1. Overview of Worker Classification

The IRS and the Department of Labor (''DOL''), as well as state labor commissioners and other agencies, each have a stake in ensuring the proper classification of workers. From the IRS's perspective, the misclassification of workers results in lost income and employment taxes and employee benefit (e.g., retirement plan) qualification issues. From DOL's perspective, it results in the violation of employee protections. Businesses that properly classify workers as employees also are disadvantaged by businesses that save money by misclassifying workers as independent contractors.

1.1. Employee or Independent Contractor — What's the Big Deal?

Why does the IRS care so much about whether a worker is classified as an employee or an independent contractor? While there are several reasons, money is the primary driver. More taxes are collected when workers are classified as employees because taxes are withheld from their wages. Congress and the IRS both believe that the misclassification of employees as independent contractors significantly contributes to the tax gap (i.e., the difference between the amount of taxes that the federal government should be collecting and the amount it actually is collecting).

Most laws protecting workers focus on employees and not independent contractors. The Department of Labor and other federal, state, and local agencies enforce these employee-protection measures, and do not want firms classifying workers as independent contractors to avoid providing these protections.

Before the advent of income tax withholding and employment taxes[1] in the 1940s and the evolution of employee protections, there was little reason to debate the classification of a worker as an employee or independent contractor, except in the case of a tort liability claim. In that case, the issue is whether the worker is an employer because a ''master'' (employer) is liable for the acts of a ''servant'' (employee) acting on behalf of the master. The business landscape changed dramatically, however, when income tax withholding and employment taxes became permanent fixtures in the 1940s.

Today, an employer making payments to an employee must:

- Withhold income tax from those payments.
- Withhold the employee's share of employment taxes from those payments.
- Pay the employer's share of employment taxes on the payments.
- Pay the employee at least the minimum wage.
- Pay the employee overtime if the employee is an hourly worker.
- Generally include the employee in any employee benefit plans, including health insurance and retirement, offered by the employer.
- Generally provide COBRA coverage.
- Provide the employee a work environment that is free of any form of prohibited discrimination.
- Provide the employee with medical leave in accordance with the federal, state, and local laws.
- Ensure that the work environment complies with all OSHA (Occupational Safety and Health Administration) and ADA (Americans with Disabilities Act) requirements.

In contrast, a person making payments to an independent contractor must:

- Furnish and file a Form 1099 when required.
- Pay the independent contractor the agreed upon amount for his or her services.[2]

[1] Federal Insurance Contribution Act (''FICA'') tax, which funds Social Security and Medicare, and Federal Unemployment Tax Act (''FUTA'') tax, which is used to help fund state workforce agencies.

[2] Certain laws relating to a safe and healthy work environment may extend to independent contractors.

In addition to tax compliance being higher when taxes are withheld, the general perception is that a higher percentage of employees are covered by medical insurance and retirement plans than are independent contractors. For both tax and social policy reasons, federal, state, and local governments have a vested interest in having workers classified as employees.

1.2. Tax Considerations

The IRS treats a person performing services (i.e., a worker) as falling into one of four categories:[3]

- *Independent contractor*. The general rule is that an individual is an independent contractor if the firm[4] has the right to control or direct only the result of the work and not what will be done and how it will be done.
- *Employee (common-law employee)*. Under common-law rules, anyone who performs services for a firm is the firm's employee if the firm can control what will be done and how it will be done. This is so even when the firm gives the employee freedom of action. What matters is that the firm has the right to control the details of how the services are performed.
- *Statutory employee*. If workers are independent contractors under the common-law rules, such workers may nevertheless be treated as employees by statute (statutory employees) for certain employment tax purposes if they engage in four types of activities[5] and meet three conditions described under Social Security and Medicare taxes.
- *Statutory nonemployee*. There are three occupational groups of statutory nonemployees (workers who may be classified as employees under common law, but who are classified as independent contractors by statute): direct sellers, licensed real estate agents, and certain companion sitters.[6]

Most worker classification disputes are over whether the worker is an employee or independent contractor. Disputes over whether a worker is a statutory employee or statutory nonemployee are less common.

The modern era of the worker classification issue began in the 1970s when the IRS began aggressively examining businesses for the misclassification of employees as independent contractors. Because the tax liability (including interest and penalties) for misclassifying employees as independent contractors could be staggering at that time, many businesses were financially crippled by IRS assessments.

The business community took its concerns with the IRS examinations to Capitol Hill. The House and Senate conferees on the Tax Reform Act of 1976 included in the Statement of Managers a request that until the completion of a study by the staff of the Joint Committee on Taxation on the problems of classifying persons as employees or independent contractors,[7] the IRS shall ''not apply any changed position or any newly stated position in this general subject area to past, as opposed to future taxable years.'' The Joint Committee on Taxation had previously asked the General Accounting Office (GAO) to examine the IRS's administration of the employment taxes, including the classification of individuals as either self-employed individuals or as employees.

The GAO report[8] indicated that the principal problem with regard to the classification of individuals for employment tax purposes is the uncertainty in the interpretation and application of the governing common-law rules. In its report, the GAO noted that this uncertainty had created difficulty for individuals, employers, tax practitioners, and tax administrators.

Congress held hearings in 1978 regarding the worker classification issue, and in the Revenue Act of 1978[9] provided interim relief for taxpayers who were involved in worker classification controversies with the IRS, and who potentially faced large assessments, as a result of the IRS's proposed reclassification of workers. The interim relief was to last until 1980 to give Congress adequate time to resolve the many complex issues involved in this area.

Although initially intended as interim relief for one year, Section 530 of the Revenue Act of 1978 was extended several times and then made permanent. For more than 30 years, Section 530 has provided a ''safe harbor'' to businesses with a reasonable basis for classifying a worker as an independent contractor. Moreover, it generally has prohibited the IRS from publishing any regulation or revenue ruling with respect to the employment status of any individual for purposes of employment taxes.

Because Section 530 of the Revenue Act of 1978 generally provides relief to businesses that have a reasonable basis for

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[3] The general definition of these categories is taken from the IRS website.

[4] For purposes of this Handbook, the term ''firm'' generally refers to the person (whether an individual, business enterprise (e.g., corporation, partnership, limited liability company or sole proprietorship), organization, state, or other entity for whom the work is being done and from whom the worker receives payment.

[5] The four occupational groups (types of activities) are:

- A driver who distributes beverages (other than milk) or meat, vegetables, fruit, or bakery products, or who picks up and delivers laundry or dry cleaning, if the driver is the firm's agent or is paid on commission.
- A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.
- An individual who works at home on materials or goods that the firm supplies and that must be returned to the firm or to a person the firm names, if the firm also furnishes specifications for the work to be done.
- A full-time traveling or city salesperson who works on the firm's behalf and turns in orders to the firm from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for the firm must be the salesperson's principal business activity.

[6] Direct sellers and licensed real estate agents are treated as self-employed for all federal tax purposes, including income and employment taxes, if:

- Substantially all payments for their services as direct sellers or real estate agents are directly related to sales or other output, rather than to the number of hours worked, and
- Their services are performed under a written contract providing that they will not be treated as employees for federal tax purposes.

Companion sitters who are not employees of a companion sitting placement service are generally treated as self-employed for all federal tax purposes.

[7] H.R. Rep. No. 94-1515, 94th Cong., 2d Sess. 489 (1976).

[8] Report of the Comptroller General to the Joint Committee on Taxation, ''Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions,'' GGD-77-88 (Nov. 21, 1977).

[9] Pub. L. No. 95-600, H.R. 13511, § 530. This matter also was the subject of a similar, separately reported bill in the 95th Congress, H.R. 14159, which was reported by the House Ways and Means Committee (H.R. Rep. 95-1748, Oct. 10, 1978). The provisions adopted in the Revenue Act of 1978 were based on a Senate amendment, which followed S. 3007 (referred to the Senate on April 27, 1978 by Senate Finance Comm.), a Senate bill, as well as H.R. 14159.

classifying workers as independent contractors but does not preclude the IRS from examining the classification of workers by firms, the IRS has continued to examine firms on the classification of workers. As noted earlier, there also is a general belief at the IRS and on Capitol Hill that the misclassification of employees as independent contractors contributes to the tax gap.

In early 2010, the IRS launched its National Research Employment Tax Program. This was a three-year program during which the IRS conducted thorough employment tax examinations on approximately 1,500–2,000 randomly selected taxpayers for each calendar year 2008, 2009, and 2010. In the course of these examinations, the IRS specifically stated that it would be looking at worker classification issues.

In addition to the IRS examination efforts, a number of bills have been introduced in recent years, both in Congress and State legislatures, to address the worker classification issue. The general thrust of these legislative proposals is to limit the number of workers being classified as independent contractors.

1.3. Labor Considerations

DOL, as well as state labor commissioners and other state agencies, are concerned with worker classification from the perspective of employee benefits and protections. Misclassified employees are often denied access to certain benefits and protections — such as family and medical leave, overtime, minimum wage and unemployment insurance — to which they are entitled. DOL also is concerned with substantial losses to the Treasury and the Social Security and Medicare funds, as well as to state unemployment insurance and workers compensation funds.

DOL launched a Misclassification Initiative, under the auspices of Vice President Biden's Middle Class Task Force, to combat the misclassification of workers and restore employee rights to those denied them.[10] In September 2011, then-Secretary of Labor, Hilda L. Solis, announced the signing of a Memorandum of Understanding (''MOU'') between DOL and the IRS. Under this agreement, the agencies are to work together and share information to reduce the incidence of misclassification of employees, to help reduce the tax gap, and to improve compliance with federal labor laws.

Additionally, labor commissioners and other agency leaders representing twenty-seven states have signed MOUs with DOL's Wage and Hour Division, and in some cases, with its Employee Benefits Security Administration (''EBSA''), Occupational Safety and Health Administration (''OSHA''), Office of Federal Contract Compliance Programs (''OFCCP''), and the Office of the Solicitor. DOL is actively pursuing MOUs with additional states as well.

The purpose of these MOUs is to enable the DOL to share information and to coordinate enforcement efforts with participating states to level the playing field for law-abiding employers and to ensure that employees receive the protections to which they are entitled under federal and state law. Employers that misclassify their employees may not be paying the proper overtime compensation, FICA and Unemployment Insurances taxes, or workers' compensation premiums.

Under MOUs that IRS has with 39 states, IRS and state workforce agencies (''SWAs'') are permitted to: (1) exchange audit reports; (2) exchange audit plans; (3) participate in side-by-side examinations, when appropriate; (4) receive information; and (5) participate in reciprocal sharing of information. After IRS conducts a worker classification examination that results in the misclassification of an employee as an independent contractor, it determines whether information regarding the examination should be forwarded to the appropriate SWA. SWAs make a similar determination when they conduct an employment examination. Since 2004, IRS has been using information received from states to identify potential candidates for employment tax examinations.

On July 15, 2015, David Weil, then DOL's Wage and Hour Administrator, released Interpretation No. 2015-1, titled ''The Application of the Fair Labor Standards Act's ''Suffer or Permit'' Standard in the Identification of Employees Who Are Misclassified as Independent Contractors.'' The impetus for the Interpretation is the belief that employees are intentionally being misclassified as independent contractors. The Interpretation notes that, while most misclassified employees are labeled ''independent contractors,'' employees increasingly are being labeled something else, such as ''owners,'' ''partners,'' or ''members of a limited liability company.''

The Interpretation asserts that most workers are employees under the Fair Labor Standards Act (''FLSA'') based on the broad definition of ''employment'' under the ''suffer or permit to work'' standard of FLSA. For this purpose, economic dependency is key; that is, whether a worker is ''economically dependent'' on the firm or ''is in business for himself.'' If a worker is economically dependent on the firm, he is ''suffered or permitted to work,'' and, therefore, an employee under FLSA.

The Interpretation treats as irrelevant (i) the worker's receipt of a Form 1099-MISC, and (ii) a written agreement between the firm and worker designating the worker as an independent contractor.

The Interpretation is not limited to FLSA. It specifically states that the same expansive standards apply in classifying a worker under the Federal Family and Medical Leave Act (''FMLA'').

The Interpretation is not legally binding, but courts generally defer to such interpretations in applying the underlying law — here the FLSA. The Interpretation signals DOL's heighted focus to curtail firms' ability to provide goods or services through independent contractor relationship, and the likelihood of an increased enforcement initiative concerning worker classification.

[10] Information on DOL's Misclassification Initiative can be found at http://www.dol.gov/whd/workers/misclassification/#newsroom.