

Form 1099 Issues

Pepper Horton, CPA
Greene, Finney & Horton LLP

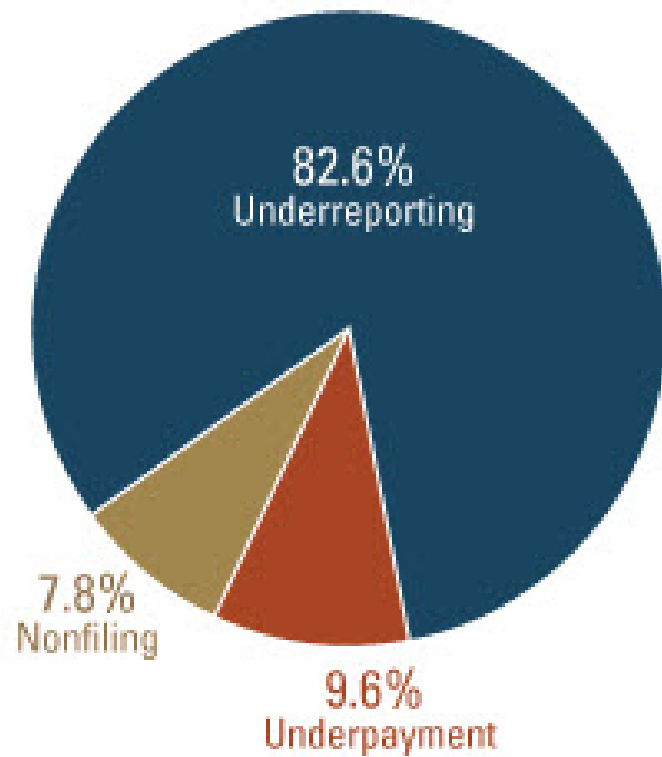
Independent Contractor Issues



The Tax Gap

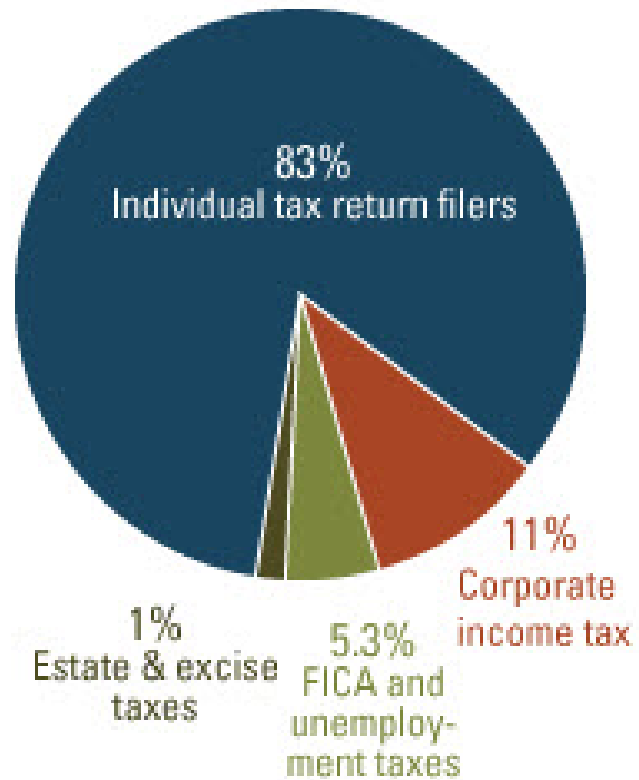
- ▶ The tax gap is the difference between taxes owed and taxes paid.
- ▶ The Internal Revenue Service estimates that over the past thirty years the tax gap has ranged from 16 to 20 percent of total tax liability.

Figure 1. Components of the Gross Tax Gap



Source: Internal Revenue Service.

Figure 2. Components of the Underreporting Gap



Source: Internal Revenue Service.

The Tax Gap

- ▶ Individual income taxpayers fail to report about 54 percent of income from sources for which there is no information reporting.
- ▶ Over 60 percent of underreported individual tax is for business and self-employment income, which the IRS has no easy way to verify independently.
- ▶ Only 10.5 percent of the underreporting gap is attributable to corporate income tax, and only 1.4 percent to the estate tax and excise taxes.

Independent Contractors Issues

- ▶ IRS “Right-to-control test” lists factors which are designed to evaluate who has **control** over the work being performed.
- ▶ The more control - when, where, how and by whom - more likely to be employees, not independent contractors.
- ▶ Can file Form SS-8 - 66 tough questions over 6 pages.
- ▶ An example of a trick question is *“Can the relationship be terminated by either party without incurring liability or penalty?”*
- ▶ *Correct Answer (for IC status):* No, the independent contractor cannot quit at any time without incurring liability because the independent contractor is under a contract with the company and could incur liability if the independent contractor simply walks away from its responsibilities under the contract.
- ▶ Trap!



20 Factors

- ▶ 1. Instructions, 2. Training, 3. Integration, 4. Services Rendered Personally
- ▶ 5. Hiring/Supervising/Paying Assistants, 6. Continuing Relationship
- ▶ 7. Set hours of work, 8. Full-time required, 9. Work done on premises
- ▶ 10. Order/Sequence, 11. Oral/Written Reports, 12. Payments by hours/week/month
- ▶ 13. Payment of Expenses, 14. Furnishing Tools/Equipment, 15. Investment
- ▶ 16. Profit or Loss, 17. Working for More than One, 18. Services Available to Public
- ▶ 19. Right to Discharge 20. Right to Terminate Relationship
- ▶ Evolved into three categories of control:
 - ▶ (1) Behavior
 - ▶ (2) Financial
 - ▶ (3) Relationship

Employee?

- ▶ Statutory - the law defines the worker as an employee (corporate offices, full-time life insurance sales people, homeworkers)
- ▶ Common Law - the employer has the right to exercise control over the manner and means by which the worker performs their services.
- ▶ Caution - Incorrect classification can cause you to be help responsible for:
 - Back Federal/State payroll taxes
 - Back unemployment taxes
 - Back employment benefits - health insurance, stock options, sick/vacation
 - Pension Contributions



Case Studies

- ▶ Microsoft “Independent Contractors”
- ▶ In the late 1980s, Microsoft employed approximately 1,000 workers who were categorized as independent contractors
- ▶ signed an agreement - I/C and no benefits
- ▶ IRS Audit - Microsoft had “control” and MS agreed to pay employment taxes.
- ▶ Backfired - new employees now demanded benefits that they would have received. Sued & won.



Case Studies

▶ Nokia - 3rd Party

- ▶ Nokia contracted with a third party to staff engineers for Field Support Centers.
- ▶ Engineers were responsible to provide Nokia's field techs with phone support as needed.
- ▶ Engineers routinely worked in excess of 40 hrs/week, but were not paid OT
- ▶ Engineers worked on Nokia property, used Nokia equipment and worked under Nokia's supervision and control.
- ▶ Engineers were engaged and paid through a third party.
- ▶ Engineers and other Field Support Center workers performed nonexempt work; were treated as ICs.
- ▶ It's important to recognize and understand that the company (in this case Nokia) who is the beneficiary of the services rendered is not exempt from the risk.

§530 Relief

- ▶ Three requirements must be met to receive relief:
- ▶ Reporting Consistency - Timely filing of all required returns, e.g. Form 1099-MISC “At least you did that!”
- ▶ Substantive Consistency - Consistent treatment of all similar workers.
- ▶ Reasonable Basis - Must have a reasonable basis for not treating workers as employees.
- ▶ Judicial Precedent
- ▶ Prior Audit with no assessment
- ▶ Recognized Industry Practice
- ▶ Other Reasonable Basis

Safe Harbor

- ▶ FedEx Ground
- ▶ Used the “prior audit” to claim safe harbor.
- ▶ For Federal purposes - their drivers are independent contractors
- ▶ For State Purposes - they are employees ...Hybrid Workers
- ▶ Legal tests are different in EACH STATE.
- ▶ The result is a **hybrid worker**: FedEx drivers in California, Illinois, and Massachusetts are *employees* for state purposes, but *independent contractors* for federal tax purposes.
- ▶ Isn't this REALLY a Federal issue?

The Fair Playing Field Act of 2012

- ▶ Closing the loop-hole (so called) that FedEx Ground used to escape \$319 million.
- ▶ Would eliminate the continued use of the Section 530 safe harbor
- ▶ Employee Misclassification Prevention Act
- ▶ Many other acts all....
- ▶ **NOT ENACTED YET**

Online Matching Program

- ▶ Allows Payors to check TIN/Payee Name combination prior to filing a 1099
- ▶ Reduces number of backup withholding notices
- ▶ IRS eServices
- ▶ No fee
- ▶ Interactive - 25 names and Bulk - 100,000 names

Form 1099-K

- ▶ Many businesses will receive Form 1099-K which reports credit card sales.
- ▶ Payment settlement entities (Visa, PayPal, etc) are required to report payments to merchants for goods/services paid by credit card.
- ▶ Form 1099-K, Merchant Card and Third Party Payments
- ▶ Currently the IRS has conceded that taxpayers are not required to reconcile income reported on Form 1099-K with income reported on tax return.
- ▶ Notification of Possible Income Underreporting - range from “please review” to “provide written explanation” to Form 14420, Verification of Reported Income
- ▶ Basically, the IRS is looking!

Form 1099-B Reports Basis

- ▶ Form 1099-B reports Gross Proceeds and...
- ▶ Basis for stocks purchased on/after 1/1/2011
- ▶ No basis if purchased before 2011
- ▶ Debt instruments and options basis if purchased in 2014 or after

How is Basis Calculated?

- ▶ Specific Identification (*Youngquist*)
- ▶ Standing orders (HIFO, LIFO, etc)
- ▶ If no instructions then FIFO.
- ▶ Change of Brokers? Inherited Stock? Gifted Stock?