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Worker Classification in Light of Remote Workers May Need to be Revisited

By Larry Brant on 2.17.23

INTRODUCTION

As I have discussed in prior blog posts (March 11, 2013, April 9, 2013 and December 9, 2013), worker classification has historically been a focus of attention of various government agencies as well as others. Misclassifying workers, even if unintentional, can create nightmares for businesses and their owners.

The worker classification rules are not always objective, making them difficult to apply. Additionally, the rules applicable to a particular business may vary depending on who is looking at the matter. For example, in many cases, the laws applied by the Department of Labor ("DOL") and the Internal Revenue Service ("IRS") differ from the laws applied by state or local agencies. On top of that, the laws of the states are not uniform.

As a result of the COVID-19 pandemic, we have seen a significant worldwide change in the structure of workforces caused by the emergence of the remote worker. The number of remote workers has significantly multiplied in the last two years, adding one more factor to the worker classification analysis. In and of itself, having workers performing services from remote locations (usually their personal residences) does not make the workers per se employees or per se independent contractors. While the location where a worker performs services should be considered in making a classification determination (i.e., whether the business can or does control the worker), it is not a definitive factor. Nevertheless, with a changed workforce model, which is likely here to stay, businesses should invest the time and energy in revisiting their prior worker classification conclusions to see if they remain valid today.

WHO CARES ABOUT WORKER CLASSIFICATION

The question many businesses pose is: who cares about worker classification? The list of who cares is long and includes -- (i) the IRS; (ii) the DOL; (iii) state and local agencies such as the state department of revenue, the unemployment department, the worker compensation department, and the employment division; (iv) labor unions; and (v) the workers.

Internal Revenue Service

In October 2022, the Department of the Treasury released its estimate of the annual federal gross "tax gap" (the difference between what taxpayers should have paid and what they actually paid on a timely basis). The number is staggering. The treasury's most recent estimate of the annual tax gap is $496 billion, a $58 billion increase from prior estimates.

The government has concluded worker misclassification is a component of the tax gap. Studies conducted by the National Research Program ("NRP") conclude that the tax gap is comprised of three components, namely non–filing of tax returns, underreporting of income and underpayment of taxes. Further, through its studies, the Joint Committee on Taxation ("JCT") has concluded tax revenue loss associated with worker misclassification is significant. The JCT, in a May 2007 report, concludes when workers are classified as employees, more than 99% of wage and salary income is reported. By comparison, only 77% of gross income is reported when workers are classified as independent contractors and receive IRS Forms 1099-MISC, and only 29% of gross income is reported if no IRS Form 1099 is received. Additionally, a 2006 report of the General Accountability Office, estimated the underreporting of income resulting from misclassified workers is at least $2.7 billion per year. So, it is safe to say the IRS cares about worker classification.

Department of Labor

The DOL has historically made worker classification one of its priorities. In 2013, it proposed a budget increase of $14 million to combat worker misclassification. The requested budget increase was specifically designated for: (i) grants to the states to help them identify noncompliance and recover unpaid taxes ($10 million); and (ii) the hiring of 35 new DOL investigators to handle misclassification complaints ($4 million). In 2014, the DOL awarded $10.2 million to 19 different states to help support their worker classification compliance efforts.

Under its "Misclassification Initiative," the DOL has entered into information sharing and coordinated enforcement partnerships with 28 states, including California, New York, Florida, Texas, and Illinois. The DOL reported that, in 2015, its new initiative resulted in more than $74 million in back wages being paid to more than 102,000 misclassified workers. Interestingly, these workers came from a wide variety of industries. The investigatory and enforcement actions by the DOL show that it cares about worker classification.

State and Local Government

Historically, many state and local government agencies have targeted worker misclassification. State and local governments assert they lose millions of dollars, including tax revenues, because businesses improperly classify workers as independent contractors. Consequently, many state and local governments aggressively pursue businesses or specific industries known to utilize independent contractor business models. To illustrate, between late 2007 and 2009, various state agencies in New York discovered 31,500 cases of misclassified workers

and more than $157 million in unreported wages in New York alone. The violations led to the recovery of $4.8 million in unpaid unemployment taxes, more than $1 million in unemployment insurance fraud penalties, more than $12 million in unpaid wages, and more than $1.1 million in workers' compensation fines and penalties. Other states that have cracked down on worker misclassification include:

- **California** – California's Attorney General obtained a $13 million judgment against two companies that had misclassified janitors as independent contractors, and had failed to pay significant payroll taxes. The attorney general obtained an award against a construction company of $4.3 million for misclassifying its workers. In 2014, California enacted a law imposing joint and several liability on staffing firms that supply, and businesses that use misclassified workers.
- **Maryland** – Maryland lawmakers passed a law authorizing the state to investigate the misclassification of workers in the construction and landscaping industries. The law also authorizes the state and local agencies to issue citations and impose fines for worker misclassification. For knowingly misclassifying a worker, the fine in Maryland is $5,000 per employee. The fine increases for repeated violations. In addition, any person who "knowingly" advises an employer to violate the law (i.e., misclassifying workers) is subject to a penalty of up to $20,000.
- **Colorado** – Colorado lawmakers passed a law imposing a penalty of $5,000 per employee for the first worker misclassification offense. Subsequent violations may result in a $25,000 penalty per employee.
- **Illinois** – Illinois lawmakers passed a law imposing harsh civil and criminal penalties for misclassification of workers, including disbarment of the employer from government contracting.
- **Delaware** – Delaware lawmakers passed a law covering construction industry employers. Misclassification by such employers may result in a $1,000 to $5,000 penalty per employee.
- **Michigan, New Jersey, Massachusetts and Iowa** – State governors of Michigan, New Jersey, Massachusetts and Iowa issued executive orders creating task forces and commissions to address worker misclassification.
- **Oregon** – Oregon established an Interagency Compliance Network to:
  - Establish consistency in agency determinations relating to the classification of workers;
  - Gather and share information relating to persons who pay workers in cash and do not comply with tax or employment laws;

- Gather and share information relating to worker misclassification;
- Develop investigative methods for auditing persons who pay workers in cash, or misclassify workers, and who do not comply with employment or tax laws;
- Conduct joint audits of persons who pay workers in cash, or misclassify workers, and who do not comply with employment or tax laws;
- Identify opportunities for (and obstacles to) improving compliance with laws relating to the classification of workers;
- Create a coordinated enforcement process for the laws relating to worker classification that is efficient, fair and effective for the public and the regulatory agencies charged with enforcing employment or tax laws;
- Engage in public outreach efforts to educate the public generally on the distinctions between independent contractors and employees, and the laws and regulations governing worker classification; and
- Take other appropriate actions to improve compliance with employment or tax laws administered by the member agencies.

The states have the same motivation to prevent worker misclassification as the federal government—to generate tax revenue, reduce their tax gaps, and ensure workers are treated appropriately under their employment laws. State and local governments, like the IRS, want to collect the proper amount of income and related taxes. State and local governments are also concerned about the financial well-being of their unemployment insurance and workers' compensation systems.

If a business classifies a worker as an independent contractor, as shown by the federal government's studies, it is likely that some of the workers will not properly report their income, resulting in a loss of tax revenue for the state and local government. Also, the misclassifying business is generally not liable to make unemployment insurance payments to the state for that worker. Likewise, if the business terminates a worker, the worker will likely be ineligible for state unemployment insurance benefits. If, however, the worker is an employee, he or she may be eligible for the benefits. This creates a serious problem in the case of a misclassified worker: Money is being distributed out of the state's unemployment fund, but the employer has paid nothing in. As state coffers are running on empty with the significant unemployment we have seen on and off over the last several years, states are increasing audits to determine if businesses are paying adequate unemployment taxes. Many of these audits are triggered by an "independent contractor" who files a claim for unemployment insurance benefits. Other audits are triggered by third-party tips (e.g., competitors, disgruntled workers or labor unions), random audit activity, or industry-focused audit activity.

If a worker is classified as an independent contractor and is injured while performing work for a business, unless the worker has workers' compensation coverage, the worker's injuries will not be covered by the workers' compensation insurance of the business and may not be covered by his/her personal medical insurance, if any. If the worker is an employee, however, the employee is likely eligible for the workers' compensation insurance coverage paid for and carried by the business for whom he or she is performing services. Without coverage, the costs of medical treatment for injured workers will likely burden both the government and the public due to increases in the costs of services for otherwise complying citizens. Consequently, states have an interest in ensuring workers are appropriately classified and eligible for such insurance coverage.

For all of these reasons, it is clear that state and local governments care that workers are properly classified.

Labor Unions

Labor unions cannot organize independent contractors. So, if a workforce or members of a workforce are misclassified as independent contractors, the labor unions do care. Organizational activities could be impaired by worker misclassification.

Workers

The workers themselves care about proper classification. If a worker is misclassified as an independent contractor, he or she will not receive employer contributions to Social Security and Medicare, unemployment insurance, worker compensation insurance, employee benefits such as health, life and disability insurance, overtime pay, paid time off, and reimbursement of business expenses. The benefits are important to most workers.

RISKS OF MISCLASSIFICATION

Many businesses have legitimate business reasons for classifying workers as independent contractors, especially when the worker performs temporary, specialized services for a business and also performs such services for other businesses. In some industries, using independent contractors is a common practice (e.g., construction and transportation). Workers in such industries often prefer to be treated as independent contractors because it gives them the freedom to be their own boss and to freely run their own business. In many instances, the independent contractor model allows the worker to be entrepreneurial and potentially earn a higher income.

Nevertheless, some businesses may be motivated to classify workers as independent contractors to avoid payroll and other "employee-related" expenses. Other businesses may do so to circumvent minimum wage laws, overtime laws, anti-discrimination laws, or the Affordable Care Act ("ACA") requirement to offer health insurance coverage. Worker misclassification becomes most prevalent during recessions, when unemployment rates are high.

Whatever the reason, businesses that treat workers as independent contractors rather than employees enjoy significant benefits, including:

- With respect to each worker, avoiding payroll taxes and the obligation to withhold income taxes from wages;
- Avoiding the cost of workers' compensation insurance, health insurance, overtime pay and other fringe benefits; and
- Avoiding the impact of labor laws applicable to employees, which are not applicable to independent contractors, such as the FLSA, ACA, the Family and Medical Leave Act ("FMLA"), the National Labor Relations Act ("NLRA"), and Title VII of the Civil Rights Act.

In effect, businesses classifying workers as independent contractors may cut payroll costs by up to 20-30%. Moreover, such businesses may avoid exposure to many types of employment lawsuits and resulting liability under federal, state and local laws intended to protect employees. They may also avoid attempts at unionization or the expansion thereof. The risks of misclassifying employees, however, regardless of motivation, may have serious repercussions.

Federal Level Risks

On the federal level, if the IRS determines a worker is misclassified as an independent contractor, it may be able to assess the following taxes, fees and/or penalties (as well as charge interest):

- The amounts which should have been withheld for federal income tax withholding purposes, plus interest and penalties;
- The employer and employee portions of FICA (Medicare and Social Security), and FUTA (unemployment) taxes, plus interest and penalties;
- Penalties for failing to withhold and failing to properly file tax returns (more severe penalties may be imposed if the employer engaged in negligent, intentional or fraudulent misconduct);

- Penalties under the ACA for failing to offer health insurance coverage (discussed below);
- Criminal sanctions, including imprisonment and fines; and/or
- Personal liability for corporate officers, up to 100% of the amount that should have been withheld and paid over to the government.

Other federal agencies, including the DOL and the National Labor Relations Board, may impose additional penalties or fines. The amount of the penalty or fine usually varies, depending upon the degree of the business's culpability for misclassifying the workers. For example, Code Section 3509 provides several levels of reduced tax liability if an employer **unintentionally** misclassifies a worker. Under Code Section 3509, an employer that fails to deduct and remit withholding, Social Security and Medicare taxes from an employee's wages due to misclassifying the employee as an independent contractor is liable for:

- The full employer share of Social Security and Medicare taxes;
- Withholding taxes equal to 1.5% of the employee's wages; and
- 20% of the employee's share of Social Security and Medicare taxes.

In cases where the employer also fails to file information returns with respect to a misclassified worker (i.e., IRS Form 1099) and does not have reasonable cause for the failure, the employer is liable for:

- The full employer share of Social Security and Medicare taxes;
- Withholding taxes equal to 3% of the employee's wages; and
- 40% of the employee's share of Social Security and Medicare taxes.

Code Section 3509 does not apply when an employer intentionally misclassifies a worker. In such cases, more severe penalties and fines (mentioned above) may be imposed, in addition to the full amount of taxes due.

With the ACA enactment, employers face additional risks of misclassifying workers. The ACA requires all employers with at least 50 full-time equivalent employees (i.e., "Applicable Large Employers") to offer health insurance coverage meeting certain requirements—including that affordable, minimum value coverage is offered to at least 95% of full time employees—or face penalties under two different penalty regimes. Applicable Large Employers are also required to file information returns about coverage offered to each full-time employee. The ACA penalty regime significantly increases the potential misclassification liability for businesses with larger workforces. These financial risks are compounded by the fact that reclassification may be retroactive and the ACA penalties are applied year-by-year.

State Level Risks

State and local agencies may also be able to assess the following taxes, fees and/or penalties (depending on the state's laws) (as well as charge interest):

- State withholding taxes, plus interest;
- State unemployment taxes;
- Local taxes based in whole or part on employee payroll (e.g. in Oregon, Lane County and Tri-Met Transit taxes);
- Workers' compensation tax/insurance payments;
- Penalties for failing to withhold and failing to properly file tax returns (more severe penalties may be imposed if the employer was engaged in negligent, intentional or fraudulent misconduct);
- Additional taxes based on the loss of the business expense deduction for remuneration paid to workers;[1]
- Criminal sanctions, including imprisonment and fines; and/or
- Personal liability for corporate officers, up to 100% of the amount that should have been withheld.

Private Actions

The assessment of taxes, fines and penalties, and the charge of interest, by federal, state and local governments is not the end of the scary saga. It can get much worse!

The workers themselves may initiate private actions against businesses for additional (minimum or overtime) wages, benefits, workers' compensation coverage, pensions, sick pay, vacation pay, expense reimbursements, etc. When many workers are involved, class action lawsuits may be instituted against businesses. In recent years, class actions have been filed in several states against several renowned companies, including Microsoft Corporation, Hewlett Packard, Time Warner, UPS, Target, Uber, Lyft; and Allstate Insurance.

These cases can result in damages or settlements in the millions of dollars, as well as substantial legal costs to defend the cases. Cases of this nature also cause unwanted internal distractions, taking away from successful business operations. The negative publicity created by these cases can erode customer goodwill. In addition, any victories by the workers in a particular jurisdiction will likely lead to additional cases against these companies and other companies in other jurisdictions. The cases referred to above each easily consumed legal fees and costs in the millions or even billions, and lasted multiple years. For smaller companies, these types of lawsuits could easily lead to the death of the business.

Criminal Sanctions

The First Circuit United States Court of Appeals issued its decision in ***United States v. Albania DeLeon***, 704 F.3d 189 (1st Cir., 2013). This case illustrates that worker misclassification may lead to criminal sanctions, including imprisonment, in addition to the imposition of taxes and civil penalties.

Albania DeLeon owned and operated two businesses: an asbestos abatement training school ("ECT") and a temporary employment agency ("MSI"). The case focuses on Ms. DeLeon and MSI. MSI supplied temporary workers to asbestos abatement contractors.

MSI maintained two separate payrolls for its workforce. One payroll reported a minority of the workers as employees. For these workers, MSI properly withheld payroll and income taxes, properly reported, and properly paid over to the government the employer and employee portions of these taxes. In addition, it issued IRS Forms W-2 to these workers. MSI reported in writing to both its customers (including governmental entities) and the occupational safety division of its local government that it was responsible for and was complying with all employee withholding tax obligations.

The second payroll, which encompassed most of MSI's workers, treated the workers as independent contractors. Consequently, no withholding of payroll or income taxes from worker remuneration was done by MSI. Additionally, it did not pay the "employer portion" of payroll taxes to the government. Rather, MSI issued IRS Forms 1099 to these workers. MSI told its accountants that these workers were independent contractors. Evidence in the trial record indicated Ms. DeLeon had absolutely no factual or legal basis for that conclusion.

In late 2006, as a result of an anonymous tip to the government that MSI was violating immigration laws and was involved in fraudulent payroll activity, state and federal investigators raided the offices of both companies. Based upon the information gathered in the raid, including computer records, the IRS concluded MSI had fraudulently avoided paying over $1,000,000 in payroll taxes.

Ms. DeLeon, the owner of both companies, was charged with several counts of:

- mail fraud;
- making false tax returns;
- procuring false tax returns; and
- conspiracy to violate multiple federal criminal laws.

After an eleven-day trial, Ms. DeLeon was convicted on all counts. She was sentenced to 87 months in federal prison.

Ms. DeLeon had no basis for her characterization of a majority of the workers as independent contractors. She simply reported them as independent contractors to reduce her tax liability. She told her customers and the government she treated the workers properly as employees. Worker misclassification cost her 87 months behind bars. This case illustrates worker misclassification can lead to more than simply a monetary liability and civil penalties.

CONCLUSION

Worker classification is **not** an exact science. While some types of workers should clearly be classified as employees, there is a significant gray area with respect to other types of workers. Moreover, although workers are often classified in groups based on occupation or industry, classification should technically be done on an individual-by-individual basis. Additionally, state and local rules may differ from federal rules, such that a worker may potentially be classified as an employee under state law and an independent contractor under federal law. This leads to interesting tax reporting and compliance problems.

Making matters even more complex, state and local rules may differ within a single jurisdiction, depending upon the application within the jurisdiction. For example, it is not uncommon for some of the classification rules applicable to workers within a state to differ for purposes of unemployment taxes, workers' compensation taxes/insurance premiums, and withholding taxes. These differences, which are often less than obvious, make compliance extremely difficult for most businesses. It requires businesses using independent contractors to engage accountants and attorneys knowledgeable of these issues.

Worker classification has always been a concern for federal, state and local agencies. It should be a concern for businesses using the services of independent contractors. Due to recent changes in workforces, largely brought about by the COVID-19 pandemic, businesses need to revisit their worker classification determinations to confirm whether prior conclusions remain valid today.

The stakes are potentially high.

[1] For example, Oregon has a statute, ORS 305.217, which provides that employers are not allowed a deduction for wages paid for personal services if the employer fails to file information returns (i.e., IRS Form W-2 or Form 1099) or if the Department of Revenue determines employer has misclassified the worker as an independent contractor, unless the employer has reasonable cause for misclassifying the worker, such as reasonable reliance on cases, rulings, past IRS audits, industry practice, or the advice of a tax professional.