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Employees vs. Independent Contractors – Tax concerns

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In 1982, Section 3509 of the Internal Revenue Code was enacted. The primary purpose of the law was to relieve the "...tax burdens that may arise when a worker who has been treated as an independent contractor is reclassified as an employee."

Our purpose here is to explain the tax consequences of misclassifying workers because we have reason to believe that the IRS may soon implement a special program designed to ensure that employees are not misclassified as independent contractors.

Depending on the facts and circumstances, the rules impose various levels of obligations on employers who misclassify employees. The following provides examples.

- a) If an employer unintentionally fails to deduct and withhold taxes from an employee by misclassifying them as an independent contractor, the employer's liability might be equal to 1.5% of wages paid for federal withholding and 20% of the employee's portion of FICA under Section 3509.
- b) If an employer unintentionally fails to deduct and withhold taxes from an employee by misclassifying them as an independent contractor AND disregards and does not meet reporting requirements the employer's liability may be increased to 3% of wages for federal withholding and 40% of the employee's portion of FICA, again under Section 3509.
- c) If an employer intentionally misclassifies an employee, Section 3509 does not apply. Instead the IRS can subject the employer to the full amount of income taxes that should have been withheld, the full amount of employer and employee shares of FICA, as well as interest and penalties.

On June 20, 2008, the IRS Chief Counsel Advice issued a memorandum that clarified when employers can apply the rates and provisions found in Section 3509 to mitigate harsh consequences under the law. The memorandum concludes that Section 3509 may be utilized to determine the employer's liability when the employer has learned of the misclassification after receiving a determination letter from the IRS, meets the requirements of Section 3509, or seeks to correct deficiencies of prior years. The 2008 memorandum offered nothing new except to simply clarify current law.

Clearly, to avoid exposure it is advisable to classify workers correctly from the start. The following are some of the characteristics that can assist in the determination of the proper classification. The following is not all inclusive:

With regard to **employees**, generally the employer will control how and with what resources the service is to be performed. Employees often have fixed hours of work, are paid according to a set salary, and can be fired or quit at any time.

Independent contractors, on the other hand, often determine for themselves how work is performed and provide their own equipment or supplies. Often, independent contractors set their own hours of work, are paid by the job, and may typically work for more than one business.

The IRS has published additional information in its guidance on worker classification. The 160-page guidance is essentially training material used by examiners.

If you have questions, or if you would like a copy of the IRS training material, please contact Vincent Ruocco, LLC, CPA at 203.932.2931.

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