

How to Survive an Employment Tax Audit

The Internal Revenue Service's ("IRS") most commonly audited employment tax issue is the reclassification of independent contractors (1099-MISC) to employees (W-2). The IRS is aggressively pursuing these cases because employers avoid paying

1. 15.3% in employment taxes (Social Security and Medicare);
2. Federal Unemployment taxes;
3. Retirement Benefits;
4. Health Insurance;
5. Paid Time Off; and,
6. Liability Insurance.

Employees are **expensive**! The general rule of thumb when deciding whether to hire an independent contractor or an employee is dependent on the cost.

Independent Contractors:

\$50 dollars an hour X 40 hours a week = \$2,000 dollars

Employee:

\$50 dollars an hour X 40 hours a week = \$2,000 dollars X 1.5 (above) = \$3,000 dollars

A small business should generally try to hire independent contractors, when possible because it is the affordable and reasonable decision. Businesses would usually convert the contractors to employees, when the business becomes stable and grows to a point where it is able to support an employee full-time with full benefits.

Audit Proofing Your Business

Contracts



The reason why more than 80% of businesses lose their employment tax audits is because they don't have the proper records, documents and contracts! It's important for businesses to make sure that they have these contracts properly written and prepared according to the law, so that the IRS will read these contracts and clearly see that you understand as well as prepared by the law.

Contracts must clearly detail and define the role of the independent contractor. There are 20 different issues that the IRS would examine to determine if some hired is an independent contractor or employee. The contract has to show that these issues have been considered and explained away. (Obviously, we're not trying to lie. We're trying to protect ourselves by stating the truth in advance to avoid any future confusion or problems.)

Revenue Ruling 87-41: The Twenty Factors

To help determine whether a worker is an employee under the common law rules, the IRS identified 20 factors that may indicate whether the employer can exercise enough control to establish an employer-employee relationship. These factors, set forth in Revenue Ruling 87-41, were based on the circumstances that the courts identified and relied upon to decide whether an employment relationship existed. Not all the factors must be present to find an employee/employment relationship, but the factors are guides to use to assess the likelihood as to whether an individual is an employee or an independent contractor.

1. **Instructions.** An employee must comply with instructions about when, where and how to work. The control factor is present if the employer has the right to require compliance with the instructions.
2. **Training.** An employee receives on-going training from, or at the direction of, the employer. Independent contractors use their own methods and receive no training from the purchasers of their services.
3. **Integration.** An employee's services are integrated into the business operations because the services are important to the business. This shows that the worker is subject to direction and control of the employer.
4. **Services rendered personally.** If the services must be rendered personally, presumably the employer is interested in the methods used to accomplish the work as well as the end results. An employee often does not have the ability to assign their work to other employees; an independent contractor may assign the work to others.
5. **Hiring, supervising and paying assistants.** If an employer hires, supervises and pays assistants, the worker is generally categorized as an employee. An independent contractor hires, supervises and pays assistants under a contract that requires him or her to provide materials and labor and to be responsible only for the result.
6. **Continuing relationship.** A continuing relationship between the worker and the employer indicates that an employer-employee relationship exists. The IRS has found that a continuing relationship may exist where work is performed at frequently recurring intervals, even if the intervals are irregular.
7. **Set hours of work.** A worker who has set hours of work established by an employer is generally an employee. An independent contractor sets his/her own schedule.
8. **Full time required.** An employee normally works full time for an employer. An independent contractor is free to work when and for whom he or she chooses.

9. **Work done on premises.** Work performed on the premises of the employer for whom the services are performed suggests employer control, and therefore, the worker may be an employee. Independent Contractor may perform the work wherever they desire as long as the contract requirements are performed.
10. **Order or sequence set.** A worker who must perform services in the order or sequence set by an employer is generally an employee. Independent Contractor performs the work in whatever order or sequence they may desire.
11. **Oral or written reports.** A requirement that the worker submit regular or written reports to the employer indicates a degree of control by the employer.
12. **Payments by hour, week or month.** Payments by the hour, week or month generally point to an employer-employee relationship.
13. **Payment of expenses.** If the employer ordinarily pays the worker's business and/or travel expenses, the worker is ordinarily an employee.
14. **Furnishing of tools and materials.** If the employer furnishes significant tools, materials and other equipment by an employer, the worker is generally an employee.
15. **Significant investment.** If a worker has a significant investment in the facilities where the worker performs services, the worker may be an independent contractor.
16. **Profit or loss.** If the worker can make a profit or suffer a loss, the worker may be an independent contractor. Employees are typically paid for their time and labor and have no liability for business expenses.
17. **Working for more than one firm at a time.** If a worker performs services for a multiple of unrelated firms at the same time, the worker may be an independent contractor.
18. **Making services available to the general public.** If a worker makes his or her services available to the general public on a regular and consistent basis, the worker may be an independent contractor.
19. **Right to discharge.** The employer's right to discharge a worker is a factor indicating that the worker is an employee.
20. **Right to terminate.** If the worker can quit work at any time without incurring liability, the worker is generally an employee.

Three Categories of Control Factors

Over the years, the Internal Revenue Service recognized changes in business practices and therefore created three categories of factors to assess the degree of control and independence. These factors are to be used in conjunction with the 20 Factors.

1. **Behavioral Control** - Includes the type of instructions the business gives to the worker, such as when and where to do the work, and the training the business provides to the worker. The key consideration is whether the business has retained the right to control the details of the worker's performance or has relinquished that right
2. **Financial Control** - Address the business's right to control the business aspects of the worker's

job.

3. **Relationship Of Parties** - The nature of the relationship may be evidenced by:
 - i. a written contract;
 - ii. the benefits the business provides to an employee, such as paid vacation and health coverage;
 - iii. the permanency of the position; and
 - iv. the extent to which the services performed are a key aspect of the regular business of the company.

These contracts must be retained and documented for a minimum of 7 years from the year-end of their employment.

Tax Returns



It's important that all tax returns are always properly filed on time and in accordance with the IRS. The tax returns are the basis of your case with the IRS. The goal is to show and prove that your tax returns filed with the IRS match your records.

For example, you'd want to show that contracts for work billed are the same amounts shown on your independent contractor's 1099-MISC informational returns.

Bank records and canceled or voided checks should tie to the amounts billed under the contract and 1099-MISC.

Total amounts billed 1099s filed, contracts signed and checks canceled should always equal your 1096 Annual Summary and Transmittal Informational Returns.

Industry Standard Reports



Following accepted business practices is great ways to justify your tax position. It's important to obtain reliable sources such as industry reports from established research companies or professional guides, written opinions from tax professionals (attorneys and certified public accountants), governmental departments, judicial decisions and similar sources. A strong industry standard report is often a powerful tool to win an audit.

Automatic Wins

Revenue Act of 1978 Section 530 relieves businesses from Federal tax liabilities when they can show that:

1. The business did not treat an individual as an employee for any period in audit;
2. All returns were filed on a basis consistent with the workers being treated as independent contractors;
3. The business didn't treat any worker holding a substantially similar position as an employee for employment tax purposes for an period beginning after 1977; and,
4. The business had a reasonable basis for not treating the worker as an employee.
 - i. Judicial precedent, a published ruling, a letter ruling, technical advice or a determination letter issued to the taxpayer
 - ii. a prior IRS audit resulting in no assessment attributable to the treatment of the individual whose status is at issue and
 - iii. a long-standing, recognized practice of a significant segment of the taxpayer's industry.(12) Employers may also rely on any other reasonable basis for not treating a worker as an employee, such as the advice of an attorney or accountant,(13) prior state administrative action (e.g., workers' compensation decisions)(14) or other Federal determinations (e.g., determinations under the Fair Labor Standards Act).(15)



IRS Audit Victory

The IRS is an incorporated legal entity in the business of tax collection. The IRS is a corporation whose goal is to make money for the government, so it's important for the IRS to make money off of the audits that they decide to pursue. The IRS pays its auditors 100k per year, so it's in their interest to only go after businesses that unprepared because they need to make sure that their tax collections are profitable. More than 80% of the cases the IRS deals with are automatic wins because they have a lack of documentation.

Businesses with the ability to produce an audit report that contains all of their contracts, tax returns and industry standard reports within 24 hours of their IRS notice is sending a clear message. Don't mess with me! If a business can produce a complete audit defense within a short period of time, then the IRS knows that you understand the law and that you're prepared to win. The IRS would rather move on to another case and find greener pastures.

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