

Employee versus Independent Contractor Misclassification: A Costly Post-Pandemic Mistake

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As the U.S. economy continues to recover, many businesses are increasing employment to pre-pandemic levels. However, according to various surveys, job seekers across a variety of industries are now prioritizing flexible work arrangements, including part-time and telecommuting opportunities. There seems to be a strong sentiment against the more traditional “in-office, nine to five” career. While many businesses appear to be adapting to the workforce’s desires, these new employment models raise concerns with respect to employment classification, specifically employees versus independent contractors.

The Issue

At the crux of the issue, the federal government and state legislatures are highly motivated to classify workers as employees (i.e., Recipients of Form W-2), as this label requires an employer to withhold income taxes, remit payroll taxes up to 15.3% of gross wages for social security and Medicare, and open the door to a range of employee benefits. Essentially, while monies smoothly flow into the government’s tax coffers, families often have the opportunity to receive benefit coverage from the employer and governments are released from providing hefty financial support

programs.

Conversely, many job seekers, especially in light of today's "gig economy," prefer independent contractor status (i.e., to receive Form 1099-MISC), which avoids paycheck reductions for taxes, unemployment insurance, social security and other similar costs. It also allows individuals to offset gross income with expenses they've incurred outside the office, all while being able to move more freely as a telecommuter because they do not have a direct tie to a particular state's tax regime.

Over 43% of the U.S. workforce is made up of independent contractors, meaning that close to half of all employees do not contribute to federal or state unemployment assistance programs, despite the fact that these gig workers were permitted to draw from these funds during the COVID-19 pandemic. As a result, unemployment insurance funds are severely depleted. This newly created tax gap has not gone unnoticed. Many states, as well as members of President Biden's inner circle, have indicated that investigations into employee misclassifications are likely coming in an effort to replenish these programs.

Classification Conundrum

The IRS and state governments have traditionally evaluated multiple factors in determining whether one is considered an employee or an independent contractor. Generally, the degree of control exercised by an employer over an individual is the most important factor. Independent contractors are usually free from direction and control regarding the performance of their services, as they are in business for themselves and offer their services to the general public.

The degree of control is typically broken down into the following categories:

- **Behavioral control:** Who chooses when, where and how the services are performed? What is the level of management supervision? Is there exclusivity in terms of work for the company?
- **Financial control:** Who sets the rate of pay? Who bares the risk of loss? Is the individual covered by the business' insurance policy or other industry membership? Whose tools are used and who must purchase the requisite

materials?

- **Type of relationship:** Is there a formal employment contract? Who has the right to review and approve one's work product? Are there performance evaluations? Does the individual service other businesses?

Beware of Misclassification

Worker misclassification can be a costly mistake for employers, as both federal and state labor agencies have, and continue to, aggressively audit businesses. Minimum penalties include \$50 fines for each missed Form W-2, as well as tax penalties of 1.5% of the wages from which an employer fails to withhold, 40% of unwithheld social security and Medicare and 100% of the matching FICA taxes the employer should have paid. Interest on these penalties also accrue from the date they originally should have been deposited. Moreover, responsible persons within an organization can be held personally liable for any uncollected taxes and states also have their own parallel penalty regulations.

With the workforce trying to return to business as usual and alternative work arrangements becoming commonplace, worker classification mistakes are ripe for government scrutiny. In recently released statistics from the state of New Jersey, an audit of only 1% of state employers uncovered more 12,300 cases of worker misclassification, totaling more than \$460 million in underreported wages and \$14 million in lost unemployment and disability contributions. In response, New Jersey has passed a package of bills aimed at cracking down on the misclassification of employees as independent contractors. Companies therefore need to take steps to protect themselves from such misclassification, regardless of how they describe the relationship. While liability insurance may mitigate the risk of misclassification, employers are still advised to discuss their firm's classifications with their tax advisors.

If you have questions with regard the employee versus independent contractor classification of individuals under your watch, please contact [Alan Goldenberg](#), Leader of Anchin's Tax Controversy and State and Local Tax groups, or your Anchin Relationship Partner, for more information.