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Ten Things GAO Has to Say About Employee/Contractor Misclassification

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The U.S. Government Accountability Office is known as the investigative arm of Congress and GAO's own website calls itself the congressional watchdog.

Despite its slick accolades, I admit I do not usually read reports produced by the GAO. It is hard enough to keep up with guidance issued by the Treasury Department and the Internal Revenue Service.

Yet the GAO has produced a fascinating report about independent contractor versus employee problems. Issued in August, it bears an ungainly title—*Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention*.[1]

The GAO study starts by saying employee misclassification itself is not a violation of law, but is often associated with labor and tax law violations. The GAO then talks about IRS and the Department of Labor (DOL). Strangely, the study points out that DOL and IRS do not exchange the information they collect in misclassification audits.

Yet clearly a lot more will be happening in Washington, D.C., on these issues sometime soon. Here, then, are 10 things you need to know about what GAO says about worker misclassification.

[1] GAO Study GAO-09-717.

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1. Watch Out for Legislation

GAO refers to four bills regarding worker misclassification introduced in the 110th Congress. Two such bills (H.R. 6111 and S. 3648), were introduced in the House and Senate, respectively, to amend the Fair Labor Standards Act. If passed, these bills would require employers to keep full records on independent contractors, and would add misclassification penalties.

Perhaps more significantly, the Independent Contractor Proper Classification Act of 2007 (S. 2044) would have amended the Internal Revenue Code to require IRS and DOL to exchange information. Another bill, H.R. 5804, would have also modified misclassification rules. Of course, none of these four bills was enacted. Nevertheless, we can expect to see more legislative action in this area.

2. Big Bucks Are Involved

It really is not clear just how big a problem misclassification has become. The last IRS report on this matter was back in 1984 (yes, that does sound pretty stale!). According to GAO, IRS is now saying that the results of a new study will not be available until 2013 (yes, that does sound like a long way away!).

The truly big ticket tax items are FICA and income taxes. You will need lots of decimal places to get some sense of how staggering a financial issue this could be.

DOL is a little more up to date. In 2000, DOL found that from 10 percent to 30 percent of firms audited in nine selected states had misclassified workers, treating

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some employees as independent contractors.[2] That study suggested that even if only 1 percent of all employees nationally were misclassified, the loss in unemployment insurance revenue alone would be nearly $200 million annually.

Multiply that out, and consider that we are not talking only about unemployment insurance revenue. In fact, the truly big ticket tax items are Federal Insurance Contributions Act and income taxes. You will need lots of decimal places to get some sense of how staggering a financial issue this could be.

The words ''too big to fail'' may come to mind.

3. Construction Industry Targeted

As if the construction industry in this country does not already have enough problems (especially home construction), consider this. GAO reports that a New York State DOL task force has especially targeted misclassification in the construction industry. The GAO report mentions violations in nearly half of the construction businesses surveyed.

Regardless of who uncovers a putative misclassification, whether DOL, a state employment or insurance commission, IRS, or someone else, beware. There tends to be a domino effect to such assertions.[3]

4. IRS Tends to Conclude Workers Are Employees

Given that the ''latest'' IRS survey information goes all the way back to 1984, you might think IRS does not care about misclassification. Wrong! In fact, the Employment Tax Examination Program (ETEP) is used by IRS to examine employers that IRS considers to have a high likelihood of misclassifying workers.

IRS also has a Questionable Employment Tax Practices (QETP) program. Under it, IRS and the states share information on these issues in examination. In fact, the GAO study reports that IRS made tax and penalty assessments in a whopping 71 percent of the examinations it closed on this topic during 2008.

5. Consider Filing a Form SS-8

An IRS Form SS-8 is a streamlined ruling form that either worker or company can fill out to obtain an IRS determination on worker status. The GAO report indicates that the IRS SS-8 program is helpful. I agree. In fact, I have long thought the Form SS-8 program is underutilized by taxpayers. A significant number of taxpayers miss out, and more should take advantage of it.

But there is certainly risk involved. In fact, IRS has indicated that in fiscal year 2008, 72 percent of all Form SS-8 requests it received resulted in IRS determinations that the workers in question were employees. Twenty-five percent were closed without any advice given. Only 3 percent (yes, you read that correctly!) resulted in determinations that the workers in question were independent contractors.

Given these statistics, it is certainly worth questioning in individual cases whether the Form SS-8 procedure makes sense. I still think it works reasonably well, although clearly there is some amount of give and take necessary. In fact, the GAO study states that when IRS closes cases without making a determination, it is usually because of glitches in communication.

As you evaluate these (not very inspiring) statistics, you will want to know some further information. In fact, about 90 percent of Form SS-8 requests are filed by workers. That means they are not filed by employers. That may account for the skewed numbers.

I suppose this is where the rubber meets the road. Employers should be taking advantage of this process more frequently, notwithstanding these admittedly somewhat frightening statistics. But pay attention to details and nuances. If you submit a Form SS-8, get professional help and take it seriously.

6. IRS Will Probably Not Discover You

This may give you a false sense of security. IRS says it only has the resources to detect and pursue a tiny fraction of misclassification situations. In fact, IRS says its Small Business and Self Employed Division completed examinations of fewer than 1,200 employers in 2008. The GAO says—quite correctly—that this is a drop in the bucket.

This is one more reason to worry about the domino effect. If you have an unemployment insurance ''employee'' determination, it may well lead to one on workers' compensation, state disability, IRS issues, etc.

7. Some IRS Notices Are 'Voluntary'

This may come as a surprise, but not all IRS notices are of the ''pay up or else'' variety. In fact, take the Form SS-8 process. If IRS receives a Form SS-8 from a worker, it investigates and then may rule the worker to be an employee. However, IRS often does not try to enforce the ruling!

IRS says only about 20 percent of employers who are sent SS-8 determination letters (but who are not selected for examination) voluntarily comply with the IRS classification determination.

Instead, IRS usually will send a ''soft notice'' to encourage the employer to change its practice. But enforcement is spotty. In fact, IRS says only about 20 percent of employers who are sent SS-8 determination letters (but who are not selected for examination) voluntarily comply with the IRS classification determination.[4]

[2] See Planmatics Inc., *Independent Contractors: Prevalance and Implications for Unemployment Insurance Program* (Rockville, Md.: U.S. Department of Labor, February 2000), cited in GAO-09-717 (p. 11).

[3] See Robert W. Wood, ''Independent Contractor Vs. Employee: Domino Effect of Recharacterization,'' Vol. 16, No. 4, *California Tax Lawyer* (Fall 2007), p. 4.

[4] GAO-09-717, pp. 25-26.

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8. Remember Section 530 Relief

One of the great elephants in the room about the contractor/employee divide concerns Section 530 relief. If you face an IRS assessment based on failures in the past, you may be entitled to a type of get-out-of-jail-free card. Section 530 of the 1978 Revenue Act (as amended) provides relief from employment tax liability for employers who misclassified workers as independent contractors using the common-law facts-and-circumstances standards.

Section 530 applies only if:

- the taxpayer does not treat an individual as an employee for any period, and does not treat any other individual holding a substantially similar position as an employee (for purposes of employment tax) for any period (this is referred to as ''the substantive consistency requirement'');
- for post-1978 periods, all federal returns (including information returns) that are required to be filed by the taxpayer with respect to the worker for such periods are filed on a basis consistent with the taxpayer's treatment of the individual as an independent contractor (this is referred to as ''the reporting consistency requirement''); and
- the taxpayer had a reasonable basis for not treating the worker as an employee (based on judicial precedent, IRS rulings, a past IRS audit, or a long-standing practice of a significant segment of the relevant industry) (this is referred to as ''the reasonable basis requirement'').

Interestingly, the GAO report suggests that the IRS feels hamstrung by Section 530. Indeed, IRS employment tax officials told GAO that businesses regularly request IRS guidance. However, the GAO study says IRS officials do not answer such inquiries because of Section 530!

Instead, GAO says, IRS tells the businesses to file Forms SS-8. Something seems to be going wrong. After all, as the GAO study also says, the vast majority of Forms SS-8 are filed not by employers but by workers. If people want guidance and are not getting it because of Section 530, Section 530 relief may need to be changed. Indeed, one proposed bill (see the first item above) would cut back on Section 530 relief.

9. GAO Is Frustrated, Too!

As frustrated as I sometimes get with independent contractor versus employee issues, it is apparent that I am not alone. I know clients are frustrated by a lack of clarity. Yet I was surprised to find that GAO is frustrated, too!

The GAO study says that as far back as 1977, GAO has been analyzing options about worker misclassification issues. Plus, it has been offering suggestions for addressing noncompliance issues related to employee misclassifications. GAO made recommendations in 1977, in 1979, and again in 1992.

In fact, in 1992, GAO laid out 19 options (count them, 19!). All 19 are laid out in the GAO study. Someone, it seems, needs to address this growing problem.

10. New GAO Recommendations

To go with the 19 recommendations GAO made in the past, GAO now posits six new recommendations. In essence, GAO suggests that the secretary of labor and commissioner of internal revenue should instruct their various troops to increase detection of misclassification errors. It is very clear that GAO is suggesting more exchanges of information and more joint projects.

Moreover, GAO is suggesting that low-wage industries should be a special focus. GAO is calling on DOL and IRS to ''offer education and outreach to workers on classification issues and implications and related tax obligations.''[5] According to GAO, such collaborations should include ''developing a standardized document on classification that DOL would require employers to provide to new workers.''[6]

It does not take a rocket scientist to imagine that such developments could effect a sea change. One of the last recommendations GAO makes is that IRS should extend its classification settlement program to include employers who volunteer to prospectively reclassify their misclassified employees. That is interesting, and ties in with a practical observation.

In my experience, on many occasions, IRS especially wants to get workers classified as employees going forward. The past is less of a concern, even if it means IRS has to give up on collecting back taxes, interest, and penalties. The bigger dollars are typically to be had in the future.

Conclusion

As anyone who has ever been involved in a worker status dispute knows, these disputes can be messy and time-consuming. They can also be difficult to control, particularly because one dispute can lead to other disputes. That can make the stakes in worker status disputes tough to assess.

For example, you may think the total dollar amount involved is, say, $50,000. However, if several other agencies come along thereafter, the dollar amount might turn into $1 million. Sometimes to win the entire war you must win the first battle, even if that first battle seems a mere skirmish.

In the furor of current activity, the GAO study may not get a huge amount of attention. If it does, though, you can count on the fact-intensive worker classification field to become even more volatile.

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[5] GAO-09-717, p. 41.
[6] Id.