Worker Misclassification Penalties Likely to Increase as IRS Audits More Employers

by William E. Bonano

Legislation is likely to be proposed to increase penalties for Internal Revenue Service worker misclassification audits, reduce availability of Section 530 relief and impose additional requirements for reduced employer withholding under Section 3509. In light of the National Research Program under which 6,000 tax audits on worker misclassification will be initiated over three years, employers should focus on the proposed changes in tax penalties and relief provisions.

Background

In prior years, the tax penalties associated with worker misclassification issues were usually relatively small. Even when penalties were proposed, the IRS Classification Settlement Program often offered employers relief through prospective-only reclassification at reduced rates of withholding. Moreover, Section 530 generally permitted businesses to treat workers as independent contractors where that treatment was both consistently applied and premised on a "reasonable basis," as defined in the statute.[1]

However, in response to various studies concluding that worker misclassification has resulted in a significant "tax gap,"[2] Congress and the IRS have given increased scrutiny to what they perceived as worker misclassification abuses. As a result, as discussed below, taxpayers can now expect increased penalties on audit and reduced opportunities for mitigating adjustments through settlement.

Present Penalties Potentially Applicable to Worker Misclassification Adjustments

The following penalties could be proposed in a worker misclassification audit:

[1] Section 530 of the Revenue Act of 1978 created a safe harbor allowing employers to continue to treat a worker as an independent contractor even if the worker would have been treated as an employee under common law tests. See Rev. Rul. 87-41, 1987-1 C.B. 296 for a listing of 20 factors reflecting common law tests. To qualify for section 530 relief, an employer must meet the following requirements: (i) the employer must have filed all required returns (e.g., Form 1099) reporting payments to the worker as an independent contractor (reporting consistency); (ii) the employer must have not treated the worker or any similarly situated worker as an employee after 1978 (substantive consistency); and (iii) the employer must have had a "reasonable basis" to have treated the worker as an independent contractor. A "reasonable basis" for treating a worker as an independent contractor would include reliance on judicial precedent, a past IRS audit, industry practice or another reasonable basis for treating the worker as an independent contractor.

[2] For example, the IRS conducted a preliminary analysis of Fiscal Year 2006 data and found that underreporting attributable to misclassified workers is likely to be "markedly higher" than an earlier $ 1.6 billion estimate based on 1984 data. See, e.g., *Treasury Inspector General for Tax Administration*, 2009 TNT 25-28 (February 4, 2009).

Civil Penalties

- **Section 6651** This is the general failure-to-file penalty, which could apply to a failure to file Form 941 employment tax returns. The penalty is 5% per month during the period of failure, up to a maximum of 25%. This penalty is applied to the tax amount required to be shown on the return.
- **Section 6656** This penalty applies to a failure to make deposits of taxes, and would apply to a failure to make timely employment tax deposits. The penalty is 10% if the failure is more than 15 days (with lower percentages of 2% and 5% for failures of not more than 5 and 15 days, respectively). The penalty increases to 15% if not paid within 10 days of a delinquency notice, or on the date of notice and demand in the case of a jeopardy assessment under Sections 6861, 6862 or 6331(a).
- **Section 6662** This Section contains "accuracy-related" penalties, which apply at a rate of 20% of the underpayment in tax attributable to negligence or a substantial understatement of tax—the two provisions most likely to apply in employment tax cases. The Section provides for reductions in the penalty for the portion of the understatement attributable to any item where there is "substantial authority" or where the relevant facts are adequately disclosed on the return, with exceptions for tax shelters, which are unlikely to apply in the employment tax context. These penalties are subject to the "reasonable cause" exception in Section 6664(c), which could include reliance upon a qualified professional adviser, again with limitations in the tax shelter context.
- **Section 6663** This is the civil fraud penalty and is 75% of the portion of the underpayment that is attributable to fraud. The IRS has the burden of proving fraud, but if that burden is met, the entire underpayment may be treated as attributable to fraud, except for the portion that the taxpayer establishes by a preponderance of the evidence (i.e., greater than 50%) as not attributable to fraud. Section 6663(b). In order to prove civil fraud, the IRS must establish that the taxpayer's purpose was to avoid or evade tax know to be due. See, e.g., *Estate of Trompeter v. Commissioner*, 279 F.3d 767, 773 (9th Cir. 2002). Generally, because of the highly factual nature of worker misclassification issues, it is unlikely that the IRS would propose a civil fraud penalty in the absence of evidence of a taxpayer knowingly misclassifying a worker.
- **Section 6672** This section applies a penalty to any person who "willfully" fails to collect and pay over tax. The amount of the penalty is the total amount of the tax not collected and paid over. This so-called "100% penalty" is frequently applied in employment tax cases where employers divert funds from employment withholdings to other purposes, typically because of cash-flow concerns of distressed businesses. The penalty applies to "responsible persons" and can be applied based on facts and circumstances showing that a person has authority over the expenditure of funds (including check-signing authority) and knowledge that employment taxes have not been paid. While this penalty could be applied in a worker misclassification context, it is more often applied in the context of a failure to withhold and pay over for acknowledged employees.
- **Section 6721** This Section applies a penalty for failure to file correct information returns, which would include Form 1099 information returns. The penalty amount is $50 per return, up to a maximum of $250,000 per year. Section 6721 includes a "correction" period provision providing that the penalty for failures corrected within 30 days of notice of the failure will be reduced to $15 per occurrence with the maximum aggregate amount reduced to $75,000. The Section provides for reduced penalties where the correction occurs after 30 days, but before August 1 of the calendar year in question. Section 6721(b). Section 6721(d) also provides for reduced penalties for taxpayers with gross receipts of less than $5 million. This penalty would be increased under previously proposed legislation that is expected to be reintroduced in the 112th Congress.
- **Section 6272** This Section applies to failures to furnish payee statements, which would include a failure to provide Forms W-2 to employees and Forms 1099 to independent contractors. This penalty is $50 per failure with an aggregate total of $100,000 per year. This penalty would be increased under previously proposed legislation that is expected to be reintroduced in the 112th Congress.

- **Section 6273** This Section applies to failures to comply with a "specified information reporting requirement," which in an employment tax context presumably would include failure to file forms such as Form W-2C, Corrected Wage and Tax Statement. This penalty is $50 per failure with an aggregate total of $100,000 per year.

Criminal Penalties

- **Section 7202** This Section applies to a willful failure to collect or pay over taxes. The penalty is a fine of not more than $10,000 and/or imprisonment for not more than 5 years. In the context of a criminal case, "willfulness" is the "voluntary, intentional violation of a known legal duty." *Cheek v. United States*, 498 U.S. 192, 201 (1991), quoting from *United States v. Pomponio*, 429 U.S. 10, 12 (1976) (per curium)). As with civil fraud, it is unlikely that a worker misclassification issue could trigger a criminal prosecution in the absence of convincing evidence of a knowing violation. Gross negligence, for example, would not be sufficient.
- **Section 7204** This Section applies to the willful failure to furnish statements to employees and would include a willful failure to provide a Form W-2. The penalty is a fine of not more than $10,000 and/or imprisonment for not more than 1 year.

State Criminal Penalties

States are also becoming increasingly involved in enacting criminal penalties for misclassifying workers. See, for example:

- Pennsylvania's "Construction Workplace Misclassification Act" (H.B. 400, October 13, 2010), making it a criminal offense for an employer to intentionally misclassify a worker as an independent contractor, with each worker misclassification treated as a separate offense.

- New York's "Construction Industry Fair Play Act" (S.B. 5847A, August 27, 2010), making it a criminal offense for an employer to willfully misclassify a worker as an independent contractor, with punishment of imprisonment of up to 30 days for a first offense and up to 60 days for a subsequent offense.

Recent Developments

National Research Program Audits

In 2010, the IRS began a "National Research Program" under which 6,000 taxpayers will be selected over a three-year period for comprehensive employment tax audits. These audits will emphasize worker misclassification and Form 1099 information reporting issues (please see Perspectives from Pillsbury's Executive Compensation and Benefits Practice: IRS National Research Program). These NRP audits are ongoing and the IRS has stated that one of the principal purposes of the audits is to determine "compliance characteristics" so that it can focus on the most "noncompliant" employment tax areas. In effect, these audits will determine guidelines for future employment tax audits, including guidelines for proposing penalties. See, e.g., 2011 TNT 10-5 (January, 2011).

Executive and Legislative Activity

On a parallel course, Congress and the Obama administration, both eager to address perceived abuses in classifying workers, have been active in proposing legislation.

Both Representative Jim McDermott and Senator John Kerry have proposed legislation concerning worker classification. In the 111th Congress, Representative McDermott introduced the "Fair Playing Field Act of 2010" (H.R. 6128) with the companion bill introduced in the Senate by Senator Kerry (S. 3786). While these bills did not pass the 111th Congress, a staff member for McDermott recently stated that McDermott

will “absolutely” introduce the legislation again. See 2011 TNT 78-3 (April 22, 2011). The legislation, if enacted as previously proposed, would end the moratorium on Internal Revenue Service guidance addressing worker classification, requiring the Secretary of the Treasury to issue prospective guidance clarifying the employment status of individuals for federal employment tax purposes. These bills would also change the three statutory standards under Section 530, making it more difficult for an employer to qualify for the safe harbor treatment of workers as non-employees. These bills would also place the burden of proof in satisfying the Section 530 requirements upon the employer. Finally, these bills would increase the information return penalties as follows:

- **Section 6721** Increasing the penalty for failure to file correct information returns from $50 per instance to $250, with the maximum per year increasing from $250,000 to $3 million.
- **Section 6722** Increasing the penalty for failure to furnish correct payee statements from $50 per instance to $250, with the maximum per year increasing from $100,000 to $1 million.
- **Section 6723** Increasing the penalty for failure to comply with “Other Information Reporting Requirements” from $50 per instance to $250, with the maximum per year increasing from $100,000 to $1 million.

Representative McDermott also introduced H.R. 3408, the "Taxpayer Responsibility, Accountability, and Consistency Act of 2009," which did not pass the 111th Congress, but based on the recent statements of McDermott’s congressional staff, may well be reintroduced. That legislation, as previously proposed, would have eliminated the reduced withholding under Section 3509 where, as stated in the proposed legislation, the taxpayer does not have a “reasonable basis” for its worker classification. The Internal Revenue Manual currently mandates application of Section 3509 where it applies. See IRM 4.23.8.5(4) (August 11, 2009).

In concert with these legislative proposals, President Obama in his 2012 Budget included proposals that would permit the IRS to issue rulings addressing worker classification issues, would limit the prospective application of Section 530 safe harbor relief provisions, and would limit the application of the Section 3509 reduced penalty provisions. As stated in the Budget proposal:

> The proposal would permit the IRS to require prospective reclassification of workers who are currently misclassified and whose reclassification has been prohibited under current law [i.e., by Section 530]. The reduced penalties for misclassification provided under current law [i.e., Section 3509] would be retained, except that lower penalties would apply only if the service recipient voluntarily reclassifies its workers before being contacted by the IRS or another enforcement agency and if the service recipient had filed all required information returns (Forms 1099) reporting the payments to the independent contractors.
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> ….
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> The Department of the Treasury and the IRS also would be permitted to issue generally applicable guidance on the proper classification of workers under common law standards.
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> Department of the Treasury, General Explanations of the Administration's Fiscal Year

2012 Revenue Proposals (“Green Book”), February 2012, pp. 107-109.

Conclusion

In the past, employers who failed to properly classify workers as employees often did not suffer significant penalties. Further, where penalties were imposed, Section 3509 was available to reduce the penalties and Section 530 was available to permit employers to treat workers as independent contractors where that treatment was consistently applied and premised on a “reasonable basis.”

However, in an effort to address a perceived "tax gap," Congress and the IRS have given increased scrutiny to worker classification issues. As a result, taxpayers can now expect increased attention to worker classification issues on audit. Further, in the event of an audit, taxpayers can expect the IRS to propose penalties that may be significantly greater than penalties taxpayers have been accustomed to for these audits. Finally, taxpayers will likely have fewer opportunities for mitigating proposed adjustments and penalties through administrative settlement, as exemplified by the likely diminished availability of the Section 530 and 3509 relief provisions. Employers are thus advised to proactively investigate and take appropriate action in view of these pending adverse employment tax audit developments.

If you have any questions, please contact the Pillsbury attorney with whom you regularly work, the author, or any of the following members of Pillsbury's Employment Tax Audit Task Force.

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