

**Auditor of State David Yost**  
**2011 Local Government Official's Conference**  
**Employment Tax Update**

April 7, 2011  
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**Agenda**

- IRS Payroll Tax Audit Initiatives
  
- Independent Contractors vs. Employee
  
- 1099 Reporting
  
- Withholding Taxes
  - Federal
  - State & Multistate

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**IRS Payroll Tax Audit Initiatives**

- IRS is scheduled to conduct 6,000 Employment tax Audits
  
- Employment Tax National Research Project
  - IRS plans to conduct audits over the next several years
  - IRS Audits will focus primarily on the following:
    - Worker's Classification
    - Fringe benefits
    - Officer Compensation

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## Independent Contractor vs. Employee

- **Publication 1779** provides factors used to help determine worker status as either an independent contractor or an employee
- **SS-8** can be filed by firm or worker with Internal Revenue Service to determine worker status

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## Independent Contractors

- Treasury Inspector General for Tax Administration report (February 4, 2009) estimates at least \$1.6B tax gap due to worker misclassification
- Federal budget for 2010 assumes \$7B over 10 years in workers reclassification gain
- US Cracks Down on 'Contractors' as a Tax Dodge (NY Times, 2/17/10)
- NYS "Wages Theft Prevention" Act (effective April 12, 2011) – requires written notice, increased penalties
- MN requires "pre-qualification" of certain IC job types (e.g., construction requires Exemption Certificate in advances or else will be deemed employee)
- Taxpayer Responsibility, Accountability, and Consistency Act of 2009 (H.R. 3408, S. 2882) introduced July 30, 2009
- Employee Misclassification Prevention Act (S. 3254, H.R. 5107) introduced April 22, 2010

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## Independent Contractors (continued)

- Fair Playing Field Act of 2010 (S.3786, H.R. 6128) introduced on September 15, 2010
  - End moratorium on IRS guidance, require Sec. of Treasury to issue guidance and annual reports
  - Amend tax code regarding reduced penalties for withholding income taxes and FICA
  - Require employers to provide written statements if IC's
- Department of Labor Proposals
  - Shift burden of proof to companies
    - Written compliance plan required for companies
    - Companies must document process and reasons for classifying W-2 vs. 1099 and exempt/non-exempt under FLSA
- IRS to conduct Employment Tax Audits of 6,000 Businesses
  - IRS plans to conduct audits over the next several years, beginning during 2010, and focusing primarily on the following:
    - Fringe benefits
    - Officers Compensation
    - Workers Classifications

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### Employees: Common Law Standard

When Employer-Employee relationship exists, **all** payments and benefits the employer provides to the employee are compensation and taxable as a wage unless **specifically excluded by law**.

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### Employees: Common Law Standard

Employer-employee relationship exists when the business for which the services are performed has the right to direct and control the worker who performs the services.

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### Employees

Some factors that may indicate worker are employees:

- Required to wear uniforms or dress code
- Required to work certain hours
- Worker doesn't advertise for customers
- Agency provides training
- Agency provides office space/training room, supplies and materials
- Stands no risk of loss

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## Form 1099 - MISC

A small thumbnail image of the Form 1099-MISC document, showing its header and various sections for reporting miscellaneous income.

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## Who must file Form 1099-MISC?

- Entities who have paid (in the course of their trade or business):
  - \$10 or more in Royalties or Dividends
  - \$600 or more
    1. Rents
    2. Services
    3. Prizes or awards
    4. Gross Proceeds to an attorney
    5. Certain other payments

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## What Payments Must Be Reported?

- Certain payment to:
  - Individuals
  - Partnerships
  - Corporations

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General Exceptions to Filing Form  
1099-MISC

- Payments to a Corporation
  - Except Legal or Medical Service Corporations
  
- Payments for only merchandise
  - Examples:
    1. Office Supplies
    2. Cleaning Supplies

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Form 1099-MISC

**Box 1 – Rents**

- Real estate rentals
  
- Equipment Rentals
  
- Rental assistance payments made to owners of housing projects

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Form 1099-MISC

**BOX 2 – Royalties**

- Report oil and gas royalties of \$10 or more
  - Before reductions other taxes that may have been withheld and paid

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Form 1099-Misc

**Box 3 – Other Income**

- Prizes and awards that are not for services performed
- Various damage payments that are not considered wages
- Excess mileage reimbursement over 14 cents per mile for volunteer drivers

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Form 1099-MISC

**Box 4 – Back-Up Withholding**

- Back-Up Withholding Requirements
  - If you make reportable payments to persons (or corporations) who have not furnished their TIN (Tax Identification Number), the withholding rate is 28%
  - Back-up Withholding begins when aggregate payments for the calendar year equal or exceed \$600 OR
  - IMMEDIATELY if:
    - ✓ Payee was paid >\$600 in prior year and an information return was issued or
    - ✓ Payee was subject to backup withholding in the prior year

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Form 1099-MISC

**Box 7 - Non-employee Compensation**

- Payment for services of a person who is not your employee,
- Professional service fees – ex. Attorneys (including corporations), architects and accountants, and
- Prizes and awards for services performed as a non-employee

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## Form 1099-MISC

### **Box 16-18 State Information**

- Box 16 – State income tax withheld
  - Box 17 – Abbreviated name of the state  
Payer's state identification number
  - Box 18 – Amount of the state payment
- COPY 1 – To the state tax department  
➤ COPY 2 – To the recipient

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## Form 1099-MISC: Void Returns

- If you make an error on the form,
  - Enter an "X" in the "VOID" box at the top of the form
  - Go to the next form on the page, or to another page and enter the correct information. (Do not mark the "Corrected" box)
- Submit the entire page even if only one of the forms on the page is completed correctly

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## Form 1099-MISC: Corrected Returns

- Enter "X" in the "Corrected" box
- See pages 6 and 7 of the General Instructions for Form 1099 to complete corrected returns
- Step-by-step chart for filing corrected returns on paper forms on page 7

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### Form 1099-MISC Due Dates

- **January 31<sup>st</sup>** – Copy B to the recipient
- **February 28<sup>th</sup>** – Copy A with Form 1096, Annual Summary and Transmittal of U.S. Information Returns to IRS
- **March 31<sup>st</sup>** – if filed electronically

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### Who must file Electronically

- 250 or more information returns

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### Form 1096

- Submit Form 1096 with paper filings

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**Information Return Penalties**

**Failure to File Correct Information Returns by the Due Date**

May be subject to penalties, if you:

- Fail to file timely
- Fail to furnish to payee timely

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**IRS Section 6721 Penalty  
Failure to File by Due Date**

- Corrected filed by March 30                      \$15/return
- Correctly filed after March 30, but before August 1                      \$30/return
- Correctly filed August 1, or later                      \$50/return

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**Information Return Penalties  
Failure to Furnish to Payee**

Failure to Furnish Correct Payee Statements

**\$50 per statement**

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### IRS Fact Sheet on Employment Taxes and Classifying

- IRS Fact Sheet, FS-2007-27 (2007) helps employers better understand their responsibilities regarding employment taxes and classifying workers
- Focuses the determination on the substance of the relationship rather than the form
- Identifies three key factors/categories of evidence
  1. Behavioral control
  2. Financial control
  3. Relationship of the parties

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### IRS Fact Sheet on Employment Taxes and Classifying (continued)

#### **Behavioral Control**

Does the company have the right to direct and control how the worker performs the task, including providing instructions on the following:

- When and where to do the work
- What tools or equipment to use
- Which workers are hired or who will assist the work
- Where to purchase supplies and services
- What work must be performed by a specified individual
- What order or sequence to follow

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### IRS Fact Sheet on Employment Taxes and Classifying (continued)

#### **Financial Control**

Does the company have the right to direct and control the economic aspects of the workers activities?

- Substantial investment in own business
- Incurred business expenses
- Services made available to the general public
- Method of payment, e.g., flat fee, piecemeal, hourly, etc
- Realization of profit and loss

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## IRS Fact Sheet on Employment Taxes and Classifying (continued)

### Relationship of the parties

How do the company and the worker view the relationship?

- Intent via written contract
- Reporting (W-2/1099)
- Benefit provided, e.g., vacation and sick pay, pension plan, health or life insurance
- IC entity, e.g., corporation, sole proprietorship, etc.
- Permanency of the relationship, e.g., continuing indefinitely or for a specific project or period.

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## Significance of Determining the Employer/Employee Relationship

- Audit reclassification Risks (IC or EE)
    - FICA ramifications
      - 100% of employer FICA due
      - 20% of employee FICA due
    - 1.5% of wages subject to withholding penalty
- NOTE: see IRC Section 3509 – rates shown require that the employer has filed a Form 1099-MISC for compensation paid to the worker*
- State income tax penalty and interest varies
  - FUTA amounts due, with penalty and interest
  - SUI/SDI amounts due, with penalty and interest, potential increase in SUI rates on claim filing
  - Retroactive benefits/equity compensation impact

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## Impact of Reclassification

- Example - \$50,000 per Form 109
  - Federal Exposure (excludes interest)
 

• FICA-Employer's Share	\$3,100 (6.20%)
• FICA-Employee's Portion	\$620*
• Medicare-Employer's Share	\$725 (1.45%)
• Medicare-Employee's Portion	\$145*
• Federal Income Tax Withholding	\$750 (1.50%)
Total Cost	\$5,340
- \* 20% of the employee's share

NOTE: IRC Section 6205 interest-free adjustment provision may be available

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### Impact of Reclassification (continued)

- \$5,340 Federal Tax Assessment per Individual/Year
  - 5 Individuals \$26,700 X 3 yrs = \$ 80,100
  - 10 Individuals \$53,400 X 3 yrs = \$ 160,200
  - 50 Individuals \$267,000 X 3 yrs = \$ 801,000
  - 100 Individuals \$534,000 X 3 yrs = \$ 1,602,000

**THIS DOES NOT INCLUDE STATE AND LOCAL ASSESSMENTS OR INTEREST**

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### How are Audits Generally Initiated?

- Random
- Disgruntled worker (Form SS-8 filing)
- State unemployment claim filing
- Class action

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### Reclassification Relief

#### Current Relief Available

- §503 of the Revenue Act of 1978 safe harbor rules
  - No worker reclassification and worker may continue to be deemed IC
  - No financial penalties
- Worker Classification Settlement Program
  - Requirement to reclassify workers as employees prospectively
  - Graduated settlement

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## Section 530 Relief Provisions

- §503 of the Revenue Act of 1978 safe harbor rules
  - Appropriate returns filed
  - Reasonable basis for position
  - Consistency in reporting
- Applicability of §503 relief must be reviewed on audit
- Does NOT require a reclassification of IC's to employees
- Prohibits the IRS from issuing regulations or rulings with respect to employee/independent contractor status
- Some states honor §503 if IRS approves

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## Section 530 Relief Provisions (continued)

### Primary Components of 530 Relief

- Appropriate return filing
  - All required Form 1099 and related documents must have been filed
- Reasonable basis for work classification
  - Reliance on judicial precedent
  - Long-standing industry practice
  - Past IRS Exam
  - Reliance on professional advice/opinion
- Consistency in reporting
  - Once an IC/EE, always an IC/EE

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## What should you do?

- Analysis of current policies and procedure
- Increased financial audit scrutiny
- Implementation of defined independent contract review programs
- Utilization of third-party providers in engaging contractors/temporary help
- Formalizing document storage in the event of audit
- Process centralization

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## Withholding Taxes

- Federal
  - You must withhold federal income tax from your employees' wages
  - If applicable, you must withhold part of the Social Security and Medicare taxes from your employees and you must pay the matching amount yourself.
- State
  - You must withhold state and local income taxes from your employees' wages

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## Section 218

Section 218 coverage involves agreements between a state and the Social Security Administration to provide social security and/or Medicare coverage to employees of governmental entities.

State Social Security Administrators are responsible for administering and maintaining the State's Section 218 Agreement

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## Current Status of Public Employees

- Employees not covered by a retirement system are covered for Social Security and Medicare
  - under a Section 218 Agreement or
  - Mandatorily under Federal law (with some exceptions)

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## Current Status of Public Employees

- Employees covered by a retirement system MAY be:
  - Covered for Social Security and Medicare under a 218 Agreement
  - Not covered for Social Security and Medicare
  - Covered for Medicare only

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## Basic Concepts of Section 218 Coverage

- Coverage is voluntary and obtained through a legal written Agreement between State and SSA
- Must be legal authority under both Federal and State law to enter into Agreement
- Types and extent of coverage must be consistent with Federal and State laws
- Employees brought under Section 218 Agreement in groups is known as “coverage groups”
- Agreements cover positions, therefore, any worker filing that position is covered

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## Basic Concepts of Section 218 Coverage (Continued)

- Additional coverage provided by modification to the Agreement
- Each modification, like the original Agreement, is a legal document
- Each State determines which groups of employees to cover and when coverage begins
- Coverage cannot be terminated

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### KEY POINT

- Despite the diverse number of provisions governing State and Local coverage, one aspect of the process has been consistent:

Coverage for public employees is activated by a Section 218 agreement between the State and SSA on behalf of those employees.

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### Mandatory Social Security and Medicare

- Almost all state and local employees hired or rehired after March 31, 1986 must be covered for Medicare , and pay Medicare taxes regardless of their membership in a retirement system.
- July 2, 1991, social security coverage became mandatory, with some exceptions, for the state and local government employees who are neither covered by a Section 218 Agreement nor qualified participants in a public retirement system.

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### Mandatory Social Security and Medicare

- Section 218 coverage is based on the position an employee occupies, Mandatory coverage is based an employee.
- It is important to understand that you must first determine whether the position or services are covered under a Section218 Agreement. We only apply the mandatory coverage rules when the employee's position, and therefore the employee, is not covered under the Section 218 Agreement

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## Depositing Federal Taxes

- Form 941 Employer's Quarterly Federal Tax Return or Form 944 Employer's Annual Federal Tax Return
- Electronic Deposits Mandatory unless:
  - Total tax liability (withholding taxes, social security, and Medicare) for either the current quarter or preceding quarter is less than \$2,500 and
  - Generally, you did not incur a \$100,000 next day deposit obligation during the current quarter.

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## Depositing Federal Taxes (Continued)

- Two Deposit Schedules – Monthly and Semi-Weekly

Summary of Steps to Determine Your Deposit Schedule

1. Identify your lookback period
2. Add the total taxes from line 8, Form 941 your reported during the lookback period
3. Determine if you are a monthly or semiweekly schedule depositor

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## Depositing Federal Taxes (Continued)

If the total taxes you reported in the lookback period were	Then you are a
\$50,000 or less	Monthly Schedule Depositor
More than \$50,000	Semiweekly Schedule Depositor

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## Look-Back Period

LOCKBACK PERIOD				
2009			2010	2011 Calendar Year
July 1	Oct. 1	Jan. 1	Apr. 1	January Thru December
Sept. 30	Dec. 31	Mar. 31	June 30	

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## State Income Tax Withholding – The Basics

- Requirements and obligation of employer
- Sourcing rule (Generally)
  - Income should be sourced to state where employee performs services
  - Nonresident employees traveling to different states should have SIT withheld in those states
  - Treatment of deferred comp/equity compensation generally follows withholding treatment

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## State Withholding Deposits

**Quarterly (FORM IT-501)** – less than \$2,000 withheld during the 12-month period ending June 30 of the preceding calendar year. Employers who register after July 1 are required to remit quarterly, unless otherwise notified by the state.

**Monthly (Form IT-501)** - greater than \$2,000 but less than \$84,000

**Electronic Filing is required** - \$84,000 or greater withheld during the 12-month period ending June 30<sup>th</sup> of the preceding year.

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## Multi-State Withholding

- States Look Beyond Borders to Collect Owed taxes (NY Times 03/21/2010)
  - “Anyone who crosses a border for work probably owes income tax in that state.”
  - States have greater access to data warehouses to help them better track taxes owed
- The biggest burden associated with multistate taxation is the administrative effort it requires for both parties to comply
- The states with the most aggressive tax compliance teams have the most to gain (CA, CT, NY....)

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## Reciprocity Agreements

- Work state/resident state agreements
- Specific filing requirements
- The biggest burden associates with multistate taxation is the administrative effort it requires for both parties to company
- Ohio Form IT 4 NR, *Employee’s Statement of Residency in a Reciprocity State*
  - Indiana
  - Kentucky
  - Michigan
  - Pennsylvania
  - West Virginia

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## Varying Approaches to Multistate Withholding

### NONCOMPLIANCE

Non complying with nonresident withholding rules regardless where compensation was sourced as earned

### PARTIAL COMPLIANCE

Establish a system for all or select employees who performed services in specific state to track source income.

### FULL COMPLIANCE

Building an in-house system to ensure proper withholding and source recognition of earnings in nonresident states

### Full Compliance is not an option, it is required

Any approach that does not involve withholding and remitting taxes on all wages earned in nonresident state could have an associated tax expense, including penalty and interest assessment.

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Thank you

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