No 1099/No Tax Deduction: IC vs. Employee Status

By Stewart Karlinsky


Stewart Karlinsky

Stewart Karlinsky is professor emeritus at San José State University. He has lectured on tax simplification in Australia, England, Portugal, and the United States.

Karlinsky discusses the pros and cons of the IRS's new Voluntary Classification Settlement Program. Karlinsky suggests that an auxiliary way to help close the tax gap would be for Congress to expand section 6722 to deny a tax deduction if the company does not file Forms 1099 for independent contractors earning more than $600 a year.

The question whether workers are independent contractors (IC) or employees is certainly not new, but lately it has prompted a significant amount of regulatory and audit activity. For over a year now, the IRS has been conducting a National Research project involving employment tax audits of 6,000 businesses. On September 19 Treasury announced that in conjunction with 11 states and the Department of Labor (DOL), it signed memorandums of understanding regarding information sharing, training, and coordinating law enforcement to level the playing field for complying employers and to protect employees' rights.[1] And on September 21, IRS Commissioner Douglas Shulman announced the Voluntary Classification Settlement Program (VCSP),[2] which will allow employers to voluntarily reclassify workers as employees for federal employment tax purposes.[3]

This VCSP will be similar to an existing audit program called the Classification Settlement Program (CSP), which applies to taxpayers under audit and is less generous as to the computation of tax liability.[4] Both programs allow companies to reclassify their workers for federal employment tax purposes from IC to employee status.

VCSP

For the VCSP, eligible taxpayers are those treating their workers as ICs and who have filed all required Forms 1099 for the past three years,[5] and are not currently under a worker classification audit by the IRS, DOL, or state agencies. If accepted into the program, the business agrees to prospectively treat its workers as employees and pay 10 percent of the employment tax liability computed under section 3509 relative to compensation paid to workers for the most recent tax year. No interest or penalties will be imposed. A reduced tax liability is computed under section 3509 as follows: Income tax withholding is calculated at the rate of 1.5 percent, plus the employer's FICA liability computed at the rate of 20 percent of the employee's share, plus the entire employer's share.

Section 3509(a) Example	Percentage
Employer's share of FICA	7.65
Employee's share of FICA (0.20 x 7.65 percent)	1.53
Total FICA	9.18
Income tax withholding (1.5 percent of wages)	1.50
Total section 3509(a) percentage	10.68

[1]*See* Shamik Trivedi and Eric Kroh, "New IRS Compliance Program Targets Worker Misclassification," *Tax Notes*, Sept. 26, 2011, p. 1336. Also, the government announced that a voluntary agreement like the Voluntary Classification Settlement Program will not be disclosed to the states nor to the DOL because it is not an audit.

[2]Announcement 2011-64, 2011-41 IRB 503, *Doc 2011-20066*, *2011 TNT 184-9*.

[3]By filing Form 8952, "Application for Voluntary Classification Settlement Program (VCSP)."

[4]The CSP requires a larger tax liability — that is, either 25 or 100 percent of the employment tax liability for the audited tax year, depending on the justification for the IC position and disclosures, compared with 10 percent under the VCSP.

[5]Filing a Form 1099 means within six months of the filing date, so being slightly tardy won't disqualify the employer.

Because the employer in the example would owe 10 percent of employment tax liability, the tax cost would be 1.068 percent of consulting income, now designated wages, for the year. Also, the statute of limitations for the first three years of employee status will be extended to six years. On the surface, it sounds like a really good deal; however, one fly in the ointment is that you must be accepted into the program. What if a business wants to switch status and it is not accepted? Has it therefore opened itself up to federal, state, and DOL audits or incurred significant tax liability?

Obviously, those taxpayers who are paying workers in cash and who are omitting cash income from their gross receipts and not deducting cash labor costs are neither eligible for the program nor interested in volunteering for it. A more relevant target group includes taxpayers that are in a gray area regarding the appropriate status for their workers. On one hand, certainty for 1.068 percent of one year's labor costs is attractive, but what is the ancillary effect on pension plans, fringe benefits, medical coverage, unionization, workers' compensation, federal and state unemployment insurance, and state government audits? More than 120 government organizations and companies have submitted applications for the VCSP, but no closing agreements have been signed yet.

A big advantage of the VCSP is that it is easier to meet its criteria than to qualify under section 530 of the 1978 Revenue Act. Thus, if the taxpayer has been aggressive on the worker classification, the VCSP only requires that Forms 1099 have been filed over the immediately preceding three years, which is far more liberal than the section 530 requirement of always having filed Forms 1099. Also, one can apply for the new program even without a reasonable basis for choosing IC status for its workers or class of workers, which is not the case for section 530 compliance. Thus, aggressive businesses, tax-exempt organizations, and government entities might want to take advantage of the VCSP by filing Form 8952.

Common Law 20-Factor Test

Whether a worker is performing services that require that he be treated as an employee or an IC depends on facts and circumstances related to common law tests. Those tests address who has the right to direct and control the worker in performing the services required. The government and the courts generally look at the relevant items in the 20-factor test outlined in Rev. Rul. 87-41, 1987-1 C.B. 296. The status may be determined by looking at who trains the worker; the level of integration of the work being done with the business operations; whether the worker is paid on a per-job, hourly, weekly, or monthly basis; whether services are made available to the public or competitors; and who provides the tools and equipment. Robert Wood's recent *Tax Notes* column[6] offered a good discussion of some relevant recent cases,[7] and his most recent column outlined the 20 factors.[8] The government also looks at three factors relative to the relationship between the company and its workers: behavioral control, financial control, and relationship of the parties. In the most recent IC/employee case,[9] the court used a seven-part test, which included: permanent relationship; opportunity for profit by the worker; company's ability to discharge the worker; principal's investment in facilities where the worker works; principal's ability to exert control over worker; parties' belief regarding the nature of the relationship; and whether the work performed was part of the principal's regular business. In the case, both statutory and common law employees were held to be employees, and section 530 was found inapplicable because there was no basis in fact or law to treat the workers as anything other than employees. The court imposed several different penalties on the employer.

Act Section 530

Because of the subjectivity of the 20-factor common law test and the uncertainty of the factors' relative weight, many taxpayers have relied on Act section 530 to justify their IC position. That section requires that the taxpayer treat the worker and all similarly positioned workers as IC for *all* periods; that Forms 1099 have been properly filed for all post-1978 periods; and that long-standing industry standards, judicial precedent, or previous IRS audit gave the taxpayer a reasonable basis for its IC position. It should be noted that if a taxpayer opts for the VCSP, it will never again be eligible for Act section 530 treatment. That important section was modified in 1982 and in 1986 to require the previous audit criterion to involve examining the IC issue and added ''technical service workers,''[10] which in my part of the world — Silicon Valley — are a

---

[6]Robert W. Wood, ''Is the IRS Raising the Worker Status Relief Bar?'' *Tax Notes*, Oct. 3, 2011, p. 105, *Doc 2011-19918*, *2011 TNT 194-10*.

[7]Particularly *Peno Trucking v. Commissioner*, T.C. Memo. 2007-66, *Doc 2007-7174*, *2007 TNT 56-12*, *rev'd*, 296 Fed. Appx. 449 (6th Cir. 2008), *Doc 2008-21241*, *2008 TNT 194-75*, and *303 West 42nd St. Enterprises Inc. v. IRS*, No. 93 Civ. 4483 (LBS) (S.D.N.Y. 2000), *Doc 2000-19746*, *2000 TNT 142-56*. For raciness of the subject matter, the latter takes the cake.

[8]Wood, ''Is the IRS Independent Contractor Settlement Program a Good Deal?'' *Tax Notes*, Oct. 24, 2011, p. 487, *Doc 2011-20546*, *2011 TNT 208-11*.

[9]*D&R Financial Services Inc. v. Commissioner*, T.C. Memo. 2011-252, *Doc 2011-22880*, *2011 TNT 211-15*.

[10]Technical service workers include engineers, designers, draftspersons, computer programmers, and system analysts.

significant portion of the workforce. Nonetheless, those workers and others who do not qualify for the Act section 530 safe harbor may still be treated as ICs under the common law criteria discussed above.

IC vs. Employee Status

It remains to be seen how many taxpayers will apply for the VCSP, especially because it requires the taxpayer to show its cards first and not be sure whether the IRS will accept it into the program. From a revenue and tax gap perspective, the problem with IC status is twofold: first, the recipient may not declare the income; second, if it does, it will deduct expenses above the line to reduce the self-employment tax liability as compared with the Social Security liability, which is based on gross wages. Unfortunately, 1984 was the last year the IRS did a comprehensive study of how many taxpayers misclassified their workers.[11] It found that 15 percent of employers misclassified 3.4 million workers to the tune of $1.6 billion in revenue lost from Social Security, unemployment insurance, and federal income taxes. Of those misclassified workers, 84 percent received a Form 1099-MISC from their employers and reported 77 percent of their compensation. Sixteen percent of companies misclassified workers and did not issue Forms 1099, and only 29 percent of the compensation paid was reported.[12] Those are the taxpayers who should be penalized and at whom my proposal of ''no 1099, no tax deduction'' is really aimed.

Another ancillary issue that businesses must consider in deciding to apply for the VCSP is the possibility of a flat tax, under which employee compensation is generally disregarded (not deductible) in computing taxable income and IC income is generally deductible. Reclassifying workers as employees under the VCSP could be an expensive business decision in terms of income tax under a flat tax regime, rather than just in terms of Social Security tax.

Penalty for Nondisclosure Proposal

Section 6722 imposes a penalty of $100 per nonfiled Form 1099 return, up to $1.5 million.[13] If intentional disregard is found, then the greater of $250 per nonfiled return or 10 percent of omitted amounts with no annual cap is imposed. The penalty's effectiveness, rate of imposition, and revenue collection potential are likely to be minimal.

I suggest Congress address the issue of nonreporting of income by the IC recipient and to help close the tax gap. If a taxpayer does not file the appropriate Form 1099 for its workers, it would lose the deduction. If it does file the forms, then a concept similar to that in the deemed inclusive rule of reg. section 1.83-6(a)(2) would allow the deduction. If the forms were not filed and the deduction was disallowed, my proposal would also increase revenue for many states, because they often piggyback their income tax system on the federal tax regime. Some states, like California, already have a disallowance-for-nondisclosure provision, but they rarely enforce it. The individual tax return audit process would be needed to mitigate the second half of the problem: above-the-line deductions reducing gross receipts to net self-employment income. Another advantage of disallowing the deduction for income tax purposes is that it would force independent auditors and the IRS to address the matter when evaluating Financial Accounting Standards Board Accounting Standards Code (ASC) 740-10 (formerly known as FIN 48) undisclosed tax position disclosures in a company's financial statements and tax returns. That is because when IC vs. EE status is simply a Social Security issue, it is not covered by the FIN 48 rules, but when it affects income taxes (by not being deductible), it is covered.

---

[11] *See* James Bickley, ''Tax Gap: Misclassification of Employees as Independent Contractors,'' Congressional Research Service report R40807 (Mar. 10, 2011), *Doc 2011-5232*, *2011 TNT 49-52*.

[12] Although the data are from 1984, the problem may have grown. In a February 2005 report, the Government Accountability Office suggested that ICs account for 7.4 percent of the workforce and that another 10 million are contingent workers (part time, hourly).

[13] The Small Business Jobs Act of 2010 (P.L. 111-240) doubled the per-missing-return penalty and expanded the ceiling 15-fold for returns due on or after January 1, 2011. Some small-business exceptions and intentional disregard provisions are also in the section.

(Footnote continued in next column.)