The Newsletter of the AICPA Private Companies Practice Section

The Risk Management Resource

Provided by Aon Insurance Services

December 2012

Employee or Independent Contractor? An Elephant or a Mouse?

Executive Summary

- The tests used by the Internal Revenue Service and Department of Labor to determine whether a worker is an independent contractor or an employee are different.
- Newsletters should be sent to clients addressing worker classification and explaining the IRS voluntary classification settlement program.
- Worker classification is the client's responsibility and should be memorialized in the engagement letter.
- If it appears a client may be misclassifying workers, the CPA firm should inform the client in writing of the potential issue.
- Clients should be advised both orally and in writing to consult with an attorney with expertise in taxation and employment law regarding worker classification.

Congratulations on the new client. The engagement includes performing a compilation and preparing income tax returns and Form 1099s for the workers in January. Great job!

Unfortunately, there may be an elephant in the room. Has the client properly classified workers as independent contractors, or should they be treated as employees? Just as important, does the client assume that the CPA firm will advise if workers were treated incorrectly as independent contractors?

Employers are motivated to classify employees as independent contractors to save the costs of employment taxes, health insurance, other benefits and overtime.

The Regulators

The U.S. Department of Labor (DOL) Wage and Hour Division, as well as various state departments of labor, enforce the Fair Labor Standards Act and state wage and hour laws. These agencies also are responsible for determining if workers are employees or independent contractors. The federal DOL uses an "economic reality" test under applicable laws to determine whether a worker is an employee or independent contractor. In contrast, the Internal Revenue Service considers behavioral control, financial control and the relationship of the parties in making this determination. The IRS as well as federal and state DOLs publish guidance applicable to specific industries.

The IRS and federal and state DOLs are aggressively pursuing employers who misclassify workers as independent contractors. The Obama administration estimates that increased enforcement will result in collection of $7 billion of unpaid taxes during the next 10 years.[1] In September 2011, the IRS and the federal DOL signed a memorandum of understanding (MOU) designed to strengthen information sharing on enforcement actions related to misclassified workers. Additionally, a number of states have signed related MOUs with the DOL, and, in some cases with the Employee Benefits Security Administration, Occupational Safety and Health Administration, Office of Federal Contract Compliance Programs and the Office of the Solicitor.

In 2011, the IRS added a question to income tax returns reporting business income, including Forms 1120, 1120S, 1065 and certain individual income tax returns schedules. The question asks if the taxpayer made any payments requiring Form 1099s to be filed and, if the forms are required, if they will be filed. These questions allow the IRS to monitor taxpayer compliance and highlight the increased IRS emphasis on enforcement.

While a discussion of when Form 1099s must be filed is beyond the scope of this article, a CPA should explain the reporting requirements to the client—preferably in writing through a newsletter or a letter specifically addressing the client's needs. The client should be required to confirm in writing its answers to the questions related to Form 1099s needed to complete these forms and schedules. If the client says it has a filing obligation but will not be filing the required forms, the CPA should advise the client both orally and in writing of the potential consequences. The CPA also should inform the client of the imposition of penalties due to failure to file the Form 1099s. If the client does not provide the requested information or refuses to comply with the reporting requirements, the CPA should consider withdrawing from the engagement without preparing the tax returns.

Misclassification Risks

Truck drivers, home health aides, high tech engineers and construction contractors are some of the workers most frequently misclassified as independent contractors, but those are not the only workers misclassified.

Conflicting guidance increases the risk of misclassification. Clients should be advised both

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1 Steven Greenhouse, U.S. Cracks Down on "Contractors" as a Tax Dodge, *New York Times*, February 10, 2010

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orally and in writing to consult with an attorney with expertise in taxation and employment law regarding worker classification. While tax practitioners may be knowledgeable about IRS guidance on the subject, classification represents a fact-based analysis, requiring a review of relevant case law. If the attorney's research is inconclusive, the CPA firm should recommend the client submit a Form SS-8 to the IRS to obtain a Determination of Worker Status. If the CPA firm makes the classification determination, it should disclose that the classification is for tax purposes only and that the worker may not be properly classified for other purposes, such as for overtime compensation.

What happens when an employer is penalized for misclassifying workers and the CPA firm was involved in payroll processing or preparing Form 1099s for the client? The client may file a malpractice claim against the firm, alleging failure to advise regarding classification of workers. The allegations may also seek recovery of the tax, penalties and interest. While unpaid taxes typically do not compromise elements of malpractice claims, the client's inability to recover withholding taxes from employees after the fact may result in a potential claim for the tax as well as the interest and penalties. So what can a CPA firm do to protect itself?

Steps for CPA Firms

To begin, CPA firms should educate clients about misclassification issues in a newsletter article sent to all clients. The article should describe the problem, consequences of misclassification and corrective measures, including participation in the IRS voluntary classification settlement program (VCSP). Under the VCSP, eligible taxpayers will pay approximately 10% of the employment tax liability due on compensation paid to reclassified workers for the past year. Indicate that it is the client's responsibility to properly classify workers. In addition, inform the client that questions about classification should be directed to an attorney with expertise in both taxation and employment law. If the client requests a referral, provide them with several law firms specializing in this area as possible options for such guidance.

For payroll processing clients especially, it is essential that the engagement letter should clearly state it is the client's responsibility, not the CPA's, to properly classify the workers.

If a payroll processing client is treating workers as independent contractors, the CPA should notify the client in writing of the potential issue and recommend the client engage an attorney to assist in determining the proper classification. The CPA can mention the availability of VCSP as additional motivation to review classification now.

For annual income tax clients, the CPA firm should consider reviewing the trial balance and the answers provided by the client to the Form 1099 questions included on the 2011 income tax returns to determine if and to what extent workers are being treated as independent contractors. Some clients may operate in an industry at an increased risk of being audited. For example, if the client is a trucking company, and the trial balance reflects almost all payroll expense related to the owner's compensation, with a large amount in an account labeled contract labor, that should raise a red flag of possible misclassification. If it appears a client may be misclassifying workers, the CPA firm should inform the client in writing of the potential issue. The firm should recommend the client retain an attorney to assist them in determining proper classification.

If the CPA firm becomes aware the client is misclassifying employees as independent contractors under the guidance issued by the IRS, Treasury Department Circular No. 230 Section 10.21 requires the CPA firm to advise the client of the error and the consequences of noncompliance, including potential liability for tax, penalties and interest. The AICPA Statements on Standards for Tax Services (SSTS) No. 6 also requires practitioners to recommend corrective measures to be taken, which may include participation in the VCSP. All advice regarding worker classification should be provided in writing.

A practitioner may not willfully, recklessly or through gross incompetence sign a tax return or claim for refund that the practitioner knows, or reasonably should know, lacks a reasonable basis under Circular No. 230 Section 10.34. Additionally, SSTS No. 3 requires practitioners to "make reasonable inquiries if the information furnished appears to be incorrect, incomplete or inconsistent either on its face or on the basis of other facts known to the member." If the practitioner becomes aware the client has been misclassifying employees as independent contractors and the client refuses to correct the problem before filing outstanding tax returns, withdrawal from the engagement is recommended, as the practitioner cannot knowingly sign incorrect tax returns.

If the practitioner is providing payroll processing services or preparing Form 1099s for the client, an increased degree of scrutiny should be applied to the engagement. If a practitioner has advised the client orally and in writing to undertake further research to ensure proper classification of workers, but the client does not follow up, consider withdrawing from providing further services.

Vigilance Needed

CPAs should be vigilant in defining both the scope of their engagement and the client's responsibilities regarding worker classification to avoid both misunderstandings and malpractice claims. Newsletters alerting clients to the problem, a properly designed engagement letter and written documentation of communications with clients regarding the need to consult with legal counsel all serve to protect the CPA firm while providing the client with value added service.

Resources:

For information on the IRS voluntary classification settlement program:
www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Voluntary-Classification-Settlement-Program-(VCSP)-Frequently-Asked-Questions

For an overview of the IRS's interpretation of independent contractor or employee:
www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Independent-Contractor-(Self-Employed)-or-Employee%3F

From the U.S. Department of Labor:
www.dol.gov/whd/regs/compliance/whdfs13.pdf

www.dol.gov/regulations/2010RegNarrative.htm

Text of the Fair Labor Standards Act:
www.dol.gov/whd/regs/statutes/FairLaborStandAct.pdf

For information on providing professional referrals:
AICPA Member Insurance Programs. "Risk and Professional Referrals." *AICPA Member Insurance Programs*, 2011. Web. July 2011 <www.cpai.com/show-article?id=339>.

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