

WATCH OUT! THE IRS MEANS BUSINESS

Businesses, including Cooperatives and Condominiums, received a surprise break from the Internal Revenue Service in late September 2011. The break involves the treatment of independent contractors.

Before we get too excited, let's remember two things: (1) if the IRS is giving a break, there is usually a reason (such as they know there is abuse and they want to rein it in), and (2) when the IRS gives us a break, it usually has a price.

While the IRS has just announced an amnesty period related to independent contractor issues, it is important to note that this is an issue the IRS has been struggling with for many years. In exchange for the amnesty program, there are assurances that there will be a crackdown on abuses. This comes on top of the recent significant increase in non-compliance penalties.

In this article we will look at the issue, cover the amnesty program, and talk about little known pitfalls that you can easily get trapped by.

Background: Historically, there has been a struggle between the taxing authorities and employers and contractors. The IRS wants everyone to be considered as an employee so that taxes are withheld and collected up front, rather than depending on an independent contractor paying them by making estimated payments and with their tax return for the year. Independent contractors want to remain independent rather than be an employee, because by being in their own business they are allowed to deduct expenses directly from the income, rather than treat the expenses as employee business expenses for which they may not receive the same tax benefit. Employers also prefer independent contractors because they don't have to pay benefits and they don't have to withhold taxes and contribute the matching portion of social security and Medicare or pay unemployment insurance for the worker. Independent contractors are also not governed by minimum-wage and overtime laws.

Labor Secretary, Hilda Solis, has indicated that employers can knock 20% - 30% off of their labor costs by classifying employees as independent contractors. A Government Accountability Office report in 2009 indicated that for 2006 misclassifications cost approximately \$2.72 billion dollars in lost federal taxes, unemployment and state workers' compensation premiums.

Adding to the problem is the fact that the distinction between employee and independent contractor is not always clear. The current law depends on common-law standards that look at approximately 20 factors. In 1996 the IRS gave further guidance and divided the factors into those that are critical, significant and largely irrelevant. Under common-law rules, if the employer has the right to control what will be done and how it is done, the worker is an employee. The important factor is having the right to control. What this all boils down to is a lack of clarity and a lot of confusion, resulting in the easiest answer being to ignore the issue and call a worker an independent contractor.

One other risk for employers, is that workers want to be called independent until they are hit in the pocketbook. In 2007, the IRS released Form 8919, which allows a worker to claim that they have been misclassified as independent and that the employer should have paid the matching social security and medicare taxes.

Amnesty: The new Internal Revenue Service initiative, called the Voluntary Classification Settlement Program (VCSP), will require firms to pay 10% of the employment taxes due for the reclassified workers for the past year. There will be no interest or penalties due. Additionally, the entity will not be audited for employment tax purposes for prior years with respect to the worker classification of the workers.

To be eligible, the company must:

- o Have consistently treated the workers as non-employees;
- o Have filed required 1099 tax forms for the past three years; and
- o Not be under a worker classification audit by federal or state agencies.

Additionally, the entity must agree to treat the workers as employees for future periods and extend the period of limitations on the assessment of employment taxes for the first, second and third calendar year beginning after the date the taxpayer has agreed under the VCSP.

This program is open to companies of any size; however the IRS expects most of the amnesty applicants to be smaller entities as they generally have less personnel and a “looser” structure. The IRS’s announcement indicated that this program is part of an effort to rein in misclassification. In fact, within days of the announcement of the amnesty program, officials from the Labor Department, IRS and seven states announced that they have agreed to work together to curb abuse.

Decision: Should you apply for amnesty? The decision is different in each case. It depends on how secure your position is for treating the worker as an independent contractor. Additionally, consideration should be given as to the effect of other federal and state statutes (including pension and benefit rules, etc.). If you have independent contractors we would be more than happy to consult with you to determine whether your entity should apply for amnesty under the VCSP.

Related Issues

Penalties: If your worker truly is an independent contractor receiving \$600 or more of income during the course of a calendar year, you must issue Form 1099. As of early 2011, the penalties for failure to comply are quite steep. If you fail to file the return by the due date but file within 30 days of the due date the penalty is \$30 per return; with a maximum penalty of \$75,000. Keep in mind that once you go beyond 30 days the penalties increase. There are additional penalties if you don’t furnish the worker with a 1099. You may be assessed a \$60 penalty per 1099. If the IRS determines that it was due to “intentional disregard of the law”, the penalty could be at least \$100 per 1099 and there is no maximum penalty.

Attorneys: The rules for 1099s require that the \$600 amount for filing applies not only to individuals but all attorneys including those who are incorporated. Any entity that pays an attorney or law firm \$600 or more during the course of a year should file a Form 1099 for the payments. This is an easy requirement to miss as the rules are different for attorneys than other service providers. The penalties can be substantial for missing this one.

If you have any questions Czarnowski & Beer, LLP will be more than happy to consult with you. Please contact Stephen W. Beer, CPA.