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## Independent Contractor or Employee? How the IRS determines a Worker's Status during an Audit

The IRS estimates millions of workers are misclassified as independent contractors, depriving the federal government of huge sums of tax revenue because of underreported income and related unpaid employment taxes. In an effort to narrow the annual tax gap (the difference between what taxpayers should pay and what they do pay on a timely basis), the IRS is focusing on worker classification issues as a means to collect funds. There are currently several IRS initiatives in progress to snare the unsuspecting employer.

In an effort to avoid paying workers compensation, FICA, Medicare and Unemployment taxes, many businesses misclassify their workers as independent contractors and end up being audited and forced to pay back taxes on these misclassified workers as well as hefty penalties and interest.

**Example:** Rite-Bike, Inc., a motorcycle shop, hires Susan, a nationally known model, to work as a consultant at its stores. Susan answers customers' questions and helps them find the "Rite" bike. Susan works in a similar capacity for one other store. For each of the last five years, Rite-Bike paid Susan \$50,000 per year as an independent contractor. Rite-Bike properly files Form 1099-MISC for the payments made to Susan. The company pays no employer FICA or FUTA tax, and no income or employment taxes are withheld from the payments to Susan.

The IRS audits Rite-Bike's 2009 income and employment tax returns, and proposes reclassifying Susan as an employee. It determines Rite-Bike's misclassification was unintentional. If the IRS wins, Rite-Bike will be liable for the following employer and employee portions of employment taxes for one year under IRC Sec. 3509:

Employer's FICA ( $\$50,000 \times 7.65\%$ )	\$	3,825
Employer's FUTA ( $\$7,000 \times 0.8\%$ )		<u>56</u>
Employer's portion of employee liability		3,881
Employee's FITW ( $\$50,000 \times 1.5\%$ )		750
Employee's FICA ( $\$50,000 \times 7.65\% \times 20\%$ )		<u>765</u>
Total payroll tax liability for one year	\$	<u><u>5,396</u></u>

Under general employment tax procedures, the IRS generally expands the examination to include all prior open tax years. Therefore, Rite-Bike's tax bill for three years might approximate \$16,188 ( $\$5,396 \times 3$ ). In addition, the IRS will assess penalties and interest for each year.

**Caution:** The total additional tax costs incurred for reclassified workers (including penalties and interest) are commonly double the amounts potentially saved by claiming independent contractor status. Additionally, the above calculation excludes state payroll tax and penalties that would be assessed.

When **deciding** if a worker should be classified as an *employee or independent contractor* the IRS looks at 20 factors, as follows (if the questions are answered in the affirmative then the worker is an employee and not an independent contractor):

1. Whether the party for whom a worker is performing services has the right to instruct the worker concerning the details of how the work is performed.
2. Whether the employer provides training for the worker.
3. Whether the worker's services are integrated into the employer's operation.
4. Whether the worker must personally render the services.
5. Whether the employer hires, supervises, and pays any workers who assist the worker whose employment status is in question
6. Whether the relationship between the worker and employer is continuing.
7. Whether the worker must work set hours.
8. Whether the worker must work full-time for the employer.
9. Whether the worker must perform the services provided on the premises for the employer.
10. Whether the work performed must be done in an order or sequence set by the party for whom the services are done.
11. Whether the worker must submit regular oral or written reports.
12. Whether the worker is paid on an hourly, weekly, or monthly basis, rather than by the job or on commission.
13. Whether the employer pays the worker's business or travel expenses.
14. Whether the employer provides the worker with tools and materials necessary to do the work.
15. Whether the worker has failed to invest in equipment or facilities used to provide the services.
16. Whether either the worker or employer is free to terminate the relationship between them at any time.

Among the twenty factors, an affirmative answer to the following indicates the worker is an independent contractor and **not** an employee, as follows:

17. Whether the worker has had to make a significant investment in the facilities used in performing the agreed on work.
18. Whether the worker can either realize a profit or suffer a loss as a result of the performance of the services as agreed.
19. Whether the worker performs services for multiple parties that are not related to one another.
20. Whether the worker's services are made available to the general public.

Best Regards,

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