LEGAL DEVELOPMENTS

The Return of Worker Classification Audits: Impacts More Than Employment Taxes

In this article, the author reviews the federal tax laws that could be affected by worker reclassification and the relief provisions available. The focus then turns to the impact of qualified plans and how plan sponsors can prepare for these issues to limit any potential federal tax and benefits exposure.

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In February, the Internal Revenue Service (the "IRS") launched a National Research Program (the "Program") study of employment taxes and the impact of worker classification issues on the estimated $345 billion tax gap—which measures the difference between what taxpayers should have paid and what they actually paid on a timely basis. The Program will include random audits of approximately 6,000 employers over a three-year period. These audits appear to be focused on the SB/SE division, which covers employers with under $10M in assets, but may well be extended to larger employers, as well. Although the audits will focus on employment tax liabilities for worker misclassification—i.e., improperly treating workers as independent contractors rather than common law employees who are subject to employment taxes—any reclassification of workers impacts various federal and state issues and, importantly, participation in employee benefits programs.

This article briefly reviews the applicable federal tax laws that may be impacted by a reclassification and the relief provisions available (and legislative proposals to limit such relief). It then focuses on the impact of qualified plans and what steps plan sponsors can take now to prepare for these issues and limit any potential federal tax and benefits exposure.

I. Worker Misclassification Background

Worker misclassification reportedly accounts for approximately $1.6 billion of the $54 billion employment tax gap (which is part of the total $345 billion tax gap), and it is believed that this estimate is markedly low as misclassification continues to grow. The classification of workers as independent contractors instead of common law employees raises tax and legal implications for both employers and workers. Employers must pay federal employment taxes on, and withhold federal and state income taxes from, their employees. Additionally, employers must comply with other employment laws, such as statutes regulating worker's compensation, minimum wage, workplace safety, and employment law discrimination. Moreover, tax-favored retirement and benefit plans are generally limited to covering common law employees.

For workers, reclassification may result in filing amended tax returns for the open tax years on Form 1040X, as common law employees' income is reported as wages on line 7 of Form 1040 and unreimbursed expenses are subject to a 2% AGI floor and reported on Schedule A rather than directly offsetting income on Schedule C. It may also result is unintended availability of additional employee benefit programs offered by the company that are limited to common law employees, such as health care coverage, qualified pension plans (401(a), 403(b), 457(b)) coverage, and other welfare benefits (e.g., group term life insurance, cafeteria plan).

The employer's tax implications of worker reclassification are more fully described below, followed by the plan qualification exposure and available correction procedures.

II. Employer Employment Tax Liability

If workers are reclassified as common law employees (either voluntarily or through IRS determination or audit), the employer may be responsible for income, FICA, and FUTA taxes that it failed to withhold for such workers for any "open" tax years (which is a three-year statute of limitations), along with interest and penalties for failure to timely report and withhold such taxes. A summary of these potential obligations is set forth in Attachment A. Importantly, the IRS has developed three relief provisions to mitigate this liability: (1) Section 530 relief, (2) relief under Section 3509 of the Internal Revenue Code of 1986, as amended (the "Code"), and (3) the IRS classification settlement program. These long-standing programs are briefly described below. However, it is unclear to what extent these programs will remain available in light of Congress' and the Administration's focus on closing the tax gap.

A. Section 530 Relief

Section 530 of the Revenue Act of 1978 ("Section 530") provides that, if certain tests are satisfied, the IRS on audit may not retroactively reclassify any individual as an employee if the taxpayer had not previously treated that individual as an employee for employment tax purposes for any period [Revenue Act of 1978, P.L. 95-600, § 530]. Section 530 does not alter an individual's status, but merely relieves an employer of liability for employment tax (and related interest and penalties). To qualify for this relief, the following three requirements must be satisfied:

- *Reasonable Basis.* The taxpayer must have a "reasonable basis" for treating the consultant as an independent contractor. There are several safe harbors for satisfying the reasonable basis test, including (1) a prior audit safe harbor, (2) judicial precedent and published IRS rulings, and (3) a long-standing recognized practice of a significant segment of the industry in which such individual was employed.
- *Reporting Consistency.* For taxable periods ending after December 31, 1978, all federal tax returns (including information returns) required to be filed by the taxpayer with respect to an individual must have been filed on a basis consistent with the taxpayer's treatment of the individual as an independent contractor—i.e., consistent Form 1099-MISC reporting (and not W-2 reporting).
- *Substantive Consistency.* The taxpayer or a predecessor must not have treated any individual holding a "substantially similar" position as an employee for employment tax purposes for any period beginning after December 31, 1977.

This relief is not available if the employer voluntarily reclassifies workers outside of an IRS audit. Moreover, pending legislation would largely limit this relief. Specifically, over the past few years, several bills have been introduced that make it more difficult for employers to obtain relief from such taxes. For example, in August 2009, the Taxpayer Responsibility, Accountability, and Consistency Act of 2009 (H.R. 3408) was introduced by Rep. Jim McDermott (D-Wash). Like its predecessors, H.R. 3408 would replace the existing safe harbor provision under Section 530 of the Act with a new, more restrictive "safe harbor," and provide workers with procedures to determine their employment status and protections against misclassification.

More recently, on December 15, 2009, Sen. John Kerry (D-Mass) introduced the Taxpayer Responsibility, Accountability and Consistency Act of 2009 (S. 2882), which is similar to H.R. 3408 (as well as legislation introduced by then-Senator Obama in 2007 (S. 2044)). S. 2882 would replace the existing safe harbor provision under Section 530 with a very restrictive safe harbor that would essentially require an IRS ruling to treat a worker as an independent contractor. In general, under the new safe harbor provision, a "reasonable basis" for not treating a worker as an employee would exist only if the employer classifies workers holding similar positions as independent contractors on a consistent basis, and treatment of the worker was in reasonable reliance on (1) a written determination from the IRS addressing the employment status of the worker or another worker holding a substantially similar position, or (2) a concluded IRS examination for employment tax purposes under which there was no determination that the worker or any other person working in a substantially similar position should be treated as an employee. An employer would no longer be permitted to rely on a long-standing recognized industry practice.

The proposed legislation also directs Treasury to issue annual reports on worker misclassification enforcement actions against (and examinations of) employers who have misclassified workers, allows workers to petition the IRS for a review of an employer's classification status determination, requires information sharing between the IRS and the DOL in cases of misclassification, and substantially increases

penalties for misclassification by increasing information return penalties. The Obama Administration also supports major reform in this area in order to increase certainty with respect to worker classification, including significant limitations on the available relief described herein.

B. Code Section 3509 Relief

Code Section 3509 provides for a reduction in an employer's employment tax liability under certain circumstances when an individual is reclassified as an employee. Under this provision, an employer's income tax liability is equal to 1.5% of the wages paid to the reclassified employee. The employer's liability for the employee's share of FICA equals 20% of the amount the reclassified employee is obligated to pay. The employer is liable for the entire employer share of FICA and FUTA taxes. If, however, the employer, without reasonable cause, fails to meet the information return requirements of Code Sections 6041(a), 6041A, or 6051 with respect to the reclassified employee (i.e., it failed to provide Form 1099-MISC), the special 1.5% withholding rate is raised to 3% and the special 20% FICA rate is raised to 40%. Moreover, this relief is not available for employers who intentionally disregard the law in treating an employee as an independent contractor.

An employee's liability for income or employment taxes is not affected by the employer's payment of taxes under Code Section 3509. Moreover, an employer is not entitled to recover from the employee any tax determined under Code Section 3509 or to credit any tax paid by the employee against its liability. Lastly, the employer may still be liable for penalties that apply for the failure to withhold such taxes, plus applicable interest for the late payments. However, the amount of such penalties is based on the amount of the employer's liability for such tax as determined under Section 3509 [Prop. Treas. Reg. § 31.3509-1(d)(6)].

C. Classification Settlement Program Relief

The IRS has established a classification settlement program ("CSP"), designed to allow taxpayers and examining IRS agents to resolve worker classification issues as early as possible in the administrative process. [*See* Notice 98-21, 1998-1 C.B. 849 (Apr. 1, 1998).] Under the CSP, a series of graduated settlement offers are available [I.R.M. 4.23.6.13.1 (04-21-1999)]. If a taxpayer meets the reporting consistency requirement under section 530, but clearly does not meet the substantive consistency requirement or clearly does not meet the reasonable basis requirement, the CSP offer will be a full employment tax assessment for the most recent taxable year under examination. If a taxpayer meets the reporting consistency requirement, and has a colorable argument that it meets the substantive consistency requirement and the reasonable basis requirement, the CSP offer will be an assessment of 25% of the employment tax liability for the most recent year under examination. For purposes of determining the employment tax liability, Code Section 3509 (as discussed above) may apply. In either case, the taxpayer must agree to treat the workers as employees on a prospective basis. This relief is not available if the employer voluntarily reclassifies workers outside of an IRS audit.

In addition, prior to an employment tax audit, employers have the option to seek a determination from the IRS (with no filing fee) as to the proper classification of their workers. Employers submit a Form SS-8 that sets forth the factual terms of the relationship, largely following the 20-factor test set forth in Revenue Ruling 87-41. Once a determination is made, the employer can consider the available relief options discussed above to limit the employment tax liability.

III. Qualified Plan Exposure

Reclassification of workers may also impact the tax-favored status of a qualified plan. Specifically, an operational violation results from failure to follow the plan terms, which can result in plan disqualification if corrective actions are not taken. Moreover, unlike employment taxes, the IRS's position is that there is no statute of limitations for qualified plan purposes. Therefore, for the entire period that a worker is reclassified, the applicable plan documents must be reviewed to assure that the worker is still excluded from plan participation. Otherwise, employer corrective contributions will be required, plus interest, to restore the worker's pension benefit in accordance with the IRS voluntary correction program—Employee Plans Compliance Resolution System under Revenue Procedure 2008-50 ("EPCRS").

When reviewing plan documents, there are a number of provisions on which to focus:

1. *"Exclusionary" Language.* Most plans have language in their documents that expressly excludes reclassified employees from participation in the plan—either excluding the worker from participation prior to the reclassification or excluding the

reclassified worker from any participation in the plan (past or future). This language typically covers reclassification by a governmental agency, but may not cover an employer's voluntary reclassification of workers without IRS or other agency involvement.

This exclusionary language is typically included in 401(a) plans, but its use is less clear in 403(b) plans, where the Code requires that all employees be eligible to participate with respect to elective deferrals. Moreover, even if plan language can help exclude these participants from participation, the retroactive effect of reclassification may impact the 410(b) coverage results as these employees would be includible in the coverage group.

2. *Age/Hours Requirement.* Some plans have a year of service or minimum age requirement to participate in the plan, in accordance with Code Section 410(a). A year of service may be defined as 1,000 hours of service (either counting actual hours or using equivalencies) or the plan may use an elapsed time formula. These requirements may be imposed on initial plan participation, or as ongoing eligibility for match or profit sharing contributions. (For 403(b) plans, 1,000 hours of service requirement can be added for employer contributions (but not elective deferrals).) To the extent that the worker does not satisfy the applicable age/hours requirements, then no corrective contributions are required if the individual is reclassified as an employee.

   Similarly, some 403(b) plans require an employee to be "regularly scheduled" to work at least 20 hours per week to be eligible to make elective deferrals (pre-tax or Roth). To the extent that this provision is not satisfied, no corrective contributions are required for such deferrals (and arguably any related missed match).
3. *Vesting Schedule for Employer Contributions.* Even where the reclassified worker would be eligible to participate in the plan, if the former worker would not have satisfied the applicable vesting schedule for employer contributions, then no corrective employer contributions may be required (or if required, may be subsequently forfeited) if the worker does not meet the applicable vesting provisions. (This provision is not applicable for missed employee deferrals that are always 100% vested.)
4. *Year-End Employment Requirement.* Some plans require current employment as of the end of the plan year in order to be eligible for an employer contribution. Therefore, to the extent that the worker has a short-term contract to provide services, a reasonable position may be that such employer contributions are not required if the worker is not performing any services at year-end.
5. *Employment Contract.* The employment contract may contain provisions relating to eligibility of participation in the employer-sponsored plans. If the contract expressly excludes the worker from participation, the employer may take the position that the plan document includes the provisions of the contract. This argument may be better suited for 403(b) and 457(b) plans, where there is more general guidance on what constitutes a plan document. For example, prior to the issuance of the final IRS 403(b) regulations that generally went into effect on January 1, 2009, there was very limited guidance as to what documents constitute a "plan document." [*See* Donovan v. Dillingham, 688 F.2d 1367, 1373 (11th Cir. 1982) (defining a plan or program under ERISA).] Furthermore, even now, the IRS accepts a "plan document" consisting of multiple plan documents as a valid document for 403(b) purposes. Because multiple documents can constitute a "plan document," one approach is to take the position that the "plan document" includes the provision in the employment contract, providing for an exclusion from participation in the plan. In that case, no corrective contributions would be made to the plan.

   The courts may be more inclined to accept this approach than the IRS. But, for 403(b) plans, there is an added complication. Although there appears to be no case law that would impose coverage under a 403(b) plan retroactively for misclassified workers, there is a concern that this interpretation of the plan document as including the employment contract may violate the Section 403(b) rules that, for elective deferrals, only permit the exclusion of employees working fewer than 20 hours per week. One alternative is to interpret the plan document to provide for elective deferrals for the reclassified workers, but not the employer contributions.
6. *Part-Time Exclusion.* In the past, some plan documents may have had an exclusion from participation for part-time employees. However, this language violates Code Section 410(a) and should not be relied upon to justify making no corrective contributions (particularly post-1994, when the IRS indicated this type of exclusion is unacceptable). Specifically, the risk of excluding "part-time" or "seasonal" classifications is that the IRS

or the courts will view it as a classification based on service, which violates Code Section 410(a) and ERISA Section 202(a)(1)(A) for any employee who performs at least 1,000 hours of service with the company. [*See* Treas. Reg. § 1.410(a)-3; IRS Field Directive on Plans with Class Exclusions for Part-Time Employees (issued November 22, 1994); IRS National Office Technical Advice Memorandum, July 28, 1999; Questions to IRS/Treasury and Summary of Their Responses, March, 1996, presented at the 1996 Enrolled Actuaries Meeting, Q&A-35 ("an employer's classification of employees as 'temporary' suggests that their employment status is intended to be short-lived (whether full-time or part-time temps). This suggests a class based on time rather than function, which would be viewed as an impermissible service requirement.").]

IV. Qualified Plan Correction Methods

A. Prior Errors

Once it is determined that there is an operational failure for the impermissible exclusion of reclassified workers as eligible to make elective deferrals or to receive employer contributions (e.g., match, discretionary contributions, nonelective contributions, forfeitures) under the tax-qualified plan, EPCRS can be used to make these corrective contributions, adjusted for earnings. Moreover, the worker's vesting schedule must also be determined for these corrective contributions.

EPCRS provides pre-approved correction methods for improperly excluded employees, which vary depending on the type of plan and type of missed contributions. For example, for a nonsafe harbor 401(k) plan, the employer must make a QNEC to the plan on behalf of the misclassified workers equal to 50% of the employee's missed deferral, adjusted for earnings. The missed deferral is determined by multiplying the actual deferral percentage for the year of exclusion for the employee's group in the plan (either non-HCEs or HCEs) by the employee's compensation for such year, subject to applicable plan and IRS limits. Moreover, 100% of the missed match attributable to such missed deferrals is also required to be made in the form of a QNEC (subject to plan and IRS limits), adjusted for earnings.

This correction can be made through either self-correction or a voluntary correction filing under EPCRS. Whether or not a formal correction filing under EPCRS would be required would depend on whether these missed contributions are a "significant" or "insignificant" failure (which is a facts and circumstances test) and the degree of legal certainty desired by the plan sponsor. If the failure was "significant," self-correction must be made within a two year period; otherwise a formal VCP application is required for IRS approval. If the failure was "insignificant," no filing fee or IRS application would be required. If an IRS voluntary correction filing were pursued, the plan sponsor can attempt to negotiate a lesser correction than the standard pre-approved correction set forth above. Moreover, no other IRS interest or penalties should be imposed under EPCRS.

B. Prospective Errors

To the extent the participation requirements outlined in Part III above are not set forth in the plan, these provisions can be added with an amendment to the plan to be applied prospectively, provided that the amendment complies with the anti-cutback requirements of Code Section 411(d)(6). These types of discretionary amendments must be adopted by the end of the plan year in which they take effect; they cannot be adopted retroactively prior to such plan year. For example, language can be added to exclude reclassified workers from the plan prospectively, add a 1,000 hour requirement for new hires to become participants in the plan, or add a year-end and 1,000 hour requirements for employer contributions that have not yet accrued.

V. Next Steps for Plan Sponsors

As worker classification comes back into focus, we recommend employers take the following steps to limit their exposure for employment taxes described above—as well as potentially costly claims for benefits under their pension and welfare programs.

- *Welfare Plans:* Review your plan documents to ensure that misclassified workers are excluded from participation in the plans. Otherwise, amend the plans retroactively, to the extent permitted.
- *Pension Plans:* Review your qualified plan documents to ensure that misclassified workers are excluded from participation in the plans. Otherwise, amend the plans prospectively to provide for this exclusion.
- *Employee Handbooks/Administrative Materials:* Review the employee handbooks and administrative manuals to ensure they provide a consistent message that these workers will not be eligible for benefits, even

if reclassified by a court, an agency, or voluntarily by the company.

- *Employment Contract:* Review the employment contract used for consultants and other independent contractors that receive a Form 1099-MISC. Make sure it clearly states the impact of the services on Social Security taxes and employee benefit programs of the employer. Also, compliance with factors under Revenue Ruling 87-41 that support independent contractor is helpful.
- *SS-8 Review:* Consider filing a Form SS-8 with the IRS to receive a determination letter as to the proper classification of your workers. Alternatively, review the 20-factors in Revenue Ruling 87-41, along with Publication 15-A and the IRS training materials on worker classification to ascertain the level of comfort on the facts and circumstances test.
- *Section 530 Relief:* Review your files on these workers and any documentation on the determination to treat the worker as an independent contractor, including prior IRS examination, industry standard, IRS or court ruling, or attorney or accountant opinions.

Attachment A

FICA Liability—Form 941: The employer is liable for both the employee share and employer share of FICA (7.65% for each share up to the taxable FICA wage base for the year ($106,800 for 2009), or 1.45% each in excess of the FICA wage base (if not already reached for the year) [Code §§ 3102, 3111]. If an employee who was misclassified as an independent contractor actually paid self-employment taxes for the period he or she was treated as an independent contractor, the employer may be relieved of liability for FICA if the statute of limitations for refund of the self-employment taxes has expired [Code § 6521]. However, as a practical matter, it is administratively burdensome to prove that affected employees actually paid self-employment tax.

FUTA Liability—Form 940: The employer is liable for FUTA tax up to the maximum wages for the year [Code § 3301].

Federal Income Tax Withholding Liability: In general, the employer is liable for the federal income tax that should have been deducted and withheld [Code § 3403]. However, if the employee pays the tax, then the employer is not required to pay [Code § 3402(d)].

Interest on the Underpayment: Interest is generally imposed on the underpayment of FICA, FUTA and income tax withholding [Code §§ 6601(a), 6205(b); Treas. Reg. § 31.6205-1]. The interest rate applicable to underpayments is the Federal short-term rate plus 3% [Code § 6621(a)(2)].

Failure to File Form W-2: $50 per return (maximum $250,000 per year), subject to reasonable cause exception; 10% of the aggregate amount of the items required to be reported correctly if intentional disregard of filing requirements, with no maximum [Code § 6721].

Failure to Furnish Form W-2 to Employee: $50/per return (maximum $100,000 per year), subject to reasonable cause exception; 10% of the aggregate amount of the items required to be reported correctly if intentional disregard of filing requirements, with no maximum [Code § 6722].

Failure to Deposit Taxes—Employer Share of FICA, FUTA: Generally 10% of the underpayment, subject to reasonable cause exception [Code § 6656].

Willful Failure to Withhold: Willfully (i.e., voluntary, consciously, and intentionally) fails to collect and pay over the tax: liable for 100% of the underpayment (income tax withholding, FICA, and FUTA) [Code § 6672].

Failure to Report and Pay Tax on Form 941/940: 0.5% of the tax due per month (maximum 25%), reasonable cause exception [Code § 6651].

Accuracy-Related Penalty: Failure to properly report on Forms W-2, 941, or 940 the underpayment of tax due to negligence or disregard of rules or regulations results in a penalty of 20% of the tax underpaid [Code § 6662(b)(1)]. This penalty is not combined with the failure to file penalty [Code § 6662]. Alternatively, if the understatement results in a substantial understatement (i.e., exceeds the lesser of: (a) 10% of correct tax (or, if greater, $10,000) or (b) $10,000,000), then the 20% penalty will apply (but not both the negligence penalty and this penalty) [Code § 6662(d)].

Civil and Criminal Fraud Penalties: The IRS may also impose civil and/or criminal fraud penalties [Code §§ 6663, 6674, 7201, 7202, 7203, 7204, 7207]. For example, willful failure to collect any tax is a felony and, upon conviction, the person may be fined not more than $100,000, or imprisoned not more than five years, or both, together with the costs of prosecution [Code § 7202]. ■