

# 10 steps to avoid problems with employee misclassification

by LAWRENCE L. HOENIG

**THE INTERNAL REVENUE** Service, Congress and the President have indicated that they plan a major focus on correcting employee/independent contractor misclassification. As part of this effort, the IRS has created an Employment Tax National Research Project and is conducting a series of more intense employment tax audits, in addition to the usual enforcement actions. Companies should be reviewing their compliance in this area to reduce the potential for significant tax, penalty and interest exposure.

Here is a list of 10 important steps your company should/could take today to reduce future tax/labor exposures on employee misclassification as well as similar executive compensation, expense reimbursement and Section 409A deferred compensation issues.

1. Review the treatment by (i) each division or business group to see whether such division or group has any service providers not treated as employees; and (ii) across the divisions or business groups to confirm that the treatment of service providers providing similar services is consistent.

2. With respect to service providers not treated as employees, make sure that there

**Editor's Note:** Employee misclassification is a huge problem in the construction industry. Some companies classify workers as independent contractors rather than full-time employees to avoid paying the required taxes and benefits (see Page 5). However, even contractors who strive to play by the rules may find themselves in hot water with federal and/or state tax authorities if they're not careful. The following article by Lawrence Hoenig, a partner in the national law firm Pillsbury Winthrop Shaw Pittman LLP, outlines several easy steps every contractor should take to ensure their company is in full compliance with the law..

is a written contract in place for each such service provider.

3. With respect to such contracts, make sure that each form of contract helps to establish why such service provider is an independent contractor under the 20-factor and other relevant tests. Pay careful attention to service providers claiming to be independent contractors but using SSNs (rather than EINs), who are likely subjects of agent inquiries in the event of an audit.

4. With respect to such contracts, make sure that the service provider has been told and accepts the fact that he or she will not be entitled to any benefits, stock plan rights, medical coverage, etc., which are limited to employees — and include this exclusion in the contracts.

5. Consider whether it would be possible to have some or all of the independent contractors hired by a third-party employer and then contract with that employer to provide the services.

6. Confirm that your company is complying with the various tax reporting requirements for independent contractors, primarily the issuance of Form 1099s.

7. Confirm that your company is complying with the various federal and state tax

and labor requirements for all employees, including issuance of W-2s, filing of Form 940s and 941s, etc., and overtime requirements under wage and hour laws.

8. If your company is publicly held, confirm that your company is in compliance with the Internal Revenue Code section 162(m) rules and documentation requirements for performance-based executive compensation.\*

9. Review expense reimbursement policies and confirm compliance with the same.\*

10. Identify “deferred compensation” arrangements subject to Internal Revenue Code section 409A and confirm compliance with the documentation requirements effective Dec. 31, 2008, or that such documents have been corrected in accordance with IRS Notice 2010-6.\*

\* These steps are included as they are issues that are also subject to audit under the IRS's Employment Tax National Research Project which focuses on worker misclassifications. ■

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