

FRANZEN & FRANZEN, LLP

CERTIFIED PUBLIC ACCOUNTANTS

May 29, 2012 – Independent Contractor vs. Employee

Currently, the likelihood of your business being involved in a worker classification or employment tax audit is increased because the IRS is aggressively attempting to reduce the “tax gap,” which is the annual shortfall between taxes owed and taxes paid. Employment tax noncompliance is estimated by the IRS to account for approximately \$54 billion of the tax gap. Under-reporting of FICA makes up \$14 billion; under-reporting of self-employment tax accounts for \$39 billion; and under-reporting of unemployment tax accounts for \$1 billion in lost revenue.

Because the existing worker classification rules are complex and ambiguous, much uncertainty surrounds their interpretation and application. The lack of a single, definitive test for classifying workers as either employees or independent contractors contributes significantly to the worker classification problem.

Therefore, understanding the difference between an employee and an independent contractor is very important. If you are an employer, you are required to withhold and contribute a matching amount of FICA and Medicare taxes from your employee’s income. However, if your workers are independent contractors, you are only required to report payments of \$600 or more on a Form 1099-MISC (Miscellaneous Income). Failing to make the right classification could cost.

If you have workers who make substantial financial investments in tools, equipment, or a place to work, or undertake some entrepreneurial risks, they are probably independent contractors. However, when you control and direct the workers who perform services for you as to the end result and how it will be accomplished, you are probably involved in an employer-employee relationship.

Unless there is a reasonable basis for treating your employees as independent contractors, failing to withhold income and employment taxes from their wages can result in severe penalties and interest, in addition to the back taxes owed. Of course, penalties for intentional worker misclassifications are harsher than they are for inadvertent mistakes.

Your benefit plan may also be in jeopardy if any eligible employees have been misclassified as independent contractors. Since these employees have been excluded from plan participation, your retirement plan may lose its tax-favored status. The problem is compounded when excluded employees seek restitution for lost benefits not only due to their exclusion from the benefit plan, but also for health coverage and other employee benefits.

However, in September of 2011 the IRS announced the launch of a new Voluntary Classification Settlement Program (VCSP) that allows employers to resolve past worker classification issues and achieve certainty under the tax law at a low cost, by voluntarily reclassifying their workers.

Since the potential liability is considerable, we feel that it would be beneficial for you to verify that your workers are properly classified. If misclassifications are discovered, we can help you minimize your exposure through use of Section 530 relief or the VCSP. It is important that your employment tax

records are in compliance with IRS guidelines, especially in the event of an audit. Please contact our office if you would like to discuss this further.