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As we embark on a new year we often use the phrase "out with the old and in with the new". This may be the slogan that businesses perhaps should adapt at it relates to their taxes and the way they operate. What has worked in the past does not mean it will work in the future, particularly when mistakes or poor decisions have been made, and a business owner runs the risk of getting audited.

A very problematic area for the government and businesses alike is the

Some of the most common worker classification issues occur from misclassification of employees as independent contractors, and classifying common law employees as statutory employees.

Employment audits can occur at the federal or state level, and with most states having contracts with the federal government, many labor audits begin by state labor agencies with the audit findings being submitted to the Internal Revenue Service. This should be of particular interest to businesses that get audited by their state labor department because what may seem as a non-significant state audit can turn into a federal case with serious consequences.

A worker classification audit can be triggered due to various reasons. A high number of 1099-MISC being filed can trigger an audit, a random audit can occur, or a current or former disgruntled worker can file Form SS-8 requesting that the IRS make a determination on their worker classification status.

A worker submitting Form SS-8 doesn't necessarily trigger the IRS to conduct an audit, but it certainly can be an element that opens Pandora's Box. As I always tell clients, it boils down to the magnitude of the case and how much money the government can get from the audit. Of course, that is not to say that a small employer with a handful of employees won't get under audit for misclassifying their workers.

Businesses that misclassify their workers can either be proactive to solve the problem, or they can hedge their bets that they won't get caught and it will never become a problem. After all, don't we often hear that you don't have a problem unless you are caught doing something wrong? This thought process isn't always the best when it pertains to taxes and misclassifying workers. Depending on the position a business takes will determine which course of action can be taken to resolve the worker classification issues.

The three options available are to either do nothing and keep doing it wrong, which

An employer can be proactive and submit Form 8952 Application for Voluntary Classification Settlement Program, which if accepted mitigates the majority of the risk that the business is exposed too from misclassification of its workers. Under the original VCSP program an employer could not be under audit before applying, but with the modified Announcement 2012-45, a taxpayer can apply for the VCSP program even if they are under audit providing that it's not an employment examination.

Keep in mind that an audit can quickly expand into an employment exam if the revenue agent identifies a worker classification problem, particularly if it is a significantly large case that can generate a big tax bill for the government. If an audit expands into an employment exam it prohibits the employer from being accepted in the VCSP program.

Therefore, it is wise for an employer with worker classification issues to submit the Voluntary Classification Settlement Program application before any problems occur. Aside from this main requirement an employer must meet six other requirements in order to qualify for the Voluntary Classification Settlement Program.

1. The employer must not currently be under audit for worker classification by their state labor department or state revenue department.
2. The employer must currently be treating the workers they are looking to reclassify as independent contractors or other nonemployees.
3. The employer must have consistently treated the workers as independent contractors for the previous three years.
4. The employer must have consistently met the tax filing obligations during the previous three years by filing the required Forms 1099-MISC.
5. If an employer is a member of an affiliated group no company in the group may be under an employment audit by the IRS, or any state agency in order for the

employer to qualify for the VCSP program.

independent contractors but not issue Form 1099-MISC or not file them with the IRS.

By being proactive a business can minimize the potential tax nightmare for a fraction of what it would otherwise pay under an audit, which ultimately can force a business to close its doors if it can't pay the huge tax bill. Once accepted into the program the employer pays 10% of the amount of employment taxes that would have been due on the compensation paid to the workers being reclassified for the most recent tax year.

The taxes are calculated under the reduced rates of IRC §3509(a) which makes it affordable for the employer to settle their wrong doings for a very small amount. The business can apply for the VCSP program for one or multiple classes of workers. It is not necessary to apply for all classes of workers, but you must apply for all workers within a class or group. You can't pick and choose depending on what will provide the lowest tax bill.

Let's look at the example of United Manufacturing, a small business with 50 employees all misclassified as independent contractors for the last six years it has been in business. United Manufacturing pays each of its workers $36,000 annually for a total payroll $1,800,000 in 2014. Assuming the business meets the VCSP requirements and gets accepted into the program, it will only pay $19,224 to enter the program. A factor of 10.68% will be used to compute the tax liability for tax year 2014 since all employees are under the social security wage base.

$1,800,000 salaries x 10.68% factor for FICA & Federal Income Tax Withholding $192,240

$192,240 x 10% Tax Due **$ 19,224**

United Manufacturing will enter the VCSP program and will have their prior years

having other years placed under audit. Additionally, the owner or responsible parties will face a Trust Fund Penalty of 100% which is another serious problem.

$1,800,000 salaries x 7.65% employer FICA	$137,700	
$1,800,000 salaries x 7.65% employee FICA	$137,700	
$1,800,000 salaries x 28% federal backup withholding		$504,000
Total tax liability	**$779,400**	
25% Penalty	$194,850	
Total Taxes and Penalties	**$974,250**	

(*The figures above are for illustration purposes only and you should check the latest tax brackets and penalty percentages when consulting your clients*).

Unlike other IRS programs such as the Offer-In-Compromise that requires the taxpayer to submit a percentage as a down payment with the application submission, the Voluntary Classification Settlement Program does not require the employer to pay the 10% taxes until they are accepted into the program. If the employer is denied for any reason it doesn't cost them any money.

As you work with your business clients, whether it is during tax season or throughout the year, it is imperative that you review the policies and procedures your clients have in effect, and make recommendations to those who have potential worker classification problems. The IRS and state labor agencies are on high enforcement and nobody is immune from this problem. Small and big businesses are at risk if they get it wrong, and the government won't hesitate to knock on the door.

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Andrew G. Poulos, EA, ABA, ATP, is principal of Poulos Accounting & Consulting,

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