ALERTS AND UPDATES

Businesses Employing Independent Contractors - Beware

November 15, 2011

The IRS is becoming more aggressive in enforcement of employment classification and is scrutinizing the distinctions between employees and independent contractors with an increasing level of focus. The question of whether a worker is an independent contractor or employee for federal income and employment tax purposes is a complex one. It is intensely factual, and the stakes are high. As you may know, if a worker is an employee the employer must withhold federal income and payroll taxes, pay the employer's share of FICA taxes on the wages plus FUTA tax, and often provide the worker with fringe benefits it makes available to other employees. There may be state tax obligations as well. However, these obligations do not apply to independent contractors and the business's only tax reporting obligation is to send the independent contractor a Form 1099-MISC for the year showing what he or she was paid (if it amounts to $600 or more).

Despite the favorable tax advantages, using independent contractors can be risky for many businesses. It is a complex issue whose determination hinges on the facts and circumstances of each case and one that the Internal Revenue Service closely monitors. Improper classification can generate significant penalties and financial hardship for the unwary business owner, particularly if it involves a large number of misclassified workers over a period of several years.

Rest assured, the IRS will aggressively pursue collection activities against firms that inappropriately classify employees as independent contractors, and consequently fail to remit payroll taxes as required by law. As payroll taxes are deemed trust fund taxes, civil penalties may apply to those responsible for collection and remittance. Therefore, it is essential to understand the factors the IRS uses to accurately classify workers.

Who is an "employee"? There is no uniform definition of the term.

Under the common-law rules (so-called because they originate from court cases rather than from the tax code), an individual generally is an employee if the enterprise he works for has the right to control and direct the worker regarding the job assigned and related performance. Other factors include whether the work is substantial, regular or continuous, and whether the services performed require someone to comply with the employer's general policies.

The IRS uses the following three categories of factors—also known as the 20-factor test—to determine if a worker is an employee or an independent contractor:

- **Behavioral:** Does the company control or have the right to control what the worker does and how the worker does his or her job? Facts that indicate whether a business has a right to direct and control include instructions. Generally, an employee is told when to work; where to work; how to work; what tools or equipment to use; what workers to hire; what workers to assist with the work; where to purchase supplies and services; what work must be performed by specified individual; and what order or sequence to follow. An employee may be trained to perform services in a particular manner.

- **Financial:** Does the payer control the business aspects of the worker's job? Facts that indicate whether a business has a right to control the business aspects of the worker's job include the extent to which the worker has unreimbursed expenses; the extent of the worker's investment; the extent to which the worker makes services

available to the relevant market; how the business pays the worker; and the extent to which the worker can realize a profit or loss.

- **Type of Relationship:** Are there written contracts or employee-type benefits? Will the relationship continue? Is the work performed by the worker a key aspect of the business? Some facts that indicate the nature of the relationship are written contracts describing the relationship the parties intended to create; demands for full-time work; whether the worker is provided with employee-type benefits; the permanency of the relationship; and how integral the services are to the principal activity.

All three categories should be considered when classifying a worker as an employee or independent contractor. It is important to keep in mind that the specific facts of each case stand on their own and determine the weight the IRS may give to a particular factor. Although some factors may indicate the worker is an employee, other factors may signify that the worker is an independent contractor. No bright-line test or "set" number of factors must be satisfied to determine if the worker is an employee or an independent contractor, and no single factor stands alone in making the determination. Seeking counsel from experienced tax professionals when faced with this issue may be beneficial.

National Research Program

The IRS is in its second year of an intensive employment tax research study of 6,000 randomly selected taxpayers as part of a national research program (NRP) aimed at investigating tax compliance issues related to employment taxes and independent contractor classification, among other tax reporting issues. These in-depth examinations, which are effectively audits, can be burdensome for those selected to be included in the study. Due to the initiative's broad scope, many businesses may find themselves in the unenviable position of undergoing examination.

The IRS is using various data sources as part of the audit process—including information from Forms 1099 and W-2 filed with the IRS—to determine audit strategies concerning the compliance characteristics of firms filing employment tax returns. Although there are no surefire ways to avoid being targeted, businesses can take certain measures to help minimize risk.

Businesses should consider reviewing their current payroll practices, specifically focusing on the areas identified by the NRP initiative. Documentation and record-keeping procedures should be assessed and updated if necessary. Businesses may also want to review their three most recent years' employment tax returns, including Forms 1099 and all supporting documents and records. In many cases, the company's third-party payroll administrator can assist with this process.

Taxpayers may also wish to engage a tax professional to conduct a "simulated audit" for the purposes of reviewing record-keeping policies and existing tax positions and obtaining guidance on correcting problems or deficiencies that would be likely targets in the event of an actual IRS examination.

The fourth quarter is a particularly good time to review employment data to ascertain whether employees are properly classified, before it is too late to make any required changes. A fourth quarter review can help prevent any potential misclassification issues and the wrath of the IRS. This is particularly true now, as the IRS recently partnered with the U.S. Department of Labor to allow eligible employers relief from past federal payroll tax liabilities if they prospectively treat workers who have been improperly classified as independent contractors as employees.

Voluntary Classification Settlement Program

For businesses who have been misclassifying workers there is relief. In September 2011 the IRS announced that employers who participate in the Voluntary Classification Settlement Program (VCSP) will enjoy partial relief from federal employment taxes, provided they agree to prospectively treat improperly classified workers as employees for all future tax periods. To participate in the VCSP, a taxpayer must apply to participate in the VCSP and enter into a closing agreement with the IRS. However the taxpayer must first meet all of the following eligibility requirements:

- The taxpayer must have consistently treated the workers as non-employees;
- The taxpayer must have filed all required Forms 1099 for the workers for the previous three years; and
- The taxpayer cannot currently be under audit by the IRS or under audit concerning classification of the workers by the U.S. Department of Labor or by a state government agency.

As a result of their participation, employers who agree to prospectively treat workers as employees for future tax periods will pay only 10 percent of the employment tax liability that may have been due on compensation paid to the workers for the most recent tax year; will not be liable for any interest and penalties on the liability and will not be subject to an employment tax audit with respect to employees improperly classified in prior years.

In addition, a taxpayer participating in the program must agree to extend the statute on assessment of employment taxes for three years for the first, second and third calendar years beginning after the date on which the taxpayer has agreed to begin treating any improperly classified workers as employees.

Taxpayers who wish to participate in the VCSP are required to submit the recently published Form 8952 (Application for Voluntary Classification Settlement Program) at least 60 days before they want to begin treating the workers as employees. The IRS will contact the taxpayer once it has reviewed Form 8952 and verified the taxpayer's eligibility.

The VCSP offers employers who have misclassified their workers an opportunity to voluntarily correct this issue prospectively with limited exposure for the past liabilities. However, the impact of reclassifying workers as employees may have a significant impact on the taxpayer's ERISA covered plans in that such plans may need to be amended to cover reclassified workers for the prospective period only. All taxpayers who classify workers as non-employees should consider reviewing that classification and determining whether a filing under the VCSP is appropriate.

It is vital to document the factors considered and the conclusions reached when classifying a worker, particularly in light of the IRS's continued focus in this area. Employers may also want to seek the guidance of a qualified tax professional to discuss these complex rules and factors, and to determine if filing a VCSP application is appropriate.

For Further Information

If you have any questions regarding this *Alert*, or for further information, please contact Steven M. Packer, CPA, manager in the Tax Accounting Group; Brian K. Adams, CPA, manager in the Tax Accounting Group; or the practitioner with whom you are regularly in contact.