

**MSP
#19****IRS WORKER CLASSIFICATION PROGRAM: Current Procedures Cause Delays and Hardship for Businesses and Workers by Failing to Provide Determinations Timely and Not Affording Independent Review of Adverse Decisions****RESPONSIBLE OFFICIALS**

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DEFINITION OF PROBLEM

The delay in classification of workers as employees or independent contractors by the IRS's SS-8 Unit has significant tax consequences for businesses and individuals. The classification impacts employment tax liabilities, income tax withholding obligations, information reporting, the allowance of expenses that may be derived from a "trade or business," and eligibility for employee benefit or pension plans.¹ The enactment of the Affordable Care Act magnifies the tax consequences of worker classification. The National Taxpayer Advocate has previously recommended that the IRS simplify its worker classification criteria, and has offered legislative and administrative remedies to alleviate the burden on applicants. These proposals include the development of a free online self-help tool that would give employers a preliminary determination of employment status based on their responses to specific questions.²

As of fiscal year (FY) 2013, 81 percent of cases in the IRS SS-8 Worker classification program are "overage."³ This means that applicants must wait an average of a year before receiving a determination.⁴

The National Taxpayer Advocate has several additional concerns. First, the SS-8 Program uses new Internal Revenue Manual (IRM) guidance that results in premature rejection of legitimate applications without giving applicants an opportunity to respond and cure minor defects. Second, applicants who receive adverse determinations from this unit do not automatically receive administrative appeal options.

1 Internal Revenue Code (IRC) §§ 162, 401, 411.

2 See National Taxpayer Advocate 2012 Annual Report to Congress 19-20; National Taxpayer Advocate 2010 Annual Report to Congress 371; National Taxpayer Advocate 2008 Annual Report to Congress 375-90.

3 Treasury Inspector General for Tax Administration (TIGTA), Ref No. 2013-30-058, *Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings* (June 14, 2013); IRS Response to TAS Research Request (Nov. 20, 2013).

4 Minutes of the Meeting of the SS-8 Worker Classification Advocacy Project Team, Jan. 16, 2013.

ANALYSIS OF PROBLEM

Background

Delay in classification of workers as employees or independent contractors has serious tax consequences.

Proper worker classification, whether as an employee or independent contractor, is critical to both businesses and workers. Generally, if a worker is misclassified as an independent contractor by a firm that is paying for services and the IRS reclassifies the worker as an employee, he or she is responsible for federal income tax and an employee's share of Federal Insurance Contributions Act (FICA) tax on the income.⁵ If that reclassified worker already paid self-employment tax, he or she may be eligible for a refund. The related firm is responsible for federal income tax withholding, Federal Unemployment Tax Act (FUTA), and Social Security and Medicare taxes on the earnings unless special rates apply.⁶ Specifically, the following employment taxes are at issue in an SS-8 determination:

- Federal income tax withholding at source of wages as provided by Internal Revenue Code (IRC) § 3402;
- FICA tax as provided by IRC § 3101; and
- FUTA tax as provided by IRC § 3301.

A business that has treated a worker's income incorrectly, or has been notified by the IRS that its worker's employment status has been reclassified, may have to file or adjust the related employment tax return(s) to pay the appropriate amount.⁷

A delay in worker classification decision impacts workers and businesses adversely, as any delinquent income and employment taxes are subject to penalties and interest. In some situations, a delayed determination may cause workers to lose refunds of overpaid self-employment taxes if the refund statute of limitations has expired. The filing of a Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, does not prevent the expiration of the time in which a refund must be claimed.⁸ Many other benefits and determinations hinge on whether a worker is considered an employee or an independent contractor.⁹

Congress Has Passed Legislation to Address Ambiguities in Worker Classification but Additional Action Should be Taken.

The basis for determining the status of a worker as an independent contractor or employee had primarily rested on a common-law test of 20 factors that enumerated the degree of control that a person engaging

Proper worker classification, whether as an employee or independent contractor, is critical to both businesses and workers.

⁵ IRC §§ 3401, 3012(a), as amended by the Social Security Protection Act of 2004, Pub. L. No. 108-203.

⁶ IRC §3406(a)(1).

⁷ See, e.g., Publication 4341, 20 (Rev. 01/2010).

⁸ In general, the statute of limitations period for credits or refunds is governed under IRC § 6511, which states such claims must be filed within three years from the time a return is deemed to be filed or two years from the time the tax was paid, whichever is later.

⁹ For example, IRC § 404(d) which limits deductions for deferred compensation paid to independent contractors; Section 531, The Deficit Reduction Act of 1984, Pub. L. No. 98-369, (addressing employee fringe benefits), IRC §401, *supra*.

the services of another had on the work, detail, and means by which the work was performed.¹⁰ Congress addressed employment status by enacting Section 530 of the Revenue Act of 1978.¹¹ This section prohibits the IRS from reclassifying independent contractors as employees provided the payor consistently treated the payee as a contractor in good faith. It also barred the IRS from issuing guidance on the employment status of individuals.¹²

Congress' objective was to *temporarily* relieve businesses of uncertainties and provide a “safe harbor” if payors reasonably relied on past audit practices, published rulings, or judicial precedents, recognized practices in an industry, or long-standing treatment by the payors with regard to employment taxes.¹³ However, the “temporary” relief was extended and then made permanent by the 1982 Tax Equity and Fiscal Responsibility Act.¹⁴

The National Taxpayer Advocate has previously recommended that Congress repeal § 530 and replace it with safe harbors applicable to employment and income tax determinations.¹⁵ Repeal would also remove restrictions on IRS guidance.¹⁶

The Form SS-8 Process Can Require Lengthy Fact Gathering, Investigation, and Application of Law.

A worker or business may file Form SS-8 to receive a determination from the IRS as to whether the person in question is an employee or independent contractor.¹⁷ The four-page, five-part form requires the submitter to answer numerous questions and provide a detailed explanation of the work relationship between the business and the worker. The SS-8 Unit screens the forms and returns them to the submitters if they are incomplete.¹⁸ Once a form is complete and accepted for processing, the SS-8 technician will send a letter to the business, if the worker was the submitter, and ask the business to complete Form SS-8, because the determination of employment status affects both parties.¹⁹ The technician may ask for additional information from the submitter, other involved parties, or third parties to help clarify the work relationship.

10 See Rev. Rul. 87-41, 1987 C.B. 296.

11 Section 530, Revenue Act of 1978, P.L. 95-600 (Nov. 6, 1978), as amended.

12 Section 530(b), Revenue Act of 1978, Pub. L. No. 95-600 (Nov. 6, 1978), as amended.

13 S. Rep. 95-1263 (Oct. 1, 1978).

14 Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, § 269(c).

15 See National Taxpayer Advocate 2012 Annual Report to Congress 19-20; National Taxpayer Advocate 2010 Annual Report to Congress 371; National Taxpayer Advocate 2008 Annual Report to Congress 375-90.

16 Congress expressed a concern that the IRS's increased enforcement of employment tax classifications could result in a heavy liability for employers: “If the IRS prevailed on a [worker] reclassification, the [business] became liable for employment taxes — withholding, Social Security, and unemployment — which neither had been withheld nor paid to the Treasury... many [businesses] lack [information that could offset the liabilities] about their workers and cannot benefit...” (S. Rep. 95-1263 (Oct. 1, 1978, *supra*)). In addition, businesses have expressed concern to TAS that any IRS-issued guidance would weigh heavily towards a determination that there is an employer-employee relationship. The online tool proposed by the National Taxpayer Advocate would provide an objective system that would be impartial to workers and employers based on their accurate responses to questions.

17 A Form SS-8 determination may be requested only to resolve federal tax matters. The Form SS-8 is filed according to the firm's location. In general, forms from western states are sent to Holtsville, NY and those from the East are sent to Newport, VT.

18 IRM 7.50.1.3.1 (Oct. 3, 2013). New Form SS-8 Receipts: First Read Screening Process.

19 The language specified by IRM Exhibit 7.50.1-17 (Oct. 3, 2013) assumes that the worker is the applicant; however, it instructs the SS-8 technical employee to send a letter “to the other party involved with the SS-8 determination” when preparing a full determination case for assignment. IRM Exhibit 7.50.1-17 (10-03-2013).

The technician reviews the facts, applies the law, and makes a determination. The determination is generally made under a facts-and-circumstances analysis that seeks to ascertain whether the worker is subject to the control of the service recipient, not only as to the nature of the work performed, but also the circumstances under which it is performed. In Rev. Rul. 87-41, the IRS enumerated 20 factors for determining whether an employer-employee relationship exists.²⁰ The importance of each factor varies depending on the occupation and the factual context in which the services are performed.²¹

A determination issued in response to a Form SS-8 request is binding to the IRS and applies only to the business and the worker to which it is addressed. If only one worker provided information about a work relationship, but the facts are not materially different for other workers in the same class, the SS-8 Unit may apply a written determination to those workers.²²

A worker or business that disagrees with a determination may request a reconsideration if additional information is provided. However, the same group considers the reconsideration and almost all of the original determinations are upheld.²³ Under current procedures, no administrative appeal rights are allowed.

The IRS's last comprehensive estimate of the number of workers improperly classified was for tax year (TY) 1984. At that time, it found that 15 percent of employers misclassified 3.4 million workers as independent contractors. This resulted in an estimated total tax loss of \$1.6 billion in Social Security taxes, Medicare taxes, federal unemployment taxes, and federal income taxes (for 1984).²⁴ The IRS has included a worker classification study in its ongoing National Research Program (NRP), but results will not be available until 2015.²⁵

The SS-8 Unit Has a Backlog of Inventory.

In fiscal year 2013, the SS-8 program received 3,982 requests for determination filed by workers and 128 by employers.²⁶ The unit had a total inventory of approximately 11,545 cases of which 9,387 — more than 81 percent — were considered “overage,” having been in process for 180 days or more. As the following chart shows, although the volume of overage cases has fluctuated over the last three years, the overall trend is worsening.

20 See Rev. Rul. 87-41, 1987 C.B. 296.

21 If the business fails to complete and return the form to the SS-8 Unit, the technician will base the determination solely on the information in the worker's Form SS-8. If both parties complete Form SS-8, the technician mails the determination letter to the business and a copy with a cover letter to the worker, regardless of which party is the requester.

22 IRM 7.50.1.5.2 (Rev. Oct. 3, 2013).

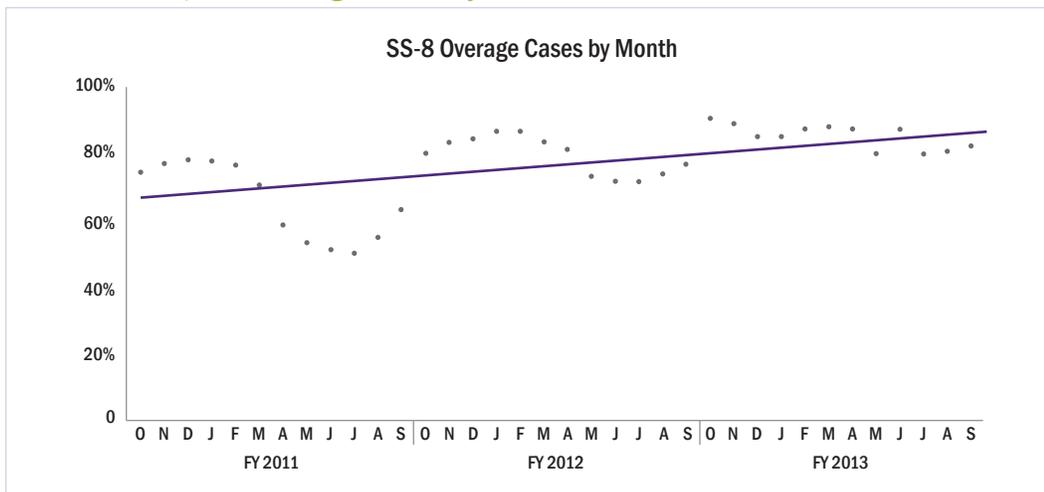
23 In FY 2011 318 reconsideration requests were received and one resulted in reversal. In FY 2012 119 reconsideration requests were received and three resulted in reversal. In FY 2013 196 reconsideration requests were received and four resulted in reversal. IRS response to research request (Nov. 20, 2013). There are no provisions in the IRM for quality or managerial review. (See IRM 7.50.1.5.10.1 (Oct. 3, 2013)).

24 Beier, Ken. “Strategic Initiative on Withholding Noncompliance (SVC-1), Employer Survey, Report of Findings.” Unpublished: Department of the Treasury, Internal Revenue Service, June 1989. Beier, Ken. “Strategic Initiative on Withholding Noncompliance (SVC-1), Misclassified Employee Survey, Report of Findings.” Unpublished: Department of the Treasury, Internal Revenue Service, September 1989. TIGTA, Ref No. 2013-30-058, *Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings* (June 14, 2013).

25 The NRP is a comprehensive, statistical effort by the IRS to measure compliance for different types of taxes and various sets of taxpayers. (IRM 4.22.1.3 (Apr. 25, 2008)). The scope of the NRP includes worker classification issues. (IRM 4.22.10.3.3 (Oct. 1, 2011)). An examiner must review Form 1099s issued to individuals, determine that the classification of employees was correct and, if adjustments are proposed, determine if the taxpayer qualifies for Section 530 relief or if settlement programs apply, as part of the NRP's required analysis of Form 1099. (IRM 4.22.10.5.1 (Oct. 1, 2011)).

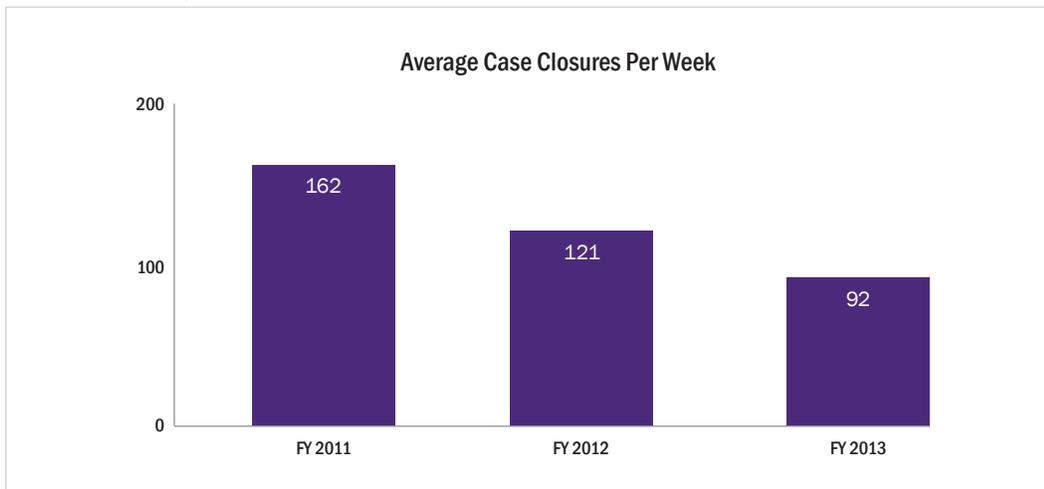
26 IRS response to TAS research request (Nov. 20, 2013).

FIGURE 1.19.1, SS-8 Overage Cases By Month²⁷



The IRS has claimed that its large inventory was partially due to the SS-8 Unit’s previous policy of accepting all forms filed.²⁸ The program’s managers have since instituted “first read screening” procedures for new receipts — outlined above — to reduce incomplete filings. Despite these new procedures, the average case closures continue to decline.

FIGURE 1.19.2, AVERAGE WEEKLY CLOSURES²⁹



27 IRS response to TAS research request (Nov. 20, 2013).

28 TAS call with IRS Operating Division (Jul. 19, 2013).

29 IRS response to TAS research request (Nov. 20, 2013).

IRS Procedures Direct Employees to Reject Legitimate Applications Without Substantive Applicant Contact.

In accordance with its new IRM, the SS-8 Unit's clerical staff screens new Form SS-8 receipts to ensure the documents are complete, accurate, and meet criteria.³⁰ Until recently, the examiners have been working without formal guidance, but the standards in the new IRM (which encompasses the “first screening process”) for rejecting cases are skewed. For example, the Unit can reject cases if the forms are incomplete or have missing information. The Form SS-8 instructions state all questions must be answered or state “Unknown” or “Does not apply.”³¹

Some questions are necessary to make a determination as they shed light on the level of control by the business over the worker. However, other questions could be left unanswered. The SS-8 Unit is currently returning many forms as incomplete even though taxpayers, in most cases, will come back with the needed information. The IRS has allowed taxpayers to “cure” incomplete submissions in other areas, including the Collection offer in compromise program. The National Taxpayer Advocate described the hardships faced by taxpayers whose offers were rejected by the IRS during initial screening before they were considered for investigative review.³² Collection employees are now guided to call taxpayers, before sending correspondence or rejecting an offer, and solicit any missing or incomplete information.³³ A similar approach could be beneficial in this instance; rather than rejecting incomplete SS-8 filings and increasing future receipts, simply picking up the phone and calling the taxpayer to request additional information could move a case forward with little burden to either party.

As shown below, a substantial number of Form SS-8 submissions have been returned to the submitters since the institution of first read screening procedures.³⁴ In fact, as technicians work through the backlog of unprocessed forms, they are now returning almost as many submissions as they are receiving.

FIGURE 1.19.3, SS-8 Submissions and Returns³⁵

| Form SS-8 Submissions | Fiscal 2011 | Fiscal 2012 | Fiscal 2013 |
|-----------------------|-------------|-------------|-------------|
| Filed by workers. | 9,198 | 5,392 | 3,982 |
| Filed by firms | 645 | 264 | 128 |
| Returned | 0 | 3,104 | 3,905 |

Currently, the SS-8 Unit immediately closes cases under a counter-productive standard based on “the adequacy of information provided,” rather than keeping them open and notifying submitters of deficiencies. The Unit sends the submitter an information courtesy letter advising that it could not process the request for a determination since the form was incomplete or missing documentation.³⁶ If the submitter subsequently submits a completed form, the Unit opens a new case and starts aging the case at that time. This

30 IRM 7.50.1.3.1 (Oct. 3, 2013).

31 Form SS-8 (Rev. Aug. 2011) *Disclosure of Information, Parts I-IV*: “If you cannot answer a question, enter “Unknown” or “Does not apply.”

32 National Taxpayer Advocate 2007 Annual Report to Congress 380.

33 IRM 5.8.4.7 (May 10, 2013).

34 IRS response to TAS research request (Nov. 20, 2013).

35 *Id.*

36 IRS Courtesy Information Letter 4949.

allows the Unit to return substantial numbers of forms and delete them from its open inventory. Due to the importance of a determination, the Unit should give the submitter at least 30 days to cure the defects and submit a completed Form SS-8, rather than rejecting it out of hand. In some cases, an outbound call from the SS-8 unit to the submitter could cure any perceived defects in the submission and quickly resolve the case for both the applicant and the IRS, as opposed to statistical gamesmanship.

A delay in a worker classification decision impacts workers and businesses adversely, as any delinquent income and employment taxes are subject to penalties and interest.

The IRS can address the backlog by providing a self-help tool for businesses to receive classification determinations. The United Kingdom provides a free, web-based, non-binding “indication of employment status” to requestors through an online tool called Electronic Status Indicator (ESI).³⁷ A similar tool would benefit U.S. taxpayers and the government.³⁸ Unless facts and circumstances have materially changed, workers and employers could rely on an online determination without submitting a Form SS-8.

The current SS-8 program is a paper-based system in which forms must be mailed to the IRS — faxed, photocopied, or electronic versions forms are not accepted for initial determinations.³⁹ An online system that would prevent requestors from submitting forms with missing data could help applicants by minimizing delays in the application cycle and the IRS by avoiding complications and downstream costs associated with resubmitted forms.

Applicants Who Receive Adverse Determinations from the SS-8 Unit Lack Independent Administrative Appeal Options.

Applicants whose cases are in the SS-8 Unit have no option for an independent review if they receive an adverse determination. Instead, any disagreement is referred back to the unit, with no safeguards to ensure that the reviewer is independent of the group that made the original decision.⁴⁰ While the statute does not expressly provide appeal rights, nothing prevents the IRS from providing appeal rights to workers or businesses as to a status determination, even where there is no examination of a federal return. As noted above, the SS-8 Unit upholds almost all of its original determinations, which raises concerns about the impartiality of those reviews. An incorrect decision by the IRS has significant consequences to the income and employment tax liabilities of the affected parties. The IRS should provide applicants the right to an independent, administrative appeals review of adverse determinations.

37 HM Revenue & Customs <http://www.hmrc.gov.uk/calcs/esi.htm> (last visited Nov. 3, 2013). According to the site, “The ESI tool is helpful for anyone who takes on workers, such as employers and contractors. (The tool refers to anyone in this position as an engager.) Individual workers can also use the tool to check their employment status. The tool cannot, however, be used to check the employment status of some workers: company directors and other individuals who hold office, agency workers, [or] anyone providing services through an intermediary...”

38 National Taxpayer Advocate 2008 Annual Report to Congress, 376.

39 Form SS-8 (Rev. Aug. 2011).

40 IRM 7.50.1.5.10 (Oct. 3, 2013); IRM 8.7.16.1 (Oct. 1, 2012).

CONCLUSION

The National Taxpayer Advocate remains concerned that Congress and the IRS have not acted on previous recommendations in this area. The inventory backlog in the SS-8 unit means that businesses and applicants incur substantial tax consequences as they wait for classifications, and applications may be rejected in a narrow and rote screening process, leading to even more delays. The IRS has yet to provide online tools that applicants can rely on to determine their worker classification status and that would reduce SS-8 submissions. Further, businesses and workers alike are denied their full administrative appeal rights.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Adopt the National Taxpayer Advocate's previous recommendation to develop an electronic self-help tool for employers or workers to determine employment status.⁴¹
2. Allow applicants the right to an independent administrative appeals review of adverse determinations by the SS-8 unit.
3. Increase staffing to address the existing backlog and prevent future accumulation of worker classification requests.
4. Provide applicants an opportunity to cure perceived deficiencies in their initial filings rather than rejecting the applications outright through an initial screening process.

⁴¹ National Taxpayer Advocate 2012 Annual Report to Congress 19-20.