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The Consequences of Misclassifying Workers

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Classifying workers as employees or independent contractors can be a difficult task, with each classification triggering different tax reporting and payment responsibilities. For example, employers are obligated to withhold employment taxes from their employees' pay, are liable for one-half of the Social Security tax due on employee compensation, must forward employment taxes to the government on a timely basis, and must file a W-2 with the IRS. Additionally, if workers are classified as employees, they must be included in employee benefit programs. For independent contractors, however, businesses are only required to submit Form 1099-MISC to the IRS for service payments over $600 made under a contract.

The IRS provides guidance for classifying workers as either employees or independent contractors, but Rev. Rul. 87-41 (1987-1 C.B. 296) is too vague to be administered on a consistent basis. Yet if an employer makes an error in classifications, it can be very costly. Even inadvertent misclassifications of an employee as an independent contractor may cause a business to be subject to the mandatory back-tax formula (IRC §3509) that can literally bankrupt the company. If an employee is classified as an independent contractor without a reasonable basis for doing so, the employer will be held liable for employment taxes for that worker based on the §3509 formula.

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Section 3509 states that the employer's tax liability due to misclassification of a worker is made up of two components: income tax withholding and employee Social Security taxes. The income tax withholding component is computed as 1.5% of the wages paid to the misclassified employee. The employee Social Security taxes are imposed at 20% of the amount that would have been subject to the Social Security tax. If the employer fails to file a Form 1099-MISC for an employee misclassified as an independent contractor, the income tax withholding liability increases to 3%, and the Social Security tax liability increases to 40%. Relief from the mandatory back tax is available if the misclassification was due to a reasonable cause. Relief requirements are met under IRC §530 if the employer had:

1. A *reasonable basis* for not treating the workers as employees,
2. Was *substantively consistent* in its treatment of the worker, and
3. *Consistently reported* payments made to workers.

Reasonable basis may be met in three ways. First, the employer reasonably relied on one of the following: a judicial precedent, advice of a business lawyer or accountant who was familiar with the facts, or a ruling issued to the employer by the IRS. Second, following an audit, the IRS didn't reclassify similar workers treated as independent contractors by the employer as employees. Third, workers are treated as independent contractors based on a long-standing recognized industry practice. Even if none of these conditions is present, the employer may still be entitled to relief if it can show that it had some other reasonable basis for treating the workers as independent contractors.

Substantive consistency is present if the employer, as well as any predecessor business, treated the worker and any similar workers as an independent contractor. If similar workers were treated as employees for even a short period of time, relief isn't available.

Reporting consistency requires that the employer must have filed Form 1099-MISC for each worker who earned over $600. Relief isn't available for any year or any employee for which the forms weren't filed. For employers who have been filing Form 1099-MISC for misclassified workers, a Classification Settlement Procedure (CSP) has been available since March 5, 1996. A CSP allows employers and tax examiners to resolve worker classification cases early in the administrative process and helps to ensure that the relief provisions under §530 are applied properly. Under the CSP, graduated settlement offers may be available. If an employer meets the reporting consistency requirement but clearly fails to meet either the substantive consistency requirement or reasonable basis test, it is liable for a full tax assessment for one taxable year, computed according to §3509. If, however, the employer meets the reporting consistency requirement and presents a reasonable argument that it meets both the substantive consistency requirement and the reasonable basis tests, it is liable for 25% of the employment tax liability for the audit year. In each instance, the employer must properly classify its workers in the future. If several classes of workers are at issue, the employer may qualify for more than one CSP offer.

Employers aren't entitled to recover from the employee any taxes they are obligated to pay to the IRS due to misclassification (§3509) of that employee. The employee's liability for income tax or employee Social Security taxes isn't affected by the assessment or collection of any tax determined and any amount collected from the employer, and these amounts can't be credited against the employee's tax liability. That is, an employer can't demand that a misclassified employee pay any tax penalty that the employer was assessed, but the employee is obligated to pay his or her tax liabilities whether or not the employer has paid its share.

Classifying workers is a difficult task, and innocent errors can be costly to businesses. Employers need to make sure that they have reasonable basis for the classification, are consistent in treatment of their workers, and always meet the reporting requirements. If an incorrect classification occurs, the employer may be eligible for the Classification Settlement Procedure as long as all the payment-affected workers have been properly reported. ■

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