Focus CROSS-BORDER LAW

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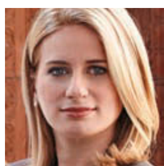
The devil is in the classification

South of the border, not knowing the difference between an independent contractor and an employee can be costly



Emina Poricanin

Federal and state agencies in the United States have launched aggressive enforcement initiatives against businesses that misclassify employees as independent contractors. The potential for misclassifying workers and misclassification liability is particularly high for businesses that engage salespersons as independent contractors because of the myriad of laws defining the status of salespersons. Canadian companies with independent sales representatives in the U.S. should review the classification of those workers carefully. Businesses found guilty of misclassification face stringent consequences, which may include criminal and civil fines and imprisonment of key employees.

Misclassification of workers refers to a business's improper classification of a worker as an independent contractor instead of an employee. There are critical differences between the two categories. For each employee, an employer must pay federal payroll taxes (Social Security and Medicare taxes, and federal unemployment insurance) as well as state unemployment insurance and workers' compensation. Also, an employer may be required to provide certain employee benefits. None of these obligations exist when engaging independent contractors.

Businesses that misclassify workers as independent contractors effectively deprive the government of tax revenues and other funds. Due to the fiscal crisis of the last decade, cash-strapped federal and state governments realized that they could recover billions of dollars in lost tax revenues from businesses that misclassify workers. As a result, government agencies launched various initiatives to identify misclassified workers and collect unpaid taxes and other funds from businesses. The United States Internal Revenue Service, Department of Labor, and various state agencies agreed to share information about businesses suspected of misclassifying workers and jointly prosecute offenders. The IRS has audited thousands of businesses, with a particular focus on worker misclassification, and state legislatures have increased penalties for misclassification. In the courts, class action lawsuits on misclassification have skyrocketed, with plaintiffs seeking unpaid wages and benefits. Collectively, these factors have created an unprecedented emphasis on prosecution of businesses that misclassify workers in the United States.

To properly classify a worker, a business must first examine the law under which the worker is being classified. Different laws define the employment relationship differently. Thus, for example, the Internal Revenue Code defines employment for purposes of federal payroll taxes. State laws define the employment relationship for purposes of *state* payroll taxes, and workers' compensation premiums or unemployment insurance. A business with workers in multiple states must examine the laws of each state when classifying workers. Generally, a worker's classification will depend on his or her duties and relationship to the business.

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Snowbirds going south warned to count the days

Canada, U.S. authorities now share entry and exit data, with harsh penalties for overstaying your welcome

Roy Berg

It's not news that Canadian snowbirds must keep track of how many days they spend in the U.S. and outside of Canada — "bad" tax and non-tax surprises may await those who are in or out of either country too long. What *is* news is that prior to June 30, neither the U.S. nor Canada knew how many days an individual spent within its borders. With the final phase of the Entry-Exit Initiative of the Perimeter Security and Economic Competitiveness Action Plan in effect, however, Canada and the U.S. now share exit data with each other, and snowbirds need to know how this change affects them.

The legislation allows both countries for the first time to independently determine, in real time, the number of days a traveller spends within their borders. Consequently, Canadian snowbirds must be more vigilant than ever in counting and reporting the days spent in and out of each country.

Typically, five unpleasant surprises can result from being in the U.S. or outside of Canada for too long.

All of the following "bad" tax and non-tax surprises hinge on whether an individual is "resident" or not. Those who expect consistency and logic in law (whether it be related to taxes, immigration, or health services) will be disappointed, though probably not surprised, to learn the definition of "resident" is different in each of the following examples.

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>
> **Roy Berg**
> Moodys Gartner Tax Law

Banned from travel to U.S.

Perhaps the most draconian consequence of spending too much time in the U.S. is to fall into the "unlawful presence" rules. Canadians who remain in the U.S. for too long risk being deemed unlawfully present, the consequence of which is a travel ban to the U.S. How long is "too long?" It is largely at the discretion of the border guard.

U.S. tax on worldwide income

The U.S. taxes its citizens and "U.S. residents" on their worldwide income. If the snowbird is present in the U.S. for too many days, he or she risks becoming deemed a U.S. resident and therefore subject to tax on worldwide income.

Estate tax on worldwide assets

The U.S. also taxes citizens and "U.S. residents" on the fair market value of their worldwide assets at death. Unfortunately, the definition of "U.S. resident" for estate tax is fundamentally different than the definition for U.S. income tax purposes. The result is that the heirs of the uninformed snowbird can find their inheritance subject to the U.S. estate tax.

Canadian departure tax

Canada taxes its residents on their worldwide income. Once a Canadian resident is no longer "resident," they are deemed to have disposed all of their assets (subject to exceptions), recognize the gain on those assets, and pay tax on that gain. Whether an individual is no longer resident is a facts and circumstances test; however, a big factor in that analysis is day count. Therefore, the snowbird who spends too much time in the U.S. risks a nasty Canadian tax surprise.

Loss of provincial health care

Canadian residents are entitled to participate in provincial health services. Once an individual is no longer a resident of the particular province, they lose this entitlement. Of course, the rules for "residency" in the health care context are different than those discussed above.

In light of the fact that neither the U.S. nor Canada has historically known an individual's day count, it is not surprising that day count has not usually been a trigger for an IRS or CRA examination. We have all been required to self-report our days and residence status to the appropriate authorities. It is as though we have all been lulled into the quotidian task of grading our own homework and have been generously giving ourselves high marks, regardless of whether we deserve them or even completed the assignment at all. Now, the teacher is grading our homework...and she knows what the answers are.

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Liability: A 'direct seller' can work from home, but not a retail establishment

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The classification of salespersons may be particularly tricky because the IRC has technical rules defining the classification of workers engaged in sales. To complicate matters, a salesperson could be properly classified as an independent contractor under the IRC for federal payroll tax purposes, but as an employee under state law, such as workers' compensation laws.

Under the IRC, salespersons may be classified as: (1) statutory non-employees (i.e., independent contractors); (2) statutory employees; (3) employees; or (4) independent contractors.

"Direct sellers" are "statutory non-employees" under the IRC. From the perspective of a business, this is the preferred classification. However, to be a "direct seller," the salesperson must be engaged in the sale of consumer products in a home or other location that is not a "permanent retail establishment" pursuant to a written contract, and the salesperson must be paid on a commission basis.

If a salesperson is not a statutory non-employee, the IRS will apply the "common-law test" to determine whether the worker is an employee or independent contractor. This test examines the degree of financial and behavioural control exercised by the business over the salesperson and the relationship between the parties.

However, a salesperson that satisfies the criteria for independent contractors under the common-law test may nevertheless be classified as a "statutory employee." Under the IRC, full-time "traveling or city salespersons" are such statutory employees. The principal business activity of traveling or city salespersons is solicitation of orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments on behalf of a business. The salesperson sells merchandise for resale or supplies for use in the buyer's business. Further, to be a traveling or city salesperson: (1) the contract between the worker and the business requires the worker to perform the services personally; (2) the worker does not have a substantial investment in the equipment and property used to perform the services; and (3) the services are performed on a continuing basis for the same payer.

Businesses that misclassify workers face stiff penalties. Violation of federal tax laws subjects a business to criminal and civil penalties, with criminal fines of up to US$500,000 (US$100,000 in the case of an individual). Business owners and corporate officers may be criminally prosecuted and imprisoned. State penalties vary, but many state statutes also provide for criminal penalties and fines. Additionally, businesses that misclassify workers may be liable for all of the unpaid taxes and other amounts to the government. Other misclassification-related risks include wage and hour liability to workers that are allegedly misclassified.

Before engaging salespersons as independent contractors in the United States, businesses should carefully review the propriety of that classification.

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