



DAILY TAX REPORT



Ten Things IRS Wants Workers to Consider When Contractors Become Employees

By ROBERT W. WOOD

I have often written about the myriad of tests that can apply for purposes of determining whether a worker must be treated as an employee or an independent contractor¹—the Internal Revenue Service uses one test; state unemployment development departments use one of several others; Title VII and other federal discrimination laws use another still; there are workers' compensation tests, Employee Retirement Income Security Act employee benefit criteria, and rules for agency liability.

Then there are the facts. Obviously, you must evaluate the worker contract and other documents. But the contract and other writings alone are not enough. You must also look to the entire course of conduct between the worker and the company.

A contract that purports to give the worker total freedom and to secure independent contractor services will not immunize the relationship from being recharacterized as employment. If, notwithstanding the contract, the worker receives detailed direction as to the method, manner, and means by which to do the work, that will spell employment.

Regardless of which test applies, worker status determinations can be terribly fact-intensive. What is more, precisely because there are varying tests, what satisfies one agency or party may not satisfy another. That

means you actually can end up with workers who are independent contractors for some purposes, while the same workers are employees for other purposes.

The stakes in worker status disputes are high. Understandably, most of the focus in this area is on the overall characterization question—that is, who is and is not an employee. After all, that is a rather large issue. Too frequently, though, we do not focus as much on what it will mean if the workers are in fact recharacterized.

Recently, I commented on the litany of things to be done once a worker is recharacterized.² If, either voluntarily or through some legal compulsion, a worker who is being treated as an independent contractor is ruled to actually be an employee, what happens?

It appears that I was not alone in worrying over these issues. In fact, IRS has just released its own list of steps to take after a putative independent contractor is characterized as an employee. Released in July, IRS Notice 989³ addressed commonly asked questions once IRS determines that a worker's status is that of an employee rather than an independent contractor.

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¹ See Robert W. Wood, "Independent Contractor-Versus-Employee Issues Arise in Multiple Contexts," *BNA Daily Tax Report* (192 DTR J-1, 10/4/07).

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This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

Interestingly, this notice is not a directive to employers. Rather, it is a to-do list for the workers themselves. If you are a worker being paid as an independent contractor, but you are ruled to be an employee, what should you do? Here are IRS's major points.

² See Robert W. Wood, "Ten Consequences of Reclassifying Independent Contractors as Employees," *Daily Tax Report* (123 DTR J-1, 6/30/09). See also Robert W. Wood, "Ten More Consequences of Reclassifying Independent Contractors as Employees," *Daily Tax Report* (140 DTR J-1, 7/24/09).

³ Rev. 7-2009 (153 DTR G-3, 8/12/09).

1. Consider Tax Returns And Amended Returns

IRS started off with a rather imposing category dealing with tax return filing obligations, filing amended tax returns, claims for refund, etc. Understandably, IRS said you must first ask yourself if you have filed your tax return. What you should do will hinge on how you answer that question.

If you have not yet filed your tax return for that year, and IRS rules that you are an employee, you need to report as wages on your Form 1040 the amount reported to you on Form 1099-MISC.

This may not sound like common sense. After all, you have received a Form 1099, not a Form W-2. Yet IRS is saying that even though you received a Form 1099, you were ruled to be an employee. That means your pay was really wages notwithstanding the Form 1099. Clearly, there were no Federal Insurance Contributions Act (FICA) taxes withheld from the wages, so IRS said you must compute and pay the employee portion of both the Social Security and Medicare portions of these taxes with your return.

What if you have already filed a federal income tax return and you did not report the Form 1099 amount as wages? Plainly, you would have had no reason to report the amount as wages if both you and the paying company thought you were an independent contractor. If, after filing your tax return claiming independent contractor treatment, IRS rules that you are an employee, IRS said you must file an amended tax return.

You must compute the FICA tax on the amount you were paid, and you must pay the employee portion of it. In fact, if you filed a return and reported the Form 1099 amount as income but not as wages, IRS made clear that you still need to file an amended return. In this event, you would only add to the amended return the unpaid employment tax.

What if you have already filed your income tax return and you reported the Form 1099 income as self-employment income? That would be entirely consistent with treating yourself as an independent contractor. Yet we once again assume that IRS has ruled you to be an employee.

Here, IRS said, you still have to file an amended tax return. In fact, in all likelihood, you have overpaid, because you paid self-employment tax (which is equivalent to paying both halves of FICA). Now that you are ruled to be an employee, the IRS said you must compute and pay only your one-half of the FICA tax.

You thus should get a refund, but as we will see, it is not quite so simple.

2. Why File Amended Returns?

Filing amended tax returns is time consuming and can be expensive. In fact, in my experience, taxpayers are rarely excited about the idea of filing amended returns. That can even be true where they will receive a refund.

You are, of course, required to file a tax return that is complete and accurate, and to sign it under penalties of perjury. However, amended return filing obligations are not quite so clear. Let us assume you accurately file your return based on the information you have, but you later get new information.

If you become aware of an error in a return that you previously filed, the regulations say that you “should” file an amended return to correct it.⁴ It is generally assumed (rightly or wrongly) that amended returns are out of the ordinary, and receive additional scrutiny from the IRS. Of course, amended returns showing liability for additional tax also extend the statute of limitations.⁵

Clearly, if you do choose to file an amended return, it must be accurate. That means if you become aware of three errors on a return you previously filed, you must correct all three of them if you correct any of them. Whether you are actually obligated to file an amended return is a somewhat murkier question.

In fact, many taxpayers are surprised to find that as long as they were accurate and truthful in their original return, there is no mandatory obligation to amend.⁶ IRS did not discuss this topic in Notice 989. Words mean what they say, and IRS stated clearly in Notice 989 that you “must” file an amended return.

Yet it seems equally clear (to me, at least) that this requirement in an IRS notice does not trump the statement in the Treasury regulations that you “should” (but are not actually obligated to) file an amended return.⁷ That is puzzling.

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To file an amended return, you generally must do so within three years after the date you file the original return, or within two years after the date you paid the tax, whichever is later.⁸ A return that is filed before the date it is due is considered filed on the due date. Thus, if you file a return on March 1 that is not due until April 15, it is considered filed on April 15. Three years later, it would generally be too late to amend.

The notice spent a considerable amount of time describing how to fill out an amended return, where to get forms, etc. Some new nomenclature is noted with IRS specifying that you send your amended return to the “IRS Campus” where you normally file your returns. For those failing to recognize the service’s legerdemain, an IRS “campus” used to be called a “Service Center”!

3. Watch for Corrected Forms W-2

IRS stated that if you are now treated as an employee, your employer may send you a corrected Form W-2, re-

⁴ See Treasury Regulations Sections 1.451-1(a) and 1.461-1(a)(3).

⁵ Internal Revenue Code Section 6501(c)(7).

⁶ See Treas. Reg. Sections 1.451-1(a) and 1.461-1(a)(3). See, also, *Badaracco v. Commissioner*, 464 U.S. 386, 397 (1984).

⁷ See Treas. Reg. Sections 1.451-1(a) and 1.461-1(a)(3).

⁸ See Instructions to Form 1040X.

flecting the fact that the employer has paid your (the employee) portion of the FICA tax. Strangely enough, if your employer has done that, that amount constitutes income to you in the year it is paid. Ouch!

IRS indicated that if you have already paid FICA tax on the income, you can amend your tax return to request a refund of this tax. Once again, the amended return rules kick in. Notice 989 said you must amend but the Treasury regulations only say you “should.”

4. Consider Schedule C Expenses And Proprietor Treatment

Most independent contractors include all their income and expenses from their independent contractor business on Schedules C to their IRS Forms 1040. Schedule C to Form 1040 is kind of a mini-tax return itself. It is the basic tax form for self-employed business people to complete, and would include both income and expense.

The bottom line of Schedule C is the net taxable income from the business. That net income is then entered on the face of the Form 1040 along with any other income. For someone who has been reporting independent contractor income on a Schedule C (which is the appropriate treatment for an individual independent contractor), the recharacterization can be messy.

IRS now said that you “must” file an amended return to reflect your status as an employee (again, see the discussion above about the nature of the amended return filing requirements). IRS indicated that the expenses you deducted from the income on your Schedule C must now be deducted as miscellaneous itemized deductions. Since you are not self-employed you cannot use a Schedule C. Instead, you claim your deductions on Schedule A, subject to a 2 percent limitation. Ouch again.

Not only that, IRS said, but some of the expenses may no longer be deductible at all. For example, self-employed persons are allowed a deduction on Form 1040 equal to one-half the amount of their self-employment tax. As an employee, you would lose this deduction. Triple ouch!

5. Put Other Income on Schedule C

For an independent contractor who has been reporting on a Schedule C, having to untangle everything and file an amended tax return will be a big bother. Of course, we are assuming that this is prompted by IRS’s recharacterization decision. Yet what does a worker do who performs services (as an independent contractor) for four different companies?

If that worker’s relationship with only one of them is now characterized to be “employment,” what must the worker do? The IRS answer is that the Schedule C reporting is still correct as to those other three companies. The worker would be responsible for self-employment tax on the income paid to him by those three companies.

Nevertheless, you are still required to file an amended tax return with respect to income from the one company that IRS has ruled to be your employer. You would back out deductions from your Schedule C, computing self-employment tax on the new net income (omitting the income from the one employer that you will now be reporting as wages).

In effect, you will have independent contractor (Schedule C) reporting for some income, and W-2 wage treatment for other income.

6. Beware IRS Bills and Processing

If you somehow thought an IRS ruling on employee status would translate to a slacking off or grace period on unrelated tax bills, think again.

If the worker owes money to IRS, the notice indicated that billing will continue. In fact, everything will hinge on the processing of the amended return. IRS even indicated that if you are paying IRS on an installment plan, you should continue making payments until your amended return has been processed and you have been notified by IRS whether there is any balance due.

7. What to Do About Employer Failures

IRS gave some strange advice about what to do if your employer fails to send you a corrected reporting form. Suppose you were an independent contractor receiving a Form 1099-MISC every year. IRS now rules you to be an employee for your work over the last two years. You would think the obligation would be on your employer to straighten this out.

If you do not receive a new Form W-2 from your employer, or if the amount of the Form W-2 you do receive is incorrect, you can complete an IRS Form 4852. You can use this Form 4852 as a substitute for Form W-2 to send in with your tax return or amended tax return.

IRS tells you to estimate your income as accurately as possible if you do not have evidence of the actual amounts. Of course, if you have any proof that the employer actually withheld taxes, you should include that on the Form 4852 and attach the proof to the form.

8. Consider IRS Form SS-8

IRS Notice 989 contemplates that one of the methods by which IRS determines worker status is the submission of an IRS Form SS-8. If you completed that form to respond to an inquiry from the IRS “Automated Under-Reporter” (AUR) operation, you should submit the results of the SS-8 determination to AUR.

IRS indicated that even if your case with AUR is closed, it can reconsider the outcome using the new information.

9. Consider Audit Determinations

The notice also indicated that the “you are an employee” determination may come about because of a self-employment tax deficiency brought to your attention through an IRS audit. In that event, it said, you should submit the results of the determination to the auditor.

Even if the audit is closed, the auditor can reconsider the outcome using the new information.

10. Ask the \$64,000 Question

IRS saved the \$64,000 question for near the end of Notice 989. IRS suggested that you might well ask, “What are the benefits of correcting my returns to re-

fect my status as an employee?” That is a head-scratcher.

By taking the initiative to correct your account, IRS said, you may be able to reduce or avoid any otherwise applicable interest or penalty charges on any additional tax due. Alternatively, you might receive a refund of any overpayment of tax. Finally, if you did not initially pay FICA or self-employment tax on the income, paying it now will ensure that you get credit for this income with the Social Security Administration. That may eventually go into your benefits someday.

If you are like me, this seems like a pretty lukewarm list of benefits, especially considering the enormous hassle involved. For one thing, a common misconception relates to self-employment tax. Self-employment tax is a whopping 15.3 percent. A worker who was an independent contractor and now is an employee might think he or she would get all the self-employment tax back. Not so, said the IRS notice.

In fact, the amount of FICA tax the worker owes will be compared to the self-employment tax he or she originally paid. That is one variable. Plus, you must examine whether any of the business expenses you originally deducted on Schedule C can be transferred to Schedule A. Schedule A deductions are much more limited.

There are also certain deductions to which one is entitled as a self-employed person that one cannot claim as an employee. These include one-half of the self-employment tax paid, the self-employment health insurance deduction, deductions for retirement plans, etc.

Finally, your tax computation will need to reflect changes (positive or negative) to your tax computation based on alternative minimum tax, earned income credit, credit for child and dependent care expenses, etc. That means you can actually end up owing more in taxes after the reclassification.

Conclusion

It is becoming common knowledge that worker status disputes are messy. It is also becoming common knowledge that precisely how one assesses workers and evaluates the status of workers can be complicated and quite fact-specific. Fewer and fewer people today tend to assume that if you call someone an independent contractor—even in writing—it must be immutably true.

It is good that we are collectively becoming sensitive to these issues. Indeed, whether for purposes of IRS, unemployment insurance, workers’ compensation, ERISA, agency liability, labor law compliance, or some

other purpose, most of us know that the real substance of the relationship will control. That plainly does not mean that everyone is an employee.

What it does mean is that merely labeling someone as an independent contractor tells you relatively little. Beyond these platitudes, though, many people (including many lawyers, and even including many tax lawyers) do not think too much about the consequences of recharacterization, either retroactively or prospectively. I believe this is particularly true at the worker level.

I am not suggesting that recharacterization is a bad deal for the worker. In fact, a recharacterization from independent contractor to employee status for the worker may be a very good deal. The worker may receive employee fringe and pension benefits, may be entitled to reimbursement for business expenses, may be entitled to federal and state minimum wage and hour standards, and may receive coverage under nondiscrimination statutes, unemployment insurance, and workers’ compensation protection, to name only a few advantages. The list of potential benefits to the worker is long and comprehensive.

Of course, remember that Notice 989 addressed an IRS ruling on employee status only. The IRS notice is presumably of no effect if a labor board, unemployment insurance commissioner, state taxing authority, or court in a civil dispute makes the ruling that you are an employee. Although one recharacterization domino may knock over another, which, in turn, knocks over a third, the IRS’s new notice should not affect other agency rulings until the IRS weighs in and makes its own worker status ruling.

Yet IRS’s recent notice clearly indicates that some level of compliance by the worker will be expected. Whether the burden of that compliance should be placed on the worker (as IRS seeks to do in this notice) is debatable. Moreover, I question the extent to which IRS can effectively attempt to impose mandatory amended tax return filing obligations, when the prevailing Treasury regulations clearly use permissive (and not mandatory) language.

Finally, even if it is appropriate to place the compliance burden on the worker, and even if IRS meant “must” (in the notice) when it said “should” (in the regulations), and even if an IRS notice can supersede a Treasury regulation (!), is IRS Notice 989 realistic? I question whether a significant number of workers in this situation will be both willing and able to follow through as IRS expects.