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Proposal Would Limit 'Safe Harbor' Provision, Raise Tax Penalties for Misclassifying Workers

Legislation recently introduced in the House would limit existing "safe harbor" provisions for employers that have treated employees as independent contractors, increase tax penalties in misclassification cases, and make penalties more difficult to avoid.

The Taxpayer Responsibility, Accountability and Consistency Act of 2009 (H.R. 3408), introduced July 30 by Rep. Jim McDermott (D-Wash.), would replace Section 530 of the Revenue Act of 1978 with a new Internal Revenue Code section that requires the Internal Revenue Service to propose new worker status rules, narrows "reasonable basis" justification for prior misclassification of workers as independent contractors, and substantially increases penalties for compliance failures.

McDermott introduced a similar bill with the same name in the last session of Congress. The new bill is the first of several legislative proposals addressing worker misclassification expected to be introduced this term, sources told BNA.

Determining Worker Status

Section 530 currently prohibits IRS from issuing any regulations or rulings on independent contractor issues and contains a relief provision that excuses employers from employment tax liability, regardless of a worker status determination under the common law test. The relief provision applies if an employer has a "reasonable basis" for treating a worker as an independent contractor, and if the employer meets "substantive consistency" and "reporting consistency" requirements.

The "reasonable basis" part of the Section 530 relief, known as a safe harbor, can rely on a court ruling or other judicial precedent; published IRS rulings; IRS technical advice or a letter ruling directed to the employer; a previous IRS audit that did not turn up misclassification issues; a long-standing, recognized practice of a significant segment of the industry in which the individual worked; or even advice of a business lawyer or accountant who knew the facts of the situation.

McDermott's bill would narrow the definition of "reasonable basis" to reliance on a written determination issued to the employer. The determination would address the employment status of the workers or a concluded employment tax examination that determined no employment relationship, along with consistent treatment since Jan. 1, 1977, of all workers in similar positions.

$3 Million Penalty

Under the proposed legislation, which would amend Chapter 25 of the IRC, employers misclassifying employees as independent contractors would face higher fines, including a $3 million penalty for "intentional disregard." Other penalties include:

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- Fines of $1 million for employers with receipts of up to $5 million. The current penalty is $100,000.
- Fines of up to $1.5 million for failing to correct a tax return on or before Aug. 1. The current penalty is $150,000.
- Fines of up to $500 per tax return for employers that intentionally disregard filing rules. The current penalty is $100.
- A minimum penalty of $250 for each incorrect tax return. The current penalty is $50.

Under the bill, the Treasury secretary is to issue an annual report on worker misclassification. The report is to include the number and type of enforcement actions taken, employer examinations, fines and penalties, the number of employers that misclassified workers, and the estimated number of workers who were misclassified.

H.R. 3408 also would require information reporting of payments to companies.

Misclassified Numbers Vary

About 15 percent of employers misclassified 3.4 million workers as independent contractors rather than as employees, the statement from McDermott's office said, citing Internal Revenue Service data. The Government Accountability Office, meanwhile, estimated in a 2007 report that the number of independent contractors was 10.3 million in 2005.

An honest mistake is one thing, McDermott said, "but when at least 3.4 million Americans are called independent contractors, you have to conclude that there are unscrupulous companies gaming the system and hurting innocent workers and honest companies; it's our job to level the playing field."

Administration Gets Tough

In 2008, the Obama administration's platform signaled an increasingly aggressive compliance stance in this area, and not just because there could be additional revenue during a down economy. The administration also looks to increase membership in unions, and to be a union member, a worker generally needs to be an employee and not an independent contractor.

President Obama's stance on worker status issues became clear in 2007, when as a U.S. senator he sponsored a bill to update procedures for properly classifying employees and independent contractors. The bill would have required that employers treat workers misclassified as independent contractors as employees for tax purposes. The bill also would have identified and tracked misclassification complaints to enforce wage and hour laws, and would investigate industries identified by IRS as misclassifying workers.

Policy Guide
On Independent Contractors. . .

More Consequences of Reclassifying Workers as Employees

Many businesses rely on a combination of employees and independent contractors, and there are associated risks, including reclassification, if employers hire independent contractors. Reclassifying employees brings up a host of issues that Robert W. Wood discussed in the July 8 PAG Newsletter article, "Reclassifying Workers as Employees Can Have Big Consequences."

In a July 24 article in BNA's Daily Tax Report, Wood discussed 10 more issues employers should pay close attention to if independent contractors are recharacterized as employees:

■ **State new-hire registry reporting requirements.** Most states and the federal government maintain a new-hire registry, requiring employers to list new employees and certain key data. Whether the characterization is retroactive or prospective, the provision would apply if an employer starts to treat the worker as an employee for all purposes. Check with the state employment development department or other agencies to determine what must be filed with the state. In some cases, employers may already have to file for independent contractors.

■ **Immigration Reform and Control Act.** The Immigration Reform and Control Act made it illegal to knowingly hire or recruit illegal immigrants, required employers to attest to their employees' immigration status, and granted amnesty to certain illegal immigrants already in the United States. These rules have had at least one significant impact in the workplace: the completion of employment verification forms. Employers need to comply with these laws if contractors are recharacterized.

■ **FMLA.** The Family and Medical Leave Act allows employees to take unpaid leave because of a health condition that makes the employee unable to perform his or her job. The rule also allows unpaid leave to care for a sick family member or to care for a new child. For the law to take effect, the employer must have 50 or more employees within a 75-mile radius. In the case of recharacterization, it may be helpful that an employee must have worked for the company for at least 12 months.

■ **COBRA coverage.** Health care continuation coverage under COBRA requires the employer to allow employees to buy coverage for up to 18 months after termination. The provision generally applies to employees, though it may in some cases apply to independent contractors covered by the company health plan. If independent contractors are recharacterized as employees, an employer may have to worry more about the health insurance program than COBRA.

Employers have to address many details if independent contractors are recharacterized as employees.

■ **State COBRA.** Employers should be aware that many states have their own version of COBRA health continuation coverage. That can be significant if the state rules are more strenuous than the federal ones. In California, the state COBRA rules generally apply to employers having 10 or more employees. Under the federal COBRA rules, that number is 20 or more employees.

■ **WARN Act.** The Worker Adjustment and Retraining Notification Act protects employees, their families, and communities by requiring most employers with 100 or more employees to provide at least 60 days' notice of plant closings and mass layoffs. The class of employees covered is broad, including managers and hourly and salaried workers. There are many nuances in the act, and some exceptions can absolve employers of requirements. Legislators recently introduced a bill to beef up WARN Act rules.

■ **OSHA.** As a general proposition, OSHA covers every employee in the workplace, regardless of the worker's title, status, or classification. OSHA does not apply to independent contractors. OSHA regulations are an imposing and voluminous set of requirements, and employers need to at least check the basics if recharacterization occurs.

■ **State OSHA.** In addition to OSHA, many states have their own workplace condition laws. Employers that operate in one of those states should follow the state rules rather than federal OSHA rules. Some states, such as California, have workplace rules that are tougher than federal rules.

■ **Employee Polygraph Protection Act.** The Employee Polygraph Protection Act of 1988 generally prevents employers from using lie detector tests in the workplace. The rules apply either for pre-employment screening or during the course of employment.

■ **Insurance.** In all likelihood, workers' compensation and unemployment insurance account for many initial recharacterization battles, and coverage needs to be reexamined if recharacterization of workers increases the employer's staff. It can also be appropriate to check all forms of insurance, including general liability coverage. For example, an employer that has to reclassify as employees 10 delivery drivers who had been independent contractors would be liable if a driver caused an accident.

Conclusion

Employers have to address many details if independent contractors are recharacterized as employees, either by a court, an agency, or voluntarily.

Recharacterization decisions are often made on an ad hoc basis, which can result in a lack of consistency. The result is an imposing number of issues for employers to deal with when reclassifying independent contractors as employees.

PAG ISSN 1524-1580