SO YOUR EMPLOYER MADE YOU AN INDEPENDENT CONTRACTOR AND DIDN'T PAY ANY FICA TAX: HOW TO HAVE YOUR CAKE AND EAT IT TOO

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ABSTRACT

Employees who have been misclassified as self-employed independent contractors need to know how to correct the misclassification and how to avoid paying excessive taxes. This paper focuses on four issues: (1) how misclassified workers may avoid paying any self-employment tax, (2) how they possibly may avoid paying the employee's half of FICA tax as well, (3) how they may secure reclassification as employees through the help of the IRS, and (4) how they may have their earnings record updated to obtain maximum Social Security benefits after retirement despite paying neither self-employment nor FICA tax on the misclassified earnings. Recommendations are based on recent case law and administrative pronouncements.

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SO YOUR EMPLOYER MADE YOU AN INDEPENDENT CONTRACTOR AND DIDN'T PAY ANY FICA TAX: HOW TO HAVE YOUR CAKE AND EAT IT TOO

by Robert Atkins Walker and Clifton L. Kling

I. Introduction

A. Purpose

Continuing controversy surrounds the employee versus independent contractor classification issue.[1] To date, research on worker status has concentrated on the factors used by the courts and the IRS to determine whether workers are employees or self-employed independent contractors.[2] Some research has addressed worker misclassification issues from the employer's standpoint,[3] but no article to our knowledge has specifically dealt with the misclassification issue from the employee's perspective.[4] We investigate the effects and remedies for misclassified employees because they typically are not in an advantageous or knowledgeable position to redress the misclassification.

We focus on four employee-related employment tax and benefit issues: (1) how

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[1]*See, e.g.*, U.S. House of Representatives. Hearing before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means. 103d Congress, 2d session. *Selected Tax Provisions in the Administration's Health Security Act* (Washington, DC: Government Printing Office, Serial 103-83, February 8-9, 1994). and Cherie J. O'Neil and Linda Nelsestuen, "Employee or Independent Contractor Status?: Conflicting Letter Rulings Continue Controversy," *Tax Notes Today* 93 (May 26, 1993), pp. 112-35.

[2]*See, e.g.*, Thomas F. Broden, Jr., "General Rules Determining the Employment Relationship under Social Security Laws: After Twenty Years an Unsolved Problem," *Temple Law Quarterly* 33 (1960), pp. 307ff; Aaron Levine, "Current Factors That Distinguish Between `Employee' and `Independent Contractor'," *Journal of Taxation* 37 (1972), pp. 188ff; William Kenny and Myron Hulen, "Determining Employee or Independent Contractor Status," *The Tax Advisor* 20 (1989), pp. 661ff; and "Fishing for Dollars: The IRS Changes Course in Classifying Fisherman for Employment Tax Purposes," *Cornell Law Review* 77 (1992), pp. 393-438.

[3]*See, e.g.*, Myron Hulen, "Incorrect Determination of Worker Status Can Lead to Penalties, but Relief Is Available," *Taxation for Accountants* 37 (1986), pp. 108-12; Stuart Duhl and Donna Shaw, "Keeping Independent Contractors from Being Reclassified," *Taxation for Lawyers* 19 (1991), pp. 210-7; and William L. Fulcher, "Withholding Tax: Whose Liability Is It?" *The National Public Accountant* (September 1991), pp. 36-8.

[4]Per correspondence from William Fulcher dated August 29, 1994, his article in *The National Public Accountant, id.,* was written "from the point of view of misclassified employees," but "was subjected to much editing" such that the original thrust became camouflaged.

misclassified workers may avoid paying any self-employment tax (SECA), (2) how they possibly may avoid paying the employee's half of FICA tax as well, (3) how they may secure reclassification as employees through the help of the IRS - in recent years, about 90% of the Private Letter Rulings addressing the issue have classified workers as employees rather than independent contractors,[5] and (4) how they may have their earnings record updated to obtain maximum Social Security benefits after retirement despite paying neither self-employment nor FICA tax on the misclassified earnings. The proper action for misclassified workers is to report their independent contractor earnings as wages and pay no self-employment tax. The following is an example of one such worker that one of the authors met during the writing of this article.

B. An Example

Officer B, a security guard at Georgetown University, moonlighted in 1993 for a laundry firm driving a delivery truck. The company treated him as an independent contractor and reported his earnings of $7,041 on a Form 1099-MISC instead of a W-2. B realized that he had been misclassified by his employer and was preparing to seek an IRS determination of his status.[6] He had already drafted but not yet mailed his amended 1993 Federal income tax return including $995 of self-employment tax liability. After discussing his situation with one of the authors, B reclassified the self-employment income as wages and saved the self-employment tax. His next step will be to contact the Social Security Administration to have his earnings record updated for

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[5]Specifically, during the 15-months from January 1987 through March 1988, 94% of the Private Letter Rulings issued by the IRS in response to workers', and to a lesser extent, employers' requests for a determination of status classified the workers as employees. *See* Barry H. Frank, "Independent Contractor vs. Employee: Guidelines for the Practitioner," *The Practical Accountant* 22 (December 1989), pp. 17-30 at p. 22. Similarly, during a three-month period from March through May 1992, 87% of the 173 rulings classified the workers as employees. *See* Cherie J. O'Neil and Linda Nelsestuen, "Employee or Independent Contractor Status? Conflicting Letter Rulings Continue Controversy," *Tax Notes Today* 93 (May 26, 1993), pp. 112-35.

[6]Officer B was actually a statutory employee per I.R.C. Sec. 3121(d) which classifies a driver who picks up and delivers laundry as an employee regardless of the common law definition.

the missing wages. Failing to do this could cost him about $1,100 in eventual Social Security benefits.[7] Had B been a full-time worker for the delivery firm, the effect would have been more dramatic. He would have earned about $30,000, saved about $4,300 in self-employment tax, and lost about $4,700 in Social Security benefits for *each* year of employment.

C. Employer Incentives and Employee Consequences

Employers have an incentive to classify their employees as self-employed independent contractors because they avoid paying employer FICA, federal and state unemployment, worker compensation, medical insurance, vacation and holiday pay, pension contributions, and other fringe benefits.[8] Employers are in a position to do so because prospective workers are usually at a disadvantage in negotiating terms of employment. Even if employees do have some bargaining power, they often do not realize the financial impact of their classification. As a result, employees are misclassified as independent contractors and rarely are aware of the procedures for correcting the misclassification.

The most immediate financial impact on misclassified workers face is having to pay 15.3% in self-employment taxes on their earnings.[9] Misclassification may have other serious consequences which are not covered in this analysis. Independent contractors are typically not eligible for the employer's fringe benefits such as health insurance, although they have recourse

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[7]This is estimated using current Social Security benefits tables, assuming a normal life span and no discounting for the time value of money. See *The Social Security Handbook* (Cincinnati: National Underwriter, 1994).

[8]In fairness to employers, however, some workers may decide it is to their advantage to be misclassified as independent contractors. If the compensation is not reported on Form 1099-MISC or if the worker gives the employer a false Social Security number, the worker has a better chance of evading tax by not reporting the income. Also, the worker may deduct work-related expenses above-the-line as an independent contractor.

[9]Actually, the effective rate is less because only 92.35% of earnings is subject to self-employment tax, and one-half of the self-employment tax is deductible in arriving at adjusted gross income on the tax return. Taxpayers in the 15% and 28% marginal tax brackets effectively pay self-employment tax of 13.1% and 12.2% on their self-employment earnings respectively.

against the employer for those benefits if they have been misclassified. Additionally, independent contractors are not eligible for unemployment and workers' compensation coverages, unless obtained privately. They also lack the protection of other laws for employees including, for example, the Age Discrimination in Employment Act, and the Fair Labor Standards Act which governs overtime pay as well as other wage and hour issues.[10] Nonetheless, misclassified workers can obtain unemployment and workers' compensation coverage through state review boards and may assert their rights as *de facto* employees for the other legally mandated employee protections.

D. Organization

This analysis is structured as follows.

- Part II briefly addresses the legal issues involved in determining worker status.
- Part III analyzes recent court decisions along with the relevant statutory law and administrative pronouncements. The court cases, all of which hold that a misclassified employee does not have to pay self-employment tax, are divided as to whether the misclassified employee is liable for the employee's share of FICA taxes.[11]
- Part IV explains the administrative steps necessary to avoid paying self-employment tax and to update one's Social Security earnings record. If neither the employee nor the employer has paid FICA tax, the IRS will not forward the earnings data to the Social Security Administration. The employee must contact a Social Security office to update their earnings record for the reclassified wages. Failure to have one's Social Security earnings record updated for the misclassified earnings usually will mean less Social Security benefits after retirement.
- Part V summarizes the findings and recommends strategies for misclassified employees.

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[10]Other laws include the National Labor Relations Act governing collective bargaining, the Civil Rights Act, the Occupational Safety and Health Act (OSHA), and the Americans With Disabilities Act.

[11]Throughout the paper, FICA tax means the combined Social Security tax and the Medicare tax. The employee's share of FICA tax, which the employer deducts from the paycheck, includes the 6.2% Social Security tax and the 1.45% Medicare tax for a combined rate of 7.65%. The employer also pays an equal amount of tax.

II. Is a Worker an Employee or an Independent Contractor?

Determination of a worker's correct status is a necessary first step. The law is well established on this issue. The primary test of employee status is whether the employer has the right to control and direct the worker.[12] It is not a requirement that the employer actually controls and directs; merely the right to do so indicates an employer-employee relationship. Based on the facts and circumstances of each case, the courts decide whether sufficient direction and control exist to establish an employer-employee relationship. Considerable case law now exists in which the courts have considered a variety of factors in determining the level of direction and control.[13]

In the absence of statutory guidelines for most types of employment,[14] the IRS has sought to issue regulations for clarifying the common law rules that govern classification. Fearing the retroactive tax assessments that could result from reclassification (the IRS has estimated that $2 billion in income and employment taxes is lost each year as a result of employer misclassification of 3.4 million employees),[15] small businesses and independent contractors successfully lobbied Congress to bar the IRS and the Treasury from issuing such regulations.[16] Consequently the IRS resorted to issuing a Revenue Ruling that emphasizes the direction and control issue, and lists 20 additional factors distilled from court opinions for use in deciding worker misclassification

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[12]*See, e.g., United States v. W.M. Webb, Inc.*, 90 S. Ct. 850 (1970); *United States v. Silk*, 67 S. Ct. 1463 (1947); and *Breaux & Daigle, Inc. v. United States*, 900 F. 2d 49 (5th Cir. 1990).

[13]*See, e.g.*, for example, *Professional and Executive Leasing, Inc. v. Commissioner*, 89 T.C. 225, 231 (1987), *affd.*, 862 F. 2d 751 (9th Cir. 1988); *Packard v. Commissioner*, 63 T.C. 621, 629 (1975); and *Gamal-Edlin v. Commissioner*, 55 T.C.M. (CCH) 582 (1988), *affd. without published opinion*, 876 F. 2d 751 (9th Cir. 1989).

[14]Congress has classified workers in certain occupations as statutory employees, *e.g.*, some delivery truck drivers, all full-time life insurance sales agents, and traveling salesmen and women (I.R.C. Sec. 3121(d)), and certain others as statutory non-employees, *e.g.*, licensed real estate agents and direct sellers of products such as Avon (I.R.C. Sec. 3508).

[15]*See*, United States General Accounting Office, *TAX GAP: Many Actions Taken, But a Cohesive Compliance Strategy Needed* (Washington, DC: U.S. General Accounting Office report, GAO/GGD-94-123, May 11, 1994), p. 17.

[16]Sec. 530(b) of the Revenue Act of 1978, Public Law 95-600. For additional explanation of Sec. 530, *see* note 41 *infra*.

disputes. These factors, taken together, are known as the common law test of employee-versus-independent-contractor status. As listed in Rev. Rul. 87-41,[17] the factors consider a worker an employee if the worker:

1. Must comply with the employer's instructions
2. Receives employer sponsored training
3. Provides services that are an integral part of the business
4. Renders services personally
5. Hires, supervises, and pays assistants for the employer
6. Has a continuing relationship with the employer
7. Must follow set hours of work
8. Works full time for the employer
9. Works on the employer's premises
10. Performs tasks in an order of sequence set by the employer
11. Must submit oral or written reports
12. Is paid by hour, week, month
13. Is paid for business and/or travelling expenses
14. Is furnished with tools and materials
15. Does not have a significant investment in the service-providing facilities
16. Cannot realize a profit or loss
17. Works for only one employer at a time
18. Does not make services available to the general public
19. Can be fired, and
20. May quit without incurring liability to the employer.

Employing this non-objective approach, the Revenue Ruling further states that, "[t]he degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed."[18]

Both the courts and the IRS have set a low threshold for determining the necessary level of direction and control to establish employee status.[19] A worker that is treated as an independent contractor and who thinks there is evidence supporting employee status has a good chance for

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[17]1987-1 C.B. 296, 298-9.

[18]*Id.* at 298.

[19]For a detailed discussion of worker classification, more from the employer's standpoint, *see* Myron Hulen, William Kenny, Jack Robison, and D. Michael Vaughn, "Independent Contractors: Compliance and Classification Issues," *American Journal of Tax Policy* 2 (Spring 1994), pp. 13-89.

reclassification through the IRS or the courts.[20]

III. Can the Misclassified Worker Avoid Paying Both Self-Employment and FICA Tax?

A. Recent Court Decisions

Recent court decisions involving misclassified workers establish that self-employment tax does not have to be paid, but are in conflict as to whether the employee's half of FICA tax must be paid. Most recently, *Casety* (1993)[21] and *Laraway* (1992)[22] released misclassified workers from paying self-employment tax. The third case, *Myers* (1992),[23] held that the IRS cannot collect the employee's portion of FICA tax directly from the employee unless either the IRS is statutorily prevented from collecting from the employer or the IRS can offset the tax against an overpayment owed the taxpayer. The fourth case, *Navarro* (1993)[24] is consistent with *Casety* by exempting the reclassified worker from self-employment tax but conflicts with *Myers* by requiring that the employee pay their half of FICA tax even if the employer remains fully liable.

1. *Casety*. In *Casety*,[25] the Tax Court allowed a misclassified employee's non-payment of self-employment tax. Ed Casety earned $18,661 working as a paralegal during the 1988 tax year. His attorney employer treated him as an independent contractor and reported his earnings on Form 1099-MISC. Casety believed that he was an employee based on the common law definition and

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[20] *See* the accompanying text at note 5 *supra*.

[21] *Casety v. Commissioner*, 66 T.C.M. (CCH) 616 (1993).

[22] *Laraway v. Commissioner*, 64 T.C.M. (CCH) 1503 (1992).

[23] *Myers v. United States*, 69 A.F.T.R. 2d (P-H) 1207 (D. Ariz. 1991), *reconsidered and reversed on other grounds*, 70 A.F.T.R. 2d (P-H) 5900 (D. Ariz. 1992).

[24] *Navarro v. United States*, 72 A.F.T.R. 2d (P-H) 5424 (W.D. Tex. 1993).

[25] *See* note 21 *supra*.

did not report self-employment tax on Form 1040. The IRS issued a $2,452 deficiency notice for the self-employment tax due on his earned income for 1988. The Court concluded that he was not liable for self-employment tax, ruling that he was an employee. The judge determined that the employer retained the right to control the manner in which Casety's services were performed.

The issue of whether Casety was liable for the employee's share of FICA tax was not raised at trial[26] because the Tax Court does not have jurisdiction over FICA tax issues per I.R.C. Sec. 7442.[27] As stated in *Purdy v. Commissioner*,[28] the Tax Court's jurisdiction "is normally predicated upon issuance of a notice of deficiency."[29] Per I.R.C. Secs. 6211-6214, "Subtitle C - Employment Taxes" of the I.R.C. (Secs. 3401 *et. seq*.) is not among the types of tax for which a deficiency notice may be issued. Self-employment (SECA) taxes, however, are covered under I.R.C. Subtitle A (Sec. 1401) and are within the Tax Court's jurisdiction.

If the IRS determines that a taxpayer has underpaid FICA taxes, the IRS may issue a tax due notice per I.R.C. Sec. 6303 but not a deficiency notice (*see* I.R.C. Sec. 6155(b)(1)). Because the Tax Court has no jurisdiction over FICA tax issues, the taxpayer generally must pay the tax liability and sue for a refund in a U.S. District Court or in the U.S. Claims Court.[30] If the taxpayer

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[26]The day before the trial, Casety and the IRS auditor reached a compromise that he would pay the employee's FICA tax share, but the auditor's supervisor rejected the compromise. Personal communication with Ed Casety on September 24, 1993.

[27]*See Marvel v. United States*, 548 F. 2d 295 (10th Cir. 1977) at 297.

[28]45 T.C.M. (CCH) 74 (1982). *See* also *Grooms v. Commissioner*, 63 T.C.M. (CCH) 3040 (1992) where the IRS issued a deficiency notice to the misclassified worker for both unpaid income taxes and the employee's share of FICA taxes. The Tax Court held the taxpayer liable for the income taxes but not the FICA tax because it had no jurisdiction over FICA taxes.

[29]*Id*. at 76.

[30]If the taxpayer is an employer, the employer generally may contest an employment tax assessment by paying the tax for one worker for one quarter and then suing for a refund of that tax. The IRS typically will counterclaim in the same litigation for the balance of the assessment. *See, e.g., Marvel v. United States, see* note 27 at 296.

In 1982, the Senate attempted to extend the Tax Court's jurisdiction to include tax liabilities arising from employment misclassificationh, but the provision was dropped by the conference agreement. The conferees agreed, however, "that the [IRS] generally will forebear from active collection efforts while [the taxpayer's] refund litigation is pending ...." *See* United States House of Representatives Report No. 97-760, 97th Congress, 2d Session, H.R. 4961, *Tax Equity and Fiscal Responsibility Act of 1982* (Washington, DC: Government Printing Office, August 17,

does not pay the FICA tax liability shown on the tax due notice, the IRS may enforce its own tax lien (I.R.C. Sec. 6321) by levying on the taxpayer's property (I.R.C. Secs. 6331 *et seq*.). In Casety's case, once the IRS had lost on the self-employment tax issue, sending a tax due notice for the employee's share of FICA taxes was barred because the statute of limitations had expired.

2. *Laraway*. The facts in *Laraway*,[31] decided by a different Tax Court judge than *Casety*, are very similar to *Casety*.[32] An automobile mechanic whose earnings were reported on Form 1099 by the employer was held by the judge to be an employee based on the common law definition and was not liable for self-employment taxes. As in *Casety*, the issue of whether he was liable for the employee's FICA tax share was not raised in the court hearing because it was outside the Tax Court's jurisdiction.[33] Also the statute of limitations had passed for sending a tax due notice.

3. *Myers*. In *Myers*,[34] the issue was whether the IRS can collect the employee's share of FICA tax directly from the employee rather than from the employer when the employer had not paid the tax. Although nothing prevented the IRS from attempting to collect from the employer, *e.g.*, the statute of limitations or another law, the Service instead offset the employee's share against a tax refund the Myers were expecting. The judge ruled in favor of the Myers because he could find no authority allowing the IRS to collect FICA tax directly from the employee unless some other statute relieved the employer of liability. The judge quoted I.R.C. Sec. 3102(a) which

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1982) at p. 653.

[31]*See* note 22 *supra*.

[32]*See* note 21 *supra*.

[33]Per communication with John Laraway on February 1, 1995, the IRS attorney tried to convince Laraway, who represented himself, that he would lose the case and that he ought to accept the IRS's settlement offer to pay the employee's FICA tax share instead.

[34]*See* note 23 *supra*. The Myers were assessed a deficiency on unreported earnings. They did not dispute the deficiency. The IRS offset it against their 1990 income tax refund, but mistakenly offset $232 too much, and the Myers sought a refund. An IRS Problem Resolution Officer agreed to the refund, but offset $137 against it for FICA taxes not previously withheld on the unreported income. The court opinion does not reveal the nature of the earned income, but the Problem Resolution Officer assessed the employee FICA tax only. The Myers disputed the FICA tax offset and sued for a refund.

establishes employers' FICA liability to the IRS and says nothing about employee's liability: "The [FICA tax] shall be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages as and when paid."[35] He then pointed out, according to Treas. Reg. Sec. 31-6205-1(b)(3), that the employer is liable even if no deduction is made from the employee's wages.[36] I.R.C. Sec. 3102(b) states it succinctly: "Every employer required so to deduct the [FICA] tax shall be liable for the payment of such tax [to the IRS] ...."

In *Myers*,[37] the IRS contended "that an employee is jointly liable with the employer for FICA taxes not collected from the employer," relying on *Stewart v. United States*[38] and Rev. Rul. 86-111,[39] discussed below. In each, the employers had misclassified the employees as self-employed and had not deducted FICA tax, yet the employees were required to pay their portion of the FICA tax. In *Stewart*,[40] the judge held that because the employer qualified for release from all FICA tax liability for the misclassified worker under Sec. 530(a)(1) of the Revenue Act of 1978,[41] the employee was liable for his share of the FICA tax. In such cases where a law such as the above mentioned Sec. 530, or a rule of law such as the statute of limitations,[42] relieves the employer of

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[35]*Myers v. United States*, 69 A.F.T.R. 2d (P-H) 1207 (D. Ariz. 1991), at 1208.

[36]*Id*.

[37]*Id*.

[38]55 A.F.T.R. 2d (P-H) 506 (E.D. Wis. 1984).

[39]1986-2 C.B. 176.

[40]*See* note 38 *supra*, *see* also the judge's *dictum* at note 49 *supra*.

[41]Sec. 530(a)(1) of the Revenue Act of 1978, Public Law 95-600, as amended by Sec. 269(c) of the Tax Equity and Fiscal Responsibility Act of 1982, Public Law 97-248, relieves employers who unintentionally misclassified employees as self-employed and who filed all tax returns consistent with that misclassification, of all liability for the employees' FICA tax share. In this event, the employees are liable for their share of the FICA tax per the effect of I.R.C. Sec. 6521(a)(3). Section 530 is not part of the I.R.C. except as a footnote to I.R.C. Sec. 3401.

Rev. Proc. 85-18, 1985-1 C.B. 518, further clarifies the fact that the employees are liable for their FICA tax share if the employee's liability is terminated under Sec. 530(a)(1).

[42]*See* William L. Fulcher, "Withholding Tax: Whose Liability Is It?" *The National Public Accountant* (September 1991), pp. 36-8, for a good discussion of a number of issues covered here, including the shifting of FICA tax liability to the employee if the employer is relieved of liability through the statute of limitations. Fulcher gives the example of a group of fishing boat owners who treated their workers as independent contractors. The workers'

the employee's FICA tax liability, I.R.C. Sec. 6521 allows the IRS to offset the employee's FICA tax share against a refund sought by the employee for self-employment (SECA) tax erroneously paid. If the misclassified employee has not paid SECA tax, Sec. 6521 is inapplicable and does not grant the IRS the authority to collect FICA tax directly from the employee.

Rev. Rul. 86-111[43] was the second authority relied on by the IRS in *Myers*. In the ruling, an employer's liability for the employee's FICA tax liability was reduced under I.R.C. Sec. 3509,[44] and the employee was determined to be fully liable for the employee's FICA tax share, unreduced by the amount paid by the employer. The IRS's ruling did not rely on I.R.C. Sec. 6521 to make the employee liable. Because I.R.C. Sec. 3509(d)(1)(C) makes I.R.C. Sec. 6521 inapplicable to Sec. 3509, the IRS has no authority for shifting FICA tax liability to the employee in situations where Sec. 3509 reduces the employer's liability.[45] Instead, the Service inferred that the employee "remains fully liable for the [employee's share of the FICA] tax," citing I.R.C. Sec. 3509 (d)(1)(A) which reads, "the employee's liability for tax shall not be affected by the assessment or collection of the tax so determined [under Sec. 3509]."

There is no basis for the IRS's inference that a misclassified employee is fully liable for

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classification was changed to employee status by an appellate court. *Bishop v. United States*, 334 F. Supp 415 (S.D. Tex. 1971), *rev'd*, 476 F. 2d 977 (5th Cir. 1973), *cert. denied*, 417 U.S. 931 (1973). As a result the workers filed claims for refund of self-employment tax. All of the claims were granted except one. Because this individual experienced a delay in getting a court hearing, the worker was outside the statute of limitations for I.R.C. Sec. 3102(b). Therefore, the worker was only refunded about half the self-employment tax, *i.e.*, the employer's portion.

[43]*See* note 25 *supra*.

[44]I.R.C. Sec. 3509 relieves employers of most of their liability for withholding and FICA taxes if they unintentionally misclassified workers as self-employed. Specifically, regarding FICA taxes, such an employer must pay only 20% (40% if the employer failed to file information returns without good cause) of the combined employer's and employee's FICA tax liability.

[45]In Prop. Treas. Reg. Sec. 31.3509-1(d)(1)(iii), the Treasury has added to the words of I.R.C. Sec. 3509 (d)(1)(C), "sections 3402(d) and section 6251 shall not apply," the words "with respect to such employer's liability determined under this section, *although section 6251 may apply with respect to an employee's liability regardless of whether the employer's liability is determined under section 3509*." (Emphasis added.) Despite Congress's lack of specific wording to make the misclassified employee directly and jointly liable with the employer for the employee's FICA tax share, the Treasury has assiduously attempted to create such liability.

their FICA share either in the passivity of the Code's wording itself or in the Congressional Committee Reports at the time of enactment in 1982.[46] I.R.C. Sec. 3509(d)(1)(A) seems to apply to the misclassified employee's *income* tax liability rather than the FICA tax liability. In reclassification cases as explained in the Joint Committee Print,[47] absent Sec. 3509, the IRS would reduce an employer's liability for unwithheld income taxes by the amount of income tax the employer could prove had been paid by the misclassified employees. This was not the case for the employer's FICA tax liability even if the employee incorrectly had paid SECA tax. In other words, Congress intended to prevent misclassified employees from claiming a credit for income tax withheld equal to the amount the employer was required to pay under I.R.C. Sec. 3509(a)(1).

Despite the holdings and *dicta* in Rev. Rul. 86-111[48] and in *Stewart*[49] that the employees are liable to the IRS for their share of the FICA taxes, the judge in *Myers* limited the holdings' applicability by emphasizing that they only "indicate that the government can collect FICA taxes from the employee in circumstances in which the government is unable to collect the employee's FICA taxes from the employer."[50] The judge concluded: "Neither [the ruling nor the case] answers the question whether the government can collect FICA taxes from an employee where the employer is fully liable for payment of such taxes and before any attempt is made to collect the

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[46]Joint Committee on Taxation, [Joint Committee Print JCS-38-82, Public Law 97-248, H.R. 4961] *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (Washington DC: Government Printing Office, December 31, 1982) and United States Senate Report No 97-494, 97th Congress, 2d Session, H.R. 4961, *Tax Equity and Fiscal Responsibility Act of 1982 (Part 3 of 3)* (Washington, DC: Government Printing Office, July 12, 1982).

[47]*Id.*

[48]Rev. Rul. 86-111, note 25 *supra* at 177, contains *dictum* as follows: "Regardless of whether it is the employer or the Government who collects [the employee's share of FICA tax], the employee is ultimately liable for the tax ...."

[49]In *Stewart v. United States* note 24 *supra*, at 508, the judge added the *dictum*, "Moreover, even without the release of the employer, the [employee] remains liable for his portion of FICA taxes since they were never withheld from his wages."

[50]*See* note 21 *supra* at 1208.

taxes from the employer."[51]

Based on the lack of legal authority supporting the IRS's collection of FICA taxes from the employee first before attempting to collect from the employer when the employer is fully liable, the judge held that the IRS had to refund the FICA taxes it had held back from the Myers' refund. Specifically, the judge took I.R.C. Sec. 3102 as *prima-facie* evidence that Congress intended employers to collect and pay the employee's share of FICA taxes in the first place.

4. *Myers* reconsidered. Subsequently, the IRS moved for reconsideration. In its brief, the IRS contended that "one set of circumstances in which the government may assess the [employee's share of FICA] taxes directly against the employee is where the government already is in possession of funds belonging to the employee by virtue of an overpayment on other taxes assessed for the same tax year."[52] The IRS's contention was based on the Supreme Court's holding in *Lewis v. Reynolds*[53] that a taxpayer claiming a refund bears the burden of proving they overpaid their taxes for the particular tax year. Because the Myers were suing for a refund rather than being sued for payment, the judge agreed with the IRS in light of this newly-introduced precedent, reasoning that the focus of the case changed from the method of FICA tax payment to the "employee's underlying liability for the FICA taxes."[54]

Although the judge reversed his prior determination and held in favor of the IRS, he did so on other grounds which do not diminish the reasoning and holding in the original decision.[55] In the revised opinion, the judge carefully worded the holding so as not to negate any of the reasoning that the IRS must first try to collect from the employer if the employer is fully liable for the

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[51]*Id*. at 1209.

[52]*Myers v. United States*, 70 A.F.T.R. 2d (P-H) 5900 (D. Ariz. 1992), at 5902.

[53]52 S. Ct. 145.

[54]*See* note 36 *supra*.

[55]*See* note 14 *supra*.

employee's share of FICA taxes. He wrote, "... the fact that the government already holds taxpayer funds takes the analysis beyond the provisions of payment of the tax and into the realm of ultimate liability for the taxes owed."[56]

5. *Navarro*. In *Navarro*,[57] the U.S. District Court judge declined to follow *Myers*[58] and held that an employee is jointly liable with the employer for FICA taxes not collected from the employer regardless of whether the employer has been released from any of the liability. Even though the employer had not been released from his liability, the judge concluded that the IRS did not first have to seek payment for the employee's share from the employer. As a consequence, the misclassified worker, Navarro, was liable for approximately one-half the self-employment tax, *i.e.*, the FICA amount that would have been withheld from her paychecks had she been treated as an employee in the first place. The judge allowed the IRS to offset Navarro's FICA tax liability against the tax refund she had coming from the earned income credit, using reasoning similar to *Myers*[59] and citing *Lewis v. Reynolds*.[60]

The *Navarro* decision contains four misinterpretations, we believe. First, the judge supported his joint employer-employer liability holding by citing Rev. Rul. 86-111[61] and various

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[56]*See* note 36 *supra*.

[57]*See* note 15 *supra*. Francisca Navarro was a farm laborer working for farm labor contractors who had classified her as an independent contractor. She earned $8,300 in wages for the tax year 1990, and did not pay any self-employment tax. The IRS assessed a deficiency for the unpaid self-employment tax. Navarro administratively appealed the deficiency to the IRS on the ground that she was an employee of the labor contractors and did not owe self-employment tax. One year later the IRS ruled that Navarro was in fact an employee and reduced her deficiency to one-half the self-employment tax. The IRS had determined that she was liable for the $634 employee share of FICA tax instead of the entire self-employment tax. The IRS applied the deficiency against her Earned Income Credit refund in 1991, and she paid the remaining balance. Navarro then sued for a refund of the FICA tax paid, but was denied.

[58]*See* note 15 *supra* at 5429, citing *Myers v. United States*, *see* note 36 *supra*.

[59]*See* note 14 *supra*.

[60]*See* note 37 *supra*.

[61]*See* note 25 *supra* and the related discussion on pp. xx-xx *supra*.

cases,[62] all of which found misclassified employees liable for their share of FICA taxes *because* the employers had previously been released from liability.

Second, in deciding whether an employee is directly liable to the IRS for FICA taxes, the judge went beyond the clarity of I.R.C. Secs. 3101 and 3102 in relying on Treas. Reg. Secs. 31.3101-3 and 31.3102-1(c). Despite the judge's quote, "... when [a] statute leaves room for two interpretations, Courts must only look to see if [the] agency's interpretation is reasonable,"[63] we believe, consistent with the opinion in *Myers*,[64] that the relevant I.R.C. sections are sufficiently clear to spare the need to rely on the Treasury Regulations. Taken together, I.R.C. Secs. 3101, 3102(a) and 3102(b), state that the employer is liable for paying FICA taxes whether the employer actually withheld from the employee or not, unless, according to I.R.C. Sec. 6521, another statute such as the statute of limitations relieves the employer of FICA tax liability.[65] In addition to his misplaced reliance on the Regulations, the judge misconstrued their meaning, as discussed next.

Third, the judge bolstered his holding in *Navarro*[66] that the employee is ultimately and directly liable to the IRS for FICA tax by altering the meaning of the language in Treas. Reg. Sec. 31.3102-l(c), inferring the word "him" as meaning "the employer": The Regulation reads, "Until collected from *him* the employee also is liable for the employee tax with respect to all the wages

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[62]*Stewart v. United States*, *see* note 24 *supra* (employer deemed to have been released under Sec. 530 of the Revenue Act of 1978 - *see* note 27 *supra*); *Roscoe v. Commissioner*, 48 T.C.M. (CCH) 1078 (1984) (employer paid all the employee's payroll taxes rather than withholding them; because the amounts paid on behalf of the employees for their withholding and their share of the FICA tax were not included in gross wages, the court assessed income tax on the payroll taxes paid on behalf of the employees); and *In re Eryurt*, 142 Bankr. 999 (Bankr. M.D. Fla. 1992) (employer released through IRS settlement).

For a detailed analysis of Section 530 and recommendations for amending it, *see* the reference at note 11 *supra*.

[63]*See* note 15 *supra* at 5428.

[64]*See* note 21 *supra*.

[65]See discussion of I.R.C. Sec. 6521, at pp. 9-10 *supra*.

[66]*See* note 15 *supra*.

received by him." (Emphasis added.) The judge in *Myers*[67], however, correctly interpreted the Regulation:

> [The IRS] inserts the words "the employer" in this excerpt from the regulation as the antecedent for "him." The employee's liability ends, however, when a deduction is made from his wages for FICA taxes, even if the government does not collect the tax from the employer. *Purdy Co. of Illinois v. United States*, 812 F.2d 1183, 1186 (7th Cir. 1987). Thus the correct interpretation of this provision would appear to be that the employee remains liable for payment of FICA taxes on his wages *until the taxes are collected from the employee*. The IRS's interpretation of this provision as stated in Revenue Ruling 86-111 is in accord.[68] (Emphasis added.)

In other words, the employee remains liable *to the employer* until the tax is collected from the employee by the employer.

Based both on the context of Treas. Reg. Sec. 31.3102-1(c) and on Treas. Reg. Sec. 31.6205-1(b)(3) which provides that the FICA tax deduction from wages is "... a matter for settlement between the employee and employer", we believe that the sentence in Treas. Reg. Sec. 31.3102-1(c) merely reinforces the employer's right, and not the IRS's right, to collect FICA taxes from the employee.

Fourth, the judge in *Navarro* also erroneously interpreted Treas. Reg. Sec. 31.3101-3 to the IRS's advantage. The segment of the Regulation quoted in the case discussion reads, "[the] employee tax attaches at the time the wages are received by the employee." The judge concluded that this made Navarro liable to the IRS for employee FICA tax "at the moment she received her pay ..., regardless of the fact her employer did not withhold the tax."[69] We believe that the correct interpretation of the Regulation's text is consistent with the interpretation of Treas. Reg. Sec.

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[67]*See* note 14 *supra* at footnote 1.

[68]Of note, Rev. Proc. 85-18, 1985-1 C.B. 518 (*see* note 29 *supra* at 519), contradicts the interpretation of Rev. Rul. 86-111 (*see* note 25 *supra)* by including the words "the employer" in brackets when referring to the same word "him" in Treas. Reg. Sec. 31-3102-1(c). It appears that the IRS's right hand does not know what it's left hand is doing. Despite this, Rev. Rul. 86-111 is the more recent pronouncement and thus should be followed as the IRS did in its interpretation of "him" as meaning employee in LTR 9037005 (June 5, 1990).

[69]*See* note 15 *supra* at 5428.

31.3102-1(c) that the employee becomes liable to the employer, and not to the IRS, at the time the employee's wages are received. In support of our interpretation, Treas. Reg. Sec. 31.3101-3 refers to Treas. Reg. Sec. 31.3121(a)(2) which establishes when wages are deemed received from *the employer*. Throughout the Regulations, employees' FICA tax liability is consistently linked to the employer and not to the IRS.

In summary, we believe that the judge in *Navarro* erred in ruling that the IRS may collect the employee's share of FICA taxes first from the employee before trying to collect from the employer when the employer is fully liable for the taxes. The judge's holding is unfortunate especially considering that misclassified employees typically are less well-paid, less skilled, and less able to assert their legal rights. In contrast, the employer typically has more economic power and is more knowledgeable than the employee in negotiating terms of employment. It makes sense that Congress would expect the IRS to collect first from the employer because the employer must bear the responsibility for misclassifying employees as self-employed. To permit the IRS to collect either from the employer or the employee does not accord well with our sense of equity.[70] The judge in *Navarro* seemed more concerned about protecting the Federal Treasury than the pocketbooks of disadvantaged, misclassified workers, as suggested by the following portion of his opinion: "Moreover, the Court finds that requiring the IRS to first seek payment from employers in every case, even in such cases where the IRS's efforts would obviously not be productive, would

[70]If the government collects the employee's FICA tax share from the employer, it could imply that the employee gets a windfall. Granted, the employee has taxable income to the extent that their potential or secondary liability has been satisfied, per *Roscoe v. Commissioner*, *see* note 46 *supra*, but the fact remains that, had the employee been able to negotiate on an equal footing with the employer, the terms of employment might have been sufficiently more attractive to have compensated the employee in excess of any windfall resulting from the employer's having to pay the employee's FICA tax. In addition, the employee likely still has the task of getting their earnings record updated for Social Security purposes. This is discussed in the next section of the paper.

result in the waste of Government assets."[71]

B. *Myers* should be followed.

The *Myers*[72] holding, we believe, is better reasoned than *Navarro* and should be followed. In other words, the IRS may not collect the employee's FICA tax share directly from the employee unless the Service either is prevented from collecting from the employer because the statute of limitations has expired or because another law released the employer from liability.[73] This is not to say that the employee is not liable, but merely that the IRS must first seek to collect on the employer's liability if the employer remains fully liable. Undoubtedly the misclassified employee with circumstances similar to *Myers* or *Navarro* can expect a fight with the IRS if audited, considering the amount of resources the government expended in blocking the Myers' recovery of $137 in employee FICA taxes.[74]

C. They who hold the tax dollars win.

Regardless of the strength of the misclassified employee's case for avoiding paying their share of FICA tax, possession of the tax dollars appears to be, as the saying goes, nine-tenths of the

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[71]*See* note 15 *supra* at 5429. For a Court in West Texas (the El Paso division), this perhaps is not surprising given one strain of justice in that part of the country - that of Judge Roy Bean - known as the "Law West of the Pecos."

[72]*See* note 14 *supra*.

[73]I.R.C. Sec. 6521 is the only section that definitively makes the employee liable for their share of the FICA tax liability but *only* if the employer has been relieved of the liability. *See* the discussion on pp. 9-10 *supra*.

[74]As further evidence of the IRS's position on this issue, see Private Letter Ruling 9037005 (June 5, 1990). The taxpayer worked for a physician who paid her as an employee during regular hours but as an independent contractor for overtime hours. She received a Form 1099-MISC for the overtime compensation but paid no tax on the income pending the ruling. The Service determined that she was an employee for the time in question and that she was liable for the income tax along with the employee's share of FICA tax, despite the fact that her physician employer was fully liable for payroll taxes at the time the ruling was issued. The ruling concluded by saying that the examining agent would ensure that she would receive credit on her earnings record for Social Security, and that the "subsequent payment of the FICA employer tax on such wages is irrelevant for this purpose."

law. Even though the employee only has secondary liability for their FICA tax share if the employer is fully liable, the employee will most likely lose if they have an overpayment outstanding with the IRS, based on the holdings in *Myers* and *Navarro* citing the Supreme Court's decision in *Lewis v. Reynolds*.[75] If no overpayment is outstanding, it appears that the employee will stand a reasonable change of winning, based on the well-reasoned holding in *Myers*[76] *if* the employee were able to contest the IRS's notice of a tax liability in the Tax Court. Unfortunately the Tax Court has no jurisdiction over FICA taxes.[77] Hence, the employee will either have to pay the tax due and sue for a refund in a U.S. District Court or the U.S. Claims Court or likely suffer the consequence of an IRS tax lien and subsequent levy. Because the law implies rather than clearly stating that the IRS must first try to collect the misclassified employee's share of FICA taxes from the employer before assessing the employee, the employee may be in a *Catch 22*. Once the tax is paid, the IRS may succeed in keeping it by invoking *Lewis v. Reynolds*,[78]which put the burden the taxpayer of proving an overpayment of taxes, as was done in *Navarro*[79] and *Myers*.[80] Although we believe that the misclassified employee is not liable for the their share of FICA taxes, the best chance of success are simply not to receive a tax due notice for their share or, if sent a deficiency notice for self-employment tax, challenge it by following the procedures for getting into Tax Court as happened with *Casety*[81] and *Laraway*[82] By the time their cases came to trial, it was

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[75]*See* note 37 *supra*.

[76]The holding in *Myers*, *see* note 14 *supra* should be sufficient to pass muster under the Substantial Authority requirements of Treas. Reg. Sec. 1.6662-4(d)(iii) regarding taking an aggressive tax return position contrary to the IRS's views.

[77]*See* the discussion at pp. xx-xx.

[78]*See* note 37 *supra*.

[79]*See* note 15 *supra*.

[80]*See* note 44 *supra*.

[81]*See* note 20 *supra*.

[82]*See* note 21 *supra*.

too late for the IRS to attempt to collect the employee's share of FICA taxes because the statute of limitations had expired. This is getting into the area of administrative procedures and strategies, discussed next.

IV. Administrative and Reporting Procedures and Strategies

To redress an incorrect classification, misclassified workers have two objectives: avoidance of self-employment tax and obtaining full credit for their earnings from the Social Security Administration.

A. Avoidance of Self-Employment Tax

Based on our legal analysis, misclassified workers will be able to avoid all of the self-employment tax and possibly the employee's half of FICA tax as well. The misclassified earnings should be reported as wages on Form 1040, line 7, rather than on Schedule C. Because the employer did not issue a W-2 form, but probably sent a Form 1099-MISC, the worker should attach a sheet to the back of the tax return containing a photocopy of the 1099-MISC form along with an explanation that the wage amount shown on line 7 includes wages that were incorrectly reported as self-employment income on the 1099.[83] An arrow should be drawn from the wage amount entered on Form 1040, line 7, to a note advising, "Please see attached explanation."

Also, because the worker will not have received a W-2 form from the employer, Form 4852, "Employee's Substitute Wage and Tax Statement," may be filed with the tax return even if the worker received a 1099-MISC form. Form 4852 ordinarily is used when a correctly classified

[83]Form 1099-MISC generally is only issued if annual earnings are at least $600, per I.R.C. Secs. 6041(a) and 6041A, and the Instructions to Form 1099-MISC. If a 1099-MISC is received, the misclassified self-employment income will typically appear in Box 7 titled "Nonemployee compensation."

employee did not receive or has lost a W-2 form.[84]

To strengthen one's case that the earnings are in fact wages and not self-employment income, a copy of Form SS-8 titled, "Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding," and obtainable from the IRS should be attached to the tax return. Reference to Form SS-8 should be made on the attachment containing the wage explanation and photocopy of Form 1099-MISC. Form SS-8, which is the procedural equivalent of Rev. Rul. 87-41[85] discussed earlier,[86] requests answers to the twenty factors the IRS uses in determining whether the employer has sufficient direction and control over the worker to identify the worker as an employee rather than an independent contractor.

Despite these precautions, the IRS may automatically issue a deficiency notice for self-employment tax computed on the 1099-MISC income.[87] In this event the worker should reply with an explanation and attach a copy of Form SS-8, but send no check.

To get a formal determination of whether one has been misclassified, the worker should file a separate copy of Form SS-8 with the IRS District Director.[88] Within ninety days the IRS District's Examination Division will contact the employer to clarify the answers on Form SS-8 and

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[84]Per communication with an IRS official on June 16, 1994, filing Form 4852 with the tax return could create a double earnings input record in the IRS's database for a misclassified worker who has received a 1099-MISC form. For this to happen, the IRS would have to input the income shown on Form 4852 into its database in addition to, rather than as a substitute for, the 1099-MISC income already reported by the employer. This may trigger a deficiency notice for income tax on the unreported income.

Based on correspondence with William Fulcher dated August 29, 1994, however, this is unlikely. Fulcher stated that his firm has filed Form 4852 with misclassified employees' returns quite frequently, "stating on the 4852 the fact that a 1099 Form has been issued, rather than a W-2," and that after "about 25 years none has been picked up as a second source of income."

[85]*See* note 7 *supra*.

[86]*See* pp. 5-6 *supra*.

[87]This may occur in some IRS regions or districts, per communication with an IRS official on June 16, 1994.

[88]Form SS-8 should be filed with the District Director in the district where the employer's home office is located. The appropriate address for filing may be obtained by calling the I.R.S. at 1-800-829-1040 and providing them with the employer's nine-digit Federal identification number. The first two digits in this number reveal the company's home office district.

will then notify the worker as to the correct employment status. Although precise data were not available regarding SS-8 reclassifications, Private Letter Rulings often are issued in response to SS-8 request. In recent years about 90% of these classified the workers as employees.[89]

Sending a separate SS-8 form to the District Director may not be advisable if the worker is concerned about jeopardizing their job when the IRS contacts the employer.[90] The worker could either wait and file the SS-8 form after leaving the job (but before the three-year statute of limitations has elapsed) or, if their tax return is audited, discuss the situation with the IRS auditor and file it at that time. Obtaining a formal SS-8 determination of employee status will strengthen one's case for getting proper credit with Social Security for the income earned as a misclassified worker, as discussed in the next section.

Taking the IRS's advice as to how to report the misclassified income will be costly. The IRS Manual Handbook[91] instructs Taxpayer Service Representatives to send the worker a Form SS-8 and to tell the worker in the meantime to either:

a. Report the income wages on Form 1040 and pay the employee's portion of FICA tax (using Form 4137, discussed in the next section) if the employee permits the IRS to contact the employer regarding proper classification once Form SS-8 has been filed, or

b. Report the income as self-employment income on Schedule C and pay the self-employment tax using Schedule SE if the worker is unwilling to have the IRS

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[89] *See* note 5 for detailed statistics.

[90] According to an IRS official on June 16, 1994, the usual procedure upon receiving Form SS-8 from a worker is to contact the employer. The purpose for this contact is to verify the working conditions reported on Form SS-8. Without permission to give the worker's name to the employer, the IRS can do nothing. It is a waste of time to submit the form anonymously in hopes of the IRS conducting its own audit of the employer.

[91] Internal Revenue Service, *Manual Handbook*, Part IV - Taxpayer Service, Chapter 900 - Employment Taxes and W-2 Inquiries, Section 11 - Employee/Employer Status Determinations, Subsection 1 - General Inquiries (May 10, 1991), pp. 6810 *et seq*.

contact the employer regarding proper classification.

The IRS's instructions contrast with our advice to pay no self-employment tax and at most pay the employee's half of the FICA tax.

B. Updating One's Social Security Earnings Record

Avoiding self-employment tax is "having one's cake," but "to eat it too," a worker must have their Social Security earnings record updated for the misclassified earnings to ensure full Social Security benefits on retirement. Reclassifying the earnings on Form 1040, line 7, as wages will not automatically result in updating one's Social Security earnings record. Social Security accounts are updated automatically in three ways: direct receipt of employers' copies of Form W-2, IRS magnetic tapes of all Schedules SE,[92] and IRS magnetic tapes of all Forms 4137, titled "Social Security ... Tax on Unreported Tip Income."[93]

Correcting one's Social Security earnings record has important long-run benefits. For example, under current law and using today's dollars, a worker who earns under $30,000 per year and whose earnings record for 1995 is understated by $10,000 will receive about $100 less per year from Social Security if retiring at age 65. If earnings were understated $10,000 per year for ten years, the annual Social Security benefit would be $1,000 less.

To update one's account, the misclassified worker should wait at least until mid-year of the year following the year of misclassification to request an "Earnings and Benefit Estimate Statement" from the Social Security Administration. To do so, the worker should submit the request using Form SSA-7004-SM, obtainable through any Social Security office or by calling 1-

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[92]Schedule SE of Form 1040 is titled, "Self-Employment Tax".

[93]Per personal communication with an administrator in the Bureau of Retirement and Survivor's Insurance Office on June 24, 1994.

800-772-1213. On reviewing this statement, the worker will find that their earnings have not been credited. The next step is to contact a local Social Security office to arrange for proper credit for income earned as a misclassified worker. The local office will require evidence of the earned income such as pay stubs, copies of paychecks, and Forms 1099-MISC, and will use the common law test to determine if the earned income is indeed wage income. Of course, if the worker has already received a ruling via Form SS-8, the Social Security office will abide by the decision of the IRS. The key fact is that the Social Security office will update the worker's earnings record regardless whether FICA tax was paid on the earnings. As discussed in the legal analysis based on I.R.C. Sec. 3102 and according to the Social Security Administration,[94] the collection of FICA tax from the employer or the employee is the IRS's responsibility.

Should misclassified workers prefer to update their Social Security earnings record automatically and avoid any difficulties with the IRS (despite our belief that a more aggressive position may be warranted), they may pay their share of the FICA tax by filing Form 4137, mentioned above, and the attached Schedule U, "U.S. Schedule of Unreported Tip Income," with their tax return. Form 4137 is ordinarily used only by employees receiving tips, but the word "tips" should be crossed out and "wages" written in where appropriate on both Form 4137 and the attached Schedule U.[95] Filing Form 4137 and Schedule U with Form 1040 will automatically update the Social Security earnings record for the worker.

V. Conclusion

Our analysis finds that no court has held employees who have been misclassified as self-

[94] *Id*.

[95] *See* the IRS *Manual Handbook*, *see* note 78 at Paragraph (3)(a).

employed independent contractors liable for the self-employment tax on their earnings. Whether misclassified employees are liable for the employee's share of FICA tax depends on whether they have a tax refund pending. In Tax Court cases[96] where the IRS sued to collect self-employment tax from the misclassified employee because no tax refunds were pending, the IRS not only lost but was prevented from raising the issue that the employee was still liable for the employee's share of the FICA tax because the Tax Court has no jurisdiction over FICA tax disputes.[97] In Federal District Court cases[98] where the employee sued the government for a refund of self-employment tax already paid to the IRS, however, the results have been less clear.

The courts are split as to whether the employee is liable for the employee's FICA tax share *if* the employer is fully liable as well at the time of trial. The IRS takes the position that a misclassified worker is liable for the employee portion of the FICA tax (one-half of the self-employment tax) until it is collected from the errant employer.[99] To date, only two U.S. District Courts have decided cases on the issue. One held that an employee is not liable unless the IRS has tried to collect from the employer[100] but the other held that the employee is liable for the employee's FICA share regardless of any action against the employer.[101]

Despite the split in rationale as to when the employee is liable, both courts, based on a Supreme Court case,[102] allowed the IRS to offset the employee's share of FICA tax against tax

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[96]*Casety v. Commissioner* and *Laraway v. Commissioner*, *see* notes 12 and 13 *supra* respectively.

[97]In both cases, the statute of limitations had expired by the time the IRS lost, thus preventing the Service from attempting to collect the employee's share of FICA taxes by lien and levee.

[98]*Myers v. United States* and *Navarro v. United States*, *see* notes 14 and 15 *supra* respectively.

[99]As discussed in the analysis, I.R.C. Sec. 3102 does not appear to support the IRS on this. It states that employers are responsible for the paying payroll taxes to the government even if they have not collected it from their employees. In the event another statute relieves an employer of all or part of the FICA tax liability, however, the employee then becomes liable for the employee's portion of FICA tax liability per I.R.C. Sec. 6521.

[100]*Myers v. United States*, *see* note 14 *supra*.

[101]*Navarro v. United States*, *see* note 15 *supra*.

[102]*Lewis v. Reynolds*, *see* note 37 *supra*.

refunds the employees were expecting. Possession, as the saying goes, appears to be nine-tenths of the law in this situation. If the employee has no pending refund due from the IRS, the outcome depends on the strategy taken by the IRS. If the misclassified employee has a tax refund pending, including a refund from mistakenly paying self-employment tax in the first place, the IRS has the common law right to offset the FICA tax against the refund. If the misclassified employee pays no self-employment tax, the IRS may decide to dispute this position, issue a deficiency notice, and pursue it in Tax Court as they did in the cases mentioned above. The employee will win on the issue of self-employment tax liability if they indeed have been misclassified, and the IRS will not be able to raise the FICA tax issue. Furthermore, the statute of limitations will likely have expired by the time of trial, thus preventing the IRS from attempting to collect the employee's FICA tax share by levy and lien. If the IRS instead issues the employee a tax due notice for their share of the FICA tax, the employee will be constrained to pay the liability and sue for refund in a U.S. District Court or the U.S. Claims Court. This may be a *Catch 22* because the IRS apparently then has the right as mentioned above to offset the employee's share of the FICA tax against the refund.

Pending resolution of this question by the courts, we recommend that misclassified employees take an aggressive position and resist paying their half of FICA tax on their misclassified earnings, with two exceptions: (1) when the employer has statutorily been relieved of some or all FICA tax liability other than by I.R.C. Sec. 3509, and (2) when the employee has an outstanding tax refund (other than from paying their FICA tax share) against which the IRS may offset the employee's half of FICA tax. In either of these cases the courts will undoubtedly hold the employee liable for their half of the FICA tax.[103]

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[103]If, however, the employer is released from liability by paying all the FICA tax liability - both the employer's and the employee's portions - the IRS may assert that the employee is liable for income tax on the extinguished liability for the employee's share of FICA tax. For a related situation, see *Roscoe v. Commissioner* (*see* note 54 *supra*). Such an assertion may be rebutted on the ground that the misclassified employee had no FICA tax liability because it was the employer's liability. Since the employee had no liability, there was no discharge of indebtedness

In addition to avoiding employment taxes, we recommend that misclassified workers secure reclassification as employees through the IRS by filing form SS-8.[104] Because workers' Social Security earnings records will not be automatically updated for the misclassified earnings if employment taxes have not been paid, we recommend contacting a local Social Security office to arrange for proper credit. Failure to do so will, in most cases, result in lower Social Security benefits on retirement.

Also, misclassified employees have recourse against the employer for fringe benefits normally accorded the employer's employees such as health insurance. Moreover, they are eligible for unemployment and workers' compensation benefits, along with coverage under Federal employment laws such as the Fair Labor Standards Act and the Age Discrimination in Employment Act. All states and the Federal Government have review boards or a related process for assisting potentially disenfranchised, misclassified workers in obtaining their full rights as employees.

(I.R.C. §61(a)(12)), hence no taxable income therefrom.

[104]*See* pp. 19-20 *supra* for a discussion of Form SS-8.