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INDEPENDENT CONTRACTOR VERSUS EMPLOYEE

By Victor Sy, CPA, MBA

The Internal Revenue Service (IRS), Employment Development Department (EDD), and business owners frequently disagree on the classification of workers as independent contractors or employees. At stake is the collection of payroll taxes (FICA, Medicare, SDI, FITW, SITW). Of course, the business owner prefers to classify workers as independent contractors to save on FICA and other payroll taxes. Of course, the IRS prefers to classify them as employees. As a result of these conflicting interests, the IRS has developed audit programs to “catch” employers who “misclassify” workers. The program can be painful for small businesses that may not be able to withstand the economic strain of paying back taxes along with penalties and interests. These audits are even more painful because IRS and EDD do not conduct annual audits. Instead, they examine three years at a time. Three years of taxes, penalties, and interests could break a small business. This type of audits could be a pain for labor-intensive industries such as nursing registries, elderly care facilities, and home health companies that send nurses and caregivers to the homes of clients and patients.

There is a lot of activity in this area as **both the IRS and EDD aggressively pursue employers** who may have been wrongfully classifying employees as independent contractors.

What do you do at this time?

1. Conduct self-examination to see if you are classifying your workers correctly by filling out form SS-8.
2. Continue to treat them as independent contractors until you get audited (not a good choice).
3. Change them from independent contractors to employees. You must find a business reason for the change in status. Restructure their jobs. Have them sign employment contracts. If you have an auto repair shop and they used to supply their own tools, reclassify them now as employees by furnishing their tools and having them clock-in and clock-out to and from work.
4. Keep them as independent contractors but restructure agreements to assure their status. Have them operate their own businesses by getting fictitious business names, having their own separate offices, having them get their own business cards, invoices, letterheads, city licenses.
5. Terminate independent contractor agreements and hire them back through employee leasing firms.
6. Incorporate. Have a new beginning. You should have done this in the first place anyway.

To help you understand the problem more, let us learn a few definitions and rules:

1. Employees have payroll taxes withheld from their wages. It is these taxes that tempt both employer and employees to misclassify employees as independent contractors.
2. Independent contractors receive their gross pay without withholding any payroll tax.
3. Employees receive W2s while independent contractors receive 1099s.
4. Independent contractors are supposed to be in business for themselves. They have their own place of business, they control their own time, and they control the manner in which they accomplish their jobs. They cannot just quit as employees could; they are responsible to meet the terms of their contract.
5. There are statutory employees for FICA and FUTA (meaning they are defined as employees by law): corporate officers, full-time traveling salespersons who sell goods for resale.
6. There are also statutory employees for FICA: Full-time life insurance salespersons and homeworkers who are supplied with materials to do their work.
7. There are also statutory independent contractors with no FICA OR FUTA requirements: Qualified real estate agents and direct sellers of goods.
8. The employer is liable for withholding income tax, FICA, and FUTA taxes. If the business cannot pay, then company officers are held personally responsible.
9. The basic penalties are stiff:
 - A. Failure to file forms is \$50 per W2 and 5% per month up to 25% for failure to file payroll tax returns.
 - B. There is also a failure to pay taxes of 1/2% per month up to 25%.
 - C. There is a failure to obtain Social Security Numbers at \$50 per employee.

- D. Interest is also assessed.
 - E. Pension plan may be disqualified.
 - F. California also has its own separate set of penalties and interests.
10. Employers may not have to pay 100% of the amounts that should have been withheld and paid. There is a relief for those who file 1099s instead of W2s:
- A. Income tax withholding of only 1.5%,
 - B. Employer's FICA,
 - C. Only 20% of employee's FICA.
11. The amounts are higher for employers who do not file 1099s or W2s:
- A. Income tax withholding of 3%,
 - B. Employer's FICA
 - C. 40% of employee's FICA.

Section 530 Relief: The Revenue Act of 1978 gives employers some relief from the threat of a large retroactive employment tax liability for certain workers consistently treated as independent contractors. It provides both the IRS and taxpayers with clearer uniform standards that will reduce the number of disputes between the IRS and taxpayer over worker classification issues.

Section 530 helps employers get some relief if the following conditions are met:

1. The employer always treated the worker as an independent contractor.
2. The employer filed all returns (including information returns) required for the worker for all periods after 1978 and the returns were all consistent with independent contractor status.
3. The employer had a reasonable basis for treating the worker as an independent contractor.

As you can see, misclassifying employees as independent contractors is a very serious matter and should be dealt with carefully and immediately.

Complexity: State agencies use state laws that are often different from federal laws. On top of that, state workers' compensation definitions often differ from both federal and state employment laws. Working through three sets of laws complicates matters. If you are subjected to this type of audit, it may be worth engaging a professional to represent you – right from the start. If you make mistakes in representing yourself (and believe me, you will), it will be impossible for your professional representative to undo any damage you have caused and withdraw records that you have submitted or representations that you have made, further complicating the situation.

Bottom Line: A payroll tax audit can be very expensive and may cause the closure of small businesses that may not be able to withstand the economic strain of having to pay three years of income taxes, FICA, FUTA, SUI penalties, and interests. It's sad to state that a typical entity folds (closes) after a reclassification audit.

Court Case: **Truck drivers** were determined to be employees even though employer did not closely supervise (*Robert Day* TC Memo 2000-375).

Development for Caregivers: The Employment Development Department (EDD) of the State of California has a relief provision for home health and home care firms that send caregivers to consumers (patients who are typically elderly). The relief comes in the form Unemployment Insurance Code Section 687.2 that allows you to treat caregivers as independent contractors if all requirements are met. Note the underline for the word "all." You may want to visit our website at www.victorsycpa.com to read articles on caregivers and form SS-8.

Development - President Obama's Budget for 2011 Strengthens Efforts to Audit Independent Contractors:

The budget enables the **U.S. Department of Labor (DOL)** to **hire more than 350 new employees** including **177 investigators** and other enforcement staff, many of whom will be **bilingual** to better communicate with employees in the changing workplace. The DOL is also requesting \$10.96 million for the Employment and Training Administration, and \$12 million for the Wage and Hour Division to support a **new multi-agency** initiative to dramatically strengthen and coordinate **federal and state** efforts to address employer **misclassification of workers who are ineligible to receive unemployment benefits.** The initiative includes the addition of 100 new enforcement personnel, and competitive grants to boost state incentives and capacity to address this problem. The initiative would improve the ability of the agencies to **identify misclassification** through increased **information sharing and targeted audits in high-risk industry sectors.** The initiative would enable **collection of payroll taxes** such as **unemployment insurance.**