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IRS Allows Latitude, Safe Harbor in Cases of Misclassification

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Misclassifying an employee as an independent contractor isn't always an intentional attempt by an employer to avoid paying payroll taxes, unemployment insurance and other employee benefits. Although the correct classification of a worker may be difficult to determine in many work relationships, employers are nonetheless responsible for classifying workers appropriately.

A determination by the IRS or Department of Labor that an employer has misclassified a worker or class of workers can have serious consequences for employers, including government audits and significant penalties. Nevertheless, safe harbors that can reduce or eliminate assessed penalties are available to employers.

One safe harbor is outlined in Section 530 of the Revenue Act of 1978. To qualify for this relief, an employer must demonstrate three things: that he consistently treated the employee as an independent contractor, filed tax returns for this employee as an independent contractor, and had a reasonable basis for treating the employee as an independent contractor rather than an employee.

Section 530 Requirements

To take advantage of Section 530, the employer must have consistently treated each worker in a job classification as an independent contractor at all times under review. If the employer classified some workers as independent contractors and others doing the same job — whether concurrently or consecutively — as employees, she will have trouble satisfying this requirement.

Furthermore, the employer must demonstrate he has consistently issued appropriate documentation, including 1099 forms, to the appropriate workers to have refrained from withholding various employment-related taxes from the workers' paychecks.

Finally, the employer must have a "reasonable basis" for classifying the worker as she did. An employer can cite favorable judicial precedent or prior administrative rulings involving similar workers. She can draw on technical or legal advice to support her classifications — but only if her adviser is competent to provide that advice, she gives the adviser complete and accurate information about the disputed job and she can show she relied on the adviser's judgment.

An employer can establish a reasonable basis in two other ways: He can cite the results of a prior

IRS audit in which the agency upheld his classification of workers in the same or similar jobs, or he can assert long-standing industry practice if a significant percentage of the industry also classifies workers in a particular job or class of jobs as independent contractors rather than employees.

Voluntary Settlement

Employers who fear they have improperly classified workers as independent contractors and worry about an IRS audit can use the IRS's Voluntary Classification Settlement Program. Doing so makes them eligible for relief from some unpaid federal payroll taxes. To qualify, an employer must have consistently treated its workers as non-employees and have filed all required 1099 forms for the previous three years. And the employer must act before the government taxing authority does.

Employers wishing to explore voluntary worker reclassification can apply via Form 8952 and find additional information at www.irs.gov. For assistance and legal advice, contact an attorney who specializes in employment issues. For information about Montgomery & Andrews visit www.montand.com.

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