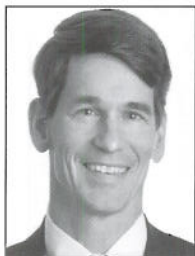


Avoiding Humpty Dumpty's Fall: Hazards of Worker Misclassification



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"When I use a word," Humpty Dumpty said in rather a scornful tone, "it means just what I choose it to mean – neither more nor less."

"The question is," said Alice, "whether you can make words mean so many different things."

"The question is," said Humpty Dumpty, "which is to be master – that's all."

– Lewis Carroll, *Through the Looking Glass*

Classifying workers for tax purposes can be like Alice's journey through Wonderland, but for an employer, the classification lacks the certainty of Humpty Dumpty because the IRS, not the employer, has the last word on whether a worker is an employee or an independent contractor. A worker's status as an independent contractor can cut costs such as avoiding withholdings and paying additional taxes and employee benefits. But in making this classification, the IRS, not the employer is master.

Businesses are generally required to withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment taxes on wages. Cutting costs by incorrectly classifying workers as independent contractors may result in the assessment of taxes, penalties and interest on both the employer and employee portions of these taxes, making this a very expensive mistake.

Taken to the next level, potential hazards increase. Employees are also commonly eligible for participation in company sponsored benefit and retirement programs. If employees are misclassified as independent contractors, the IRS could not only assess the employer for unpaid taxes and penalties, but also revoke the company's employee benefits plan. Along with this comes the expense of accountants and lawyers, assembling documents and attending meetings.

Given this parade of horrors, Humpty Dumpty was right – accurate labeling of workers as employees or independent contractors is critical. Careful planning and documentation is necessary.

Who is an Employee? Section 3121(d)(2)

of the IRS code defines an employee as "any individual who, under the usual common law rules for determining the employer-employee relationship, has the status of an employee." The resort to common law rules has led to debate because Missouri common law does not provide any "bright line" test. Missouri uses a 20 factor test, examining the behavioral and financial control over the worker and the overall relationship. For example, whether a worker has set hours of employment, control over how the job is performed, purchases his own supplies or has a designated office space are factors, but there is no formula or set number of factors resulting in either classification, and all factors may not apply.

Making the Determination If the proper classification is unclear, an employer may seek a no fee, formal determination from the IRS. If the company is already in operation, the IRS has a Voluntary Classification Settlement Program (VCS Program) to reclassify workers for future periods and provide relief from employment taxes that should have been withheld and paid. The VCS Program has eligibility and compliance requirements and should only be used with the help of a tax professional. Missouri also provides a useful web program to help determine classification at www.labor.mo.gov/forms/misclassify/index.asp.

Advance Planning Many of these issues can be addressed through advance planning and continuous review. A useful planning practice is to go through the common law test in every state where workers are added. The relationship of the company to its workers can be tailored and documented to ensure the desired classification is achieved. Job descriptions are useful because classification is not based on the title or the designation of the worker in a contract or other agreement; rather, upon how the job is performed and the level of independence versus company control over performance. With enough advance thought and planning, the company may after all, become, as Humpty Dumpty told Alice, the master of its words and avoid the painful consequences of misclassifying its workers. **BN**