Worker Classification –
Federal and Virginia Rules and Programs

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Challengers to IC Classification?

1. **Internal Revenue Service**
2. **U.S. Department of Labor**
3. **Virginia Department of Taxation**
4. **Virginia Employment Commission**
5. **Virginia Workers' Compensation Commission**
6. **The IC**
7. **Injured third party**

IRS Employment Tax Audits

How they happen:

- NRP Audits

  IRM 4.22.10 requires examiners to address worker classification issues. IRM 4.22.10.3.3.

- Employment tax audit

  IRM 4.23 requires examiners to address worker classification issues. IRM 4.23.2.2(2)(b).

Possible causes:

- Computer discrepancies
- Non-compliance / complaints by employees or ICs

IRS Employment Tax Audits

IRC §3121(d) provides four categories of employees:

- Common law employee,
- Corporate officer,
- Certain statutory employee, or
- Employee covered by an agreement under Section 218 of the Social Security Act (dealing with officers of a state or political subdivision).

It is the common law rules found in Reg. 31.3121(d)–1(c) that typically controls the determination made by Exam. But if the worker falls into one of the other 3 categories, the common law analysis is not needed; the worker will be treated as an employee.

IRS Employment Tax Audits

"Under common law, a worker is an employee when the person for whom the services are performed has the right to control and direct the individual who performs the services. This control reaches not only the result to be accomplished, but also the details and means by which that result is to be accomplished. Note that control must be present, but need not actually be exercised. Also, note that courts have held that the degree of supervision necessary to demonstrate control is only "such supervision as the nature of the work requires." *McGuire v. United States*, 349 F. 2d 644, 646 (1965 9th Cir.)." IRM 4.23.5.6.

To determine control, the examiner is directed to consider "all the facts and circumstances," using the 20 factors provided in Rev. Rul. 87-41 for reference purposes. IRM 4.23.5.6.1.

IRS Employment Tax Audits

The 20 factors of Rev. Rul. 87-41:

1. The right of one person to tell a worker when, where, and how he or she is to work;
2. One person training the worker;
3. Integration of the worker's services into the business' general operations;
4. The requirement that services be rendered personally;
5. Direction over hiring, supervising, and paying assistants;
6. A worker's continuing relationship with one business;
7. Set hours which the worker must work;
8. The requirement that the worker devote full-time attention to one business;
9. Performing work on a business' premises;

IRS Employment Tax Audits

The 20 factors of Rev. Rul. 87-41 (continued):

10. Control over the order or sequence of work performed;
11. The requirement that the worker submit reports to the person for whom work is performed;
12. Payment by hour, week, or month;
13. Compensation for business and/or traveling expenses;
14. Provision of tools and materials;
15. The worker's investment in the facilities in which he works;
16. A worker's direct interest in the profitability of the work accomplished;
17. Working for more than one firm at the same time;
18. Making services available to the general public;
19. A person's right to discharge the worker; and
20. A person's right to terminate the work relationship.

IRS Employment Tax Audits

IRC §3402(d):

If the employer, in violation of the provisions of this chapter, fails to deduct and withhold the tax under this chapter, and thereafter the tax against which such tax may be credited is paid, the tax so required to be deducted and withheld **shall not be collected from the employer**; but this subsection shall in no case relieve the employer from liability for any penalties or additions to the tax otherwise applicable in respect of such failure to deduct and withhold.

IRS Employment Tax Audits

- IRC 3402(d) claims are handled by the Campus function, i.e. post-Exam, but examiners are authorized to accept and consider claims made before the audit is closed.
- There should be entry on line 12 of the Form 4668 (Report of Employment Tax Examination Changes) for the amount of tax credit available for abatement.
- Claim is made by filing Form 4670 and attaching a Form 4669 for each employee who paid the income tax employer should have withheld. If employer pays after Exam and wants a refund, then the claim is filed on the appropriate "X" form.
- FICA and FUTA taxes are not abatable under IRC 3402(d), even though there is an entry on Form 4669 for SE tax paid. IRC 6521 governs mitigation for SE tax.
- IRC 3402(d) is **not** available for employers who deducted and withheld income taxes but failed to report the withheld income taxes to the Service.

IRS Employment Tax Audits

A ray of hope: IRC 3509.

- IRC 3509 gives reduced rates for income tax withholding and the employee's share of FICA where an employer failed to withhold employment taxes by reason of treating such employee(s) as a non-employee(s).
- The provision does not relieve the employer of the employer's share of FICA and FUTA taxes.
- **If IRC 3509 applies, the offset provisions of IRC 3402(d) and IRC 6521 do not apply**.

IRS Employment Tax Audits

- **Consideration of the provisions of IRC 3509 is mandatory for all determinations involving worker reclassification assessments.** This includes officer compensation reclassification cases. IRM 4.23.8.5.2.
- A taxpayer cannot waive IRC 3509 when its conditions are met.
- However, IRC 3509 does not apply:
  - In cases of the employer's intentional disregard of the requirement to deduct and withhold employment taxes (IRC 3509(c)),
  - In cases where the employer deducts income tax from the wages of an employee but does not deduct FICA tax (IRC 3509(d)(2)), or
  - In cases of certain statutory employees for FICA tax purposes (IRC 3509(d)(3)).

IRS Employment Tax Audits

Employee options in a 3509 situation:

- The employee's liability for FICA tax under IRC 3101 is not affected by IRC 3509. The employer is not entitled to recover from the employee any part of the tax assessed under this section. Treas. Reg. 31.3102–1(d) provides that an employee is responsible for the employee's share of FICA until it is collected from him or her by the employer. Since IRC 3509 bars the employer from collecting the tax from the employee, the employee remains liable for the FICA tax on their individual Form 1040 return. See Rev. Rul. 86-111, 1986-2 C.B. 176.
- The employee may file a claim for refund of any self-employment tax which is attributable to the reclassification. Notice 989, *Commonly Asked Questions When IRS Determines Your Work Status is "Employee"* provides instructions to the reclassified worker on how to file a claim for refund.

IRS Employment Tax Audits

Employee options in a 3509 situation:

If a worker paid self-employment tax on a net profit of $35,100 ($45,000 less $9,900 related business expenses) and during a subsequent examination of the payor, the IRS reclassified those earnings from self-employment income to gross wages of $45,000, the worker would be entitled to a SECA tax refund calculated as follows for the year 2009:

$35,100 × 92.35%	(Net earnings from SE)	$ 32,415.00
$32,415 × 15.3%	(SECA tax)	$ 4,959.50
$45,000 × 7.65%	(Employee FICA tax)	$ 3,442.50
Allowable SECA tax refund		$ 1,517.00

IRS Employment Tax Audits

Employee options in a 3509 situation:

- Expenses that the reclassified worker claimed on Schedule C would be eliminated but may be deductible, if applicable, on Form 2106 and/or Schedule A subject to the 2% floor.
- Since the related business expenses are subject to the 2% adjusted gross income limit, this change will increase the taxable income and possibly the Federal income tax. Also certain expenditures, such as medical insurance or a Keogh-type retirement plan, cannot be claimed as miscellaneous deductions on Schedule A.
- Any additional Federal income tax will offset the SECA tax refund.

IRS Employment Tax Audits

If Forms 1099 were timely-filed, IRC 3509(a) applies.

- Income tax withholding is computed at 1.5%. No abatement available under IRC 3402(d).
- The employer's liability for FICA is computed at 20% of the employee's share, plus the entire employer's share. Relief under IRC 6521 does not apply.
- For tax years starting in 2013, if any of the reclassified workers were paid more than $200,000, there is an additional Medicare tax on the excess. For IRC 3509(a) the rate is 0.18% (20% of .009).

IRS Employment Tax Audits

IRC 3509(a) Example:

Item	Percentage
ER share of FICA	7.65%
20% of EE FICA (.20 x 7.65%)	1.53%
Total FICA	9.18%
ITW @ 1.50% of wages	1.50%
Total IRC 3509(a) percentage	10.68%

IRS Employment Tax Audits

If Forms 1099 were NOT timely-filed, IRC 3509(b) applies.

- Income tax withholding is computed at 3%. No abatement available under IRC 3402(d).
- The employer's liability for FICA is computed at 40% of the employee's share, plus the entire employer's share. Relief under IRC 6521 does not apply.
- For tax years starting in 2013, if any of the reclassified workers were paid more than $200,000, there is an additional Medicare tax on the excess. For IRC 3509(a) the rate is 0.36% (40% of .009).
- If the failure to file Forms 1099 was due to reasonable cause, not willful neglect, the higher rates do not apply, e.g. corporate officer or employees treated as partners. IRC 3509(b)(1).

IRS Employment Tax Audits

IRC 3509(b) Example:

Item	Percentage
ER share of FICA	7.65%
40% of EE FICA (.40 x 7.65%)	3.06%
Total FICA	10.71%
ITW @ 3.00% of wages	3.00%
Total IRC 3509(b) percentage	13.71%

IRS CSP

The Classification Settlement Program

- Part of the employment tax audit process; it is mandatory that the examiner present the TP with a CSP offer during the audit. IRM 4.23.6.1.
- The CSP is designed to provide an early opportunity during the audit process for TPs to benefit from the relief provision of §530 of the 1978 Revenue Act.
- CSP agreements are closing agreements, binding on the TP and the Service for future tax periods.

IRS CSP

§530 provides a complete win for the TP.

- If the examiner determines that the taxpayer is entitled to relief under section 530, **the issue of worker classification will be discontinued**. IRM 4.23.5.2.2(5).
- If TP makes out a prima facie case that §530 applies, has cooperated fully with reasonable requests from the examiner, the burden shifts to the Service to prove that the TP's treatment is inaccurate.
- If Forms 1099 were not timely filed, you're out – CSP is N/A and the examination proceeds. If different classes of worker exist, CSP may apply to one class and not another.

IRS CSP

3 requirements:

1. Reporting consistency – all returns (including information returns) must have been filed on a basis consistent with TP's treatment of workers as non-employees.
2. Substantive consistency – TP must have treated similarly-situated workers consistently.
3. Reasonable basis – TP must have had some reasonable basis for not treating the worker as an employee, e.g. court decision, previous audit (post-1996), published ruling, PLR/TAM, long-standing recognized industry practice, or "any other reasonable basis."

IRS CSP

3 types of settlement offers may be presented:

1. 100% CSP Offer: If reporting consistency is present but either the substantive consistency or reasonable basis tests are not clearly met, the CSP offer will be a full employment tax adjustment for the *most recent tax year under examination* computed with the 3509(a) rates.
2. 25% CSP Offer: If TP meets the reporting consistency requirement and has a colorable argument as to the substantive consistency and/or reasonable basis requirements, the CSP offer will be an adjustment of 25% for the most recent tax year under examination, computed under 3509(a). [*25% calculation also applied to penalties.*]
3. No Assessment CSP Offer: If TP satisfies the §530 requirements, TP may still wish to enter in an agreement to begin treating workers as employees immediately or at the start of the next year.

IRS VCSP

The Voluntary Classification Settlement Program

Originally announced in Announcement 2011-64, modified and extended by Announcement 2012-45.

Modifications include:

1. Permit a TP under IRS audit (other than an employment tax audit) to be eligible
2. Clarify ineligibility if TP is contesting in court the classification of the class(es) of workers from a previous audit by the IRS or US DOL.
3. Eliminate the requirement that TP agree to extend the ASOL on employment taxes as part of the VCSP closing agreement.

IRS VCSP

Requirements

1. A taxpayer must have consistently treated the workers to be reclassified as independent contractors or other nonemployees, including having filed all required Forms 1099 for the workers to be reclassified under the VCSP for the previous three years to participate.
2. the taxpayer cannot currently be under employment tax audit by the IRS and the taxpayer cannot be currently under audit concerning the classification of the workers by the Department of Labor or by a state government agency.
3. If the IRS or the Department of Labor has previously audited a taxpayer concerning the classification of the workers, the taxpayer will be eligible only if the taxpayer has complied with the results of that audit and is not currently contesting the classification in court.

IRS VCSP

A taxpayer participating in the VCSP will agree to:

1. Prospectively treat the class or classes of workers as employees for future tax periods;
2. Pay 10% of the employment tax liability that would have been due on compensation paid to the workers for the most recent tax year, determined under the 3509(a) rates
3. Not be liable for any interest and penalties on the amount; and
4. Not be subject to an employment tax audit with respect to the worker classification of the workers being reclassified under the VCSP for prior years.

IRS VCSP

- Application for the VCSP is made by filing Form 8952.
- Form must be filed at least 60 days before the date TP wishes to begin treating the affected workers as employees.
- Eligible TPs accepted into the VCSP will have to sign a closing agreement to finalize the terms of the VCSP and simultaneously make full payment of any amount due under the closing agreement.

USDOL Audits

The Wage and Hour Division ("WHD") of the USDOL is tasked with enforcing the DOL's Misclassification Initiative, which is aimed at recovering critical benefits and protections denied to misclassified employees, e.g. family and medical leave, overtime, minimum wage, and unemployment insurance, to which they are entitled. Such misclassification also robs the federal fisc of Social Security and Medicare funds, and the states of unemployment insurance and workers compensation funds.

USDOL Audits

The DOL Misclassification Initiative includes Memorandums of Understanding with the IRS and various states, under which they will share information and investigation data relevant to related compliance efforts by agencies covered by the MOUs. The agencies are directed to refer cases to each other and then provide the information necessary for the recipient agency to conduct their own compliance review.

There is currently no MOU in effect with Virginia.

USDOL Audits

What is at stake:

- Employee pay for overtime and minimum wage (FLSA)
- Employee pay for mandatory vacation and holiday pay (Davis-Bacon Act)
- Employee pay for health and welfare benefits (Davis-Bacon Act)
- Family and/or medical leave (FMLA)
- Possibility of a related IRS or state reclassification audit.

USDOL Audits

How they start:

- Complaint by a worker;
- By referral from another federal or state agency; or
- Upon the DOL's own initiative.

USDOL Audits

- For the Fair Labor Standard Act's minimum wage and overtime provisions to apply, the worker must be an "employee" of the employer.
- The FLSA defines "employ" as including to "suffer or permit to work," the broadest definition of employment under the law because it covers work that the employer directs or allows to take place.
- Workers who are economically dependent on the business of the employer, regardless of skill level, are considered to be employees. In the DOL's view, most workers are employees.
- Independent contractors are workers with economic independence who are in business for themselves.

USDOL Audits

The Supreme Court has held there to be no single rule or test for determining whether an individual is an employee or independent contractor for purposes of the FLSA.

Rather, the totality of the working relationship is determinative, meaning that all facts relevant to the relationship between the worker and the employer must be considered.

While factors can vary and no one factor is determinative, the DOL typically considers six:

USDOL Audits

1. The extent to which the work performed is an integral part of the employer's business;
2. Whether the worker's managerial skills affect his or her opportunity for profit and loss;
3. The relative investments in facilities and equipment by the worker and the employer;
4. The worker's skill and initiative;
5. The permanency of the worker's relationship with the employer; and
6. The nature and degree of control by the employer.

Virginia Withholding Audits

The Department of Taxation includes employer withholding tax among the business tax audits it conducts, although such audits are exceedingly rare.

The 3-year statute of limitations on audits generally applies, but Virginia will routinely expand the audit period to 6 years if returns are not filed.

Virginia Withholding Audits

The Department of Taxation generally punts on the issue of employee versus independent contractor.

"Virginia law conforms to the provisions of federal law with respect to whether an employer-employee relationship exists between parties." Therefore, you should contact the IRS for a determination [sure, no problem]. If the IRS classifies you as an employer, you will also be considered an employer for Virginia purposes."

http://www.tax.virginia.gov/site.cfm?alias=BusinessFAQ#liability

Virginia Withholding Audits

August 14, 2014: Governor McAuliffe signed Executive Order 24, which established an interagency task force to work on "payroll fraud."

- Worker misclassification is one focus of the initiative.
- Members include VADT, VEC, SCC, DOLI, and WCC.
- Workplan and report on progress is due 12/1/14.

Virginia Unemployment

The VEC conducts approximately 3,700 audits per year, many of them selected by industry and focused on worker classification.

According to the VEC:

> "Employers are liable for unemployment tax in Virginia if they are currently liable for Federal Unemployment Tax. General employers are liable if they have had a quarterly payroll of $1,500 or more or have had an employee for 20 weeks or more during a calendar year. Agricultural, Domestic, and 501(c)(3) Non-Profit employers have different thresholds for liability. Additionally, if you acquire a business that is liable at the time of the acquisition, you are liable."

http://www.vec.virginia.gov/employers/faqs/Employer-UI-Tax-Questions#a70

Virginia Unemployment

"Services performed by an individual for remuneration shall be deemed to be employment subject to this title unless the Commission determines that such individual is not an employee for purposes of the Federal Insurance Contributions Act and the Federal Unemployment Tax Act, based upon an application of the 20 factors set forth in Internal Revenue Service Revenue Ruling 87-41 [*citations omitted*]." VA Code Ann. §60.2-212(C).

VEC audit will result in a bill for the current year and the 3 preceding tax years, plus interest. Audit results may also be shared with the IRS and other state agencies.

VA Workers Compensation

A contractor that hires one or more subcontractors to assist in the work of the business is responsible for the workers' compensation liability for its subcontractor's employees, regardless of whether the subcontractor has coverage.

Require legitimate subcontractors to certify their compliance with Virginia workers compensation requirements and make sure your client has sufficient coverage for their employees and all "independent contractors."

Workers' Compensation

- VA Code §65.2-101 provides the definition of "employee" for purposes of workers' compensation cases in Virginia:

> "Every person, including aliens and minors, in the service of another under any contract of hire or apprenticeship, written or implied, whether lawfully or unlawfully employed, except (i) one whose employment is not in the usual course of the trade, business, occupation or profession of the employer or (ii) as otherwise provided in subdivision 2 of this definition."

- There are 21 additional statutory inclusions for specific industries and types of worker after the general rule.
- "Subdivision 2" provides 14 statutory exclusions from the definition.

Workers' Compensation

The test applied by the Workers' Compensation Commission traces its roots to the common law:

"A person is generally considered an employee if:

1. they are selected,
2. can be dismissed,
3. earn pay or wages, and
4. control is exercised over the means and method by which the work is performed. "

http://www.vwc.state.va.us/sites/default/files/documents/Employer-FAQs_1.pdf

Workers' Compensation

"The last factor is given the greatest weight. If inquiry indicates that "control" is exercised over the worker, the worker should likely be counted as an employee for coverage purposes."

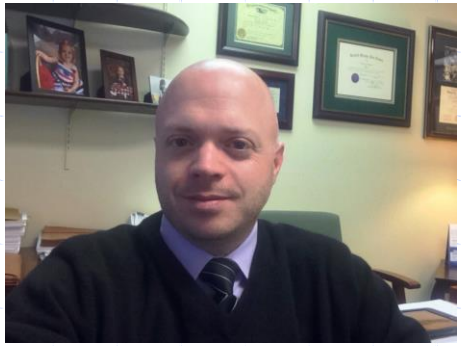
- "The power of control is the most significant indicium of the employment relationship." *Richmond Newspapers,Inc. v. Gill,* 294 S.E. 2d 840, 843 (Va. 1982).
- "An employer-employee relationship exists if the party for whom the work is to be done has the power to direct the means and methods by which the other does the work." *Intermodal Servs., Inc. v. Smith*, 364 S.E. 2d 221, 224 (Va. 1988) (holding that if the party performing the work is free to adopt such means and methods as he chooses to accomplish the result, he is not an employee but an independent contractor).

Other Considerations

Pension plans: A retroactive (or even prospective) change can have impact a company's pension and other qualified plans. Unless reclassified workers can be legitimately excluded from participation, they may be entitled to retroactive coverage, vesting, and contributions in one or more plans. Given the complexity of qualification, compliance, and nondiscrimination rules involved in such plans, the reclassification of workers as employees can cause big problems for the employer's plan(s).

Personal liability for unpaid federal and state employment taxes: Remember the discussion from last month re: the TFRP and converted state assessments.

About the presenter



Russell Haynes is a tax attorney practicing exclusively in the tax controversy field, including civil and criminal tax matters. Russell has worked for his dad, Burton J. Haynes, a tax attorney, CPA, and former IRS Criminal Investigation Division Special Agent, for nearly a decade as a legal assistant, paralegal, and attorney. The majority of Russell's work is devoted to business cases involving federal and state employment taxes, including unpaid and unfiled employment, unemployment, and entity-level income tax returns, and the accompanying personal exposure of owners, officers, and employees to the Trust Fund Recovery Penalty and converted state assessments. Russ has successfully defended a variety of businesses from state and federal action in such cases, as well as assisting individuals in avoiding or reducing their personal exposure to the business' tax problems.

Russell also works with clients on a variety of individual tax problems, including unfiled or unpaid income taxes and audits. Russell is an expert in the use of bankruptcy to handle unpayable tax debts; offers in compromise; negotiating installment agreements with the federal and state tax authorities; innocent and injured spouse claims; IRS administrative appeals and Tax Court cases; and claims for abatement of penalties. Russell is also experienced in criminal tax cases, including those involving charges of tax evasion, willful failure to file, willful failure to pay, willful failure to collect and pay over employment taxes, false statements, false claims, and conspiracy. He has worked such cases at all stages, from investigation by the IRS Criminal Investigation Division or other federal agencies, or when such cases proceed through the grand jury process. He has worked on criminal tax cases in the post-investigatory stage, including conferences at the Tax Division of the U.S. Department of Justice and the U.S. Attorney's Office, trial preparation, forensic accounting reconstruction, expedited plea agreements, sentencing, post-sentencing, and civil follow-ups with the IRS Examination Division.

Russell is also well-versed in accounting and return-preparation. He has performed forensic accounting reconstructions on numerous cases, prepared income, employment, and unemployment tax returns, is familiar with electronic filing systems for the IRS, Social Security Administration, Virginia Department of Taxation, and Comptroller of Maryland. Russell is a Quickbooks ProAdvisor.

Russell is admitted to the U.S. Tax Court, the U.S. District Court for the Eastern District of Virginia, and the Virginia Supreme Court. He is a member of the American Bar Association, the ABA Tax Section and the ABA Committee on Civil and Criminal Tax Penalties, the Virginia State Bar Association and VSB Taxation Section. He is married to another tax attorney, Heidi Kordish Haynes, and has a daughter, Hannah Haynes.

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