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WORKER RECLASSIFICATION AUDIT RED FLAGS

By Victor Sy, CPA

As the recession deepens, more companies find it more difficult to survive. One tempting source of funds is treating workers as independent contractors, instead of employees, to avoid paying payroll taxes. In response, IRS plans to conduct more worker reclassification audits. The benefits for employers to misclassify workers include “savings” from having to pay employer’s share of FICA, Medicare, and unemployment taxes. The IRS officially released a memorandum about the Questionable Employment Tax Practices (QETP) Program. The memorandum describes a nationwide program with the federal and state agencies to identify employment tax schemes and illegal practices.

Let’s identify **red flags** that can trigger a worker reclassification audit:

- **Unemployment claims** filed by workers who have been treated as independent contractors.
- **Complaints made by workers** to wage and hour or unemployment agencies, labor unions, or the IRS.
- **Complaints made by competitors.**
- **Discrepancies between payroll tax returns** - W-2s do not agree with Form 941s or 940.
- **Discrepancies between income tax returns and payroll tax returns.**
- 1099 Misc issued to the **same person for several years.**
- 1099 Misc issued to a worker who **previously received a W-2.**
- 1099 Misc issued to a worker & W2 issued to another worker in the **same line of work.**
- Employers with a **large proportion of Form 1099s compared to Form W-2s.**
- **Prior audits** for independent contractor, unemployment, or worker’s compensation.
- **Service companies with substantial labor in the cost of goods sold.**
- Payments listed as **consulting fees** on the tax return.
- Operating in **targeted industries** such as trucking or construction.
- Filing Form SS-8, **Determination of Worker Status.**

IRS EMPLOYMENT TAX AUDITS - 2010 2011 2012

Employment tax audits under the dreaded National Research Program (NRP) [begin in February 2010](#). It's the first IRS study on employment taxes in 25 years. The IRS believes this to be necessary because of significant changes in business practices with respect to employment taxes since the last IRS employment tax study in the 1980s.

The two main goals of the IRS National Research Program are to:

1. Secure [statistically valid information](#) for computing the employment tax gap, and
2. Determine compliance characteristics so the IRS can focus on the most noncompliant employment tax areas.

The IRS will randomly select [6,000 taxpayers for employment tax examinations - 2,000 each year for the next three years](#). The examinations will be comprehensive in scope. Records pertaining to employment tax returns and issues will be subject to review. The IRS is advising employers to have all of their records available to expedite the examinations. Taxpayers who are selected for audit will receive notices describing the NRP process. It does not necessarily mean that an employer has incorrectly filed a return if an employer is selected for audit.