

## Employee or Independent Contractor?

The issues relating to whether an individual is an employee or an independent contractor is a highly contested arena not only between employers and the taxing authorities such as the Internal Revenue Service (IRS), but between individuals, and their employers as well.

The issue boils down essentially to who is to bear the cost payroll taxes, pension, and insurance costs.

Employers especially in economically hard times, and in times of rising wages are highly tempted to classify workers as contractors who would otherwise be considered employees thereby transferring the cost of payroll taxes and insurance to the individual rather than incur those same costs as employers.

This can be an extremely dangerous path to follow in that the IRS, and most state taxing authorities will generally find that there is an employment relationship that exists between an individual and the business enterprise.

There are general guidelines that taxing authorities follow ranging from issues such as training, supervision, existence of written contracts, workplace, and many other criteria that define who is, and who is not an employee. (See our website at [www.petemcpa.com](http://www.petemcpa.com) and look under FAQ's for the article Independent Contractor Guidelines).

Generally the IRS, and here in the State of California, the Employment Development Department (EDD) will generally side with the individual working for an employer as to being an employee rather than that of a contractor.

The worst enemy of an employer is the terminated individual in that in many instances that individual will file an unemployment claim for benefits once terminated. Therein lies the path to disaster for the employer as the EDD immediately compares the employment tax records of the claimant to the records of the named employers. Should that individual not show up on the payroll tax returns of the named employer, the EDD initiates an audit to determine whether the claimant should have been classified as an employee, and therefore eligible for unemployment benefits. If the auditing agency finds that there was in fact an employer/employee relationship the EDD, and the IRS will then assess the employer for the escaped payroll taxes, and assess penalties and interest against those taxes not paid. The audit generally does not stop there with the one individual claiming unemployment benefits as the auditing agency will look for other similarly misclassified relationships when conducting the audit which can generally lead to substantial assessments.

The IRS, nor the EDD are impartial as to their bias in investigating these matters. When an individual is classified as an employee both agencies collect the payroll and income taxes up front from the employer whereas when a worker is classified as an independent contractor that individual has many more deductions potentially allowed to them thereby reducing the amount of taxes the government collects.

In addition, most individuals are not disciplined sufficiently to pay their own individual taxes thereby creating in each instance more and more of the uncollectible tax that is growing in this country by billions each year, therefore the taxing authorities look at such classifications with a bias towards not only the fairness to the individual, but also what is best for the government. This issue is highly biased against the employer.

The real danger is that once the audit starts the problems expand exponentially. The auditing agency not only looks at the relationship between the claimant and the business, but expands the audit to determine if others were also similarly misclassified. Should the auditing agency find that an employer is incorrect as to the classification of its workers, the IRS/EDD will assess back taxes, penalties, and interest, but now the misclassified employees have potential claims against the business under the Affordable Care Act (Obamacare). The problem further compounds if a pension plan exists within the business. The now reclassified employees who would have otherwise qualified as being covered under the company pension can now claim pension benefits paid to their benefit under the plan. There is also the danger of potential civil litigation for rights and privileges that were missed by those reclassified employees once a taxing authority finds in the favor of those individuals. Having escaped the payroll tax and insurance costs can look as a very bad managerial decision very quickly.

We recently referred an extensive employment tax audit that was being conducted by the EDD on a construction industry business where this sort of matter is highly prevalent. The EDD had initiated an employment audit where a former "contracted worker" claimed unemployment benefits which then triggered the audit.

Our audit defense procedures are such that we review all of the client records in advance of the actual audit, thereby assessing the weaknesses, and to discover any failures to comply with the specific issues under examination. We found the claimants employment arrangement to in fact to be that of an employee. We also found several other individuals that would be so classified by the EDD, thereby leading to potential IRS assessments as well. Our investigation found in that the "errors" to be majorly egregious, and that the potential assessment would have been so substantial that the business would have had to seek bankruptcy protection had the audit gone wrong.

Being ahead of the issue by conducting our own audit procedures in advance we were able to isolate the examination to the specific employee issue, and a few others that we felt appropriate to "give" the auditors to show good faith. By doing so the audit did not expand into the areas we were aware of, and were able to close the audit with an assessment that was acceptable to the client.

The entire area of independent contractor versus employee classification should be evaluated on a case by case basis.

Various issues including immigration, labor law, pension law, and now the Affordable Care Act come into play in the evaluation. We strongly suggest that any questions that relate to this arena be reviewed by us before it becomes a problem as it will once the IRS or other taxing authority becomes aware of any issues within your organization. The long term as well as the short-term implications can be substantial.