Employment Income Characterization through the Taxpayer Rights Lens

*Moderator:* Sarah Lora, Director LITC, Lewis and Clark Law School

*Panelists:* Omeed Firouzi, Christine Brunswick Fellow, Philadelphia Legal Assistance; Syd Gernstein, Branch Chief, IRS Office of Chief Counsel; Anna Tavis, Attorney, South Brooklyn Legal Services; Mari Manoogian, Michigan State Representative; Chuck Eiss, Attorney, Law Offices of Charles Eiss
Federal Tax Consequences of Misclassification for Workers

Materials Prepared By: Omeed Firouzi
ABA Section of Taxation Christine A. Brunswick Public Service Fellow, Philadelphia Legal Assistance, Low Income Taxpayer Clinic
What is worker misclassification?

- Employer gives 1099 (usually 1099-MISC but could be 1099-K or cash) to worker who should get W-2

- Wrongful 1099 if worker is common law employee: has supervision, set schedule, set pay

- Misclassification as an independent contractor = worker on the hook for both sides of FICA

- 1099ed workers could lack protections (unemployment compensation) employees enjoy
Federal tax impact of misclassification for workers

• Self-employment tax: 15.3%
• Almost always no withholding
• Independent contractors can claim expenses, some deductions
• Social Security impact of net v. gross
• Unreported cash income = no Social Security credit
• Estimated tax payments
Challenging misclassification before the IRS

- IRS Form SS-8
- Listing 1099 income as wages with 8919 for employee FICA
- U.S. Tax Court (must arise from an examination)
- Arguing fraudulent filing of information return under Section 7434
Filing an SS-8

• Process developed in 1994 to help IRS adjudicate cases
• Four-page packet (not confidential or anonymous)
• Questions related to supervision, schedule, pay assignments, benefits, expenses, etc.
• Sent to SS-8 Unit in Holtsville, NY with accompanying documentation before a return is filed
• Answers must be complete, pay documents must be included
• Employer will be sent blank SS-8 to respond, could be audited
• SS-8 Unit issues determination; no appeals process
Challenging misclassification on your return

- Filing SS-8 gives worker right to list 1099 income as wages
- 1040 or 1040X must be accompanied by Form 8919 for employee’s share of FICA
- W-2 and 1099 in same year for different income in same job: no need for SS-8, just an 8919
- 1040X must be filed within 3 years to claim refund of employer’s share of FICA
- Worker can always reduce balances
U.S. Tax Court Postures

• Appealing from negative determination in Collection Due Process case disputing liability
• Taxpayer gets Statutory Notice of Deficiency: 90 days to file petition in Tax Court
• Employer could appeal from determination under Section 7436 (must arise from examination; worker not a party)
Anonymous and confidential options with IRS

• Filing Form 211 whistleblower award: more anonymous but possibility of a whistleblower award exists

• Filing Form 3949-A to report an employment tax violation: completely confidential, taxpayer does not even have to sign the form

**Whistleblower awards spiked**

Awards to tax tipsters totaled $312.2 million in FY 2018

- 2016: $61.4M
- 2017: $34.0M
- 2018: $312.2M

Source: IRS Whistleblower Program Report
Worker Classification: Implications for LEP and Immigrant Taxpayers

Anna C. Tavis
Brooklyn Legal Services
February 1, 2019
Boca Raton, FL
Labor Market for LEP/Immigrant Taxpayers

• Misclassification common in certain industries with higher concentration of LEP + immigrant taxpayers
  - Construction
  - Home Care
  - Delivery/trucking
  - Informal service sector work

• Misclassified H-2A Agricultural Guest workers face additional challenges
  • Worker often unaware of classification at all due to timing of work vs. issuance of income reporting forms
  • Limited understanding of U.S. tax system
  • Restricted to particular employer and dependent on continued employment for reauthorization of visa
Labor Market Cont.

- LEP and Immigrant taxpayers more likely to be misclassified through cash-only payments
  - Lack of bargaining power
  - Employer’s fear regarding hiring unauthorized workers
    Note: paying in cash not a workaround!
  - Problems completing employment forms
    - I-9: USCIS Form
    - W-4: Requires SSN*
    - W-9: Often default for TPs without work authorization
Tax Implications for Cash Earners

- No withholding, resulting in substantial liabilities
- Very common for cash earners to be nonfilers
- TP files return listing Schedule C income and deductions without the books and records typical of a business
  - Owes SE tax (15.3% of net SE income)
  - Preparer claims unsubstantiated Schedule C deductions, making TP more vulnerable to audit
  - Cash earners claiming the EIC far more likely to be audited
  - Successive audits increase likelihood of future ban on refundable credits
Immigration Implications of Misclassification

• Nonfilers have no returns to prove presence in the U.S., income for sponsorship, good moral character, etc…
  • Nonfilers often required to back file, up to 10 years, with inadequate records, leading to large liabilities that must be resolved for immigration benefits

• Schedule C filers accrue liabilities due to unpaid SE and income tax, as well as liabilities resulting from audits of cash earnings and deductions
  • Liabilities must be in process of resolution for immigration benefits, but ongoing misclassification creates future compliance problem
Challenging Misclassification: SS-8

- SS-8 form lengthy and complex
  - Available in Spanish
- Fear of retaliation
  - Employer intimidation based on immigration status
- Complications arising from work under incorrect Social Security number
Tips for Misclassified LEP/Immigrant Workers

• Figuring out classification while still employed
  - Paystubs/personal checks/cash
  - IRS Wage and Income Transcripts
  - Social Security statement

• Incorrect SSN records
  - Employer can issue a W-2 with ITIN listed*

• File correctly going forward
  - Form 1040 with income reported as wages and attached Form 8919
Predatory Non-Compete Agreements
Legislative Reaction to Non-Compete Agreements

- Illinois, New York settlements: Jimmy John’s agreed to not enforce the agreements
- Obama Admin called for states to ban most non-compete agreements
- New laws passed in several states limiting the scope and use of non-competes
Are these types of agreements legal?

- Michigan law is fairly standard.
- Non-compete agreements must be “reasonable” in terms of:
  - Geography
  - Scope
  - Time
Are these types of agreements legal?

- “Reasonable” is left up to the individual court to decide, judge can void the agreement or limit it.
- Jimmy John’s agreements probably would not have held up in court if challenged.
- Do fast food workers really have the means to sue?
The Remedy: Ban Non-Compete Agreements for Low-Wage Workers

Michigan: HB 4874

Ban all non-compete agreements for workers making less than 150% of Federal Poverty Level (approximately $38,000/year for a family of four)

Require disclosure of agreement in writing before employee accepts position

Rise with inflation annually
Issues

How do we define “low-wage?”
Annual or hourly compensation?
Federal Poverty Level?
Fair Labor Standards Act Non-Exempt?
Litigating Section 7434 Claims
26 U.S. Code § 7434

(a) **IN GENERAL** If any person willfully files a fraudulent information return with respect to payment purported to be made to any other person, such other person may bring a civil action for damages against the person so filing such return.

(b) **DAMAGES** In any action brought under subsection (a), upon a finding of liability on the part of the defendant, the defendant shall be liable to the plaintiff in an amount equal to the greater of $5,000 or the sum of —

(1) any actual damages sustained by the plaintiff as a proximate result of the filing of the fraudulent information return (including any costs attributable to resolving deficiencies asserted as a result of such filing),

(2) the costs of the action, and

(3) in the court’s discretion, reasonable attorneys’ fees.

(c) **PERIOD FOR BRINGING ACTION** Notwithstanding any other provision of law, an action to enforce the liability created under this section may be brought without regard to the amount in controversy and may be brought only within the later of —

(1) 6 years after the date of the filing of the fraudulent information return, or

(2) 1 year after the date such fraudulent information return would have been discovered by exercise of reasonable care.

(d) **COPY OF COMPLAINT FILED WITH IRS** Any person bringing an action under subsection (a) shall provide a copy of the complaint to the Internal Revenue Service upon the filing of such complaint with the court.

(e) **FINDING OF COURT TO INCLUDE CORRECT AMOUNT OF PAYMENT** The decision of the court awarding damages in an action brought under subsection (a) shall include a finding of the correct amount which should have been reported in the information return.

(f) **INFORMATION RETURN** For purposes of this section, the term “information return” means any statement described in section 6724(d)(1)(A).

Kinne v. IMED Health Products, LLC et al  
Case 0:18-cv-62183-RNS  
a. Kinne classified as both employee (W-2) and Independent Contractor (1099) during the course and scope of several years of the same employment and position.  
b. Kinne performed non-exempt job functions such as marketing, sales and delivery.  
c. Kinne was not permitted to work for any competitors and wore IMED shirts.  
d. The employer directed all of the terms of Kinne’s employment.
Kinne (cont’d) – the Twist

Not only did Kinne receive an improperly issued 1099, the amount of the 1099 failed to match the amount of the checks actually paid. The amount asserted on the 1099 issued to Kinne was approximately 60% greater than the amount actually paid.
Kinne (cont’d) – the Law

• To establish a claim for tax fraud under Section 7434, Kinne must show (1) that the Defendants issued an information return; (2) that the information return was fraudulent; and (3) that the Defendants willfully issued a fraudulent information return. Seijo v. Casa Salsa, Inc., No. 12-60892-Civ., 2013 WL 6184969, at *7 (S.D. Fla. Nov. 25, 2013) (Scola, J.) (citing Pitcher v. Waldman, No. 1:11-cv-148, 2012 WL 5269060, at *4 (S.D. Ohio Oct. 23, 2012))……..

• “circuit courts around the country have found that ‘willfulness’ in the context of the statute ‘connotes a voluntary, intentional violation of a legal duty,’ and that tax fraud typically requires ‘intentional wrongdoing.’” Leon v. Tapas & Tintos, Inc., 51 F. Supp. 3d 1290, 1297 (S.D. Fla. 2014) (Moreno, J.) (citing Vandenheede v. Vecchio, 541 Fed. App’x 577, 580 (6th Cir. 2013); Granado v. Comm’r, 792 F.2d 91, 93 (7th Cir. 1986)).
Kinne (cont’d) – Individual as well as Corporate liability

Judge Scola determined:

the Court finds “[t]he complaint can be fairly read to aver that [both] defendants are responsible for the alleged conduct.” Kyle K. v. Chapman, 208 F.3d 940, 944 (11th Cir. 2000). The Court interprets Kinne’s allegations against both Defendants to mean that he has a good faith belief to allege that both Defendants were equally and coextensively responsible for the alleged conduct. At minimum, the Court can reasonably infer that McCall, as an owner with operational control, including control over employment practices and compensation, had control over the filing of the allegedly fraudulent return.
Kinne (cont’d) – Possible Issues

a. Arguments will be made that §7434 only applies where the amounts differ. See Tran v. Tran, 239 F. Supp. 3d 1296, 1297 (M.D. Fla. 2017). However, In Kinne, Judge Scola determined that no U.S. Circuit Court has opined on the issue, and declined to apply the argument.

b. The cause of action is clearly more viable once the 1099 has actually been issued, as opposed to a short term employment within the same calendar year which results in the failure to pay taxes on wages paid, but the employer still has time to correct the error prior to January 31 of the following year.
Dynamex “ABC” Test

Dynamex “ABC” Test Continued

• Specifically, the “ABC” test requires the hiring entity to establish each of the following three factors:

  (A) that the worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact; and
  (B) that the worker performs work that is outside the usual course of the hiring entity’s business; and
  (C) that the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed.