What is misclassification?

- Misclassification is when an employer wrongfully calls their worker an “independent contractor” even though the worker is actually an employee. When an employer misclassifies their employee as an independent contractor, the employer usually issues the worker a Form 1099-MISC rather than a Form W-2. As such, the employer does not withhold payroll taxes and avoids providing the worker with benefits employees enjoy.

- If an employer exercises the right to control not only the methods by which the worker performs their work but also the means by which they achieve it, such an approach evinces an employer-employee relationship.

Why is misclassification relevant to federal taxes?

- When a worker receives a Form 1099-MISC listing their income as “non-employee compensation,” they owe both the employer’s and employee’s share of Social Security and Medicare taxes under the Federal Insurance Contributions Act (FICA).

- Since there are typically no taxes withheld on a Form 1099, unemployment taxes are not taken out of workers’ paychecks. As such, if a 1099ed worker applies for unemployment compensation, it is likely that their 1099 will not be included as ‘wages’ in their notice of financial determination.

- If a worker is paid by their employer in cash off the books with no withholding, another form of misclassification, and subsequently does not account for FICA taxes on their return, this income will not count towards their Social Security earnings.

What does an employer-employee relationship look like?

- If a worker is paid on a 1099 or in cash off the table but is engaged in a relationship with their employer in which any of the following exist, there is likely misclassification:

Federal Tax Impact of Misclassification for Workers

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Supervision
Set schedule
Set rate of pay
Supervisor assigns the worker tasks and instructions
Employer has worker sign a work agreement that sets the terms and conditions of employer
Worker can be fired or demoted

How does the IRS define employment?

What does the Internal Revenue Code state?

- IRC § 3121(d) defines an “employee” as “any officer of a corporation; or any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee” or “any individual...who performs services for remuneration for any person.”

- IRC § 3121(a) establishes that such an individual is entitled to “wages,” which means “all remuneration for employment.”

- Specific classes of employment delineated in 3121(d):
  - Agent driver or commission driver;
  - Full-time life insurance salesperson;
  - Homeworkers performing services on materials or goods;
  - Traveling or city salespeople.
  - Persons acting under agreement covered by Section 218 of the Social Security Act, which deals with State and municipal employees.

What do IRS regulations and other authority state?

- 26 CFR § 31.3121(d)-1 provides more guidance:
  - Generally such relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.
  - That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so.”

- Factors cited in the regulations:
  - Right to discharge
- Furnishing of tools
- Furnishing of a place to work
- Whether the individual is running their own trade or business
- Contract “contemplates that substantially all the services to which the contract relates…are to be performed personally by such individual”
- No substantial “investment in the facilities”
- Continuing relationship

- Special classes of employees
- Agent driver or commission driver;
- Full-time life insurance salesperson;
- Homeworkers performing services on materials or goods;
- Traveling or city salespeople.

### Revenue Ruling 87-41 established 20 factors:

1. Instructions
2. Training
3. Integration
4. Services rendered personally
5. Hiring, supervising, and paying assistants
6. Continuing relationship
7. Set hours of work
8. Full time required
9. Doing work on employer’s premises
10. Order or sequence set
11. Oral or written reports
12. Payment by hour, week, month
13. Payment of business and/or traveling expenses
14. Furnishing of tools and materials
15. Significant investment
16. Realization of profit or loss
17. Working for more than one firm at a time
18. Making service available to general public
19. Right to discharge
20. Right to terminate

### U.S. Tax Court decisions:

- Focus is on 1) behavioral control, 2) financial control, 3) relationship of the parties
- Eight factors typically cited in U.S. Tax Court precedent: 1) the degree of control the principal exercises over the details of the work; 2) which party invests in work facilities used by the individual; 3) the opportunity of the
individual for profit or loss; 4) whether the principal can discharge the individual; 5) whether the work is part of the principal’s regular business; 6) the permanency of the relationship; 7) the relationship the parties believed they were creating; 8) whether the principal provides employee benefits


- 26 U.S.C. Section 7436
  - Tax Court may review IRS determination in cases where Section 530 relief is not available and there is “an actual controversy involving a determination by the Secretary as part of an examination”
  - Requirements for 7436 jurisdiction per Am. Airlines, Inc. v. Comm'r of Internal Revenue, 144 T.C. 24, 32 (2015):
    - An examination in connection with the audit “of any person”
    - A determination by the Secretary that “such person is not entitled to the treatment under subsection (a) of section 530 of the Revenue Act of 1978 with respect to such an individual”
    - “Actual controversy” involving the determination as part of an examination
    - The filing of an appropriate pleading in the Tax Court.
  - Only an employer can appeal determination that its workers were employees but workers are not parties to 7436 cases
  - 7436 cases, unlike SS-8 determinations generally, can be binding on a class of workers; such cases are useful precedent
    - Taxpayer “bears the burden of going forward with evidence that the IRS’ determinations as to worker classification are wrong.” D & R Financial Services, Inc. v. Comm’r of Internal Revenue, T.C. Memo. 2011-252.
What are the various tax withholding obligations in worker classification cases?

What taxes are employers required to withhold and how does that affect their workers?

- 26 U.S.C. Section 3402 requires employers to “deduct and withhold” income tax from their employees’ wages
- 26 U.S.C. Section 3101 imposes Social Security and Medicare taxes (FICA)
- 26 U.S.C. Section 3102 requires employers to withhold FICA taxes
- Through withholding, most workers pay 6.2% Social Security tax and 1.45% Medicare tax. Employers pay the other 6.2% in Social Security tax and 1.45% in Medicare tax. In total between the employer and the worker, 12.4% is paid for Social Security tax and 2.9% is paid for Medicare tax for a combined total of 15.3%.
  - As such, a self-employed taxpayer or independent contractor pays the full 15.3% as the “self-employment tax.”
- 26 CFR Section 31.3102-1(d) establishes that the employee and “the employer [are] liable for the employee’s share of FICA tax with respect to all wages paid by the employer, whether or not it is collected from the employee.” Karagozian v. Comm’r, T.C. Memo. 2013-164 (2013).

- Generally speaking, if the employer “intentionally disregarded” their withholding obligations and withheld neither income taxes nor FICA taxes, the following are true:
  - 26 U.S.C. Section 3403 establishes that the employer is “liable for the payment of the [income] tax required to be deducted and withheld.”
  - On the other hand, “the failure of an employer to withheld income tax does not relieve the employee of [their] obligation to pay the tax.” Goins v. Comm’r, T.C. Memo. 1997-51, slip op. at 5, aff’d without published opinion, 151 F.3d 1029 (4th Cir. 1998). Workers are also still liable for their share of FICA taxes. See Karagozian.
  - Consequently, the IRS can “collect payment from either the employee or the employer” with regard to the employee’s share of both income and FICA taxes. See Karagozian.
  - If a 1099ed worker has paid the full 15.3% self-employment tax and the three-year refund statute of limitations has expired but the statute of limitations on assessment against the employer has not expired, the employer no longer is liable for any FICA taxes (notwithstanding potential additional penalties).
If a worker pays the income tax that was not withheld from their pay, an employer is no longer liable for that employee’s income tax under 26 U.S.C. Section 3402(d) (notwithstanding potential additional penalties). In U.S. Tax Court proceedings, this information, regarding whether workers actually paid those income taxes, is disclosable and discoverable. See *In re Mescalero Apache Tribe v. Comm’r*, 2017 U.S. Tax Ct. LEXIS 12 (April 5, 2017).

- Under Section 3509, if there is no “intentional disregard” of tax obligations but the employer still failed to withhold both wage and FICA taxes and the employer is not eligible for Section 530 relief, the following is true:
  - An employer is “limited in its liability for employee FICA taxes to 20% of the amount determined under Code Section 3101 (40% if the employer failed to file information returns without reasonable cause.) See Chief Counsel Advice 201808016.
  - Further, in such a circumstance, the employer is also limited in their liability for the employee’s share of income tax to 1.5% of the employee’s wages. The liability is doubled if the aforementioned reporting requirements are not met.

What is the federal tax impact for workers of misclassification?

- When a taxpayer receives a Form 1099-MISC listing their income as “non-employee compensation,” the taxpayer owes the full 15.3 percent self-employment tax.
  - The self-employment tax consists of both the employer’s and employee’s share of Social Security and Medicare taxes.
  - The tax is generally 92.35% of 15.3% of the taxpayer’s net self-employment earnings.

- A taxpayer is entitled to modest above-the-line deductions for self-employed individuals (i.e. tax and health care) that slightly reduce their tax – but don’t affect the self-employment tax liability itself.

- There is almost always no tax withholding on a 1099. Given the lack of withholding that taxpayers could’ve claimed as a credit on their tax returns, taxpayers (if they can afford to do so) should strive to make estimated tax payments throughout the year.

- An independent contractor can claim expenses on a Schedule C to reduce their gross income to a lower net amount. A W-2 employee, pursuant to the Tax Cuts and Jobs Act (TCJA), can no longer claim unreimbursed employee expenses as an itemized deduction.
- If an independent contractor wants to claim expenses to reduce their gross income to a lower net amount, the self-employment tax will then only be assessed on their net income. Therefore, the worker’s Social Security earnings will be less than if they reported their gross. *Yoder v. Harris, 650 F.2d 1170* (10th CIR. 1981)

- Often, 1099ed workers or workers paid in cash off the books do not report their income on tax returns. As such, unless they amend within three years, they do not get Social Security credit for those years.

**What are the processes by which misclassified workers can challenge their misclassification before the IRS?**

- Filing a Form SS-8 and submitting it to the SS-8 Unit of the IRS
  - Lack of guidance in the Code on employment compelled the creation of the SS-8 process in 1994
  - SS-8 is four-page packet
  - Not a confidential or anonymous process; the employer will receive a blank SS-8 and be asked to respond
  - SS-8s are a common source of referral to the Service for audits or investigations of employers, per the Fogg Manual
  - Questions focus on financial control, behavioral control, relationship of the parties; details requested on supervision, schedule, pay assignments, benefits, expenses, etc.
  - Form must be sent to the SS-8 Unit in Holtsville, New York; SS-8 must be sent in order for a taxpayer to list 1099 income as “wages” on return without risking audit
  - Answers must be complete even if “N/A” is answer; must include pay documents or if no pay document, explain in cover letter and provide approximation on page 1
  - SS-8 Unit will issue a determination as to employment status; no direct appeals process exists (an issue the National Taxpayer Advocate has expressed concern about) but there can be a request for a redetermination, according to the Internal Revenue Manual
Pursuant to the filing of the SS-8, listing the 1099-MISC income as “wages” on a federal tax return accompanied by a Form 8919 to account for the employee’s uncollected share of FICA

- A taxpayer can file amended returns as well to reduce balances or, if within the last three years, to claim refunds for the employer’s share of FICA paid through the self-employment tax.

- If a taxpayer received a W-2 and 1099 in the same year for different income for the same job, they do not need to fill out an SS-8. Only an 8919 (to account for the employee’s share of FICA on the 1099 portion of the income) with a 1040 listing all of that income combined as “wages” is necessary for the taxpayer to configure their correct tax liability.

Litigating the correct classification in U.S. Tax Court

- Section 7436 provides jurisdiction in the Tax Court in worker classification cases for an employer to appeal a determination made by the Secretary
  - Must arise from an examination or audit in connection with an actual controversy between the taxpayer and the IRS. See Staffmore, LLC v. Commissioner, T.C. Memo. 2013-187.

- Could arise after a taxpayer has worked their way through IRS appeals with regard to their liability or after they received a statutory notice of deficiency
  - If a taxpayer disputes their liability in Collection Due Process (CDP) case after they are assessed the full SE tax and then they appeal a negative determination in CDP process to the U.S. Tax Court, they could find themselves litigating the classification in Tax Court. See Karagozian v. Comm’r, T.C. Memo. 2013-164 (2013).

- A taxpayer who gets a Statutory Notice of Deficiency for underreporting of 1099-MISC income, for instance, has 90 days to file a petition to U.S. Tax Court. They have the opportunity to then dispute liability in Tax Court because of misclassification.
- **Confidential and anonymous options to challenge misclassification**
  - Taxpayers can file a Form 211 whistleblower form
    - Possibility of whistleblower award
  - Taxpayers can file a Form 3949-A to report an employment tax violation for failure to withhold tax
    - Completely confidential process

- **Consequences for employers**
  - **SS-8 Determination**
    - If workers are found to be employees: tax ramifications could include full liability at least for employer’s share of FICA, other employment taxes
  - **Section 530 safe harbor relief under the Internal Revenue Act of 1978**
    - Reporting consistency
    - Substantive consistency
    - Reasonable basis
  - **Voluntary Classification Settlement Program**
    - No investigations underway
    - No IRS litigation/classification issues
    - No DOL or similar audit
    - Consistent treatment of workers as non-employees
    - 1099s filed in last three years