HUNTON
ANDREWS KURTH

Navigating Employee v. Independent Contractor Classifications

Presentation for:
Executive Compensation Webinar Series
June 13, 2024

Presentation by:
Anthony J. Eppert
AnthonyEppert@HuntonAK.com
512.542.5013

Housekeeping: Questions

HUNTON
ANDREWS KURTH

- Questions during this presentation
  - We encourage questions (even though your audio lines are muted)
  - To submit a question, simply type the question in the blank field of the menu bar and press return
  - If time permits, your questions will be answered at the end of this presentation. And if there is insufficient time, the speaker will respond to you via e-mail after this presentation

Housekeeping: Recording, CE Credits and Disclaimer

HUNTON ANDREWS KURTH

- Recording
  - This presentation is being recorded for internal purposes only
- Continuing education credits
  - A purpose of the webinar series is to provide FREE CE credits
  - To that end, each presentation is intended to provide 1 credit hour in the following areas:
    - CLE: 1 credit hour (CA, FL, GA, NC, NY, TX and VA)
    - CPE: 1 credit hour (Texas)
    - HRCI: This activity has been approved for 1 (HR (General)) recertification credit hours toward California, GPHR, PHRi, SPHRI, PHR, and SPHR recertification through the HR Certification Institute
    - SHRM: This program is valid for 1 PDC for the SHRM-CPSM or SHRM-SCPSM
  - If you have any questions relating to CE credits, please direct them to Anthony Eppert at AnthonyEppert@HuntonAK.com or 713.220.4276
- Disclaimer
  - This presentation is intended for informational and educational purposes only, and cannot be relied upon as legal advice
  - Any assumptions used in this presentation are for illustrative purposes only
  - No attorney-client relationship is created due to your attending this presentation or due to your receipt of program materials

About Anthony “Tony” Eppert

HUNTON
ANDREWS KURTH

Anthony Eppert , Partner
Hunton Andrews Kurth LLP
Tel: +1.713.220.4276
Email: AnthonyEppert@HuntonAK.com

- Tony practices in the areas of executive compensation and employee benefits

- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

Upcoming 2024 Webinars

HUNTON ANDREWS KURTH

- 2024 webinars:
  - ABCs of Private Company ESOP Transactions (7/11/24)
  - Compensatory Thoughts on Navigating Blackout Periods (8/8/24)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/12/24)
  - Governance: Properly Hiring and Terminating an Executive Officer (10/10/24)
  - Introduction Course on Employment Taxes (11/14/24)
  - What Happened in 2024: Year-End Review of Compensatory Items(12/12/24)

Sign up here: https://www.huntonak.com/en/insights/executive-compensation-webinar-schedule.html

Our Compensation Practice – What Sets Us Apart

HUNTON
ANDREWS KURTH

- Compensation issues are complex, especially for publicly-traded companies, and involve substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human resources

- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

HUNTON ANDREWS KURTH

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation

Our Compensation Practice – What Sets Us Apart (cont.)

HUNTON ANDREWS KURTH

- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement "best practices"
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Purpose of this Presentation

HUNTON
ANDREWS KURTH

- The purpose of this presentation is to discuss the legal and practical nuances of whether a worker should be properly classified as an "employee" or as an "independent contractor"

- This presentation will also cover how an otherwise improper classification could be prospectively corrected on a voluntary basis (*i.e.*, without an IRS audit) and on an involuntary basis (*i.e.*, pursuant to an IRS audit)

- To that end, this presentation covers:
  - Who is an "employee" from the perspective of the DOL, IRS and state equivalents (*e.g.*, Texas Workforce Commission);
  - How to properly structure independent contractor classifications;
  - Certain employment and tax issues associated with the applicable administrative agencies (*e.g.*, the DOL, IRS, state equivalents); and
  - An analysis or resolution to alleged improper classifications, including:
    - Liability protection under Section 530, and
    - The IRS Voluntary Classification Settlement Program

Consequences of Misclassification

HUNTON
ANDREWS KURTH

- From the taxpayer's perspective, the consequences of misclassifying an employee as an independent contractor include:
  - Exempt v. non-exempt worker misclassification and FLSA issues, the latter of which only applies to employees (primary agency is the DOL)
  - Taxpayer's failure to withhold income taxes (primary agency is the IRS)
  - Taxpayer's failure to withhold or pay FICA and FUTA taxes (primary agency is the IRS)
  - Taxpayer's failure to pay unemployment taxes (primary agency is Texas Workforce Commission or other state equivalent)
  - Depending on the facts, taxpayer's likely failure to provide the misclassified worker with retirement benefits, health benefits, reimbursements, fringe benefits, etc (primary agency is the DOL)

- The consequences of worker misclassification can be highlighted using Microsoft Corp as an example
  - See next slide

Consequences of Misclassification (cont.)

HUNTON
ANDREWS KURTH

- Under the facts of *Vizcaino v. Microsoft Corp*:
  - Microsoft hired freelancers and the freelancers were responsible for their own medical insurance and benefits
  - IRS audit found the freelancers were employees, and pursuant to an agreement with the IRS, Microsoft paid the employer's share of withholding, issued retroactive Form W-2s (so the workers could collect refunds on overpaid FICA taxes) and converted freelancers to permanent employees or temporary employees, as applicable
  - Plaintiff workers who had refused the above characterization were fired. Such plaintiff workers sued Microsoft and won

- As a result of the above, compensation and benefit professionals make sure that employee benefit plans contain what has become known as "Microsoft language"
  - With Microsoft language, the employee benefit plan document excludes from eligibility those individuals who are classified as independent contractors, and such exclusion continues to apply even if such individuals are later retroactively reclassified as employees

Determining Worker Status

HUNTON
ANDREWS KURTH

- As an overview, the determination of whether a worker is properly classified can be cumbersome because:
  - More than one independent contractor test exists,
  - Such tests are highly factual in nature, and
  - Many employers are not aware of the tests or do not know how the rules are applied

- The courts tend to apply a common law agency test where "control" is a primary test (*i.e.*, not an economic realities test)
  - The ultimate question to ask is whether the employer has the right to "direct and control" the worker. *See Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318 (1992)
  - The focus should be on "the common law touchstone of control." *See Clackamas Gastroenterology Associates, P.C. v. Wells*, 538 U.S. 440 (2003)

Determining Worker Status (cont.)

HUNTON ANDREWS KURTH

- In contrast, Rev. Rul. 87-42 contains a 20-factor test to determine worker classification (also contained in Treas. Reg. 31.3121(d)-1(c)(2) and IRS Manual – Audit, Part IV, Exhibit 4640-1) that includes:
  - Extent of control, training and integration;
  - Whether the services must be personally rendered;
  - Whether the nature of the work is full-time and whether specific hours of work are required;
  - Whether the work may be performed outside of the company's location;
  - Whether reports must be regularly submitted;
  - Whether the worker is paid by the hour, week or month;
  - The identity of the person responsible for the payment of business expenses, the furnishing of equipment/tools, etc.; and
  - Whether the worker performing the services has the right to work for more than one entity at a time

Determining Worker Status (cont.)

HUNTON ANDREWS KURTH

- According to IRS Publication 15 (Circular E) *Employer's Tax Guide*, the 20-factor test is organized into three main groups:
  - Behavioral control,
  - Financial control, and
  - Relationship of the parties

- Determining **behavioral control** can begin with a few questions, including:
  - Who determines the "how," "when," and "where," the work is performed
  - Who decides what tools or equipment is used

- Determining **financial control** can begin with a few questions, including:
  - Does the worker make a significant investment in the equipment used,
  - Who decides how many hours are worked, and
  - Does the worker have the financial risk of profit or loss (e.g., who has risk of loss for do-overs or mistakes)

Determining Worker Status (cont.)

HUNTON ANDREWS KURTH

- Determining the **relationship** of the parties
  - What is the relationship between the parties, are they individuals or entities;
  - What is the length of the relationship;
  - What is the evidence of the relationship, *i.e.*, are there written contracts, invoices or other evidence of a business relationship

- Other questions to ask include:
  - Is the work that the worker performs similar to work performed by employees of the entity
  - Is the work part of the essential function of the company or is it part of an unrelated function. For example, consider:
    - An electrician fixing electrical lighting in a law office is likely an independent contractor
    - However, an electrician handling overflow for an electrical services company could be an employee

- Different from the IRS, the DOL applies an economic realities test – is the worker economically dependent upon the company

Determining Worker Status (cont.)

HUNTON ANDREWS KURTH

- Pay attention to high-risk scenarios, which can include:
  - An independent contractor performing the same duties as an employee,
  - Employee is terminated and then rehired as an independent contractor doing the same job,
  - The independent contractor has worked a long time for the company,
  - The independent contractor has little or no contract with the staffing agency,
  - The independent contractor is disciplined by the company or given performance reviews, and
  - The independent contractor receives benefits along with other employees (*e.g.*, non-cash awards)

Determining Worker Status (cont.)

HUNTON ANDREWS KURTH

- Here are two examples:

- Architect in Rev. Rul. 74-412 concluded to be an employee
  - Architect worked for a professional architectural company on a project-by-project basis pursuant to an oral agreement
  - Architect had his own calculator, drafting instruments, books and could accept or decline any project
  - However, services had to be performed on company premises under the company's name. Additionally, office materials (including secretarial assistance) was provided free of charge

- Consultant – PLR 9334027 – concluded to be an independent contractor
  - Computer data manager worked 6-8 hours a day for about 6 months at the business that hired him for the job
  - He reported to the department's director 2-3x per week to report on progress
  - Consultant represented to the public that he was in the business and performed such services under his own name
  - The temporary nature of the position was noted by the IRS
  - No training was provided and the individual invested in his own equipment

Determining Worker Status (cont.)

HUNTON
ANDREWS KURTH

- Document
- Document
- Document
- Document
- Absent proof to the contrary, a carefully worded document can act to show the court the intention of the parties
  - It can also act as a guideline for the future behavior of the parties

CE Credit Verification Code

HUNTON
ANDREWS KURTH

Please write the code down on the Verification Form which was provided in the invitation and reminder e-mail for this program. If you do not have this form, please capture the code any way you can, and we will provide another copy of the form in a follow-up e-mail.

CODE:
74h5k2a

Please return the completed Verification Form to
CLEAdministrator@HuntonAK.com

Defenses: Section 530 Relief

HUNTON ANDREWS KURTH

- Section 530 of the Revenue Act of 1978 is a safe harbor that prevents the IRS from retroactively reclassifying workers as employees, thereby negating retroactive federal employment taxes, penalties and interest

- To qualify for Section 530 relief, the taxpayer must have:
  - Consistently treated the workers (and all similarly-situated workers) as independent contractors,
  - Complied with the Form 1099 requirements for the tax year in question (including the requirement to timely file), and
  - Had a "reasonable basis" for treating the workers as independent contractors, such including:
    - Legal authorities
    - Industry practice
    - Advice from an attorney or accountant

- Important to note is that the existence of a reasonable basis should be construed liberally in favor of the taxpayer (*see* H.R. Rep. No. 1748, *see also* IRM Section 4.23.5.2.2.3(1))

- Once the taxpayer has made a prima facie showing of reasonableness, the burden of proof then shifts to the IRS to verify or refute the taxpayer's explanation. *See McClellan v. U.S.*, 900 F. Supp. 101 (E.D. Mich. 1995)

Defenses: Section 530 Relief (cont.)

HUNTON ANDREWS KURTH

- To qualify under the "industry practice" safe harbor, the taxpayer must show that it reasonably relied on a long-standing recognized practice of a significant segment of its industry
  - Section 530(e)(2)(B) clarifies that 25% of the taxpayer's industry (determined without the employer) is deemed to constitute a significant segment of the industry
  - Section 530(e)(2)(C) provides that practices that have existed for more than 10 years are "long-standing," however, legislative history notes provide that 10 years is only a safe harbor (*i.e.*, depending on the facts and circumstances, a shorter period could be long-standing)

- A few interesting points:
  - The requirement under Section 530 relief that the taxpayer file the Form 1099s on a timely basis is applied on an individual-by-individual basis (*see* Section 530(a)(1)(B), *see also* IRM Section 4.23.5.2.2.1 ". . . with respect to that worker for the period.")
  - Availability of Section 530 relief is not contingent upon the taxpayer's agreement or concession to the IRS that the workers are employees (*see* IRM Section 4.23.5.2.1(2))
  - Prior to initiating the worker classification examination, the IRS is required to provide the taxpayer with a copy of IRS Publication 1976 entitled "*Do You Qualify for Relief under Section 530?*" (see IRM Section 4.23.5.2.1(5))
    - To verify, request from the IRS a copy of the transmittal, including a copy of the applicable Form 9984 entitled "Examining Officer's Activity Record." The examiner is required to notate in Form 9984 how and to whom the publication was delivered (*see* IRM Section 4.23.5.2.1(5)(C))

Defenses: Section 530 Relief (cont.)

HUNTON ANDREWS KURTH

- If under audit, the taxpayer could forego Section 530 relief contingent upon a finding by the IRS that "reasonable cause" exists for any misclassification, and as a result, any civil penalties and interest charges must be waived

- Such reasonable cause could include:
  - Taxpayer is new to the industry,
  - Taxpayer relied upon a longstanding and recognized practice that is prevalent within the industry,
  - Taxpayer relied upon the advice from its outside CPA or law firm with respect to the classification of the worker, and
  - Etc.

Defenses: Section 3509

HUNTON ANDREWS KURTH

- Section 3509 of the Code could apply as to those workers and filings to which Section 530 relief is not applicable

- Section 3509 provides that if a taxpayer fails to deduct and withhold any tax under Chapter 24 (*i.e.*, the income tax withholding provisions) or subchapter A of Chapter 21 (*i.e.*, the provisions addressing the employee portion of FICA tax), then:
  - With respect to any employee by reason of treating such individual as not being an employee,
  - The employer's liability is 1.5% of the employee's wage plus 20% of the employee's portion of the FICA tax

Defenses: VCSP Initiative

HUNTON ANDREWS KURTH

- On September 21, 2011, the IRS announced a new voluntary disclosure program entitled "Voluntary Classification Settlement Program" ("***VCSP***")
  - The purpose of the FCSP is to allow businesses to settle their potential liability by completing an application, paying a portion of the prior year's tax liability, and agreeing to properly classify the worker on a prospective basis
  - The goal of the VCSP is to increase compliance

- Eligibility requirements somewhat follow the requirements for 530 relief. To be eligible, the applicant must:
  - Have been consistent over the years in its classification of the workers as independent contractors,
  - Have filed all required Form 1099s for the previous 3 years (though currently there is no requirement that such form had to have been filed timely),
  - Not be currently under audit by the IRS, and
  - Not be currently under audit by the DOL or a state agency (*e.g.*, Texas Workforce Commission) on the issue of classification for the workers in question

Defenses: VCSP Initiative (cont.)

HUNTON ANDREWS KURTH

- If eligible, the application process involves the following:
  - The taxpayer completes and submits an application using Form 8952
  - The application should be filed at least 60 days prior to the date the taxpayer intends to treat the workers as employees, and
  - The IRS will review the application and verify eligibility

- If the application is approved, the IRS will contact the taxpayer to enter into closing agreement. Under the closing agreement:
  - The taxpayer agrees to treat the workers as employees
  - All workers in the same class as the reclassified workers must be treated the same
  - The taxpayer pays 10% of the employment tax liability that would have been due had the works been properly classified for the most recent tax year (no interest or penalties)
    - And calculated at reduced rates from the Section 3509 rates
  - Full payment of the amount due must be made at the time of signing the VCSP closing agreement
  - The IRS will conduct no employment tax audits relating to the workers for the prior years

Defenses: VCSP Initiative (cont.)

HUNTON ANDREWS KURTH

- VCSP offers a discounted cost to resolve the issue
  - The employment tax liability is first calculated at the reduced rates of Section 3509 (i.e., a reduction from the full FICA and income tax withholding rates that would otherwise apply)
  - Under VCSP, the taxpayer only pays 10% of such reduced rate
  - No interest or penalties apply if the amount owed is paid at the time of entering into the closing agreement
- The normal statute of limitations for payroll taxes is 3 years. Under VCSP, such statute of limitations continues to apply
- It is not clear what information the IRS will share with states and/or the DOL if the taxpayer participates in VCSP

Don’t Forget Next Month’s Webinar

HUNTON ANDREWS KURTH

- Title:
  - ABCs of Private Company ESOP Transactions
- When:
  - 10:00 am to 11:00 am Central
  - July 11, 2024