Worker Classification and Finding the Correct Employer

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The U.S. tax authorities have launched a major project on worker classification, with a particular focus on the issues of worker classification, payroll tax reporting, and executive compensation. While most U.S. companies think of this as a problem of characterizing services as either employment or independent contractor services, multinational employers should be thinking of the issue as also determining the correct employer among their multinational affiliates. Very significant employee benefit, social security, tax withholding and corporate deduction issues hinge on the correct and (usually) consistent determination of employment status.

For most large employers, there is generally a good sense of who are their employees. While there may be significant numbers of independent contractors, large employers are aware of the serious implications of mischaracterization of individuals as independent contractors when they are really employees.

For the large multinational employers, the issue is similar—but with the crucial difference that they also should define who is the correct employer. For example, in an all-U.S. context, the status of an individual as an employee may be clear, and that employee's employer may also be clear. However, if there is some confusion as to whether a U.S. employee is employed by, say, the parent organization, or a wholly-owned U.S. subsidiary, the reasonable response may be "who cares?" That's because all the employees are covered by social security, all their compensation is deducted on a consolidated corporate return, all their pay is on a common payroll and often all employees have the same benefits, without regard to which company within the U.S. controlled group is their employer. But when some of the possible affiliated employers are not U.S. companies, the issues get more serious.

Let's review briefly the U.S. test for employment between an employer and an employee. While there can be shades of difference, this test of employment is usually the same for payroll taxes, income tax withholding, employer compensation deductions, social security coverage and ERISA-based benefit plan coverage. This test has been captured by the IRS in its "20 factor test" set forth in Rev. Rul. 87-41 which now can be summarized as providing that employment results from a relationship between a service recipient and a service provider, where the service recipient (employer) tells the service provider (employee) what services to provide, when and how they should be provided. In other words,

the IRS in reviewing the degree of control of the employer over the worker considers (1) behavioral control—the right to direct or control how the worker does the work; (2) financial control—whether the employer has the right to control the economic aspects of the worker's job; and (3) the type of relationship—is there a written contract in place, whether benefits are provided, and whether there is an expectation that the relationship will continue indefinitely. While this test is usually applied to determine if a service provider is an employee, it is also an important indicator of the exact identity of the employer.

For example, let's assume we are dealing with executive E, who is clearly in an employment relationship with the U.S. parent company, P. While E is working for P, E is covered by U.S. social security and U.S. benefit plans, is subject to U.S. tax withholding and reporting, and all of E's compensation is deducted by P.

Now let's assume P sends E to work in another country where it has significant business operations, say, the UK. P has presumably already faced the major legal and tax decision of how P will carry on these business operations in the UK. It is possible that P has decided to have a direct presence in the UK, hiring employees there, renting office space, entering into sales contracts, etc. If P has decided to take this "direct" approach, P will have a branch operation in the UK, and while still a U.S. corporation, with all the legal and tax implications of that status, P will also be operating in the UK, have a permanent establishment there, have UK employees, etc. and would be a taxpayer and employer in the UK.

While this approach is taken by many U.S. businesses, by far the more common approach is that P will form a UK subsidiary, F. F will carry on P's business in the UK. P will try to avoid having a permanent establishment of P in the UK, and will isolate its legal, tax and employment obligations in the UK to be obligations of F.

Now let's return to our executive E. When P sends E to the UK (and P may be sending many other Es to the UK under its business plan), P will probably take the position that E is an employee, but an employee of F, the UK subsidiary. While there are some differences, generally the U.S. and the UK have the same tests for employment. Evidence that E is an employee of F may be from E's immigration status, E's agreeing to abide by the customs and practices of the UK office, and would also be evidenced by the fact that P does not think E (and E's eventual cohorts) is carrying on P's business. P does not think it has a branch in the UK, nor does P think it has a permanent establishment in the UK.

But when we turn to the compensation and benefit issues noted at the outset of this article, the question becomes "has P been consistent?" For example:

- Did P make F a "participating employer" for employee benefit plan purposes? If not, then technically E would drop out of medical, pension, 401k, etc. coverage.
- Is E treated as still in U.S. social security? U.S. social security rules state that coverage for social security (FICA) purposes is mandatory for services inside the U.S., but for services outside the U.S., E has to be a "U.S. person" (let's assume E is a U.S. citizen, and hence a U.S. person) and E's employer must be an "American Employer" [IRC section 3121(b)]. But E is an employee of F, a UK corporation. This means E is not in U.S. social security. While there is a social security "totalization" treaty between the U.S. and the UK, this does not grant U.S. social security coverage. The treaty merely sorts out the correct coverage for individuals caught in two systems. For the treaty to apply, it requires such coverage under U.S. domestic law, and then grants exemption from U.K .social security (a few treaties grant coverage, but they are unusual in the U.S. network).
- Who is deducting E's compensation? The UK would probably grant a tax deduction to F for this compensation, but the U.S. will deny a corporate tax deduction for P for an employee who is not employed by P. So P should not be deducting pay, and also should not be deducting contributions and benefits under pension, 401k, medical, etc. when they are given for service with F.
- Who has an obligation to withhold and report on E's compensation? While many employers follow the trail of payroll and currency, that is not determinative. Assume E is paid in sterling. Much of E's compensation will be subject to

UK income tax withholding, and under U.S. rules there need not be U.S. withholding for a U.S. citizen working outside the U.S. and subject to local withholding. But if there are elements of compensation taxable in the U.S. and not in the UK, there will be U.S. withholding required on that compensation. While F may believe that is not F's problem, F has an obligation under the U.S.-UK income tax treaty to assist in the administration of U.S. tax laws, and of course P has an obligation as a U.S. taxpayer to abide by these U.S. rules. Therefore there could be an obligation to withhold and remit U.S. dollars to the IRS, even for a sterling payroll employee.

What about "secondment?" This is the often cited justification for ignoring these employment issues. P declares that E has been "seconded" to the UK, and somehow that answers all the questions about inconsistent treatment as an employee. Unfortunately, this term "secondment" (in a U.S. dictionary it will usually be defined as a British military term) does not answer these legal issues which are grounded in U.S. concepts of employment.

Can the employment tests be different in different countries? Yes, certainly. For most civil law jurisdictions (as opposed to those jurisdictions grounded in common law) there may be a very different test. In that case, inconsistency is fine. For example, a French subsidiary of P, F2, may properly consider E2 to be its employee under French tests, and yet under U.S. tests E2 might be an employee of P.

The bottom line: As the IRS's new audit program looks more closely at employee status, keep in mind that part of that determination of employment status is finding the right employer. This is of particular importance for companies with multinational businesses.

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