PPACA Effects on Employee vs. Independent Contractor Designations

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2014–Issue 26—The passing of the Patient Protection and Affordable Care Act, now ubiquitously known as Obamacare, on March 23, 2010, had far–reaching effects for the application of health care in the United States. Millions who previously had no access to affordable health insurance now have expanded access through their employers or state–sponsored exchanges.

The provisions of the PPACA that were not directly related to health insurance were numerous and have been well documented, such as a tax credit for low– to middle–income Americans and small businesses to help subsidize health–care costs. Other tax provisions included a 2.3 percent tax on the sales price of certain medical devices paid by the manufacturer, producer or importer of the device, as well as changes to the previously existing excise taxes imposed on such medical devices, changes to estimated tax payments for large corporations and codification of the Economic Substance Doctrine. With the upholding of the PPACA by the Supreme Court, these tax laws are coming into effect and are beginning to have an impact on taxpayers across the United States.

Beyond these well–known changes to tax law, there are many other provisions of the PPACA affecting tax policy and taxpayer behavior. One of the main aims of the PPACA, a mandate for many employers to provide access to health insurance for full–time employees or face penalties, has created a potential incentive to classify or reclassify employees as independent contractors.

The PPACA requires certain large employers, namely those with 100 or more full–time equivalent employees in 2015 and 50 or more full–time equivalent employees in 2016 and years thereafter, to provide minimum essential coverage at an affordable rate. The coverage must pay at least 60 percent of the cost of full–time employee health–care benefits for the average full–time employees. If an employer is not offering the minimum essential coverage as required by the PPACA, the employer will be subject to an annual non–deductible penalty of $2,000 per full–time employee over a 30–employee threshold. If an employer offers health coverage that fails to provide sufficient value or is not affordable, the non–deductible penalty is $3,000 per full–time employee who receives subsidized coverage through an exchange. For an affected company, the cost of either paying for an employee's health insurance or paying the non–deductible penalty could create a material increase to the compensation costs of each employee. This mandate goes into effect for tax years starting on or after January 1, 2015. It was originally set to begin on January 1, 2014, but the Treasury Department pushed back the date by one year to allow additional time for implementation by employers.

Many companies may consider ways to circumvent these mandates to avoid additional costs. A CEO may ask his or her management team to revisit their employee classifications and examine if currently classified employees are in fact employees or independent contractors. If classified as independent contractors rather than employees, the onus is on the contractors to provide their own desired health insurance, as well as pay their own self–employment taxes such as Social Security (6.2 percent, up to the $117,000 wage threshold for each portion) and Medicare (1.45 percent of wages for each portion with an additional 0.9 percent for wages in excess of $200,000) on the employee's behalf. Companies are not required to withhold or pay employment taxes for independent contractors, with the entire burden falling on the contractor.

Say, for example, that a company has 140 full–time employees in 2015 and will now be providing competitive health–care benefits under the PPACA. In the past, none of its employees received employer–sponsored health insurance. Per the Kaiser Family Foundation/Health Research & Education Trust's 2013 employer survey, average individual premiums reached $5,384 in 2013, with $4,266 on average being paid by the employer. Therefore, if the company provides minimum affordable coverage, set at 60 percent of the premium, its burden is $3,230 per employee (with the broad assumption that all employees are single).

At a minimum, if all of the employees choose to receive employer provided health insurance coverage, the employer's cost will be $452,200. If the decision is made to forgo providing insurance to employees in 2015, the non–deductible $2,000 penalty per employee would total $220,000 (140 employees less 30 employee threshold multiplied by $2,000).

A re–examination of employee classification could provide a savings of at least $2,000 per employee if the employer accepted the penalty. Additionally, the employer would save on Social Security and Medicare taxes of 7.65 percent per employee who is now reclassified.

The above example may appear to be a simple way to save some expenses for your company, but now consider this: Claiming someone as an independent contractor when he or she is truly an employee affects multiple federal agencies, including the IRS and the Department of Labor, with multiple types of tax impacted. The IRS, DOL and multiple states have agreed to share information about misclassification, which can potentially lead to liabilities, interest and penalties. Per the IRS manual for employment tax penalty procedures, the IRS penalties that may apply include failure to file (IRC 6651(a)(1)), failure to pay (IRC 6651(a)(2)), failure to make a timely deposit (IRC 6656), failure to file certain information returns (IRC 6721), failure to furnish information returns (IRC 6722) and failure to include correct information (IRC 6723). Negligence and fraud penalties may be considered as well if the misclassification is deemed intentional.

The DOL mainly concerns itself with capturing back wages as a result of misclassified employees who were unfairly paying self–employment taxes, while the IRS focuses on the fact that you did not collect employment taxes or withhold income taxes on behalf of your "employee," both of which can lead to severe penalties. If the misclassification has been ongoing, the IRS isn't beyond looking retroactively for as many years as it is able under the statute of limitations. The non–payment and non–filing penalties can be substantial and even lead to criminal charges. The IRS notes on its website that about 150 cases of employment tax evasion are initiated every fiscal year, with around two–thirds of those resulting in indictments.

Classifying workers as independent contractors also means those workers are not eligible for workers' compensation or covered under most employers' general liability insurance, something that can lead to lawsuits if those workers suffer a workplace incident that damages property or leads to injury to themselves or others.

Shortly after the passage of the PPACA, the IRS released Announcement 2011–64, which detailed a new Voluntary Classification Settlement Program for taxpayers to voluntarily and prospectively treat workers as employees. If eligible, employers who agreed to treat the class of workers as employees going forward were only required to pay 10 percent of the employment tax liability that may have been due, received audit protection in regards to employee classification for prior years and were shielded from potential interest and penalties. This program supplements the previously existing Classification Settlement Program existing to provide relief for those under audit on this issue.

Additionally, the IRS reinterpreted so–called Section 530 relief, which provides a safe harbor if an employer has filed all required Form 1099s for independent contractors, treats groups of workers with similar positions consistently, treats the contractor as such on all applicable federal forms and has a reasonable basis for its treatment of workers as contractors. This relief dates back to Section 530 of the Tax Act of 1978. The reinterpretation surrounds the definition of reasonable basis, which in this case can be reliance on court cases, published rulings, past favorable audit results or industry standards. Given its wording, even erroneous classifications were sheltered by the safe harbor. In a 2011 Chief Counsel Memorandum, the IRS asserted that classification decisions using the safe harbor must have been made when the worker was hired, rather than a convenient court case or audit result in the future offering protection.

The classification rules for employees versus independent contractors are derived from the IRS's "20 factors" as stated in Revenue Ruling 87–4, which was released as guidance related to the Tax Reform Act of 1986. These factors were developed based on case law and rulings to determine if sufficient control exists for the person for whom the services are performed over the individual to be considered an employee rather than a contractor. The 20 factors can be more succinctly reviewed as having three main characteristics: behavioral control, financial control, and the type of relationship.

The factors have not changed or been altered in any significant manner over the past 20–plus years. In the few years since the passage of the PPACA, the IRS has renewed its focus on this issue through the 2012 release of Publication 1779 Independent Contractor or Employee, a short guide that supplements Form SS–8 Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding and Publication 15–A Employer's Supplemental Tax Guide.

Case law continues to evolve and shows that each case is fact based and not subject to any bright–line test. The 20 factors are just that — factors — that help determine but alone do not answer the classification question. In 2011's T.C. Memo 2011–99 Robinson v. Commissioner, the Tax Court sided with a part–time professor at Temple University who believed he was an independent contractor rather than an employee, as the university believed and had previously treated him. The court ruled Robinson to be an independent contractor mostly because of his control over the curriculum he taught and because he was not salaried but rather paid by the individual courses he taught, supported by separate employment agreements among other facts.

Alvarez & Marsal Taxand Says:

What can a taxpayer and employer do to protect itself against potential employment misclassification problems, which could lead to substantial back taxes, interest and penalties, as well as opening itself up to legal liability or lawsuits from disgruntled workers? Document, document, document. If you can substantiate your worker classification and show there was reasonable cause supporting those decisions, you can save yourself headaches during future examinations. Ensure that independent contractor or employment agreements are in place, depending on the classification. Make sure groups of workers with similar job functions are classified in the same manner.

To do this, consider the IRS's 20 factors and other guidance on this hot–button issue. Ask yourself these questions:

- In what manner do you assert control over the worker's behavior?
- What aspects of the worker's business are controlled by you, the employer?
- Do the workers have their own supplies?
- How are they reimbursed?
- Are there employee–type benefits like vacation, salary and insurance, or is the worker paid for his or her services solely on a job–by–job basis?

If you are concerned that you may have improperly classified either employees or contractors, look to the existing relief provisions. There are methods available to mitigate the damage caused by misclassification.

With the attention placed on the employee vs. independent contractor issue by the PPACA, it may be time to reassess your facts, documentation and conclusions.

Author

Robert Filip [2]
Managing Director, Seattle
+1 206 664 8910

Matt Bry, Senior Associate, contributed to this article.

For More Information

Brian Cumberland [3]
Managing Director, Dallas
+1 214 438 1013

J.D. Ivy [4]
Managing Director, Dallas
+1 214 438 1028

Mark Spittell [5]
Senior Director, Dallas
+1 214 438 1017

Mark Young [6]
Managing Director, Houston
+1 713 221 3932

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Alvarez & Marsal Taxand | 600 Madison Avenue | 8th Floor | New York | NY | 10022

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