

Established 1946

Offices of

Crown & Company

Certified Public Accountants

Members:

AMERICAN INSTITUTE OF CPA's
FLORIDA INSTITUTE OF CPA's

1219 FRANKLIN CIRCLE
CLEARWATER, FL 33756-5815
TELEPHONE (727) 446-3091
FAX (727) 447-5438
e-mail: tax@crowncpas.com

June 14, 2011

RE: EMPLOYEE VS. INDEPENDENT CONTRACTOR

Dear Client:

The IRS has begun a more extensive audit initiative regarding proper classification of those individuals working for you and your business. Should the IRS re-classify a worker as an employee, you could owe both Social Security, Medicare and income tax withholding that was not withheld from the employee. Withholding and payroll taxes could easily equal 30% to 45% of the amount paid the worker. Additionally, penalties and interest can easily equal 100% of the payroll tax and withholding. Thus, a misclassified employee could potentially cost 60% to 90% of the amount actually paid the worker.

Accordingly, it is extremely important to carefully consider each payment to an independent contractor. Attached is a summary of indications that a worker is an employee and a "safe harbor provision." This safe harbor provision can act to eliminate penalties.

Although no employer wants to have additional payroll tax costs, if a worker's status is in question, it may be better to treat them as an employee if there are substantial numbers of such workers or large amounts of compensation. The downside risk of attack by IRS is very large versus the relatively smaller cost of payroll taxes paid annually.

Should you have questions, please contact us.

Circular 230 Notice: In accordance with Treasury Regulations which became applicable to all tax practitioners as of June 20, 2005, please note that any tax advice given herein (and in any attachments) is not intended or written to be used, and cannot be used, by any taxpayer for the purposes of avoiding tax penalties.

Very truly yours,


CROWN & COMPANY

/gac
Attachment

EMPLOYEE VERSUS INDEPENDENT CONTRACTOR

Statutory Definition of Employee

Sec. 3121(d)(2) defines an "employee" as "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee."

The IRS Regulations provided little further guidance in most cases. Reg. Sec. 31.3121(d)(1)(c) states that, generally, under the common law, an employer-employee relationship exists if the person for whom the services are performed has the right to control and direct the services, not only as to the result to be accomplished but also as to the detail and means by which the result is accomplished. Once again, the Regulations provide that the determination is dependent on the facts and circumstances of the case.

Revenue Ruling 87-41

The IRS issued Revenue Ruling 87-41 as a test to determine if an employer-employee relationship exists based on the taxpayer's facts and circumstances. An affirmative answer indicates a factor in favor of classification as an employee, and not as an independent contractor.

The test consists of the following 20 questions regarding the right of the person for whom the work is performed to control the worker.

1. Is the person required to follow instructions about when, where and how the work is to be done?
2. Is the worker provided training that would enable him to perform a job in a specific manner?
3. Are the worker's services an integral part of the overall business operations?
4. Must the services be rendered personally by the worker?
5. Does the business hire, supervise or pay assistants to help the worker on the job?
6. Is there a continuing relationship between the worker and the person for whom the services are performed?
7. Does the person for whom the services are performed set the work schedule?
8. Is the worker required to devote his full time to this person?
9. Must the work be performed at the place of business of the company or at a specifically designated place?
10. Does the recipient of the services direct the order or sequence in which the services must be performed?
11. Must the worker submit regular written or oral reports?

12. Is the worker paid on an hourly, weekly or monthly basis, as opposed to a commission?
13. Are the worker's business and travel expenses reimbursed by the business?
14. Does the person for whom the services are performed provide the worker's materials and tools?
15. Does the worker have no investment of his own in equipment or facilities used to provide the services?
16. Is the worker protected from realizing a profit or a loss on the work?
17. Does the worker perform his services exclusively for such person as opposed to working for a number of companies at the same time?
18. Are the worker's services not available to the general public on a regular basis?
19. Can the worker be terminated for any reasons other than nonperformance of the specific contract?
20. Can the worker terminate the relationship without any liability for nonperformance?

Both the IRS and the Courts have ruled that the requisite control exists if the person for whom the services are performed has the right to control and direct the worker, even if he does not actually do so. However, the right to merely question the worker's result is not considered control.

Safe Harbor Provision of Sec. 530

Sec. 530 of the Revenue Act of 1978 provides a potential safe harbor for many employers who have consistently treated workers as independent contractors. These rules apply regardless of whether or not the worker is an employee under common law.

Under this provision, an employer may avoid any penalties for classifying a worker as an independent contractor if:

1. The worker has consistently been issued a Form 1099 as an independent contractor,
2. No workers in substantially similar positions have been treated as employees, and
3. The employer can prove a reasonable basis for classifying a worker as an independent contractor based on published IRS rulings, on prior audits, or on recognized industry practice.