

Consequences of Misclassification

The Risk of Misclassification

Inherent in the use of independent contractors is the risk that the IRS, the Department of Labor, a court, or other government authority will determine that a business should have treated particular independent contractors (or an entire class of contract workers) as employees for tax, wage-hour, unemployment, workers' compensation and/or employee benefit plan purposes.

Misclassifying employees as independent contractors may subject a business to (1) income tax liability for monies that should have been withheld from the "wages" of the "employees," (2) employer Social Security and Medicare (FICA) and unemployment (FUTA) contributions, (3) potential overtime pay and other wage claim liability, (4) state unemployment insurance payments, (5) workers' compensation insurance premiums (and potential liability for workplace injuries), and (6) other civil and criminal liability. Additionally, workers may be entitled to coverage (and benefits) under existing employee benefit plans.

Tax Consequences of Misclassifying Workers

While employers are not responsible for withholding or paying taxes on amounts paid to independent contractors, they are responsible for paying federal income taxes, FICA taxes, and FUTA taxes on wages paid to employees. Consequently, employers may face substantial tax liability if they are found to have misclassified employees as independent contractors. The tax consequences include a penalty for failing to withhold income taxes from the misclassified worker's wages, the employer's and employee's share of required FICA taxes, the employer's unpaid FUTA taxes, and interest on the unpaid taxes.

The assessments the IRS can impose for worker misclassification vary enormously, depending upon whether the IRS views your misclassification as intentional or unintentional.

Penalties for Unintentional Misclassification

When you hire an unincorporated independent contractor, you are normally required to report the payments made to the worker on IRS Form 1099 MISC. There are two ranges of assessments the IRS may impose for unintentional worker misclassification: One is imposed where you filed all required 1099 forms for the workers the IRS claims you misclassified, and the other is imposed where you did not file the 1099 forms.

a. 1099 forms filed

If 1099 forms were filed, you will be required to pay a sum equal to:

- 20% of the FICA taxes (Social Security and Medicare) the employees should have had withheld from their pay, **plus**
- 100% of the FICA taxes you should have paid on the workers' behalf as their employer, **plus**

- 1.5% of all the wages that were paid to the misclassified workers — a penalty for your failure to withhold federal income taxes from the workers' paychecks, **plus**
- All FUTA taxes that should have been paid.

b. 1099 forms not filed

If you failed to file the 1099 forms, the employee FICA and income tax assessments are doubled. You must pay a sum equal to:

- 40% of the FICA (Social Security and Medicare) taxes the employee should have had withheld, **plus**
- 100% of the FICA taxes you should have paid on the misclassified workers' behalf as their employer, **plus**
- 3% of all the wages that were paid to each misclassified worker as a penalty for your failure to withhold federal income taxes from the workers' paychecks, **plus**
- All FUTA taxes that should have been paid.

Penalties for Intentional Misclassification

IRS assessments are far higher if the IRS concludes that you intentionally misclassified as independent contractors workers you knew to be employees. You must pay:

- 100% of the FICA (Social Security and Medicare) taxes the misclassified workers should have had withheld — that is, 7.65% of the employee's wages subject to FICA, **plus**
- 100% of the FICA taxes you should have paid on the workers' behalf as their employer, **plus**
- 20% of all the wages that were paid to the workers to make up for your failure to withhold federal income taxes from their paychecks, **plus**
- All FUTA taxes that should have been paid.

Penalties can be assessed against both the business and its corporate officers.

Section 530 "Safe Harbor"

Section 530 of the Revenue Act of 1978 is a safe harbor provision that prevents the IRS from retroactively reclassifying independent contractors as employees and subjecting the principal to federal employment taxes, penalties, and interest for such misclassification. In order for an employer to qualify for Section 530 relief, it must have:

1. Consistently treated the workers (and similarly situated workers) as independent contractors;
2. Complied with the Form 1099 reporting requirements with respect to the compensation paid the workers for the tax years at issue; and
3. Had a reasonable basis for treating the workers as independent contractors.

Section 530 does not make or validate workers as independent contractors but rather classifies them as "nonemployees" for federal employment tax purposes.

Wage Consequences of Misclassifying Workers

The Fair Labor Standards Act (FLSA) requires employers to pay covered employees who are not otherwise exempt at least the federal minimum wage of \$7.25 per hour, and overtime pay of one-and-one-half-times the regular rate of pay. Employees who are misclassified as independent contractors, and paid less than required by the FLSA, are entitled to damages.

The FLSA provides three legal actions to enforce adherence with its requirements. First, a legal action can be filed by employees on their own behalf. Second, a legal action can be filed by employees on behalf of themselves and all others similarly situated. Third, the Secretary of Labor can file a legal action to recover wages for one or more employees.

Failure to properly pay misclassified employees may result in any or all of the following civil penalties:

- Payment of the unpaid wages or overtime compensation.
- Payment of an additional amount equal to the unpaid wages or overtime as liquidated damages.
- Reasonable attorneys' fees and costs of the action.

Civil enforcement actions under the FLSA are governed by a two- or three-year limitations period. Actions to enforce nonwillful violations must be commenced within two years after the cause of action accrues. The limitations period applicable to willful violations is extended to three years.

Penalties can be assessed against both the business and its corporate officers.

A significant trend in FLSA law is the recent proliferation of employee collective action lawsuits for FLSA wage and hour violations. Because the typical wage and hour claim involves only a single plaintiff or a small group of employees, they are often not economically viable. However, FLSA collective actions, which for larger businesses can involve hundreds or thousands of employees from all regions of the country, offer the potential for millions of dollars in damages. This potential has encouraged lawyers and unions to pursue collective actions under the FLSA.

Employee Benefits Consequences of Misclassifying Workers

Notably, a determination by the IRS that employers have misclassified employees as independent contractors often results in increased civil litigation, which may be even more costly than the unpaid payroll taxes.

Depending on the circumstances, a misclassified employee may be entitled, retroactively, to a number of employment benefits, including for example, reimbursement of medical expenses that would have been covered by the employer's medical insurance plan, workers' disability compensation, and unemployment benefits.

Employers may also be liable for contributions to employee retirement plans, stock options, bonuses, vacation and sick leave, or other fringe benefits offered to their employees.