

ALERTS AND UPDATES

Businesses and Households Employing Independent Contractors: Remain Aware

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Using independent contractors can be risky for many businesses and households, and it remains an age-old concern in general. The stakes are high, and the classification determines whether an employer must pay and withhold federal income tax, Social Security and Medicare taxes and federal unemployment tax (FUTA)—and possibly incur state and local tax obligations. It is a complex issue whose determination hinges on the facts and circumstances of each case. Improper classification can result in significant penalties and financial hardship for the unwary business owner or household employer, particularly if there are a large number of misclassified workers over a period of several years.

This is an area the Internal Revenue Service closely monitors. The IRS reports it will continue to aggressively pursue collection activities against firms and households 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?

While no uniform definition of "employee" exists, a worker generally is considered an employee for federal tax purposes if the employer has the right to control and direct the worker regarding the job assigned and related performance. The employer does not have to actually direct or control how the services are performed; rather, it is enough if the employer has the right to do so. Other factors include whether the work is substantial, regular or continuous, and whether the services performed may require someone to comply with the employer's general policies.

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

Behavioral: Does the business or household 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 payer 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 payer has a right to control the 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 or household 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 businesses or households classify a worker as an employee or as an independent contractor. It is prudent 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.

Increased IRS Focus

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 taxpayers 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 businesses and households filing employment tax returns. Although there are no surefire ways to avoid being targeted, certain measures can be taken to help minimize risk.

Employers should consider reviewing their current payroll practices, specifically focusing on the areas identified by the NRP initiative. Documentation and recordkeeping procedures should be assessed and updated if necessary. Those filing employment tax returns may also want to review their three most-recent years' filings, including Forms 1099 and all supporting documents and records. In many cases, a third-party payroll administrator can assist with this process. Household employers should be aware that when employing domestic workers (including but not limited to babysitters, caretakers, drivers, cleaners health aides and the like), the employer is required to file federal and state employment tax returns and remittances if the worker is paid more than \$1,700 (\$1,800 for 2012) per year. If the worker is provided through an agency, for example, and the agency controls what work is performed, then that worker is not an employee

and the employer has neither Forms 1099 nor federal and state employment tax reporting responsibilities.

Employers may wish to engage a tax professional to conduct a "simulated audit" to review recordkeeping policies and existing tax positions and obtain guidance on correcting problems or deficiencies that would be likely targets in the event of an actual IRS examination.

Voluntary Classification Settlement Program

The fourth quarter is particularly opportune for reviewing employment data to ascertain whether workers are properly classified, while there is still time to make required changes and potentially avoid both employee 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. Announcement 2011-64, issued by the IRS on September 21, states 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, the taxpayer has to meet certain eligibility requirements that are outlined below; apply to participate in the VCSP; and enter into a closing agreement with the IRS. To be eligible participants in the VCSP, a taxpayer must meet the following 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.
- 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.

The VCSP offers employees who have misclassified their workers as non-employees with an opportunity to voluntarily correct this issue prospectively with limited exposure for the past liabilities associated with worker misclassifications. In addition, 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. Taxpayers may wish to seek assistance to determine their eligibility for participation in the VCSP.

Documentation Is Vital

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.

For Further Information

If you have any questions or would like guidance to discuss these complex rules and factors, and to determine if filing a VCSP application is appropriate, 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.

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