(A) Purchasing tools or equipment necessary to provide the services;

(B) Paying for the premises or facilities where the services are provided; or

(C) Paying for licenses, certificates or specialized training required to provide the services.

(e) The person has the authority to hire other persons to provide or to assist in providing the services and has the authority to fire those persons.

The Evolution of the Economic Reality Test

The Economic Reality Test: 1996 - Today

- In 1996, the IRS released guidelines that emphasized a control-based inquiry wherein the facts and circumstances of a worker's situation were all analyzed with the intent to determine the employer's right to direct and control a worker[21].
- Today, the new "Economic Reality Test" instead analyzes all facts and circumstances of a worker's situation to determine whether the worker is "economically dependent" on the employer[22].
- The Economic Reality Test is more robust than earlier regulatory guidance, providing for a flexible, factor-based inquiry which takes the totality of a worker's circumstances into consideration.
  - No more "ABC" test where a set list of factors must be present.

[21] *See Independent Contractor or Employee? Training Materials*, INTERNAL REVENUE SERVICE (October 30, 1996).
[22] *See Small Entity Compliance Guide,* U.S. DEPARTMENT OF LABOR, WAGE AND HOUR DIVISION (May 18, 2024).

FLSA's "Final Rule" 6-Factor Test

FLSA's 6-Factor "Economic Reality" Test

- Effective as of March 11, 2024, FLSA's "Final Rule" enumerates an economic reality test that looks to 6 factors for determining whether a worker is an employee or an independent contractor[23]:
  1) Opportunity for profit or loss dependent on managerial skill;
  2) Investments by the worker and the potential employer;
  3) Degree of permanence of the work relationship;
  4) Nature and degree of control;
  5) Extent to which the work performed is an integral part of the potential employer's business; and
  6) Skill and initiative.
- No one factor is dispositive; all circumstances of the relationship should be examined together.

[23] *Small Entity Compliance Guide,* U.S. DEPARTMENT OF LABOR, WAGE AND HOUR DIVISION (May 18, 2024).

The IRS 20-Factor Test

The IRS 20-Factor Test

- The IRS uses a 20-factor "right to control" test derived from common law doctrine to determine whether workers are independent contractors or employees[24].
- The 20 factors included in the IRS test include[25]:

- ❑ Level of instruction
- ❑ Amount of training
- ❑ Degree of business integration
- ❑ Extent of personal services
- ❑ Control of assistants
- ❑ Continuity of relationship
- ❑ Flexibility of schedule
- ❑ Demands for full-time work
- ❑ Need for on-site services
- ❑ Sequence of work
- ❑ Requirements for reports
- ❑ Method of payment
- ❑ Payment of business or travel expenses
- ❑ Provision of tools and materials
- ❑ Investment in facilities
- ❑ Realization of profit or loss
- ❑ Work for multiple companies
- ❑ Availability to public
- ❑ Control over discharge
- ❑ Right of termination

[24]*See Rev. Rul. 87-41,* 1987-1 C.B. 296 (1987).
[25]*Id.*; *Form SS-8: Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding,* IRS (Rev. December 2023).

The ERISA Common-Law Employee Test

ERISA Common-Law Employee Test

- In *Nationwide v. Darden*, 503 U.S. 318 (1992), the Supreme Court adopted a "common-law test" (general agency principles) for determining who qualifies as an "employee" under ERISA, considering the following 13 factors:

  - ❑ Hiring party's right to control the manner and means by which work is done
  - ❑ Skill required of the worker
  - ❑ Source of instrumentalities and tools
  - ❑ Location of the work
  - ❑ Duration of the relationship
  - ❑ Hiring party's right to assign additional work
  - ❑ Extent of worker's discretion over when and how long to work
  - ❑ Method of payment
  - ❑ Worker's role in hiring and paying assistants
  - ❑ Whether the work is part of the regular business of the hiring party
  - ❑ Whether the hiring party is in business
  - ❑ The provision of employee benefits
  - ❑ Tax treatment of the worker

- As with other similar tests, "all of the incidents of the relationship must be assessed and weighed with no one factor being decisive"

Overlap with the FLSA Final Rule

Overlap with FLSA Final Rule

- There are several commonalities among the FLSA 6-Factor test, the IRS 20-Factor test, and the ERISA common-law test, including:
  - Worker's opportunity for and realization of profits and losses
  - Worker investment in facilities and equipment
  - A continuing/permanent relationship between worker and employer
  - Integration of the worker's services to the activities of the company
  - Nature and degree of control
- These areas of overlap can be especially important to consider when analyzing whether to classify a worker as an employee or an independent contractor.

Where Do the Tests Diverge?

- May have more to do with how the factors are weighed and interpreted than with the factors themselves
- FLSA definition of employment ("suffer or permit to work") is recognized as potentially encompassing a broader group of workers than those who might qualify as employees under the traditional agency or common-law tests
  - An interpretation that favors finding employee status may be more appropriate when applying the FLSA test
- Per the DOL, "economic dependence," rather than control, is the "ultimate inquiry" for purposes of the FLSA
  - Is a worker, as a matter of economic reality, in business for themself?

How Does Status Under the FLSA Impact Status for Tax and Benefits Purposes?

- Strictly speaking, they are independent considerations
  - A worker could be an employee for FLSA purposes but not for purposes of the Internal Revenue Code or ERISA
- However, as a practical matter:
  - Reclassification under the FLSA might prompt reclassification analysis for other purposes as well
  - Employers proactively looking to properly classify workers for FLSA purposes may voluntarily choose to treat more workers as “employees” for all purposes

Section 530 Relief and Settlement Programs

What can we do to avoid falling prey to the “Parade of Horribles?”

Section 530 of the Revenue Act of 1978

- Section 530 is a relief provision that terminates a taxpayer's employment tax liability with respect to an individual not treated as an employee (including misclassified workers) if three requirements are met[16]:
  1) **Reporting Consistency:** the filing of all required federal tax returns on a basis consistent with an independent contractor classification;
  2) **Substantive Consistency:** treatment consistent with the treatment of workers in substantially similar positions; and
  3) **Reasonable Basis:** employer has a reasonable basis for treating the worker as an independent contractor.

[16]Revenue Act of 1978 § 530.

Section 530: Effect

- Section 530 was enacted to prevent the IRS from retroactively reclassifying workers as employees where employers had a reasonable basis for treating such workers as independent contractors and followed reporting requirements[17].
  - Therefore, compliance with the three Section 530 requirements allows employers to escape the "Parade of Horribles."
- Compliance with the Section 530 requirements also allows employers to escape the burden of demonstrating the appropriate status of their workers under either statutory provisions or common law rules[18].
  - This means that misclassification cases that would otherwise be limited to a factor-based inquiry now begin with attempts to obtain Section 530 relief.

[17]*See* IRS Publication 1976, *Do You Qualify for Relief Under Section 530?,* INTERNAL REVENUE SERVICE (Rev. January 2017).
[18]*See generally General. Investment Corp. v. United States*, 823 F.2d 337 (9th Cir. 1987).

Section 530 Settlement Programs

- **Classification Settlement Program (CSP)[19]**
  - An alternative to litigation; allows taxpayers and tax examiners to resolve worker classification cases as early in the administrative process as possible.
    - Eligibility varies based on type of case and prior case history.
  - CSP agreements are binding to both the IRS and the taxpayer for all future tax periods.
- **Voluntary Classification Settlement Program (VCSP)[20]**
  - Allows eligible taxpayers to voluntarily re-classify their workers as employees for employment tax purposes for all future periods.
  - Eligibility: any employer who currently treats workers as independent contractors or other nonemployees.
    - Must meet the requirements for the "Reporting Consistency" and "Substantive Consistency" prongs of the Section 530 test.
    - Cannot currently be under an employment tax audit or a Department of Labor audit.
  - If relief is granted, no penalties or interest is owed, but the taxpayer must pay 10% of the employment taxes that would have been paid for the most recently closed tax year.

[19] *See 4.23.6: Classification Settlement Program (CSP),* INTERNAL REVENUE SERVICE (Rev. February 13, 2024).
[20] *See Voluntary Classification Settlement Program (VCSP),* INTERNAL REVENUE SERVICE (Rev. October 5, 2023).

Relevant Code Sections: Reclassification

What sections of the IRC are triggered by a worker reclassification?

Relevant Code Sections

- IRC § 3509: Determines an employer's employment tax liability for a worker misclassification.
- IRC § 162: Governs trade or business expense deductions.
- IRC § 3102: Federal payroll tax rules.
- IRC § 3121: Statutory definition of an "employee;" certain employment tax exemptions.
- IRC § 3401(c): "Employees" to which income tax withholding procedures apply.
- IRC § 3402(d): Allows employers to receive credit for employment taxes already paid by misclassified employees.