

September 24, 2013 /**24-7PressRelease**/ -- Earlier this year, Internal Revenue Service auditors surprised a staffing agency with an audit seeking to verify whether contractors working on information technology issues were not in fact full-time employees. The [employment tax audit](#) was part of the agency's crackdown on worker misclassification.

Increasing focus on classification issues stems from several factors. The most basic factor is the use by many employers of the "independent contractor" designation for workers who are legally "employees" to avoid payroll taxes as well as laws intended to benefit employees. A report by the Treasury Inspector General for Tax Administration indicates that employers are not following IRS worker determination rulings under the Worker Status Program, also known as the SS-8 program. Lack of follow up by the IRS is part of the misclassification problem.

Another factor is that in 2015, firms with at least 50 employees will need to offer affordable health care to employees or face penalties. Finally, the IRS working with Labor Department officials in many states has set a goal of investigating 6,000 employers to ensure proper classification of workers, such as those at the staffing agency. These audits are aimed at increasing tax revenue, since employers do not withhold income tax, Social Security, Medicare or unemployment taxes for independent contractors, as well as protecting workers in need of the protection provided by "employee" status.

What distinguished an employee from an independent contractor?

To appreciate the consequences of misclassifying an employee as an independent contractor, a basic understanding of the federal income tax collection system is needed. Under the Internal Revenue Code's pay-as-you-go system, the employer is a "deputy tax collector" required to withhold income tax from wages, defined as remuneration paid to employees. Whether a payment is "wages" -- and therefore subject to the withholding requirement in the first place -- therefore depends on whether the recipient is an "employee." An employer who fails to withhold payroll taxes from a payment made to someone who was legally an "employee" - even if classified as something else -- may be held liable for the unpaid taxes.

Whether a worker is an "employee" or an "independent contractor" or something else is not for the employer to decide or for the parties to agree but must be determined by state common law principles which consider such factors as the employer's right to control and direct the individual performing the services and the manner in which the services are performed in defining the legal employer-employee relationship.

In the past, the IRS used a 20-factor list to help employers resolve the question. In 1996, the agency streamlined the factors into three broad categories:

1. Behavioral Control: Does the company control or have the right to control what the worker does and how the worker does his or her job?
2. Financial Control: Are the business aspects of the worker's job controlled by the payer? (these include things like how worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)
3. Relationship of the Parties: Are there written contracts or employee type benefits (i.e. pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business.

Proper classification must nevertheless be made on a case-by-case basis using all relevant facts and circumstances and must be approached as a legal issue that may need to be decided at the judicial - rather than administrative - level.**The Voluntary Classification Settlement Program**

If some workers have been classified erroneously as independent contractors, the IRS has a program that allows employers to change them to employees. The Voluntary Classification Settlement Program may provide an opportunity to avoid some penalties.

An employer may voluntarily change the prospective classification of workers through the program. The taxpayer must file Forms 1099 for the workers treated as independent contractors over the previous three years. However, if an employer is already facing an employment tax audit related to classification issues, the program is no longer available.

As part of an agreement with the IRS, the taxpayer agrees to pay 10 percent of the employment tax due in the most recent tax year. In exchange, the business is not liable for interest or penalties and will not be subject to an [employment tax audit](#) related to classification issues.

Employee or independent contractor? IRS targets misclassified workers

Written by Australian Business

When your small business faces an IRS worker misclassification audit, contact an experienced tax attorney. Back taxes and penalties are common depending on the circumstances. If you have long-term contract workers, discussing classification and requirements of the VCSP program with an attorney could head off an audit.

Article provided by Joseph R. Viola, P.C. Visit us at www.jrviola.com