Contracts BULLETIN
a SMACNA publication
HVAC Industrial Architectural Metal
EXPERTISE
PERFORMANCE • TRAINING • STANDARDS

Volume 0, Issue Number 0 March 20, 2006

Bulletin #92: Risking an IRS Re–Classification

CONTRACTS BULLETIN #92
The Independent Contractor Conundrum:
Risking an IRS Re–Classification

Much has been written regarding worker classification issues, a large part of which has focused on the guidelines for determining the status of a worker as "employee" or "independent contractor." The purpose of this Contracts Bulletin is to provide a practical explanation of the key documents and contracts in the event of an inquiry by the Internal Revenue Service (IRS). It is not the intention of this Contracts Bulletin to address collective bargaining or union classification of workers, rather the focus is on the implications of worker status as interpreted by the IRS and the courts.

I. ESSENTIAL DOCUMENTS

The IRS uses twenty factors ("20–Factor Test") for purposes of determining the appropriate classification of a worker. If the 20–Factor Test indicates that a company has financial and behavioral control over the worker, the worker is treated as an employee. Thus, as a preliminary matter, a questionnaire based on the 20–Factor Test is filled out by a worker to help assess how the worker should be treated. The completed questionnaire is normally kept in the records of the company.

The emphasis the IRS puts on the different factors of the 20–Factor test may vary depending on the position for which a worker is retained. Generally, when relief is sought from penalties resulting from worker misclassification, the IRS requires a company to present a published court decision, IRS pronouncement or other authority upon which the company relied to classify the worker as an independent contractor. At the time of hiring of the worker, the authority relied upon for the independent contractor classification is usually put it in the worker's file.

Once a worker is identified as an independent contractor, the arrangement is normally memorialized in a written service agreement that clearly describes the relationship of the parties. The basic elements of an independent contractor agreement are explored in detail below.

If an independent contractor arrangement is ongoing, the company should periodically re–assess its relationship with the worker to determine whether the relationship has evolved into an employment relationship. As discussed in more detail below, independent contractor arrangements that are perpetual in nature tend to have an elevated risk of re–classification.

An IRS examination of the worker classification is commenced in many ways, one of which can be a disgruntled worker contacting the IRS. Therefore, companies often periodically obtain from each

independent contractor a signed acknowledgement stating that he or she understands that he or she is an independent contractor and, as such, has complied with all of the tax and legal obligations as well as company policies associated with his or her status.

Finally, the company must keep any written records that are created in the normal operations of the business, such as correspondences and reports substantiating the status of the worker as an independent contractor. In all correspondence with the IRS and other governmental agencies, the company should ensure that its independent contractors are treated consistently. In addition, each of its independent contractors must be issued the requisite Forms 1099 (tax statement for an independent contractor).

II. BASIC ELEMENTS OF AN INDEPENDENT CONTRACTOR AGREEMENT

Although an independent contractor agreement will vary depending upon the specific business practices and industry of the parties, the agreement should contain certain core provisions. For instance, the agreement could state clearly that there is no employment relationship, and the parties intend to treat the worker as an independent contractor. In addition, the agreement might state the exact nature of the independent contractor's business, and that he or she is not prohibited from providing services to others. The agreement can also state that the independent contractor:

1. is responsible for reporting and paying all applicable taxes, such as income, social security and unemployment, attributable to his or her income earned under the agreement;

2. will supply the necessary tools, equipment, materials, etc. for performing the services contracted for;

3. is to be responsible for his or her own business expenses incurred in rendering services under the agreement, and if any advances are given, the independent contractor will execute a promissory note evidencing his or her obligation to repay the amount advanced;

4. is to be paid on a commission or job basis rather than on a unit of time (hourly, weekly, monthly);

5. is not eligible to receive bonuses or fringe benefits, such as paid vacation, sick leave, pensions, and must carry his or her own workers compensation insurance; and

6. is not permitted to incur obligations or open charge accounts in the Company's name for normal business expenses.

The agreement is normally for a specified length of time and, unlimited automatic renewal provisions should generally be avoided. The agreement should not include provisions that indicate control, such as requiring work at set times, attending company training and keeping time reports.

Even a well–drafted independent contractor agreement may not be given much weight by the IRS if, in practice, its terms are not followed or applied properly by the parties. Consequently, during the term of the relationship, the company and the worker should consistently follow the arrangement outlined in their independent contractor agreement, and amend the agreement if their course of dealings deviates significantly from the terms of the agreement.

III. THE VALUE IS IN RISK MANAGEMENT

As a general matter, the IRS places great emphasis on written records. Hence, an informal independent contractor arrangement, not formally memorialized in a written agreement, faces a significant burden to overcome because the company must rely on verbal statements to support its position. It is true that the IRS is not bound by independent contractor agreements, and even a well–drafted agreement may not hold up if the true nature of the business relationship is that of employer–employee. However, an agreement that is put in place when the contractor begins work with the company will provide much needed support in the event of IRS scrutiny and may prevent re–classification of the worker.

Misclassification can have huge adverse financial consequences for the company, not only from the perspective of the additional taxes, interest and penalties due, but also because of the cost of legal and accounting fees in defending an IRS prosecution. For workers classified as employees, federal tax law imposes upon the employer certain obligations related to the withholding, payment and reporting of employment taxes. If the IRS reclassifies a worker from independent contractor to employee status, the financial burden increases dramatically because the employer is not only responsible for its own share of employment taxes that should have been paid, but it is also liable for a portion of the employee's tax obligations.

A. The Tax Burden. If income taxes are not withheld, upon re–classification, the employer will be held liable for 1.5% of the employee's wages (3% if information returns were not filed). In addition, if FICA taxes are not withheld, the employer will be liable for 20% of the employee's share (40% if no information returns were filed). The employer's liability is not reduced by income or Social Security tax payments made by the employee, and the employer cannot recover the additional tax from the employee. The employer will also be fully liable for FUTA taxes on the wages paid. Penalties may be imposed for failure to file an information return or make a timely deposit. Interest generally accrues on all taxes and penalties due.

B. Administrative Appeals and Relief. Appeals filed with the IRS tend to take a lot of time and effort due to the factual nature of worker classification matters. While attorneys fees and accounting costs will likely be significant, at the end of the day, there is no guarantee of a victory. The IRS is afforded significant leeway in this area and it tends to have a one–sided view of the issue. Hence, even where most factors of the 20–Factor Test support independent contractor status, the IRS, without much explanation, could still determine that the worker should have been treated as an employee.

It is possible that an employer who inadvertently misclassified a worker could be relieved of its employment tax liabilities pursuant to what is referred to as "Section 530 relief." A company may be entitled to the relief if it can establish that it has: (1) consistently treated the worker as an independent contractor, and had a "reasonable basis" for doing so; and (2) consistently treated other similarly situated workers as independent contractors. Reasonable basis can be established by showing that the company relied on (1) relevant court cases and IRS pronouncements; (2) a prior IRS audit in which no employment taxes were assessed for similarly situated workers; or (3) a long–standing, recognized industry practice. Reliance solely on industry practice, which is difficult to establish and susceptible to change, is risky and should generally be avoided.

One of the problems with Section 530 relief is that the relief is not available unless (1) the taxpayer is already under audit; or (2) if not under audit, the taxpayer requests, in writing, that the IRS commence an audit of the taxpayer. Intuitively, one realizes that requesting an audit entails a risk of the issue spreading to other arrangements. Even if an audit is commenced and the taxpayer complies with all of the procedural requirements, the IRS could still decide that relief should not be granted because the taxpayer's reliance on a particular court case, IRS ruling or industry practice was not reasonable.

C. Relief from the Courts. Appealing to courts could produce a favorable result, particularly in the Eighth Circuit which includes Minnesota, North Dakota, South Dakota, Nebraska, Iowa, Missouri, and Arkansas. Courts have attempted to put some balance back into worker classification procedures. One commentary published in 2003 indicates that "taxpayers who have pursued their case to the end have won over 95% of all cases that have gone to summary judgment[1] or trial since 1990."[2] It is possible that the high rate of success is attributable to the fact that only those taxpayers with strong facts and a substantial tax liability have the incentive to pursue their cases in court. In most cases, however, worker classification disputes are resolved at the audit or administrative level.

IV. THE "GRAY" TERRITORY

There may be certain arrangements where no amount of documentation can justify treating the worker as an independent contractor. Most situations, however, tend to be gray and reasonable people could disagree on how the worker should be viewed. The classification of such types of workers depends on a company's

tolerance for risk. The following is a description of arrangements that entail a higher risk of re−classification.

A. The High Risk Independent Contractor. The following factors may elevate the risk that a worker would be viewed as an employee by the IRS:

1. the worker has no office of his/her own and performs services on the company's premises;

2. the worker provides services to the company regularly;

3. the worker renders his/her services in−person;

4. the worker has no tools of his/her own and uses those of the company; and

5. the worker has no other meaningful clients and does not do any formal advertising.

In addition, the worker who has a lot of interaction with company personnel and does not work on standalone, compartmentalized projects may be perceived by the IRS as part of the "team" and, hence, an employee.

B. Dual Status/Former Employees. An individual may perform more than one function for a company. If the individual is an employee in any of those functions, it will create a strong presumption that he/she is an employee for all functions. Issuance of both a Form W−2 (for an employee) and a Form 1099 to the same individual from the same payor in a single year may prompt IRS inquiry. Moreover, a former employee rehired as an independent contractor will rarely meet the IRS's criteria for independent contractor status, especially if the former employee is rehired during the same calendar year in which he/she terminated employment.

C. Single Entity Service Providers. Ordinarily, worker classification issues are not encountered when the service provider is a business entity, such as a corporation, partnership, limited liability company or trust. Although an entity, by definition, cannot be an employee, entities with one owner may, in practice, be indistinguishable from their individual owners because the sole owner is likely to be the only director, officer and employee of the company. All interactions are likely to occur with the individual owner, which raises the risk that the entity will be disregarded altogether, and the ordinary protection that comes with dealing with an entity will not be there. When dealing with single−owner entities, at a minimum, a company should make sure that all agreements are executed in the name of the entity and all correspondences occur with the entity.

CONCLUSION

There is no magic formula for determining independent contractor status. The classification of a worker depends on the facts and circumstances surrounding the relationship between the parties. Since the IRS leans heavily toward classifying workers as employees, a comprehensive agreement with the worker is particularly important. Retention of good records ensures that any IRS inquiry is addressed promptly and resolved efficiently.

B>The discussion in this article does not constitute tax advice, are not a covered opinion as described in Treasury Regulation Circular 230, and cannot be relied upon to avoid any tax penalties or to support the promotion or marketing of any federal tax transaction. As with all advice in the Contract Bulletins, we strongly encourage SMACNA members to discuss with their attorneys appropriate contractual and business arrangements.

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[1]"Summary Judgment" involves a motion by a party seeking to have the case decided prior to trial based on

legal arguments.
[2]Courts Approve of Treating Doctors As Independent Contractors, PRACTICAL TAX STRATEGIES, Jul. 2003.

SMACNA wants the Contracts Bulletins to serve our members. Your feedback or topic suggestions are welcomed by contacting Steve Yoch (e−mail: syoch@felhaber.com; telephone 651/312−6040) or Tom Soles (e−mail: tsoles@smacna.org; telephone 703/803−2988).

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