Worker Contractor/Employee Classification Up for Debate

The question of whether a worker is an independent contractor or employee for federal income and employment tax purposes is a complex one. It is topic of recent government research and debate, and the statistics are alarming. A recent IRS study found that 15% of employers misclassified 3.4 million workers as independent contractors, which caused an estimated tax loss of $2.7 billion dollars. As the federal and state governments are searching for ways to narrow the tax gap, stricter enforcement of worker classification and less lenient legislation proposals are on the horizon. As the construction and real estate industries often face the issue of how to classify workers, it is important to understand the difference between employees and independent contractors.

If a worker is an employee, the company has a list of responsibilities. The company must withhold federal income and payroll taxes, pay the employer's share of FICA taxes on the wages plus FUTA tax, and often provide the worker with fringe benefits it makes available to other employees. There may be state tax obligations as well.

These obligations don't apply for a worker who is an independent contractor. The business sends the independent contractor a Form 1099-MISC for the year showing what he or she was paid (if it amounts to $600 or more), and that's it! It is then the independent contractor's responsibility to report the income and pay the taxes on their personal income tax return. An IRS study found that workers misclassified as independent contractors, for whom employers did not report compensation on Form 1099-MISC, reported only 29% of their compensation on their tax returns. It is clear that it is in the government's best interest to enforce the proper classification of workers and keep the majority of withholding and filing responsibilities at the company level.

Who is an "employee?" There is no uniform definition of the term.

Under the common-law rules (so-called because they originate from court cases rather than from the tax code), an individual generally is an employee if the enterprise he works for has the right to control and direct him regarding the job he is to do and how he is to do it. Otherwise, he is an independent contractor.

Some employers that have misclassified workers as independent contractors are relieved from employment tax liabilities under Section 530 of the '78 Revenue Act (not the Internal Revenue Code). In brief, Section 530 protection applies only if the employer: filed all federal returns consistent with its treatment of a worker as an independent contractor; treated all similarly situated workers as independent contractors; and had a "reasonable basis" for not treating the worker as an employee. For example, a "reasonable basis" exists if a significant segment of the employer's industry has traditionally treated similar workers as independent contractors.

Individuals who are "statutory employees," (that is, specifically identified by the tax code as being employees) are treated as employees for social security tax purposes even if they aren't subject to an employer's direction and control (that is, even if the individuals wouldn't be treated as employees under the common-law rules). Statutory employees may or may not be employees for non-FICA purposes. Corporate officers are statutory employees for all purposes.

Individuals who are statutory independent contractors (that is, specifically identified by the tax code as being non-employees) aren't employees for purposes of wage withholding, FICA or FUTA, and the income tax rules in general. These individuals are qualified real estate agents and certain direct sellers.

Some categories of individuals are subject to special rules because of their occupations or identities. For example, corporate directors aren't employees of a corporation in their capacity as directors, and partners of an enterprise organized as a partnership are treated as self-employed persons. Under certain circumstances, you can ask IRS (on Form SS-8) to rule on whether a worker is an independent contractor or employee.

What does this mean for the real estate industry?

The IRS is increasing its efforts in tracking down unreported income. We have seen an escalation of IRS notices sent to clients in the real estate industry. When a 1099-MISC is filed with the IRS, the IRS matches the name and the taxpayer identification number (TIN) with those already in their database. The IRS can then cross-check that the income reported on the 1099-MISC is picked up on the independent contractor's tax return. If the name and/or the TIN on the 1099-MISC is either missing or does not match what the IRS already has in their system, a notice will be sent to the payer. Sometimes, the error is a quick fix and no further action is required.

When the information reported on the 1099-MISC is missing or incorrect, the IRS may require the payer to perform additional procedures. The payer may have to send a B-Notice to the payee and begin backup withholding at the rate of 28%. A W-9 may have to be sent to the payee to obtain accurate name and TIN information. The IRS is placing the responsibility on the payer to adequately collect and report the payee's information.

In addition, the IRS is tightening the reporting requirements on the real estate industry beginning January 1, 2011. Under the old law, all persons engaged in a trade or business who make certain payments of $600 or more in a given year to another person are required to report that information to the IRS on Form 1099-MISC. This requirement did not extend to taxpayers whose rental real estate activity was not considered to be a "trade or business." The reporting requirement also did not apply if the payee was incorporated.

The Small Business Jobs Act of 2010 has changed this law for payments made after December 31, 2010. For purposes of the section within the Internal Revenue Code which controls information reporting, *any* person receiving rental income from real estate activities (no matter how much!) will be considered to be in the trade or business of renting property. In effect, all persons who receive rental income will have to report all payments made to another person or entity in a given year that amounts to $600 or more. This includes corporations!

What can you do to comply with the new law and avoid IRS matching notices? Be sure you are correctly classifying your workers as either employees or independent contractors. Give a W-9 to all workers and service providers, to ensure that you have the proper taxpayer name and TIN. Keep track of payments made to each worker and service provider in order to quickly ascertain at the end of the year who meets the $600 threshold reporting requirement.

Looking on the horizon, the trend with the IRS will be to continue the expansion of payer responsibilities in reporting requirements. More information will need to be reported, and requirements will tighten across all industries. Understanding the changing laws and finding ways to efficiently comply will be a challenge for the real estate industry for the foreseeable future.

If you'd like to discuss these complex rules and see how they apply to your business, please contact us to arrange for an appointment.