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Worker Intake and Classification Issues and the Related Legal Challenges for Employers

By MJ (Mike) Asensio, Greta E. Cowart, and Sang Shin[*]
Baker & Hostetler LLP and Jackson Walker, LLP

With the mobile workforce of this post-Covid era, employers are increasingly facing hiring and retention challenges. Some of those challenges come from the intersection of immigration, labor and employment, tax laws and ERISA. The worker status determination process changes were highlighted in guidance issued by various agencies in late November 2022 pursuant to President Biden's ''Uniting for Ukraine'' humanitarian program.[1] This article explores how these laws can result in challenges for employers ready to start hiring, rehiring and dealing with other employment issues and the many laws that apply.

The determination of whether a worker is an employee or an independent contractor is subject to regulation by various government agencies under very under different laws. Employers are required to navigate these rules under the Internal Revenue Code (the ''Code''), the Fair Labor Standards Act (FLSA), and other labor, employment, tax, and immigration laws, at both the federal and state levels. Complicating matters further, these rules vary greatly with different standards to determine a worker's status. If an employee is misclassified as an independent contractor, there are a number of consequences for the employer. To start, the employer would fail to file a Form W-2 and to pay all applicable payroll taxes including, state taxes, and unemployment taxes, and federal withholdings. In addition, the employer would fail to provide employment benefits such as retirement and health, and welfare. As a result, the employer might end up violating the Affordable Care Act, the National Labor Relations Act, State and local tax laws, state wage payment laws, ERISA, the Family Medical Leave Act, Americans with Disabilities Act, various discrimination laws, including the Age Discrimination in Employment Act, Title VII, the Occupational Safety and Health Act, Worker's Adjustment Retraining and Notification Act, and other employment-related laws.

Dealing with newly hired workers may be even more complex because what the Internal Revenue Service (IRS) wants you to request and obtain may be restricted by other agencies at both the federal and state levels. In addition, there are ever-evolving re-

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[*] MJ Asensio is a nationally recognized labor relations practitioner at Baker & Hostetler LLP, in Columbus, Ohio, representing clients in the healthcare, aerospace, transportation, manufacturing, and energy industries. He brings over 30 years of experience to the table handling negotiations, work stoppages, labor arbitration, employment ligation, executive compensation, and employment counseling. He is a frequent lecturer and commentator on labor matters who has been interviewed by numerous media publications.

Greta E. Cowart is a partner with Jackson Walker LLP in Dallas. She has over 30 years of experience in the areas of employee benefits, tax, and executive and deferred compensation with a focus on employee benefits. She is a frequent speaker and author in the employee benefits and executive compensation areas.

Sang M. Shin is a partner with Jackson Walker LLP in Houston. Sang provides legal counsel to companies, individuals, investors and institutions throughout the U.S. and internationally. He has broad experience managing employment-based immigration cases, immigration planning and compliance programs for entities engaged in a wide range of industries, including: energy, engineering, healthcare, construction, financial service and banking, agriculture, architecture, technology, entertainment, food service, hospitality, retail, education, export and import and other sectors.

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[1] U.S. Dep't of Homeland Security news release (Apr. 21, 2022); and U.S. Customs and Immigration Services, new ''Uniting for Ukraine'' immigration procedures effective on November 21, 2022, available on the agency's website at https://www.uscis.gov/Ukraine.

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quirements for hiring individuals new to the United States.[2]

FEDERAL AND STATE EMPLOYMENT LAWS: NOT EVERY LAW HAS THE SAME DEFINITION

Under applicable federal employment laws, the definition of an employee can vary depending on the jurisdiction and the type of employee involved — common law employees, statutory employees, officers, employees covered by an agreement under section 218 of the Social Security Act. Although it is rare that an individual can be properly classified as both an independent contractor and an employee, divergent results are certainly possible under varying federal and state definitions of employee status.

For federal employment taxes, a common law definition of an employee is used under Treas. Reg. §31.3121(d)-1(c). It is similar to the federal employment law definition which looks to a common law definition of an employer and employee and the ''right to control'' directly or indirectly the individual who performs the services.

To distinguish independent contractors from employees, a common theme has historically been to determine who has the right to control the manner and means by which the work is accomplished. The National Labor Relations Board has historically used a right-to-control test, yet recently it proposed changing to an ''authority to control'' test, which would make it far easier to establish employment status.

In October of last year, new regulations were issued for determining whether a person is an employee or an independent contractor under the Fair Labor Standards Act. Although the Code, ERISA, the Americans with Disabilities Act, and the National Labor Relations Act all use a right-to-control test (as do a number of states), the Department of Labor seeks to adopt an ''economic realities'' test under the FLSA to determine whether, under the totality of the circumstances, the worker is economically reliant on the hiring party or is instead in business for him or herself.

Finally, several states including California, Massachusetts, and New Jersey use versions of the ''ABC'' test created by the California Supreme Court.[3] The end result has been uncertainty and confusion as the definition of employment status has been ever changing at the federal and state level.

DETERMINING EMPLOYMENT STATUS UNDER THE FEDERAL EMPLOYMENT TAX LAWS

Under the Code, the standard has remained far more consistent. An employment relationship exists when the person for whom the services are performed has the right to control and direct the individuals who performs the services. For federal employment tax purposes, the IRS looks for behavioral control, financial control, the parties' relationship and other factors.

An employer who misclassifies an employee as an independent contractor can be held liable for back taxes, penalties, and fines. Penalties under Code §6674 and §6721 relate to failure to file or furnish a Form W-2, while other penalties address failure to pay employment taxes in full. Off-the-Code ''§530 relief'' from federal employment taxes may be available — but only if the employer had a reasonable basis for treating a worker as an independent contractor and meets certain requirements for substantive consistency and reporting consistency.[4]

If an employer finds it has misclassified workers, it may be eligible for the IRS's Voluntary Classification Settlement Program[5] (which is different from the Classification Settlement Program used under audit) to voluntarily change classifications going forward and correct the last three years by paying all due payroll taxes using the rates of Code §3509. If the employer disregarded reporting requirements, §3509(b) doubles the rates.

CHALLENGES EMPLOYERS FACE IN REPORTING AMOUNTS PAID TO NEW HIRES UNDER IMMIGRATION LAWS THAT INTERSECT WITH TAX AND EMPLOYMENT LAWS

Employers with new employees often face challenges in obtaining an accurate Social Security Number from a new hire. It can be complicated because of the interaction between immigration laws and the hiring process. Under immigration laws an employer must identify and have employment authorization for any employees hired after November 6, 1986. The

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[2] See *A Plan to Welcome 85,000 Ukranians*, Wall Street J., Nov. 26–27, 2022.

[3] In *Dynamex Operations W. v. Sup. Ct. and Charles Lee, Real Party in Interest*, 4 Cal. 5th 903 (Cal. 2018).

[4] Section 530 relief refers to a safe harbor provision enacted as §530 of the 1978 Revenue Act that may excuse an employer from employment tax liability regardless of worker status determination under the common law test, if the entity consistently treated similarly situated workers as independent contractors and had a reasonable basis for doing so, relying on judicial precedent, a published ruling, an IRS Private Letter Ruling or Technical Advice Memorandum issued to the entity, results of a past audit, longstanding industry practice, or other substantiation.

[5] *See* IRS Form 8952, *Application for Voluntary Classification Settlement Program (VCSP).*

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employer is required to complete and retain a Form I-9 for each employee hired after that date, and to refrain from discriminating against individuals on the basis of actual or perceived national origin, citizenship or immigration status. Accordingly, an employer may not request an SSN directly as proof of work authorization status. Employers instead must make it clear to prospective employees that they are requesting SSNs specifically for payroll and benefits purposes.

Employers who do not receive an accurate SSN from a worker are nonetheless required to include one on the Form W-2 filed with the IRS. Employers who are caught in the situation of having an invalid SSN for a worker must carefully review Code §6721 and §6674, and any regulatory guidance thereunder, regarding what may constitute ''reasonable cause'' for filing a W-2 without a correct SSN. An employer who is not given the correct SSN still is subject to state laws requiring timely payment of wages after completion of a pay period or of termination of employment. Employers may want to consider using the Social Security Administration's verification system to address incorrect or invalid SSNs provided by new hires.

Employment of Immigrants in 'Uniting for Ukraine' Program Subject to Special Requirements

''Uniting for Ukraine'' created a pathway for Ukrainian citizens and immediate family members to relocate to the United States and stay temporarily for an initial two-year period (''parole period''). Ukrainians participating in the program must have a U.S.-based ''sponsor'' who agrees to provide them with financial support for the duration of their stay. Assuming U.S. officials accept the sponsor, Ukrainian nationals are entered as ''parolees'' and invited to apply for work authorization through an Employment Authorization Document (''EAD Card'').

It should be noted that recipients of EAD Cards under ''Uniting for Ukraine'' may work as direct employees or as independent contractors. So, employers must consider this program's requirements as it retains any new worker in addition to the normal worker classification analysis, and this needs to be added to vendor contracting as well as new employee intake and hiring procedures.

Employee Benefits-Related Risks

When employees are misclassified for benefits purposes, there are a number of significant consequences. Under ERISA, benefits that an employee was eligible to receive may be pursued by filing a claim for benefits under ERISA §503, and once the administrative claim process is exhausted, an action may be filed under ERISA §502.

In addition, employers who had 50 or more full-time equivalent employees in the prior calendar year are subject to the employer shared responsibility tax[6] under Code §4980H, and failure to offer coverage to someone who meets the standard to be a full-time employee under this section can result in significant penalties. These penalties may result from failing to offer coverage to 95% of the full-time employees or penalties related to full-time employees obtaining coverage on the healthcare exchange and receiving subsidies or federal tax credits.

Employers with misclassified workers should also be concerned with minimum coverage and nondiscrimination testing requirements for retirement plans they sponsor. The inclusion of individuals who are properly reclassified as employees and are not receiving benefits may impact whether the retirement plans are able to pass those tests. Employers offering employee stock purchase plans under Code §423 must be careful of misclassified workers because ESOPs are required to be offered to all employees. Misclassification also can impact other benefits with requirements for preferential treatment under the Code. Employers can face liability for failure to provide life insurance or accidental death and dismemberment insurance or disability insurance, as the lack of coverage can result in an expensive claim.

Retirement plan record keepers who receive an incorrect SSN for a plan participant also need to be aware that it could result in an inaccuracy penalty under Code §6723.

Employers may also face claims for benefits in litigation under Title I of ERISA. The litigation risk is real since a party need only have a ''modicum of success''[7] to potentially recover the attorneys' fees incurred in the litigation.

The EAD Card recipients who are classified as employees will become eligible to participate in the employer's employee benefit plans, even if employed for only a limited time period, as there is no statutory exclusion for non-citizens earning income in the United States. So these employees must be considered for eligibility and included in compliance testing and reporting (such as Forms 1095-C) if they accrue a benefit in a U.S.-based plan. This will require more efforts to provide disclosures and benefits to this group in the future, if their benefits remain in the U.S.-based plan. Employers may need to consider if benefit communications may be required to be provided in an addi-

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[6] Code §4980H.

[7] *Hardt v. Reliance Standard Life Ins. Co.*, 560 U.S. 242, 130 S. Ct. 149, 176 L. Ed. 2d 998 (2010).

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tional language. Employee benefit plans (particularly health plans) are required to obtain the employee's SSN, and this again ties in to the immigration law restrictions, above, related to requesting SSNs from new employees.

Finally, when payroll taxes are not withheld due to worker misclassification, employers should carefully analyze the requirements under Code §6672. The penalty for failing to collect and pay employment taxes is significant, and the deadline for payment of employment taxes is not a single date but will depend on the amount of the withholding. Accordingly, it is important to understand the significance of all potential penalties, including those under Code §4980H, §6656, §6671, and §6672. Employers should consider that the cost of excluding an employee from health coverage may include costs of reinstating coverage and for COBRA continuation coverage, net of any premiums paid.

PROACTIVE STEPS FOR EMPLOYERS

Employers seeking to avoid the problems of worker misclassification should consider implementing some best practices such as:

1. Review and edit employment contracts used in the business.

2. Review and edit the worker or independent contractor intake process (particularly watch for former employees rehired on a ''temporary'' basis).

3. Perform periodic self-audits to determine whether the contracts in operation match the written terms.

4. Memorialize the factual basis upon which workers are classified.

5. Use a vendor qualification questionnaire to ask questions of each individual contractor and obtain representations from the individual contractor.

6. Assign a gate keeper to whom all vendor contracts must go to be vetted against a checklist or policy.

7. Consider conducting your own audit of Forms 1099 filed.

8. Work on proactive steps to take on vendor intake processes.

Taking steps to proactively and accurately classify workers under the various laws will help employers avoid the penalties and financial consequences of reclassifying a worker as an employee.

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