

NOTE: When the employer is not sure how a particular employee should be classified, he/she may request a ruling from the IRS by filing Form SS-8 (Reg. 31.3401(d)-1(d)).

CAUTION: Form SS-8 may be most helpful as a checklist for self-audit. If the SS-8 is actually filed, the IRS may determine that an employer/employee relationship exists without providing a reasonable forum for the employer to present his/her case. In addition, the taxpayer may increase his/her audit risk.

DANGER: This form may be filed by a worker concerned about his/her classification.

XII. TAX CONSEQUENCES WHEN A WORKER IS IMPROPERLY CLASSIFIED AS AN INDEPENDENT CONTRACTOR

- A. If an employer treats an individual as an independent contractor and the IRS later determines that the individual is, in fact, an employee, the employer is subject to a penalty of 1.5% of the individual's wages (3% if no Form 1099 was issued) for failure to withhold income tax (IRC Sec. 3509). The employee is liable for the individual's income tax even though the employer treated him/her as an independent contractor and failed to withhold the income tax.
- B. The employer is subject to a "FICA penalty" of 20% of the employee's share of FICA taxes (40% if no Form 1099 filed).
- C. The employer must pay its share of the FICA tax.
- D. The employer is subject to the full amount of the employee's taxes if it intentionally disregards the withholding rules. This could happen where the employer treats all individuals as independent contractors.
- E. The employee may file an amended return claiming a refund for overpaid self-employment tax after being reclassified as an employee (assuming it was in fact overpaid).
- F. A possible invalidation of employee benefit plans and the related consequences—including pension plans.
- G. Court-related costs of litigating the matter and the possibility of negative outcomes, both in the form of fines and/or other criminal sanctions.

CASE: *John Francis O'Rourke v. Comm.*, U.S. Tax Court, TC Summary Opinion 2009-26 (02/25/09). A person was hired by the DEA as a contractor yet had withholding like he was an employee. The taxpayer reported this income as wages on Form 1040 and included Form 2555-EZ to claim the Foreign Earned Income Exclusion thereby excluding all of his income and claiming a refund for income taxes withheld.

"Foreign Earned Income" does not include amounts "paid by the United States or an agency thereof to an employee of the United States or an agency thereof." IRC Sec. 911(b)(1)(B)(ii).