



To: Clients, Associates & Friends of Pro@ctive CPA  
From: Mark L. Wyssbrod, Managing Member  
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Re: Employees Verses Independent Contractors Classification

We have had several inquiries and a few audits for employee and independent contractor classification recently. The audits have been by well-seasoned Georgia Department of Labor auditors. They review tax returns, payroll tax returns, interview the owner, managers and staff. The auditors even review the general ledger detail! ***See below for the rules and how you can protect your business!***

Our clients who have been audited have not had any adjustments partially due to our files being well organized, our updates and guidance on this issue, our advice to our client in preparing for the audit and our well-groomed communication style with the auditor.

The IRS announced several times in the past it would team up with states in the Southeast to target misclassification of employees and contractors. The states are eager participants because the revenue starved states will enjoy a revenue share. This gives them great motivation to find errors.

The audits are to review you are remitting your payroll tax payments timely; filing your payroll tax returns timely and accurately; and you are you classifying your employees and contractors correctly. Is your company following the regulations? Is your information well organized? Can you pass this audit?

Please note this information is to be received as general tax information and not specific tax advice. Please contact us at (770) 664-8583 should you have any specific questions and comments.

### **Why is this important to you as a business owner?**

This should be important to you as a business owner because a contractor can complete Form 8919 if they believe they should have been an employee. This will trigger the IRS to complete a full audit of the business, even if the contractor is incorrect. This could lead to a large Social Security and Medicare liability and a distraction of an audit. ***The audit can result in a material amount of Social Security, Medicare, penalties and interest due!***

### **The IRS's Three Part Test for Employee and Contractor Classification**

To determine if you the individual will be an employee or a contractor the IRS uses a Common Law examination. The test is if you have behavior control, financial control and the type of relationship between the parties then the result is an employee. If you do not have these controls then the classification is a contractor.

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- Behavior Control
  - Do you have the right and control for how the worker completes a task?
    - This includes:
      - When and where they complete the task,
      - What equipment or tools they use to complete the task,
      - Which workers will assist them,
      - Where to purchase supplies or services,
      - What work must be completed by specific individuals *and*
      - What order or sequence is to be followed
  
- Financial Control
  - Do the facts show whether the business has the right to control the business aspects of the worker's job?
    - This includes:
      - The extent to which the worker will be reimbursed for business expenses,
      - The extent of the worker's investment,
      - The extent the worker's business is offered to the relevant market,
      - How the business pays the worker *and*
      - The extent the worker can realize a profit
  
- Types of Relationship
  - Do the facts define the relationship?
    - This includes:
      - Written documents defining the relationship,
      - Whether the worker is provided employee-type benefits (insurance, etc.),
      - Permanency of relationship *and*
      - The extent to which the services performed by the worker are a key aspect of the regular business of the company
  
- Extra Bonus; Consistency of the Company
  - Is the company consistent?
    - These items help, but will not guarantee a positive outcome
    - This includes:
      - Reporting Consistency, including timely filed Forms 1099 in a manner consistent with the worker's status as an independent contractor and reporting all non-employee compensation.



- Substantive Consistency, the company has treated other workers holding substantially similar positions as independent contractors and not as employees.
- Reasonableness, the company has a reasonable basis for treating the worker as an independent contractor. Industry standards also help in this area, but do not guarantee the position is correct (if everyone is not following the rules, it doesn't mean you don't have to either). A seasonal business whereby a significant portion of the industry the company operates in, also engages seasonal contractors often times on a temporary basis.

### **Questions The IRS Auditors Will Ask!**

Andrew G. Poulos mentioned the IRS has 20 direct questions they ask employers when determining the proper employee or contractor status in his article "Get it Right the First Time: Independent Contractors vs. Employee Status" (Current Accounts, November/December 2011). Of these 20 questions the 9 big ones are:

- Is the worker required to comply with instructions given by the business?
- Does the business provide the worker with training?
- Is there a continuing relationship between the business and the worker?
- Does the business provide set hours of work for the workers?
- Is the worker required to have substantial hours towards the needs of the business?
- Who furnishes the worker's tools and materials to conduct the work?
- Will the worker realize a profit or loss from the services provided to the business?
- Does the worker work for more than one business at a time?
- Does the worker receive payment by the hour, week or month?

### **Form SS-8: Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding**

If you are not certain if the worker is an employee or contractor you can receive a classification from the IRS. The classification is valid for three (3) years. Form SS-8: <http://www.irs.gov/pub/irs-pdf/fss8.pdf>

### **Consequences of Treating an Employee as an Independent Contractor**

If you classify an employee as an independent contractor and you have no reasonable basis for doing so, you may be held liable for employment taxes for that worker (the relief provisions, discussed below, will not apply). See Internal Revenue Code section 3509 for more information. *This includes a 100% penalty for willful failure to collect tax.*



(From the IRS Website <http://www.irs.gov/businesses/small/article/0,,id=99921,00.html>)

### **How can you protect your business?**

You can protect your business from having contractors reclassified to employees by taking a few pro-active steps, including, but not limited to:

- Contract only with legal entities (must have an LLC, LP or a Inc. at the end of its name)
  - Have your current individual contractor form a legal business
  - Be careful that the facts and circumstances do not trump the legal entity payment system
    - i.e. if you have a bunch of single owner legal entities the IRS may view them as employees instead of contractors, especially if you are the single source of revenue
- Set up Vender Files for each relationship
  - Have a written document stating the type of the relationship
    - i.e. Contract
  - Complete Form W-9
    - <http://www.irs.gov/pub/irs-pdf/fw9.pdf?portlet=3>
  - Complete Form SS-8 and have the IRS determine the relationship for you
    - <http://www.irs.gov/pub/irs-pdf/fss8.pdf>
  - ***Vendors send invoices, they do not complete time cards as employee do***
    - This was mentioned to me by a Georgia Department of Labor Auditor
  - If any individual, be certain to retain a copy of the contractors:
    - Driver's license
    - Social Security Card
- Be certain to issue all required 1099-MISC
  - You are required to issue a 1099-MISC
    - At least \$600 in rents, services (including parts and materials), prizes, awards, other income, medical and health care payments, crop insurance proceeds, cash payments for fish, or, generally the cash paid from a notional principal contract ***to an individual, partnership or estate;***
      - Also including single (one) Member LLC's
    - If you paid \$10 or more in Royalties;
    - Any fishing boat proceeds; and/or
    - Proceeds to an attorney
  - To review the instructions for issuing 1099-MISC visit <http://www.irs.gov/pub/irs-pdf/i1099msc.pdf>
- Follow the aforementioned rules!



## **Conclusion**

The election is over, taxes are increasing and the deficit will have to be reduced – Federal and State governments are hungry for additional tax monies. Do not be caught off guard by an audit and the potential increase in taxes, penalties and interest because your business misclassified its employees and contractors. *Take defensive actions today!*

The differences between employees and contractors can be complicated. Please contact your Pro@ctive CPA team should you have any questions (770) 664-8583 or [mark@pro-active-cpa.com](mailto:mark@pro-active-cpa.com).

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