

Chapter 1: Employment Taxation

| | | | |
|---|----|---|----|
| Employee versus Independent Contractor..... | 2 | Household Workers..... | 29 |
| Section 530 Relief..... | 11 | Reporting Fringe Benefits on the W-2..... | 35 |
| Statutory and Nonstatutory Employees | 16 | Miscellaneous Payroll Rules..... | 36 |
| Employment Tax Treatment..... | 23 | | |

Corrections were made to this workbook through January of 2009. No subsequent modifications were made.

Employment taxation compliance continues to interest the IRS. In 2008, a new form was created to report uncollected social security and Medicare tax on wages. A worker classified by an employer as an independent contractor, but who is actually an employee, can report and contribute his share of FICA and Medicare taxes using Form 8919, *Uncollected Social Security and Medicare Tax on Wages*. Information about this form is covered later in the chapter.

The Internal Revenue Manual identifies three goals for employment tax area compliance:

1. Ensure all employers and workers are filing timely, accurate, and fully-paid returns;
2. Ensure workers are properly classified as employees or independent contractors; and
3. Ensure all remuneration subject to employment tax is reported.¹

This chapter mainly focuses on information related to the second goal.

As emphasized in a November 2007 Tax Talk Today webcast, employment taxation continues to be an important issue. Properly classifying workers as either independent contractors or employees continues to concern the IRS. Much of the material for this chapter is based on information found on the IRS website and the IRS audit training manual entitled *Independent Contractor or Employee?* Even though this manual was written in 1996, the IRS still uses it to train auditors.²

On November 6, 2007, the IRS entered into a Questionable Employment Tax Practices (QETP) Memorandum of Understanding (MOU) with 29 state workforce agencies³ to exchange information for the purpose of identifying employment tax schemes and practices that have no objective other than avoiding federal or state employment tax.⁴ In particular, the purpose of the MOU is to:

- Increase compliance with federal and state employment tax filing and payment regulations,
- Increase compliance with Form 1099 and Form W-2 filing,
- Increase collection of federal and state employment/unemployment tax debts,
- Enhance efforts to reduce the tax gap at the federal and state levels, and
- Ensure businesses operate on a competitive. level playing field and pay their proper share of employment taxes.

¹. IRM 4.23.2.2

². www.irs.gov/pub/irs-utl/emporind.pdf. Accessed on June 6, 2008.

³. Arizona, Arkansas, California, Colorado, Connecticut, Hawaii, Idaho, Kentucky, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Nebraska, New Hampshire, New Jersey, New York, North Dakota, Ohio, Oklahoma, Rhode Island, South Carolina, South Dakota, Texas, Utah, Vermont, Virginia, Washington, and Wisconsin

⁴. FS 2007-25 (November 6, 2007)

2008 Workbook

In other IRS efforts to support improved worker classification, Circular 230, *Regulation Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries and Appraisers Before the Internal Revenue Service* informed tax practitioners that if they know of inappropriate tax treatment of employees, they have a requirement to notify the taxpayer, and if necessary, remove themselves from the engagement.

Although several employment taxation compliance areas are of concern, the IRS focuses a lot of effort on the proper classification of workers. Are workers independent contractors or are they employees?

EMPLOYEE VERSUS INDEPENDENT CONTRACTOR

The consequences of treating an employee as an independent contractor can be severe. If a worker is misclassified as an independent contractor, the employer may be liable for employment taxes for that worker. If the employer is not eligible for Section 530⁵ relief provisions (discussed later), the employer may have liability beyond the unpaid employment tax depending upon the employer's particular circumstances for not paying the tax.⁶

Incorrectly classifying workers can also affect qualified retirement plans, health insurance, workers' compensation, and unemployment insurance. If employers misclassify workers as independent contractors, the employer's retirement plan could be disqualified if it doesn't meet certain tests. If a worker is classified as an independent contractor and has a self-employed retirement plan, and then is reclassified as an employee, he could be subject to substantial penalties for overcontributing to his self-employed retirement plan. Correctly classifying workers is crucial to both the employer and the worker.⁷

IRC §3121(d) contains four categories of employees for purposes of FICA tax. A worker is classified as an **employee** if he is one of the following:

- A common-law employee;
- A corporate officer;
- An employee as defined by statute, commonly referred to as a "statutory employee;" or
- An employee covered by an agreement under Section 218 of the Social Security Act.

By statute, workers in three occupations are not treated as employees, and are commonly referred to as **statutory nonemployees**.⁸ They are not classified as employees for purposes of FICA, FUTA, or federal income tax withholding as long as they meet specific qualifications. These workers are:

- Real estate agents,
- Direct sellers, and
- Companion sitters.

COMMON-LAW STANDARD

The common-law standard is used to determine a worker's status. This standard was created through actions taken by the courts over many years. Under common law, the treatment of a worker as an independent contractor or an employee originates from the legal definitions developed in the law of agency action — whether one party, the principal, is legally responsible for the acts or omissions of another party, the agent — and depends on the principal's right to direct and control the agent.

⁵ Section 530 of the Revenue Act of 1978

⁶ IRC §3509

⁷ "What's Hot in Employment Taxes: Independent Contractor or Employee?," *Tax Talk Today* (November 6, 2007)

⁸ IRC §§3508 and 3506

Following the common-law standard, employment tax regulations provide that an employer-employee relationship exists when the business has the **right to direct and control** the worker who performs services for the business. An employee is subject to the **will and control** of the business not only in regard to **what** work is done, but also **how** it is done. It is not necessary that the business actually directs or controls the manner in which the services are performed; it is sufficient if the business has the **right** to do so. This is true even if the employer gives the employee freedom of action. If an employer-employee relationship exists, it doesn't matter what the relationship is called. The employee may be called an "agent" or "independent contractor." If an employer-employee relationship exists, how payments are measured or paid, or what payments are called has no bearing on the classification of the worker. It also doesn't matter if the employee works full- or part-time.⁹

Over the years, the IRS and the Social Security Administration compiled a list of 20 factors used in court decisions to determine worker status. These factors were eventually published in Rev. Rul. 87-41 and are sometimes called the **Twenty Factor Test**. The Twenty Factor Test is an **analytical tool**. It is not the legal test used for determining worker status. The **legal test** is whether there is a **right to direct and control the means and details of the work**.

Since the list of 20 factors was developed over 20 years ago, some of the factors are no longer as relevant as they once were. For example, one of the 20 factors deals with the place of employment. Twenty years ago, there were few telecommuters, whereas now, telecommuting is quite common. In 1996, the IRS categorized the 20 factors into three types of evidence that are now used to evaluate independent contractor status. When determining worker classification, the following facts in all categories are considered.

1. Behavioral control
2. Financial control
3. Relationship of the parties

Behavioral Control

Whether the employer has the right to direct or control how a worker does his work determines behavioral control. Even if the employer doesn't **actually** direct or control the way work is done, it is sufficient if the employer has **the right** to direct or control the work.¹⁰ Examples of ways employers direct and control how work is done are to provide instruction and training. Other factors that may influence worker classification are performance evaluation systems, worker identification, and the occupation of the worker.

Instruction. Virtually every business instructs workers on how to accomplish the job, whether they are independent contractors or employees. Therefore, the fact that a business provides instruction is not sufficient to determine the worker's status. Does the business retain the right to control the details of a worker's performance, or does it give up its right to control the details? Do instructions apply to how the job gets done rather than the end result? If the focus of instruction is how the work is to be done, then the worker is likely classified as an employee.

Instructions about **how to do the work** may cover a wide range of topics, including:

- When to do the work,
- Where to do the work,
- What tools or equipment to use,
- What workers to hire to assist with the work,
- What work must be performed by a specific individual (including ability to hire assistants),
- What routines or patterns must be followed, and
- What order or sequence to follow.

⁹ IRS Pub. 15, *Circular E, Employer's Tax Guide*

¹⁰ IRS Pub. 1779, *Independent Contractor or Employee?*

2008 Workbook

For example, instructions may explain the requirement that a worker obtain approval before taking certain actions.

Example 1. Lyle was hired by Premier Manufacturing Company as a management consultant for its sales department. According to Premier, Lyle's responsibilities are to:

- Ensure that the sales department is fully staffed,
- Ensure that all materials used by the sales agents are stocked and available, and
- Review all sales contracts.

Premier requires Lyle to secure prior approval to:

- Hire and/or fire within the sales department,
- Purchase additional materials as needed by the sales agents, or
- Accept any sales contract prepared by the sales department.

Premier's requirement that Lyle secure prior approval is evidence of control over Lyle's behavior in the performance of Lyle's services. Lyle is considered an employee in regard to the behavioral control test.

Example 2. Use the same facts as **Example 1**, except Premier does not require Lyle to secure prior approval to hire and fire, purchase materials, or accept sales contracts.

The absence of detailed instructions as to how Lyle will perform the job function is evidence of Lyle's autonomy in work performance. Lyle is an independent contractor in regard to the behavioral control test.

If the worker's instructions are very detailed, this demonstrates a high level of control by the business.

Example 3. Jeffrey is an independent truck driver. He received a call from the Yaro Manufacturing Company to make a delivery run from the Gulf Coast to the Texas Panhandle. Jeffrey accepts the job and agrees to pick up the cargo in the morning. Upon arriving at the warehouse, Jeffrey is given an address where the cargo is to be delivered and is advised that the cargo must be delivered within two days. This direction of instruction relates to what is to be done rather than how it is to be done. Jeffrey is considered an independent contractor.

Example 4. Terrance is a truck driver. He makes local deliveries for Zorro Manufacturing Company. Terrance reports to the warehouse every morning. The warehouse manager tells Terrance what deliveries have to be made, how to load the cargo in the truck, what route to take, and the order in which various elements of the cargo must be delivered. This instruction relates to **how** the work is to be performed. Terrance is considered an employee.

Although the presence and extent of instructions are important, it is also important to consider the importance of those instructions. Are they only imposed by the business in order to be in compliance with governmental or governing body regulations? If a business requires its workers to comply with third-party rules (e.g., municipal building codes related to construction), the fact that these rules are imposed does not demonstrate behavioral control for determining the worker's status. If the business develops more stringent guidelines for a worker, in addition to those imposed by a third party, then the business likely retains the right to control the worker.

A customer may require the business to accomplish work in a particular way ("how"). If the business passes on the customer's instructions to the worker, it has, in essence, adopted the customer's standards as its own. This situation constitutes the right to direct and control the worker's behavior.

Performance Evaluation. The extent to which the business retains the right to control the worker's compliance with instructions, and the effect on the worker in the event of noncompliance helps determine employee status. Most businesses use some type of evaluation system to monitor the quality of work performed by workers, whether independent contractors or employees. Therefore, the fact that a business has an evaluation system does not necessarily prevent the worker from having independent contractor status. If an evaluation system measures compliance with performance standards concerning the **details** of **how** the work is to be performed, then the business controls worker's behavior.

Worker Identification. The fact that a worker wears the business' uniform or has the business' logo on his vehicle does not necessarily indicate employee status. With increasing safety concerns, many businesses provide customers with some reassurance about the identification of workers who have access to their homes or workplaces.

Worker Occupation. The nature of a worker's occupation also affects the degree of direction and control necessary to determine worker status. Highly-trained professionals such as doctors, accountants, lawyers, engineers, or computer specialists may require minimal instruction on how to perform their services.¹¹ Nevertheless, an employer-employee relationship can exist between a business and workers in these occupations.¹²

An employment relationship may exist when work can be done with minimal direction and control, such as work done by a stockperson or store clerk. The absence of **need to control** should not be confused with the absence of **right to control**. The key factor is whether the business retains the **right** to direct and control the worker, regardless of whether a business actually exercises this right.

Training. Explaining detailed methods and procedures to use when performing a task is the purpose of training. Periodic or ongoing training provided by a business about procedures and methods to use indicates that the business wants the services performed in a particular manner. Training on work procedures and methods is strongly associated with an employer-employee relationship.

However, not all training rises to this level. Some types of training are not suggestive of employee status, such as:

- Orientation or information sessions about the dismissal policies, or
- Programs that are voluntary and are attended by a worker without compensation.

Financial Control

The economic aspects of the relationship between the business and the worker help determine the worker's status. Who has the right to control financial aspects of the activities undertaken is important. Financial aspects include:

- Significant investment,
- Opportunity for profit or loss,
- Unreimbursed expenses,
- Services available to the relevant market, and
- Method of payment.

All of these have a bearing on whether the worker has the right to direct and control the means and details of the business (financial) aspects of how services are performed.

Significant Investment. A significant investment indicates an independent contractor relationship may exist, although it is not necessary for independent contractor status. Some types of work simply do not require large expenditures. Even if large expenditures (such as costly equipment) are required, an independent contractor may rent the equipment needed at fair rental value.

¹¹ Treas. Reg. §31.3121(d)-1

¹² *James v. Comm'r*, 25 TC 1296 (Mar. 22, 1956)

2008 Workbook

No precise dollar limits exist that equate to a significant investment. However, the investment must have substance. As long as the worker pays fair market or fair rental value, the worker's relationship to the seller or lessor is irrelevant. The worker's investment and the risk borne by the worker are not diminished merely because the seller or lessor receives the benefit of the worker's services.

Example 5. Carla is a backhoe operator for Young Distributing Company. Young treats Carla as an independent contractor. Young claims that Carla has a significant investment in the \$75,000 backhoe that she uses. In reality, Carla leases the backhoe at less than fair rental value and can return it at any time without liability or further payments. Young pays liability insurance and regular maintenance on the backhoe. Carla's expense relates to backhoe rental. Based on the facts, Carla does not have a significant investment, although she may still be appropriately classified as an independent contractor.

Realization of Profit and Loss. The ability to realize a profit or loss is one of the strongest indicators that the worker controls the business aspects of services rendered. If the worker makes decisions which affect his bottom line, the worker likely has the ability to realize profit or loss. This ability makes it likely that the worker is an independent contractor. Examples of profit/loss decisions include the types and quantities of inventory to acquire, the type and amount of monetary or capital investment, and whether to purchase or lease premises or equipment. Although employees can also make these types of decisions, they usually affect the **employer's** bottom line.

Sometimes a worker's pay can vary by working more or less hours, thus incurring a profit or loss. However, this type of income variation is consistent with employee status and does not distinguish employees from independent contractors.

Business Expenses. The extent to which a worker chooses to incur expenses and bear their costs affects the worker's opportunity for profit or loss. This indicates the worker has the right to direct and control financial aspects of his business operations. Although not every independent contractor needs to make a significant investment, almost every independent contractor incurs an array of business expenses. These are either in the form of direct expenditures or fees for pro rata portions of one or several expenses. These may include:

- Rent and utilities,
- Tools and equipment,
- Training,
- Advertising,
- Payments to business managers and agents,
- Wages or salaries of assistants,
- Licensing/certification/professional dues,
- Insurance,
- Postage and delivery,
- Repairs and maintenance,
- Supplies,
- Travel,
- Leasing of equipment,
- Depreciation, and
- Inventory/cost of goods sold.

Unreimbursed expenses are indicative of independent contractor status because these affect the worker's profits and losses. Independent contractors are more likely to incur fixed ongoing costs regardless of whether any work is performed. On the other hand, employees may also incur unreimbursed expenses in connection with the services they perform; however, they are usually relatively minor. Sometimes employees in certain lines of business may incur more significant unreimbursed expenses, such as an auto mechanic's tools.

Services Available to Relevant Market. An independent contractor is generally free to seek out business opportunities from a variety of sources. Independent contractors often advertise their business, maintain a visible business location, and are available to work in the relevant market. All of these aspects affect the worker's ability to realize profit and loss.

Method of Payment. The method of payment may indicate whether the worker has the opportunity for profit or loss. A worker who is compensated on an hourly, daily, weekly, or similar basis is guaranteed a return for labor. This generally indicates an employer-employee relationship, even when the wage or salary is accompanied by a commission. However, in some professions, like law, it is common to pay independent contractors on an hourly basis. Paying a flat fee for services generally indicates an independent contractor relationship, especially if the worker incurs the expenses of performing the services. The timing of payments (daily, weekly, or monthly) is not relevant.

Relationship of the Parties

The relationship between the worker and the business help determine worker status. Some aspects that help define the relationship are:

- Written contracts describing the intended relationship,
- Employee-type benefits,
- Permanency of the relationship, and
- Extent of worker services being a key aspect of the business.

Intent of Parties. Many factors reflect on how the worker and employer perceive their relationship to each other. One aspect is the contractual relationship between the parties. A written agreement describing the worker as an independent contractor indicates the parties' **intent** that a worker be an independent contractor.

However, a contractual designation is not sufficient evidence for determining worker status. The facts and circumstances under which a worker performs services are determinative of the worker's status. The designation or description of the parties is immaterial. The **substance of the relationship**, not the label, governs the worker's status. The contract may be relevant in ascertaining methods of compensation, expenses that will be incurred, and the rights and obligations of each party as to how work is performed.

In the *Illinois Tri-Seal Prods* case,¹³ window installers were found to be independent contractors. The case contains helpful discussions of the distinction between instructions and suggestions, and the parties' view of the relationship in close cases.

Employee-Type Benefits. A worker who receives no employee-type benefits is not necessarily classified as an independent contractor. However, a worker who is provided with employee-type benefits is generally classified as an employee. Providing a worker with benefits traditionally associated with employee status has been an important factor in several court cases. A worker who receives employee benefits, such as paid vacation days, paid sick days, health insurance, life or disability insurance, or a pension, is likely classified as an employee. The strongest evidence of employee status exists when the worker is provided with employee benefits under a tax-qualified retirement plan.¹⁴

¹³ *Illinois Tri-Seal Prods. v. U.S.*, 353 F.2d 216, 231 (Ct. Cl. 1965)

¹⁴ *Weber v. Comm'r*, 94-2609 (4th Cir. 1995), *aff'g* 103 TC 378

2008 Workbook

Characterizations of a worker as an employee for various benefits based on state laws or state and federal agency determinations are irrelevant for determining worker status. This is the case because laws or regulations may use different definitions of employee or be interpreted to achieve particular policy objectives.

Discharge or Termination. Traditionally, if a business may terminate a work relationship at will without penalty, this provides a highly effective method to control the details of how work is performed and indicates that an employee status exists. Conversely, in the traditional independent contractor relationship, the business can terminate the relationship only if the worker fails to provide the intended product or service. This is indicative of the business not having a right to control how the work is performed.

Actual practice may be somewhat different. Businesses rarely have complete flexibility in discharging an employee. The business may have to pay severance pay in lieu of notice, “golden parachutes,” or other forms of compensation when it discharges an employee. The reasons that a business may use to terminate an employee may be limited by law, by contract, or by its own practices. As a result, the inability to freely discharge a worker no longer proves that the worker is an independent contractor.

Because the significance of facts bearing on the right to discharge/terminate is so often unclear and depends primarily on contract labor law, this type of information is rarely used for status determination.

Permanency of Relationship. The permanency of a business-worker relationship is frequently used by courts to determine whether there is an employer-employee relationship. If the business engages a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period of time, this generally indicates the business’ intent to create an employment relationship.¹⁵

However, a relationship created with the expectation that it will be indefinite is different than a long-term relationship. A long-term relationship may exist between a business and an independent contractor such that:

- The contract may be for a long term; or
- Contracts may be renewed regularly due to superior service, competitive costs, or lack of alternative providers.

A business may also have a relationship with an employee that is long-term, but not indefinite. This could occur if:

- Temporary employment contracts are renewed; or
- A long-term, but not indefinite, employment contract is entered into.¹⁶

Consequently, a relationship that is long-term, but not indefinite, is a neutral fact and is often disregarded as an indicator of worker status. While an independent contractor typically has a temporary relationship with the business, an employee may be engaged on a seasonal, project, or “as needed” basis.

Worker Services Are Key Aspect of Business. The courts have looked at the services performed by the worker and the extent to which those services are a key aspect of the company’s regular business. The fact that a service is desirable, necessary, or even essential to a business does not mean that the service is provided by an employee. An appliance store needs workers to install electricity and plumbing in the store building. However, this work can be done equally well by independent contractors or employees. In this case, the work the electricians and plumbers perform in the store is not the store’s regular business.

In contrast, the work of an attorney or paralegal is part of the regular business of a law firm. If the law firm hires an attorney or paralegal, it is likely that it presents the worker’s work as its own. As a result, it is likely that the law firm directs or controls the worker’s activities. In this case, the workers are employees. However, it is possible that the work performed is part of the principal business of the law firm, and it hired outside specialists who are independent contractors.

¹⁵ *Jones v. Comm’r*, TC Memo 2007-249 (Aug. 27, 2007)

¹⁶ *Fox v. U.S.*, 74-1 USTC ¶9460 (Apr. 1, 1974)

Incorporation. A worker may form a corporation through which he performs services and still be an employee of the business that engages the corporation. Provided that the corporate formalities are properly followed and at least one nontax business purpose exists, the corporate form is generally recognized for both state and federal law, including federal tax purposes. Disregarding the corporate entity is generally an extraordinary remedy, applied by most courts only in cases of clear abuse. Thus, the worker will usually not be treated as an employee of the business, but as an employee of the corporation.

If the worker formed an S corporation, the IRS will look at the S corporation to determine if the worker is an employee of the corporation.¹⁷

However, the fact that the worker receives payment for services from a business through the worker's corporation does not automatically require a finding of independent contractor status for those services. In the *Sargent* case, a professional athlete attempted to assign a salary received from the team to a wholly-owned professional corporation. He was nevertheless classified as a common-law employee of the team, rather than the professional corporation.¹⁸

There are numerous cases where judges have determined whether a person was a common-law employee using the factors discussed above.¹⁹

IRC §3509 REDUCED RATES

Employers may now rely on IRC §3509 when the employer reclassifies a worker following receipt of a determination letter from the IRS regarding worker reclassification or in an employment tax examination. IRC §3509 provides reduced rates for certain employment taxes when a worker is reclassified as an employee. If the employer had provided an information document (Form 1099-MISC) to the worker or the payment to the worker was less than \$600, the liability is reduced to 1.5% for federal income tax withholding and 9.18% (120% of 7.65%) for FICA and Medicare. The employer previously would have been subject to both the employer and employee portion (15.3%). The percentage is doubled to 3% for federal income tax withholding and 10.71% (140% of 7.65%) for FICA and Medicare if the employer fails to provide an information document if required to do so.

SCENARIOS

Read the following scenarios and determine whether the worker should be classified as an employee or an independent contractor, or what additional information is needed.

Scenario 1. Dr. Brown owns and operates Acme Medical Center, which provides a variety of medical services. To better serve his patients, Dr. Brown purchased an x-ray machine and hired Dr. Clark to read the x-rays. Dr. Clark is a highly-skilled and highly-trained radiologist. Dr. Brown bills and collects for all of Dr. Clark's services. Dr. Clark works solely for Dr. Brown.

What is the most probable worker status for Dr. Clark and why? What additional information is needed if status is uncertain?

Scenario 2. Leila is a sole practitioner attorney who rents office space and pays for the following items: telephone, computer, online legal research, fax machine, and photocopier. She buys office supplies and pays for bar association and membership dues for three professional organizations. Leila hires a part-time receptionist who also does the bookkeeping. She pays the receptionist, withholds and pays federal and state employment taxes, and files a Form W-2

¹⁷ *Joseph M. Grey Pub. Accountant, P.C. v. Comm'r*, 119 TC 121 (2002), *aff'd* 93 Fed.Appx. 473 (3rd Cir. 2004) (unpublished opinion), *cert. denied sub nom*; *Nu-Look Design, Inc. v. Comm'r*, TC Memo 2003-52 (Feb. 26, 2003), *aff'd* 356 F.3d 290 (3rd Cir. 2004), *cert. denied* 125 S.Ct. 60 (2004); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990)

¹⁸ *Sargent v. Comm'r*, 93 TC 572 (1989), *rev'd* 929 F.2d 1252 (8th Cir. 1991). *Sargent's* reversal by the 8th Circuit illustrates the courts' reluctance to disregard the corporate entity.

¹⁹ *Orion Contracting Trust v. Comm'r*, TC Memo 2006-211 (Sep. 27, 2006); *Kumpel v. Comm'r*, TC Memo 2003-265 (Sep. 10, 2003); *Ronald McLean E. Video v. Comm'r*, TC Memo 2003-13 (Jan. 14, 2003); *Weber v. Comm'r*, 103 TC 378 (1994), *aff'd* 60 F.3d 1104 (4th Cir. 1995); *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318 (1992)

2008 Workbook

each year. For the past two years, Leila's only client was a corporation for which there has been a long-standing relationship. She charges the corporation an hourly rate for services and sends monthly invoices that detail the work performed for the prior month. The bills include charges for long-distance calls, online research time, fax charges, photocopies, mailing costs, and travel costs which the corporation has agreed to reimburse.

What is the most probable worker status for Leila and why? What additional information is needed if status is uncertain?

Scenario 3. Manny, a sole proprietor, owns a building supplies business and has an exclusive contract with Home Stuff, a building materials manufacturer. Manny has the sole right to the territory he covers, and he sells only Home Stuff's products. He did not pay for the right to the territory.

Manny is a civil engineer and pays dues to several professional associations. He has an office and a secretary. Home Stuff does not reimburse him for these expenses. Manny's name appears in the yellow page advertisements under his own business name and the name of Home Stuff. Manny is required to provide regular sales reports to Home Stuff and attend sales meetings and trade shows conducted in his territory.

Manny bids on portions of major commercial construction contracts. These jobs require engineering skills and design work to adopt the building materials to the project plans. All bids are subject to the manufacturer's post-review. Upon winning the bid, Manny hires and pays workers who install the building material, and he provides the necessary construction bonds. Manny submits invoices to the general contractor for payment directly to his business on forms proscribed by Home Stuff. If the general contractor fails to pay, Manny is responsible for collecting unpaid amounts and is liable to Home Stuff for payment.

What is the most probable worker status for Manny and why? What additional information is needed if status is uncertain?

Scenario 4. Harv is a computer programmer. He is laid off when Beta Company downsizes. Beta agrees to pay Harv \$10,000 to complete a one-time project to create a certain product. It is not clear how long it will take to complete the project, and Harv is not guaranteed a minimum payment for the hours spent on the project. Harv does his work on a new high-end computer, which cost him \$5,000. He works at home and is not expected or allowed to attend Beta Company meetings. Beta provides Harv with no instructions beyond the specifications for the product. Harv and Beta have a written contract, which provides that Harv is considered an independent contractor, is required to pay his own federal and state taxes, and receives no employee benefits from Beta. Beta files a Form 1099 for Harv at the end of the year.

What is the most probable worker status for Harv and why? What additional information is needed if status is uncertain?

ANALYSES

Analysis 1. Dr. Brown does not instruct Dr. Clark on how to take and read x-rays. However, other evidence is consistent with employee status. The extent of financial control or the contractual relationship with the parties indicates a right to direct and control Dr. Clark. The financial control by Dr. Brown over such details of Dr. Clark's radiological practice as fees, billings, and collections indicates an employee/employer relationship.

Analysis 2. Some of the factors to analyze include:

| Employee | Neutral Value | Independent Contractor |
|---------------|---|--|
| Single client | Paid by the hour Reimbursed for expenses Payment of bar dues Direction | Hired secretary No financial control Opportunity for profit or loss Economic independency |

Leila could be an independent contractor. At the beginning of the relationship, independent contractor status is clear. However, at the end it is less clear. It is uncertain whether the attorney is an employee even with the addition of the last fact.

Analysis 3. Some of the factors to analyze include:

| Employee | Neutral Value | Independent Contractor |
|--------------------------------------|----------------------------|------------------------------------|
| One party (exclusive contract) | Civil engineer | Own expenses |
| Subject to management post-review | Professional organizations | Advertises |
| Attends meetings and submits reports | | Liable for payment to manufacturer |
| Uses manufacturer's forms | | Hires workers for installation |
| | | Submit invoice to GC for payment |
| | | Must pay bills |

Manny is an independent contractor. Although Home Stuff post-reviews his paperwork and bids and imposes common meeting requirements, these facts are outweighed by Manny's potential to experience profit or loss and the ability to direct and control the work.

Analysis 4. Some of the factors to analyze include:

| Employee | Neutral Value | Independent Contractor |
|--|--------------------------|---|
| Laid off; hired back for same kind of job | Cost of equipment | One time job |
| | Work at home | No minimum payment |
| | Length of time for "job" | Not expected or allowed to go to meetings |
| | No benefits | Written contract |
| | | Form 1099 (intent) |
| | | Pays own taxes |
| | | No benefits |
| | | No instructions —only specifications |

Harv is considered an independent contractor for the services he provided to Beta based on the majority of the evidence.

Caution. The IRS will begin to electronically identify companies who issue five or more Forms 1099-MISC totaling \$25,000 or more to workers who have no other sources of earned income. These businesses can expect employment audits in 2008.²⁰

SECTION 530 RELIEF

If an employer classifies an employee as an independent contractor and has no reasonable basis for doing so, the employer may be held liable for employment taxes for that worker. If the employer had a reasonable basis for treating the employee as an independent contractor, then relief from paying employment taxes may be available under Section 530 of the Revenue Act of 1978. This section was amended twice since 1978; once with the Tax Reform Act of 1986, and again with the Small Business Job Protection Act of 1996. Each amendment narrowed the scope for applying Section 530 relief.

When a business is audited for employment classification, the IRS examiner first determines whether the business is eligible for Section 530 relief. If certain requirements are met, the examiner terminates the audit and the employer can continue to classify a specific worker or group of workers as independent contractors. In this case, the business is relieved of employment tax liability for FICA, FUTA, federal income tax withholding, and Railroad Retirement Act taxes, as well as any interest or penalties attributable to the liability for employment taxes.²¹

²⁰ Kiplinger Tax Letter, 83. Feb. 22, 2008

²¹ Rev. Proc. 85-18, 1985-1 CB 518

2008 Workbook

To be eligible for Section 530 relief, the business must meet three tests:

1. **Reporting Consistency Test.** For the period being examined, the business must have filed all federal tax returns, including information returns, related to the worker in a manner consistent with the worker being classified as an independent contractor.
2. **Substantive Consistency Test.** The business must have consistently treated similarly situated workers as independent contractors. If the business treated a similarly situated worker as an employee, then no Section 530 relief is available.
3. **Reasonable Basis Test.** The business must have a reasonable basis for not treating the worker as an employee. This may consist of reliance on:
 - A judicial precedent or published ruling, letter ruling, or technical advice memorandum issued to the taxpayer;
 - The results of a past IRS audit of the employer;
 - A long-standing recognized practice of a significant segment of the industry in which the taxpayer is engaged; or
 - Any other reasonable basis.

Meeting the two consistency tests and the reasonable basis test gives the business relief from employment taxes for workers whose status is in question.

IRS REQUIREMENTS

Whenever a worker classification examination occurs, the IRS must explore the applicability of Section 530 even if the taxpayer does not raise the issue. In addition, a plain language summary of Section 530 must be provided to the taxpayer at the beginning of an examination of worker classification. An example of such a summary is IRS Pub. 1976, *Do You Qualify for Relief under Section 530?*

When Congress enacted Section 530, the IRS was barred from issuing any regulations or revenue rulings pertaining to worker classification. As a result, the IRS cannot issue new revenue rulings or even modify existing revenue rulings to reflect new developments.

At the same time, courts have modified their applications of the common-law standard in response to factual developments. As a result, courts may now look at the employee versus independent contractor issue somewhat differently — possibly making outstanding IRS revenue rulings outdated and in conflict with judicial decisions.

Section 530 imposes no prohibition on private letter rulings or technical advice memoranda. The IRS can also publish guidance dealing with Section 530.

TAX CONSEQUENCES FOR WORKERS

Section 530 provides relief to businesses, not to workers. Section 530 does not convert a worker from the status of employee to the status of independent contractor. Workers may find, through a determination letter or some other means, that they were misclassified as independent contractors and are actually employees. A worker classified as an employee is only liable for the employee share of FICA as opposed to being taxed under the Self Employment Tax Contributions Act (SECA).

For the period that an employee was misclassified as an independent contractor, he may have actually filed and paid his own employment tax. If the worker paid SE tax, he may file a claim for refund for the difference between SE tax and the employee's share of FICA.²²

²² Rev. Proc. 85-18, section 3.08, 1985-1 CB 518; Treas. Reg. §31.3102-1(c)

Other tax consequences for the worker are:

- **Unreimbursed Business Expenses.** Workers classified as employees generally cannot deduct unreimbursed business expenses above the line on Schedule C. If expenses are deductible, they are reported as miscellaneous itemized deductions on Schedule A, Form 1040, subject to the 2% limitation of IRC §67. This sometimes results in AMT liability.
- **Self-Employed Retirement Plans.** The worker classified as an employee cannot adopt or maintain a self-employed retirement plan.
- **Employee Benefits.** Certain benefits provided by the business to a worker classified as an employee may be excludable from income by the employee due to specific IRC exclusions provided only to employees, such as employer-provided accident and health insurance.

1. REPORTING CONSISTENCY TEST

The first requirement a business must meet to obtain relief under Section 530 is to timely file all required Forms 1099 for workers not classified as employees for a particular year. The relief provision applies only for that year.²³ If a business in subsequent years files all required returns on a basis consistent with treating the worker as an independent contractor, then the business may qualify for Section 530 relief for the subsequent period. **If a business is not required to file, the fact that a return was not required does not preclude relief.**

Example 6. Charles owns a small insurance agency. Four times per year, Charles mails information packets to all current and prospective clients. Charles employs four high school students to stuff envelopes. Each is paid a total of \$400 per year. Charles treats the students as independent contractors. Forms 1099 are not required because less than \$600 was paid to each student.

In this case, Section 530 relief will **not** be denied on the basis of failure to file information returns.

Example 7. In 2007, Charles increased the number of mailings to five per year and raised the students' payment to \$750 per year. Charles continued to treat the four students as independent contractors. In 2007, no Forms 1099 were filed for the \$750 paid to each student. All required information returns were filed for 2004, 2005, and 2006.

Charles is **not entitled** to relief for 2007 because the required information returns were not filed. However, Charles may still qualify for Section 530 relief for 2004, 2005, and 2006.

Businesses that do not timely file Forms 1099 consistent with treating the worker as an independent contractor may **not** obtain relief under the provisions of Section 530 for that worker in that year. However, if a business in good faith mistakenly files the wrong type of Form 1099, it does not lose Section 530 eligibility.²⁴

Example 8. Rain Corporation has 30 workers who were treated as independent contractors in 2007. An audit was conducted in August 2008. The revenue agent found no Forms 1099 for the workers. The controller stated that the corporation forgot to file Forms 1099, but the forms would be prepared and filed within a week.

In order to qualify for the relief provisions of Section 530, Rain Corporation should have filed Forms 1099 by the end of February 2008. Rain Corporation has other workers for whom Forms 1099 were filed. Section 530 relief may be available only for these workers.

²³ Rev. Proc. 85-18, section 3.03(B), 1985-1 CB 518

²⁴ Rev. Rul. 81-224, 1981-2 CB 197

2008 Workbook

2. SUBSTANTIVE CONSISTENCY TEST

If a business or the business' predecessor treated a worker holding a **substantially similar position** as an employee at any time after December 31, 1977, then Section 530 relief is **not available**. The treatment of a class of workers must be consistent with the business' belief that they were independent contractors. A **substantially similar position** exists if the job functions, duties, and responsibilities are substantially similar, and the control and supervision of those duties and responsibilities are substantially similar.

The relationship between the taxpayer and its workers determines whether workers hold substantially similar positions.²⁵ This can include the degree of supervision and control, although there are other factors as well. Differences in managerial responsibilities, reporting requirements, and job duties are taken into account when deciding if workers hold substantially similar positions. The contractual relationship and the provision of employee benefits are also considered.

Determining what constitutes **substantially similar work** rests on an analysis of the facts. The day-to-day services that workers perform and the method by which they perform those services are relevant in determining whether workers treated as independent contractors hold substantially similar positions to workers treated as employees. A comparison of job functions is an important fact. Workers with significantly different but overlapping job functions are not substantially similar.

Tax reporting actions taken by a business determine whether a worker is treated as an employee.²⁶ Only **federal** tax treatment as an employee is relevant. If a business treats workers as employees for state unemployment or state withholding tax purposes, this does not constitute **treatment** as an employee for purposes of Section 530. However, if the business uses a federal form to report state tax withholding, such as on the Form W-2, then this is considered "treatment" for purposes of Section 530.

The following actions are considered treating the worker as an employee:

1. Withholding federal income tax or FICA tax from a worker's wages regardless of whether the tax is paid to the government; or
2. Filing a Form 940, 941, 942, 943, 944, or W-2 related to a worker, regardless of whether tax was withheld from the worker.

The following actions are **not** considered treating the worker as an employee:

1. Filing a delinquent or amended employment tax return if the filing was a result of IRS compliance procedures, or
2. Using a return prepared by the IRS under IRC §6020(b), or signing Form 2504, *Agreement to Assessment and Collection of Additional Tax and Acceptance of Overassessment*.

Note. Filing returns for periods after the period under audit is considered **treatment** of the workers as employees for those later periods, regardless of the time at which the return was filed.

Section 530 specifically states that the treatment of predecessor entities is taken into account when determining **substantive consistency**. This insures that the substantive consistency rule is not avoided by the formation of new entities.²⁷

²⁵ Section 530(e)(6)

²⁶ Rev. Proc. 85-18, 1985-1 CB 518

²⁷ Rev. Proc. 85-18, section 3.04, 1985-1 CB 518

If the business begins to treat misclassified workers as employees, relief is available under Section 530 for the years it treated them as independent contractors, provided it meets all three tests for the years prior to the change in treatment.

Sometimes workers perform outside services for their employer. For example, a business' bookkeeper might also be contracted to design and print an advertising brochure. The fact that the bookkeeper is treated as an employee for the bookkeeping services does not preclude her from being considered as an independent contractor for the design and printing services.

Example 9. Victor Corporation's 2007 return was examined. It was found that 100 workers, all doing the same job, were treated as independent contractors. The examiner discovered that in 2001 five of these 100 workers were treated as employees. These five performed substantially the same job in 2007.

Victor Corporation cannot claim Section 530 relief in 2007 for any of these 100 workers because it treated some of the workers inconsistently between 2001 and 2007.

3. REASONABLE BASIS TEST

A business must have a reasonable basis for not treating the worker as an employee. As mentioned earlier, it may reasonably rely on one of several **safe havens** to meet reasonable basis:

- **Judicial Precedent.** This safe haven includes reasonable reliance on judicial precedent; published rulings; or a technical advice memorandum, private letter ruling, or determination letter pertaining to the business.
- **Past Audit.** This safe haven allows reasonable reliance on a past IRS employment tax audit of the business, if the audit began after December 31, 1996. The safe haven exists if the audit entailed consideration of, but no assessment attributable to, the business' employment tax treatment of workers holding positions substantially similar to the position held by the worker whose status is at issue.
- **Industry Practice.** This safe haven allows reasonable reliance on a long-standing recognized practice of a significant segment of the industry in which the business is engaged. The practice need not be uniform throughout an entire industry.
- **Other Reasonable Basis.** A business which fails to meet any of the three safe havens may nevertheless be entitled to relief. It must be able to demonstrate, in some other manner, any reasonable basis for not treating the worker as an employee.

Under Section 530, a business' burden of proof differs from that in an ordinary tax case. Section 530(e)(2) shifts the burden of proof to the IRS if two requirements are satisfied:

1. The taxpayer establishes a prima facie case that it was reasonable not to treat an individual as an employee, and
2. The taxpayer cooperates fully with reasonable requests from the examiner.

2008 Workbook

CURRENT STATUS OF SECTION 530 RELIEF

In September 2007, Senator Barack Obama and six co-sponsors introduced a bill in the Senate to eliminate Section 530 relief. Currently, Section 530 relief is available and will be available prior to the enactment of any new legislation.

Some recent cases involving Section 530 relief include:

- In a 2007 case, the court ruled the taxpayer was not entitled to Section 530 relief because he treated all workers as employees in the prior year.²⁸
- In a 1996 case, the court ruled a trucking company was not eligible for Section 530 relief even though a state court found two drivers were independent contractors. The judicial precedent safe haven only applies to cases dealing with federal employment taxation.²⁹
- In 2001, FSA Chief Counsel agreed that Section 530 relief applied to a health care provider on an entity-by-entity basis for purposes of the substantive consistency test. Even though the business used a paying agent, Section 530 was still applicable.³⁰

Note. While Section 530 relief is available, the business must demonstrate it complied fully with every provision.

STATUTORY AND NONSTATUTORY EMPLOYEES

CORPORATE OFFICERS

For employment tax purposes, no distinction is made between classes of employees. Superintendents, managers, and other supervisory personnel are all employees. Within the definitions found in the Code, officers are specifically included for purposes of FICA, FUTA, and federal income tax withholding.³¹ The common-law standard is not applicable since, by statute, an officer of a corporation is an employee of the corporation. There are two exceptions as described in the Code in which an officer is not considered an employee of the corporation:

1. The officer does not perform any services or performs only minor services, **and**
2. The officer receives no remuneration.³²

The officer must meet both of these requirements to be excepted from employee status. Determining whether services performed by a corporate officer are considered minor or nominal depends on the character of the services, the frequency and duration of performance, and the actual or potential importance or necessity of the services in relation to the conduct of the corporation's business.

A director of a corporation, acting in that capacity, is not an employee of the corporation for those services. This is true even if that worker also serves as an employee or officer of the corporation for other services. Therefore, part of the compensation paid this worker can be for services rendered as an independent contractor (director) and part of the payments can be for services rendered as an employee.³³

²⁸ *Colorado Mufflers Unlimited, Inc. v. Comm'r*, TC Memo 2007-222 (Aug. 13, 2007)

²⁹ *Peno Trucking, Inc. v. Comm'r*, TC Memo 2007-66 (Mar. 21, 2007)

³⁰ FSA 200129008 (December 15, 2000)

³¹ IRC §§3121(d)(1), 3306(i), and 3401(c)

³² Treas. Reg. §31.3121(d)-1(b)

³³ Rev. Rul. 58-505, 1958-2 CB 728

As described in a 1974 revenue ruling, three individuals were officers of a management corporation and five related brother-sister operating corporations. They were paid only by the management corporation, and consequently, were considered employees of the management corporation. For the operating corporations, they performed only minor administrative functions entailing a few hours per year and received no remuneration. Because the officers satisfy the requirements for the exception from employee status (they perform only minor services for the corporations and received no remuneration), the officers were not employees of the **operating corporations**.³⁴

In a 1971 revenue ruling, it was held that a taxpayer who is president and the sole shareholder of a closely-held corporation is an employee of the corporation. The fact that the corporation is closely held and that the taxpayer is a sole proprietor and completely in charge of the corporation's activities is immaterial. The taxpayer's services are material to the operation of the corporation, and he is entitled to and receives remuneration for these services. Consequently, the taxpayer is an employee of the corporation.³⁵

STATUTORY EMPLOYEES

When a worker is not classified as a common-law employee, he could be classified as a statutory or nonstatutory employee. Statutory employees are workers identified by statute to be employees for purposes of FICA, Medicare, and FUTA tax under certain conditions. Statutory employees do not have federal income tax withheld from their wages.

By definition, a worker cannot be a statutory employee under IRC §3121(d)(3) if that worker is considered a common-law employee. IRC §3121(d)(3) lists workers for occupational groups, who under certain circumstances are considered employees for FICA tax, and in some instances FUTA tax, but not for federal income tax withholding. Similar to corporate officers, these groups of workers are described as “statutory employees” because they are specifically listed in the Code. The following types of workers are considered **statutory employees**:

1. An agent (or commission) driver who delivers food, beverages (other than milk), laundry, or dry cleaning for someone else;
2. A full-time life insurance salesperson who sells primarily for one life insurance company;
3. A home worker who works on materials or goods supplied by a business according to specifications set by the business, and who returns the finished work to the business; and
4. A full-time traveling or city salesperson who works on behalf of one firm and turns in orders to the firm from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work must be the salesperson's principal business activity.

Statutory employees **do not have federal income tax withheld** from their wages. They are subject to having **FICA and Medicare taxes** withheld from their wages if the following three conditions are met:³⁶

1. The **contract of service** contemplates that the worker **personally performs** substantially all of the work,
2. The worker has a **substantial investment** in facilities, other than transportation facilities used in performing the work, and
3. There is a **continuing work relationship** with the business for which the services are performed.

³⁴ Rev. Rul. 74-390, 1974-2 CB 331

³⁵ Rev. Rul. 71-86, 1971-1 CB 285

³⁶ IRS Pub. 15-A, *Employer's Supplemental Tax Guide*

2008 Workbook

Contract of service means an oral or written arrangement exists under which particular services are performed. **Personally perform** means the worker does substantially all the work. Therefore, if the arrangement permits the worker to delegate as much of the work as he desires, then the worker could not be a statutory employee.

Substantial investment is not defined in the regulations. All of the facts for each situation must be considered to determine whether the facilities furnished by the worker are substantial. Factors that may be considered include:

1. What is the value of the worker's investment compared to the total investment?
2. Are the facilities furnished by the worker essential to perform the work or are they for the personal convenience of the worker?
3. Are the facilities furnished by the company being purchased or leased at fair market value or fair rental value by the worker?
4. Are the facilities furnished by the worker considerably more extensive than those usually furnished by workers performing comparable services?

Continuing nature means the relationship is continuous, and not in the nature of a single transaction.

FUTA tax applies to workers who are agent or commission drivers, and to full-time traveling or city salespersons. The other two categories of workers are not subject to FUTA tax.³⁷

Agent or Commission Drivers

The statute defines agent or commission drivers as workers who distribute meat or meat products, vegetables or vegetable products, fruit or fruit products, bakery products, beverages (other than milk), or laundry or dry-cleaning services for a business. The distribution of other services or products does not disqualify the worker from this category if handling the additional products or services is incidental to handling the specific items.

The agent or commission drivers may sell at retail or wholesale. They may operate from their own trucks or use trucks belonging to the business for which they work. The drivers may serve customers designated by the business as well as those they solicit independently. Their compensation may be based on commission, or the difference between the price charged to the customer and the price paid by the driver to the business for the product or service.

Example 10. Bart is engaged on a continuing basis in distributing meat products to retail stores for the Beef Packing Company (Beef). Bart is not a common-law employee of Beef. The contract with Beef specifies that Bart personally performs substantially all of the services. Bart has no investment in facilities other than a delivery truck and what he is paid on a commission basis. Bart is considered a statutory employee of Beef. However, if Bart expands the distribution business, hires other workers, and no longer personally performs the deliveries, he is no longer Beef's statutory employee and is an independent contractor.

Full-Time Life Insurance Salespersons

An individual whose principal business activity is selling life insurance and/or annuity contracts for one life insurance company is generally considered a full-time life insurance salesperson.³⁸ Occasional or incidental sales of other types of insurance for the business, or the occasional placing of surplus-line insurance, do not affect this requirement. An individual who is engaged in **general insurance business** under a contract(s) of service who does not sell life insurance as his principal business activity for one life insurance company is not considered a full-time life insurance salesperson. For example, if the salesperson devotes substantial effort to selling applications for insurance contracts, other than life insurance and annuity contracts (for example, health and accident, fire, automobile, etc.), he is not considered a full-time life insurance salesperson.

³⁷. Ibid

³⁸. Treas. Reg. §31.3121(d)-1(d)(3)(ii)

Generally, the employment contract reflects the intent of the worker and the business in determining whether the worker is a full-time or part-time salesperson. **The actual time devoted to the work is not determinative.** A worker may work regularly only a few hours each day and still qualify as a full-time life insurance salesperson.

Home Workers

The category of **home workers** encompasses workers who perform a wide range of duties. Traditionally, this includes workers who make things such as clothing, bedding, needlecraft products, or similar items. It can also include workers who provide typing or transcribing services at home. The work is done away from the company's place of business and is usually accomplished in the worker's own home, the home of another, or a home workshop.

In addition to the three general requirements previously listed, the worker must meet the following requirements:³⁹

1. The work must be done in accordance with the specifications given by the business (generally simple and consisting of such things as patterns or samples).
2. The material or goods on which the work is done must be furnished by the business.
3. The finished product must be returned to the business or to another designation. It is immaterial whether the business picks up the work or the worker delivers it.

IRC §3121(a)(10) provides that the pay which the home worker receives for such work is not subject to FICA tax unless \$100 or more of cash is received during any calendar year from one business. A home worker may be employed by several businesses.

If the \$100 cash paid test is met, all noncash payments (clothes, merchandise, transportation passes, etc.) from the same business are also included as wages.

Traveling or City Salesperson

This category includes workers who perform their jobs away from the business premises. Their full-time business activity is selling merchandise for a business. The test for full-time status relates to an exclusive principal business activity for a single business and not to the time spent on a job. Sideline sales activities for other businesses do not exclude these workers from being in the statutory category of employees.

In addition to the three general requirements previously listed, these workers must meet the following requirements:⁴⁰

1. Their entire or principal business activity must be devoted to soliciting and transmitting orders for merchandise of a single business.
2. The orders must be obtained from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments.
3. The merchandise sold must be bought for resale or must be supplied for use in the purchaser's business operations.

Example 11. Jaime performs sales services for a home design catalog company. Jaime solicits orders for the company's catalogs exclusively from lumber dealers, who purchase them either for resale or for free distribution to their customers. The lumber dealers are wholesalers or retailers. The catalogs for resale constitute **merchandise for resale** and those purchased for free distribution constitute **supplies for use in the purchaser's business operation**. Therefore, Jaime meets the statutory test, and is an employee of the home design catalog company. If Jaime only sold advertising space in the catalogs, she would not be considered an employee of the catalog company.

³⁹ Treas. Reg. §31.3121(d)-1(d)(3)(iii)

⁴⁰ IRS Pub. 15-A, *Employer's Supplemental Tax Guide*

2008 Workbook

Taxation Issues

Being categorized as a statutory employee can have a large impact on the tax liability of the worker. A statutory employee can claim his business expenses as an above-the-line deduction rather than being required to report the expenses as a miscellaneous itemized deduction subject to the 2% limitation.⁴¹

STATUTORY NONEMPLOYEES

By statute there are **three occupations** in which the worker is **specifically not treated as an employee** and is referred to as a statutory nonemployee. Statutory nonemployees are not treated as employees for FICA, FUTA, and federal income tax withholding purposes, provided they meet certain qualifications. The three occupations that comprise statutory nonemployees are:⁴²

1. Qualified Real Estate Agents

IRC §3508 provides that qualified real estate professionals are statutory nonemployees. These workers must meet the following requirements:

1. The worker is a licensed real estate agent.
2. Substantially all the worker's remuneration for services is directly related to sales or other output as opposed to the number of hours worked.
3. A written contract exists between the worker and the business that specifies that the worker is not treated as an employee for federal tax purposes.

Services that include management of property are not considered when determining whether the real estate agent is "qualified."⁴³ Services that include appraisal activities for real estate sales are included if the agent earns income based on sales or other output.⁴⁴

2. Direct Sellers

IRC §3508 provides that direct sellers are statutory nonemployees. These workers must meet the following requirements:

1. The worker is engaged in the sale of consumer products in the home or in a place other than a permanent retail establishment.
2. Substantially all of the worker's remuneration for services is directly related to sales or other output as opposed to the number of hours worked.
3. A written contract exists between the worker and the business for which the services are being performed that provides that the worker will not be taxed as an employee for federal tax purposes.

In 1996, newspaper carriers and distributors were added to the category of direct sellers by the Small Business Job Protection Act. This category of worker must meet the same requirements as direct sellers listed above.

3. Companion Sitters

IRC §3506 provides that qualifying companion sitters are statutory nonemployees. These workers are not companion sitting placement service employees if the placement service neither pays nor receives the salary or wages of the sitter. The placement service may be compensated on a fee basis by either the sitter or the individual or business for which the sitting is performed.

The companion sitter is considered self-employed unless he is considered a statutory or common-law employee of the individual or business for which the services are performed.

⁴¹ *Lickiss v. Comm'r*, TC Memo 1994-103 (Mar. 15, 1994)

⁴² IRS Pub. 15-A, *Employer's Supplemental Tax Guide*

⁴³ Prop. Treas. Reg. §31.3508-1(b)(2)

⁴⁴ IRS Pub. 15-A, *Employer's Supplemental Tax Guide*

SCENARIOS

Scenario 1. On the Road, Inc., is a wholesale distributor of mobile parts and rubberseal compounds to be inserted in automobile and truck tire tubes. Jaymes and Mike spend all their work time soliciting orders for the distributor's products. They spend 80% of their time soliciting orders from:

- Retail automobile dealers,
- Gasoline service stations,
- Repair shops which also sell at retail, and
- Truck fleet owners who contract with merchants to deliver packages.

They spend 20% of their time soliciting orders from owners of taxicabs and limousines used for transporting passengers. Are Jaymes and Mike statutory employees? Explain why or why not.

Scenario 2. Ron is an insurance salesperson. He is engaged full-time in soliciting life insurance and annuity contracts for four different businesses. He maintains an office in the home and spends approximately equal time selling for each business.

- a. Is Ron a statutory employee of any of the businesses? Why or why not?
 - b. Would there be any difference if Ron worked for only two businesses, assuming equal time was spent between each business? Why or why not?
 - c. Would the answer change, if 80% of his work time was devoted to one business? Why or why not?
-
-
-

Scenario 3. Gina is a transcriber for Ross Co., a court reporting business. She is engaged more or less regularly by Ross Co. Gina furnishes all supplies and equipment, performs the services at home under direct supervision, and is not an employee under the common-law rules. Even though she is not a common-law employee, is she subject to FICA, FUTA, and/or federal income tax withholding?

Scenario 4. Linda and Stan are drivers. They work for a local bakery and are not considered employees by the bakery. A written contract provides that they furnish their own trucks and pay all their own expenses. Linda and Stan have no other substantial investment in facilities. The bakery goods are purchased from the bakery which has no control over prices at which the goods are resold. Linda and Stan are not permitted to return unsold goods. It is further agreed that they perform these services personally, except in cases of illness, when they may hire a substitute. Are Linda and Stan statutory employees?

2008 Workbook

ANALYSES

Analysis 1. Jaymes and Mike are statutory employees. Eighty percent of their customers qualify as contractors or retailers. Therefore, 80% of the working time is spent soliciting orders from the types of customers specified in IRC §3121(d)(3)(D). This satisfies the **principal business activity test** that was the predecessor of the **full-time test**. In this situation, the principal business activity is soliciting orders and selling to the requisite types of customers. This meets the regulatory test, so the individuals are employees of the distributor for FICA and FUTA purposes.

Analysis 2.

- a. Ron is not an employee of any of the companies because he does not meet the “primarily for one life insurance company” rule.
- b. No, for the same reason.
- c. If 80% of Ron’s work time was devoted to working for one business, then he would probably meet all three specific requirements for being a statutory employee. The level of 80% satisfies the requirement that the salesperson must sell **primarily** for one business.

Analysis 3. Gina, who is not an employee under the usual common-law rules, is nevertheless an employee for FICA purposes because she is a home worker under the provisions of IRC §3121(d)(3)(C). The pivotal question is whether the worker has a substantial investment in facilities used in connection with her work. Rev. Rul. 70-340, 1970-1 CB 202, holds that the transcriber’s investment in a typewriter and a transcriber is not considered substantial. This conclusion is reached by taking into account the character and volume of work being done, the useful life of the equipment, and the amount of income generated by Gina. Gina’s compensation is not subject to FUTA or federal income tax withholding because she meets the requirements of a home worker.

Analysis 4. Linda and Stan are statutory employees for FICA and FUTA purposes. All general and specific requirements are met.

The investment in a vehicle is not considered in determining whether an individual is a statutory employee. Owner-drivers are the only statutory employees whose compensation is subject to FUTA.

EMPLOYMENT TAX TREATMENT

| Type of Worker | Income Tax Withholding | FICA and Medicare | FUTA |
|---|------------------------|---|---------|
| Common-law employee | Withhold | Taxable | Taxable |
| Corporate officer | Withhold | Taxable | Taxable |
| Statutory employees | | | |
| Agent and commission driver | Exempt | Taxable | Taxable |
| Full-time life insurance salesperson | Exempt | Taxable | Exempt |
| Full-time traveling or city salesperson | Exempt | Taxable | Taxable |
| Home worker | Exempt | Taxable if paid \$100 or more in cash during the calendar year. | Exempt |
| Statutory Nonemployees | | | |
| Qualified real estate agent (IRC §3508(b)(1)) | Exempt | Exempt ^a | Exempt |
| Direct seller (IRC §3508(b)(2)) | Exempt | Exempt ^a | Exempt |
| Companion sitter (IRC §3508(b)(2)) | Exempt | Exempt ^a | Exempt |

^a However, statutory nonemployees are subject to SE tax.

FORM 8919

In its attempt to identify more businesses that erroneously treat workers as independent contractors, the IRS simplified the procedure for misclassified workers to pay their share of FICA and provide information to the IRS to encourage the business to change the workers' status.

The IRS developed Form 8919, *Uncollected Social Security and Medicare Tax on Wages*, which allows the worker to pay half the total FICA and Medicare tax. This is the amount that the business would have withheld from the worker's wages if it had treated him as an employee. Filing Form 8919 does not automatically trigger an examination and does not delay the tax return's processing. This form is filed with the worker's Form 1040. The worker is also required to file Form SS-8 with Form 8919.

Prior to 2007, the taxpayer was instructed to complete Form 4137, *Social Security and Medicare Tax on Unreported Tip Income*, and cross out the word "tip" and insert the word "wage." Unfortunately, this prevented the worker from filing electronically.

Example 12. Wyle Coyote is an anvil tester for Acme Anvil Manufacturing Company. Wyle was employed by Acme beginning in January 2007. In June, he suffered multiple fractures due to improperly performing an anvil test. He was surprised when he received a Form 1099-MISC rather than a Form W-2 at year end.

Wyle's tax preparer told Wyle that he could file Form 8919 and only pay half the amount of the FICA and Medicare tax, which would normally be withheld by an employer. However, he would also be required to file a Form SS-8 (described later) which gives the IRS the necessary information to contact Acme and prevent worker misclassification in the future.

Wyle's completed Form 8919 is shown on the following page.

2008 Workbook

For Example 12

| | | |
|--|---|--|
| Form 8919 <small>Department of the Treasury Internal Revenue Service</small> | Uncollected Social Security and Medicare Tax on Wages <small>▶ See instructions on back.</small> ▶ Attach to Form 1040, Form 1040NR, Form 1040NR-EZ, Form 1040-SS, or Form 1040-PR. | OMB No. 1545-0074 <div style="font-size: 2em; font-weight: bold;">2007</div> <small>Attachment Sequence No. 72</small> |
| Name of person who must file this form. If married, complete a separate Form 8919 for each spouse who must file this form. Wyle Coyote | | Social security number <div style="display: flex; justify-content: space-between; width: 100%;"> 111 11 1111 </div> |

Who must file. You must file Form 8919 if **all** of the following apply.

- You performed services for a firm.
- The firm did not withhold your share of social security and Medicare taxes from your pay.
- Your pay from the firm was not for services as an independent contractor.
- One or more of the reasons listed below under *Reason codes* apply to you.

Reason codes: For each firm listed below, enter the applicable reason code(s) for filing this form in column (c). If none of the reason codes apply to you, but you believe you should have been treated as an employee, enter reason code G, and file Form SS-8 on or before the date you file your tax return.

- A** I filed Form SS-8 and received a determination letter stating that I am an employee of this firm.
- B** I was designated as a "section 530 employee" by my employer or by the IRS prior to January 1, 1997.
- C** I received other correspondence from the IRS that states I am an employee.
- D** I was previously treated as an employee by this firm and am performing services in a substantially similar capacity and under substantially similar direction and control. (You must also enter reason code G.)
- E** My co-workers, performing substantially similar services under substantially similar direction and control, are treated as employees. (You must also enter reason code G.)
- F** My co-workers, performing substantially similar services under substantially similar direction and control, filed Form SS-8 for this firm and received a determination that they were employees. (You must also enter reason code G.)
- G** I filed Form SS-8 with the IRS and have not received a reply.

| (a) Name of firm | (b) Firm's federal identification number <small>(see instructions)</small> | (c) Enter reason code(s) from above | (d) Date IRS determination or correspondence was received <small>(MM/DD/YYYY) (see instructions)</small> | (e) Check if Form 1099-MISC was received | (f) Total wages received with no social security or Medicare tax withholding and not reported on Form W-2 |
|--|---|-------------------------------------|---|--|---|
| 1 Acme Anvil Manufacturing Co. | 22-2222222 | E & G | | <input checked="" type="checkbox"/> | 20,000 |
| 2 | | | | <input type="checkbox"/> | |
| 3 | | | | <input type="checkbox"/> | |
| 4 | | | | <input type="checkbox"/> | |
| 5 | | | | <input type="checkbox"/> | |
| 6 Total wages. Combine lines 1 through 5 in column (f). Enter here and include on Form 1040, line 7, Form 1040NR, line 8, or Form 1040NR-EZ, line 3 | | | | | 6 20,000 |
| 7 Maximum amount of wages subject to social security tax | | | 7 97,500 00 | | |
| 8 Total social security wages and tips (total of boxes 3 and 7 on Form(s) W-2) or railroad retirement (tier 1) compensation, and unreported tips subject to social security tax from Form 4137, line 10 | | | 8 0 | | |
| 9 Subtract line 8 from line 7. If line 8 is more than line 7, enter -0- here and on line 10 | | | | | 9 20,000 |
| 10 Wages subject to social security tax. Enter the smaller of line 6 or line 9 | | | | | 10 20,000 |
| 11 Multiply line 10 by .062 (social security tax rate) | | | | | 11 1,240 |
| 12 Multiply line 6 by .0145 (Medicare tax rate) | | | | | 12 290 |
| 13 Add lines 11 and 12. Enter here and on Form 1040, line 59, Form 1040NR, line 54, or Form 1040NR-EZ, line 16 ▶ | | | | | 13 1,530 |

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 37730B

Form **8919** (2007)

FORM SS-8

The revised IRS Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, is used to ask the IRS for help in determining worker classification. It contains all of the questions needed to determine behavioral and financial control of the worker as well as the relationship of the parties. This form can be completed by either the worker or the business to request a determination or ruling letter regarding the worker's federal employment tax status. There is no user fee for this type of ruling request.⁴⁵

Unless the IRS has previously determined that a particular worker or class of workers should be treated as an employee, the worker is required to attach a Form SS-8 when he files Form 9919. The Form SS-8 gives the IRS information to use when they contact the business to make a determination on worker status and potentially conduct an employment tax examination.

The IRS will not make a determination for any year in which the 3-year statute of limitations for tax return filing has expired. In addition, they cannot issue a determination letter for proposed transactions or on hypothetical situations.

SS-8 Determination Process

When the IRS receives a Form SS-8, it acknowledges its receipt to the party(ies) who sent the form.

Because there are usually two (or more) parties who could be affected by a determination of employment status, the IRS attempts to get information from all parties involved by sending those parties blank Forms SS-8 for completion. Some or all of the information provided on Form SS-8 may be shared with the other parties. If the worker who completed the form objects to the employer being notified of his identity and the information reported, a determination letter will not be issued.

The case is assigned to a technician who reviews the facts, applies the law, and renders a decision. The technician may ask for additional information from the requestor, from other involved parties, or from third parties that could help clarify the work relationship before rendering a decision. The IRS generally issues a formal determination to the firm or payer (if it is a different entity) and sends a copy to the worker. A determination letter applies only to the requesting worker (or class of workers), and the decision is binding on the IRS.

In certain cases, a formal determination will not be issued. Instead, an information letter may be issued. An information letter is only advisory and is not binding on the IRS. However, it may be used to assist the worker in fulfilling his federal tax obligations.

Neither the Form SS-8 determination process nor the review of any records in connection with the determination constitutes an examination (audit) of any federal tax return. If the periods under consideration were previously examined, the SS-8 determination process does not constitute a re-examination under IRS reopening procedures. Because this is not an examination of any federal tax return, the appeals rights available in connection with an examination do not apply to an SS-8 determination. However, if the worker or business disagrees with the determination, and they have additional information concerning the work relationship they believe was not previously considered, they may request that the determining office reconsider the decision.

Worker Requests Determination

If the IRS determines the worker is an employee, the worker is responsible for filing an amended return to make corrections based on the determination. If the worker expects a refund or credit, the amended return must be filed within three years from the original return filing date, or within two years of the date the tax was paid, whichever is later.

A worker should not delay filing a timely return in anticipation of an answer to the Form SS-8 request. The same holds true for responding to a request for payment.

⁴⁵ IRM 4.23.2.6

2008 Workbook

Firm Requests Determination

When a worker completes a Form SS-8, the IRS will send the business a Form SS-8 to complete. The IRS is interested in collecting information from both parties about the employment status of the worker. If the business fails to respond to the request for information, this will not prevent the issuance of a determination letter.

The business may also initiate a request for determination of worker status by completing a Form SS-8. If there are multiple classes of workers, a Form SS-8 is completed for each class of worker. Once issued, a written determination applies to all workers in the same class. The IRS will ask for a list of names and addresses of all workers potentially affected by the determination.

If the business has a reasonable basis for not treating the workers as employees, it may be relieved of the requirement to pay employment taxes under Section 530 of the Revenue Act of 1978. However, this relief cannot be considered in conjunction with a Form SS-8 determination because the determination does not constitute an employment tax examination.⁴⁶

Example 13. Use the same facts as **Example 12.** Wyle attaches the completed Form SS-8 to his Form 9919 before filing. The completed Form SS-8 is shown on the following page.

⁴⁶ Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding: Instructions*

For Example 13

| | | | | |
|--|--|--|---|-------------------|
| Form SS-8 (Rev. November 2006) Department of the Treasury Internal Revenue Service | | Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding | | OMB No. 1545-0004 |
| Name of firm (or person) for whom the worker performed services Acme Anvil Manufacturing Co. | | Worker's name Wyle Coyote | | |
| Firm's address (include street address, apt. or suite no., city, state, and ZIP code) 101 Broadway, New York, NY 44444 | | Worker's address (include street address, apt. or suite no., city, state, and ZIP code) 202 Canyon Drive, Grand Canyon, AZ 33333 | | |
| Trade name Acme | | Daytime telephone number (103) 555-2121 | Worker's social security number 111 : 11 : 1111 | |
| Telephone number (include area code) (601) 555-1212 | Firm's employer identification number 22 : 2222222 | | Worker's employer identification number (if any) : | |

Note. If the worker is paid by a firm other than the one listed on this form for these services, enter the name, address, and employer identification number of the payer. ►

Disclosure of Information

The information provided on Form SS-8 may be disclosed to the firm, worker, or payer named above to assist the IRS in the determination process. For example, if you are a worker, we may disclose the information you provide on Form SS-8 to the firm or payer named above. The information can only be disclosed to assist with the determination process. If you provide incomplete information, we may not be able to process your request. See *Privacy Act and Paperwork Reduction Act Notice* on page 5 for more information. **If you do not want this information disclosed to other parties, do not file Form SS-8.**

Parts I-V. All filers of Form SS-8 must complete all questions in Parts I-IV. Part V must be completed if the worker provides a service directly to customers or is a salesperson. If you cannot answer a question, enter "Unknown" or "Does not apply." If you need more space for a question, attach another sheet with the part and question number clearly identified.

Part I General Information

- This form is being completed by: ☐ Firm ☒ Worker; for services performed 01/01/2007 to 06/30/2007
(beginning date) (ending date)
- Explain your reason(s) for filing this form (for example, you received a bill from the IRS, you believe you erroneously received a Form 1099 or Form W-2, you are unable to get worker's compensation benefits, or you were audited or are being audited by the IRS). **I received a Form 1099-MISC rather than a Form W-2.**
- Total number of workers who performed or are performing the same or similar services 3
- How did the worker obtain the job? ☒ Application ☐ Bid ☐ Employment Agency ☐ Other (specify) _____
- Attach copies of all supporting documentation (contracts, invoices, memos, Forms W-2 or Forms 1099-MISC issued or received, IRS closing agreements, IRS rulings, etc.). In addition, please inform us of any current or past litigation concerning the worker's status. If no income reporting forms (Form 1099-MISC or W-2) were furnished to the worker, enter the amount of income earned for the year(s) at issue \$ 20,000.
If both Form W-2 and Form 1099-MISC were issued or received, explain why. _____
- Describe the firm's business. **Manufactures anvils used to destroy roadrunners.**
- Describe the work done by the worker and provide the worker's job title. **Worker responsible to push anvil off canyon rim when roadrunner passes by; job title is anvil tester.**
- Explain why you believe the worker is an employee or an independent contractor. **Other workers performing same testing job received a Form W-2 with withholdings.**
- Did the worker perform services for the firm in any capacity before providing the services that are the subject of this determination request?
☐ Yes ☒ No ☐ N/A
If "Yes," what were the dates of the prior service? _____
If "Yes," explain the differences, if any, between the current and prior service. _____
- If the work is done under a written agreement between the firm and the worker, attach a copy (preferably signed by both parties). Describe the terms and conditions of the work arrangement. **N/A**

2008 Workbook

For Example 13

Form SS-8 (Rev. 11-2006)

Page **2**

Part II Behavioral Control

- 1 What specific training and/or instruction is the worker given by the firm? **"Rig and Push" training**
- 2 How does the worker receive work assignments? **The worker is notified when new anvils will be sent for testing.**
- 3 Who determines the methods by which the assignments are performed? **Acme**
- 4 Who is the worker required to contact if problems or complaints arise and who is responsible for their resolution? **Product Manager of Acme.**
- 5 What types of reports are required from the worker? Attach examples. **Pictures of the smashed roadrunner are submitted by worker.**
- 6 Describe the worker's daily routine such as, schedule, hours, etc. **When the worker receives the anvil, he takes it to the edge of the canyon wall, rigs it according to the provided instructions, and pushes it off the edge at an appropriate time. He next goes to the bottom of the canyon and collects the anvil and takes a picture of the roadrunner.**
- 7 At what location(s) does the worker perform services (e.g., firm's premises, own shop or office, home, customer's location, etc.)? Indicate the appropriate percentage of time the worker spends in each location, if more than one. **100% of work time is spent at canyon, which is employer's facility**
- 8 Describe any meetings the worker is required to attend and any penalties for not attending (e.g., sales meetings, monthly meetings, staff meetings, etc.). **Worker is required to attend "rig and push" training meetings.**
- 9 Is the worker required to provide the services personally? ☒ Yes ☐ No
- 10 If substitutes or helpers are needed, who hires them? **Acme**
- 11 If the worker hires the substitutes or helpers, is approval required? ☐ Yes ☒ No
If "Yes," by whom?
- 12 Who pays the substitutes or helpers? **Acme**
- 13 Is the worker reimbursed if the worker pays the substitutes or helpers? ☐ Yes ☒ No
If "Yes," by whom?

Part III Financial Control

- 1 List the supplies, equipment, materials, and property provided by each party:
The firm **Anvils, paperwork, rope, & camera**
The worker **None**
Other party **None**
- 2 Does the worker lease equipment? ☐ Yes ☒ No
If "Yes," what are the terms of the lease? (Attach a copy or explanatory statement.)
- 3 What expenses are incurred by the worker in the performance of services for the firm? **Travel expense to canyon wall.**
- 4 Specify which, if any, expenses are reimbursed by:
The firm **All**
Other party **None**
- 5 Type of pay the worker receives: ☐ Salary ☐ Commission ☐ Hourly Wage ☒ Piece Work
☐ Lump Sum ☐ Other (specify) _____
If type of pay is commission, and the firm guarantees a minimum amount of pay, specify amount \$ _____
- 6 Is the worker allowed a drawing account for advances? ☐ Yes ☒ No
If "Yes," how often?
Specify any restrictions.
- 7 Whom does the customer pay? ☒ Firm ☐ Worker
If worker, does the worker pay the total amount to the firm? ☐ Yes ☐ No If "No," explain.
- 8 Does the firm carry worker's compensation insurance on the worker? ☒ Yes ☐ No
- 9 What economic loss or financial risk, if any, can the worker incur beyond the normal loss of salary (e.g., loss or damage of equipment, material, etc.)? **None**

Form **SS-8** (Rev. 11-2006)

ADDITIONAL INFORMATION

Tax practitioners can get additional information about the worker classification process by downloading the following publications from the IRS website at www.irs.gov.

- IRS Pub. 1779, *Independent Contractor or Employee*
- IRS Pub. 1976, *Do You Qualify for Relief under Section 530?*
- IRS Pub. 15-A, *Employer's Supplemental Tax Guide*
- IRS Pub. 15, *Circular E, Employer's Tax Guide*

The transcript from November 2007 Tax Talk Today program on worker classification can be downloaded at www.tinyurl.com/5togc4.

HOUSEHOLD WORKERS

Because of limited time, many two-wage-earner families find it advantageous to hire household workers. If the following workers perform their duties in and around the taxpayer's home, they are considered household workers. These include:

- Babysitters
- Caretakers
- Cleaning people
- Domestic workers
- Drivers
- Health aides
- Housekeepers
- Maids
- Nannies
- Private nurses
- Yard workers

If the taxpayer controls both what work is done and how it is to be done, and the worker is paid \$1,600 or more in 2008, then Schedule H, *Household Employment Taxes*, must be attached to the taxpayer's Form 1040, *U.S. Individual Income Tax Return*. It does not matter if the worker is employed full- or part-time, or was hired through an agency or from a list provided by an agency, nor does it matter if the worker is paid on an hourly, daily, or weekly basis, or by the job.

FORM I-9 REQUIRED

Before hiring the worker, the taxpayer must determine if the employee can legally work in the United States. The taxpayer and the worker must complete the U.S. Citizenship and Immigration Services (USCIS) Form I-9, *Employment Eligibility Verification*. This must be completed no later than the first day of work. The employee must complete the employee section of the form by providing certain required information and attesting to his work eligibility status in the United States. The taxpayer must complete the employer section by examining documents presented by the employee as evidence of his identity and employment eligibility. Acceptable documents to establish identity and eligibility are listed on Form I-9. The completed Form I-9 is retained by the employer and is not submitted to the IRS or the USCIS. However, it must be available for review, if requested, by these agencies.

2008 Workbook

PAYROLL TAXES

If the taxpayer has a household employee, he may be required to withhold and pay FICA and Medicare taxes, and/or FUTA. The requirements are as follows:

1. **If the taxpayer pays cash wages of \$1,600 or more in 2008 to any one household employee, then he must withhold and pay social security and Medicare taxes.**

This does **not** include wages paid to any of the following:

- Taxpayer's spouse
- Taxpayer's children under the age of 21
- Taxpayer's parent, unless **both** of the following conditions are met:
 - a. The parent cares for a child who is either of the following:
 - Under the age of 18, or
 - Has a physical or mental condition that requires the personal care of an adult for at least four continuous weeks in a calendar quarter.
 - b. The taxpayer's marital status is one of the following:
 - Divorced and not remarried,
 - Widow or widower, or
 - Living with the spouse whose physical condition or mental condition prevents him from caring for the child for at least four continuous weeks in a calendar quarter.
- Any employee under the age of 18 at any time in 2008, unless providing household services is the principal occupation of the worker. If the worker is a student, providing household services is not considered his principal occupation.

If the taxpayer meets this requirement, the relevant figures are as follows:

- The FICA and Medicare taxes are 15.3% of cash wages;
- The employee's share is 7.65% (the employer can choose to pay the tax himself and not withhold);
- The employer's matching share is 7.65%.

2. **If the taxpayer pays total cash wages of \$1,000 or more in any calendar quarter of 2007 or 2008 to household employees, then he must pay federal unemployment tax (FUTA).**

This does **not** include wages paid to:

- Taxpayer's spouse,
- Taxpayer's child under age 21, or
- Taxpayer's parent.

If the taxpayer meets this requirement, the applicable amounts are as follows:

- The tax is usually 0.8% of cash wages.
- Wages over \$7,000 per year **per employee** are not taxed.
- Taxpayer may also owe state employment tax.

Note. If neither A nor B above applies, the taxpayer need not pay any federal employment taxes. She may still be required to pay state unemployment taxes.

State Unemployment Taxes

States vary in their treatment of household employee taxes. For example, Illinois uses the same \$1,000 per quarter test used by the IRS.

Form W-2, *Wage and Tax Statement*

If the taxpayer withheld FICA and Medicare tax or paid them for the worker or withheld income tax, a Form W-2 must be given to the worker by January 31 and a copy sent to the Social Security Administration by February 28 following the year the wages were paid. If the taxpayer pays the **worker's share** of FICA and Medicare, it is treated as additional income to the worker and is reported as taxable income in Box 1.

Example 14. Patrick and Cordelia Romanoff employed Kassandra Coveney to provide child care in their home five days per week. In 2007, they paid Kassandra \$20,000. They pay her share of social security and Medicare tax. They also withheld \$3,000 of federal income tax at her request. They filed the Schedule H and Form W-2 on the following pages.

2008 Workbook

For Example 14

SCHEDULE H (Form 1040)

Department of the Treasury
Internal Revenue Service

Household Employment Taxes

(For Social Security, Medicare, Withheld Income, and Federal Unemployment (FUTA) Taxes)

► Attach to Form 1040, 1040NR, 1040-SS, or 1041.

► See separate instructions.

OMB No. 1545-1971

2007

Attachment
Sequence No. **44**

Name of employer

Patrick & Cordelia Romanoff

Social security number

111 11 1111

Employer identification number

1 1 1 2 3 4 5 6 7

- A** Did you pay **any one** household employee cash wages of \$1,500 or more in 2007? (If any household employee was your spouse, your child under age 21, your parent, or anyone under age 18, see the line A instructions on page H-3 before you answer this question.)

☒ **Yes.** Skip lines B and C and go to line 1.

☐ **No.** Go to line B.

- B** Did you withhold federal income tax during 2007 for any household employee?

☐ **Yes.** Skip line C and go to line 5.

☐ **No.** Go to line C.

- C** Did you pay **total** cash wages of \$1,000 or more in **any** calendar **quarter** of 2006 or 2007 to **all** household employees? (**Do not** count cash wages paid in 2006 or 2007 to your spouse, your child under age 21, or your parent.)

☐ **No. Stop.** Do not file this schedule.

☐ **Yes.** Skip lines 1-9 and go to line 10 on the back. (Calendar year taxpayers having no household employees in 2007 **do not** have to complete this form for 2007.)

Part I Social Security, Medicare, and Income Taxes

| | | | | | |
|----------|---|----------|---------------|--------------|--|
| 1 | Total cash wages subject to social security taxes (see page H-4) | 1 | 20,000 | | |
| 2 | Social security taxes. Multiply line 1 by 12.4% (.124) | 2 | | 2,480 | |
| 3 | Total cash wages subject to Medicare taxes (see page H-4) | 3 | 20,000 | | |
| 4 | Medicare taxes. Multiply line 3 by 2.9% (.029) | 4 | | 580 | |
| 5 | Federal income tax withheld, if any | 5 | | 3,000 | |
| 6 | Total social security, Medicare, and income taxes. Add lines 2, 4, and 5 | 6 | | 6,060 | |
| 7 | Advance earned income credit (EIC) payments, if any | 7 | | | |
| 8 | Net taxes (subtract line 7 from line 6) | 8 | | 6,060 | |

- 9** Did you pay **total** cash wages of \$1,000 or more in **any** calendar **quarter** of 2006 or 2007 to **all** household employees? (**Do not** count cash wages paid in 2006 or 2007 to your spouse, your child under age 21, or your parent.)

☐ **No. Stop.** Enter the amount from line 8 above on Form 1040, line 62. If you are not required to file Form 1040, see the line 9 instructions on page H-4.

☒ **Yes.** Go to line 10 on the back.

For Privacy Act and Paperwork Reduction Act Notice, see page H-7 of the instructions.

Cat. No. 12187K

Schedule H (Form 1040) 2007

For Example 14

Schedule H (Form 1040) 2007

Page **2****Part II Federal Unemployment (FUTA) Tax**

| | Yes | No |
|---|-------------------------------------|--------------------------|
| 10 Did you pay unemployment contributions to only one state? | <input checked="" type="checkbox"/> | <input type="checkbox"/> |
| 11 Did you pay all state unemployment contributions for 2007 by April 15, 2008? Fiscal year filers, see page H-4 | <input checked="" type="checkbox"/> | <input type="checkbox"/> |
| 12 Were all wages that are taxable for FUTA tax also taxable for your state's unemployment tax? | <input checked="" type="checkbox"/> | <input type="checkbox"/> |

Next: If you checked the "Yes" box on **all** the lines above, complete Section A.If you checked the "No" box on **any** of the lines above, skip Section A and complete Section B.**Section A**

| | | |
|--|-----------|--------------|
| 13 Name of the state where you paid unemployment contributions ► <u>Illinois</u> | | |
| 14 State reporting number as shown on state unemployment tax return ► <u>22-12345</u> | | |
| 15 Contributions paid to your state unemployment fund (see page H-5) <u>15</u> <u>621</u> | 16 | 7,000 |
| 16 Total cash wages subject to FUTA tax (see page H-5) | | |
| 17 FUTA tax. Multiply line 16 by .008. Enter the result here, skip Section B, and go to line 26 | 17 | 56 |

Section B**18** Complete all columns below that apply (if you need more space, see page H-5):

| (a) Name of state | (b) State reporting number as shown on state unemployment tax return | (c) Taxable wages (as defined in state act) | (d) State experience rate period | | (e) State experience rate | (f) Multiply col. (c) by .054 | (g) Multiply col. (c) by col. (e) | (h) Subtract col. (g) from col. (f). If zero or less, enter -0-. | (i) Contributions paid to state unemployment fund |
|--|--|---|--|----|------------------------------------|-------------------------------------|---|--|---|
| | | | From | To | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| | | | | | | | | | |
| 19 Totals | | | | | | | 19 | | |
| 20 Add columns (h) and (i) of line 19 | 20 | | | | | | | | |
| 21 Total cash wages subject to FUTA tax (see the line 16 instructions on page H-5) | 21 | | | | | | | | |
| 22 Multiply line 21 by 6.2% (.062) | 22 | | | | | | | | |
| 23 Multiply line 21 by 5.4% (.054) | 23 | | | | | | | | |
| 24 Enter the smaller of line 20 or line 23 | 24 | | | | | | | | |
| 25 FUTA tax. Subtract line 24 from line 22. Enter the result here and go to line 26 | 25 | | | | | | | | |

Part III Total Household Employment Taxes

| | | |
|---|-----------|--------------|
| 26 Enter the amount from line 8. If you checked the "Yes" box on line C of page 1, enter -0- | 26 | 6,060 |
| 27 Add line 17 (or line 25) and line 26 (see page H-5) | 27 | 6,116 |
| 28 Are you required to file Form 1040? <input checked="" type="checkbox"/> Yes. Stop. Enter the amount from line 27 above on Form 1040, line 62. Do not complete Part IV below. <input type="checkbox"/> No. You may have to complete Part IV. See page H-5 for details. | | |

Part IV Address and Signature—Complete this part only if required. See the line 28 instructions on page H-5.

| | |
|--|--------------------------|
| Address (number and street) or P.O. box if mail is not delivered to street address | Apt., room, or suite no. |
| City, town or post office, state, and ZIP code | |


Under penalties of perjury, I declare that I have examined this schedule, including accompanying statements, and to the best of my knowledge and belief, it is true, correct, and complete. No part of any payment made to a state unemployment fund claimed as a credit was, or is to be, deducted from the payments to employees.

Employer's signature _____ Date _____

Schedule H (Form 1040) 2007

2008 Workbook

For Example 14

| | | | | | | | |
|--|--|-------------------|--|--|--|--|--|
| a Employee's social security number 222-22-2222 | | OMB No. 1545-0008 | | Safe, accurate, FAST! Use  | | Visit the IRS website at www.irs.gov/efile . | |
| b Employer identification number (EIN) 11-1234567 | | | | 1 Wages, tips, other compensation 21530.00 | | 2 Federal income tax withheld 3000.00 | |
| c Employer's name, address, and ZIP code PATRICK & CORDELIA ROMANOFF 21 EDUCATOR ROAD TRAINING, IL 55555 | | | | 3 Social security wages 20000.00 | | 4 Social security tax withheld 1240.00 | |
| | | | | 5 Medicare wages and tips 20000.00 | | 6 Medicare tax withheld 290.00 | |
| | | | | 7 Social security tips | | 8 Allocated tips | |
| d Control number | | | | 9 Advance EIC payment | | 10 Dependent care benefits | |
| e Employee's first name and initial Last name Suff. KASSANDRA COVENEY 2020 MAIN DRIVE TRAINING, IL 55555 | | | | 11 Nonqualified plans | | 12a See instructions for box 12 | |
| | | | | 13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> | | 12b | |
| | | | | 14 Other | | 12c | |
| | | | | | | 12d | |
| f Employee's address and ZIP code | | | | 15 State Employer's state ID number IL 11-1234567 | | 16 State wages, tips, etc. 21530.00 | |
| | | | | 17 State income tax | | 18 Local wages, tips, etc. | |
| | | | | 19 Local income tax | | 20 Locality name | |

Form **W-2** Wage and Tax
Statement

2007

Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

NONEMPLOYEES

If only the worker controls how the work is done, then the worker is self-employed. A self-employed worker usually provides his own tools and offers services to the general public in an independent business. A worker who performed childcare services in his own home is generally not an employee.

If an agency supplies the worker and controls what and how work is done, the worker is not a household employee.

Example 15. A taxpayer made an agreement with John Peterson to care for his lawn. John runs a lawn care business and offers his services to the general public. He provides all tools and supplies. He hires and pays any helpers he needs. Neither John nor his helpers are household employees of the taxpayer.

REPORTING FRINGE BENEFITS ON THE W-2

One area of confusion is how to report fringe benefits on the Form W-2. The following table can be used as a reference in determining the reporting:

Treatment under Employment Taxes

| Type of Fringe Benefit | Income Tax Withholding | Social Security and Medicare | Federal Unemployment Tax |
|---|---|--|--------------------------|
| Accident and health benefits | Exempt, ^{a,b} except for long-term care benefits provided through a flexible spending or similar arrangement. | Exempt, except for certain payments to S corporation employees who are 2% shareholders. | Exempt |
| Achievement awards | Exempt ^a up to \$1,600 for qualified plan awards (\$400 for nonqualified awards). | | |
| Adoption assistance | Exempt ^{a,c} | Taxable | Taxable |
| Athletic facilities | Exempt if substantially all use during the calendar year is by employees, their spouses, and their dependent children and the facility is operated by the employer on premises owned or leased by the employer. | | |
| De minimis (minimal) benefits | Exempt | Exempt | Exempt |
| Dependent care assistance | Exempt ^c up to certain limits \$5,000 (\$2,500 for married filing separate return). | | |
| Educational assistance | Exempt up to \$5,250 of benefits each year. | | |
| Employee discounts | Exempt up to certain limits. | | |
| Employee stock options | See details below. | | |
| Group-term life insurance coverage | Exempt | Exempt ^{a,d} up to cost of \$50,000 of coverage. (Special rules apply to former employees.) | Exempt |
| Health savings accounts (HSAs) | Exempt for qualified individuals up to the HSA contribution limits. | | |
| Lodging on the employer's business premises | Exempt ^a if furnished for the employer's convenience as a condition of employment. | | |
| Meals | Exempt if furnished on employer's business premises for employer's convenience. Exempt if de minimis. | | |
| No-additional-cost services | Exempt ^c | Exempt ^c | Exempt ^c |
| Retirement planning services | Exempt ^e | Exempt ^e | Exempt ^e |
| Transportation (commuting) benefits | Exempt ^a up to certain limits if for rides in a commuter highway vehicle and/or transit passes (\$115), or qualified parking (\$220). | | |
| Tuition reduction | Exempt ^c if for undergraduate education (or graduate education if the employee performs teaching or research activities). | | |
| Working condition benefits | Exempt | Exempt | Exempt |

^a Exemption does not apply to S corporation employees who are 2% shareholders.
^b Exemption does not apply to certain highly-compensated employees under a self-insured plan that favors those employees.
^c Exemption does not apply to certain highly-compensated employees under a plan that favors those employees.
^d Exemption does not apply to certain key employees under a plan that favors those employees.
^e Exemption does not apply to services for tax preparation, accounting, legal, or brokerage services.

This chart and detailed information regarding the taxation of fringe benefits is found in IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*, which is available at www.irs.gov.

MISCELLANEOUS PAYROLL RULES

TERMINATED EMPLOYEE

Employer Outplacement Services. If an employer furnishes outplacement services to terminated employees, the value of the service may be nontaxable to the employee. To be considered as a working condition fringe benefit, and excludable from income, the benefit must be one which would be allowable as a deduction if paid by the employee. This requires that the terminated employee be looking for work in the same trade or business in which he was previously involved. The expense is not deductible if he is looking to enter a new trade or business.⁴⁷

DECEASED EMPLOYEE

If an employee dies during the year, the employer must accrue any wages, vacation pay, and other compensation paid after the date of death. If payment is made in the same year the employee died, FICA and Medicare must be withheld and reported on the employee's Form W-2 only as FICA and Medicare wages. These amounts are not reported in Box 1 for total wages paid.

Whether payment is made in the year of death or the year after death, the amount is reported in Box 3 of Form 1099-MISC for the estate or beneficiary. Any uncashed checks returned to the employer because of the death and reissued to the estate are reported on the Form W-2 because they were payments for work accomplished prior to death.

TERMINATED BUSINESS

If an employer terminates the business, he must provide Forms W-2 to the employees by the due date of the final Form 941. The Forms W-2 must be filed with the Social Security Administration by the last day of the month that follows the due date of the final Form 941.

If an employee does not receive a Form W-2 and cannot obtain one from the terminated employer, the employee can use Form 4852, *Substitute for Form W-2*. If the W-2 is received later and a correction is necessary, the taxpayer must file an amended tax return.

Example 16. Alex worked for Fly-by-Night Corporation during the first four months of 2007. When Alex came to work one day, the doors were locked and a note on the window said the business was permanently closed. Alex was unable to contact the employer for a Form W-2. Alex completed the following Form 4852 based on the information from his final pay stub.

⁴⁷ Rev. Rul. 92-69, IRB 1992-36

For Example 16

| | | | | |
|--|---|---|---|---|
| Form 4852 (Rev. January 2007) Department of the Treasury Internal Revenue Service | Substitute for Form W-2, Wage and Tax Statement, or Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. Attach to Form 1040, 1040A, 1040-EZ, or 1040X. | OMB No. 1545-0074 | | |
| 1 Type or print your first name and middle initial. Alex | | 2 Social security number (SSN) 111-11-1111 | | |
| 3 Address 21 Wonder Blvd, Anywhere, TN 55555 | | | | |
| 4 Enter year in space provided and check one box. For the tax year ending December 31, 2007 , I have been unable to obtain (or have received an incorrect) <input checked="" type="checkbox"/> Form W-2 OR <input type="checkbox"/> Form 1099-R. I have notified the IRS of this fact. The amounts shown on line 7 or line 8 are my best estimates for all wages or payments made to me and tax withheld by my employer or payer named on line 5. | | | | |
| 5 Employer's or payer's name, address, and ZIP code Fly-By-Night Corp; 1 River Road, Anywhere, TN 55555 | | 6 Employer's or payer's identification number (if known) | | |
| 7 Form W-2. Enter wages, tips, other compensation, and taxes withheld. | | | | |
| <table style="width: 100%; border: none;"> <tr> <td style="width: 50%; border: none;"> a Wages, tips, and other compensation <u>5,000</u> b Social security wages <u>5,000</u> c Medicare wages and tips <u>5,000</u> d Advance EIC payment _____ e Social security tips _____ f Federal income tax withheld <u>900</u> </td> <td style="width: 50%; border: none;"> g State income tax withheld _____ (Name of state) _____ h Local income tax withheld _____ (Name of locality) _____ i Social security tax withheld <u>310</u> j Medicare tax withheld <u>73</u> </td> </tr> </table> | | | a Wages, tips, and other compensation <u>5,000</u> b Social security wages <u>5,000</u> c Medicare wages and tips <u>5,000</u> d Advance EIC payment _____ e Social security tips _____ f Federal income tax withheld <u>900</u> | g State income tax withheld _____ (Name of state) _____ h Local income tax withheld _____ (Name of locality) _____ i Social security tax withheld <u>310</u> j Medicare tax withheld <u>73</u> |
| a Wages, tips, and other compensation <u>5,000</u> b Social security wages <u>5,000</u> c Medicare wages and tips <u>5,000</u> d Advance EIC payment _____ e Social security tips _____ f Federal income tax withheld <u>900</u> | g State income tax withheld _____ (Name of state) _____ h Local income tax withheld _____ (Name of locality) _____ i Social security tax withheld <u>310</u> j Medicare tax withheld <u>73</u> | | | |
| 8 Form 1099-R. Enter distributions from pensions, annuities, retirement/profit-sharing plans, IRAs, insurance contracts, etc. | | | | |
| <table style="width: 100%; border: none;"> <tr> <td style="width: 50%; border: none;"> a Gross distribution _____ b Taxable amount _____ c Taxable amount not determined <input type="checkbox"/> d Total distribution _____ e Capital gain (included in 8b) _____ </td> <td style="width: 50%; border: none;"> f Federal income tax withheld _____ g State income tax withheld _____ h Local income tax withheld _____ i Employee contributions _____ j Distribution codes _____ </td> </tr> </table> | | | a Gross distribution _____ b Taxable amount _____ c Taxable amount not determined <input type="checkbox"/> d Total distribution _____ e Capital gain (included in 8b) _____ | f Federal income tax withheld _____ g State income tax withheld _____ h Local income tax withheld _____ i Employee contributions _____ j Distribution codes _____ |
| a Gross distribution _____ b Taxable amount _____ c Taxable amount not determined <input type="checkbox"/> d Total distribution _____ e Capital gain (included in 8b) _____ | f Federal income tax withheld _____ g State income tax withheld _____ h Local income tax withheld _____ i Employee contributions _____ j Distribution codes _____ | | | |
| 9 How did you determine the amounts on lines 7 and 8 above? FROM FINAL PAY STUB | | | | |
| 10 Explain your efforts to obtain Form W-2, Form 1099-R, or Form W-2c, Corrected Wage and Tax Statement. NO ONE HAS BEEN ABLE TO FIND THE OWNER OF THE COMPANY. HE MAY HAVE LEFT THE COUNTRY DUE TO A PENDING LAWSUIT. | | | | |
| Sign Here | Under penalties of perjury, I declare that I have examined this statement, and to the best of my knowledge and belief, it is true, correct, and complete. Signature _____ Date _____ | | | |

Purpose of form. Form 4852 serves as a substitute for Forms W-2, W-2c, and 1099-R and is completed by taxpayers or their representatives when (a) their employer or payer does not give them a Form W-2 or Form 1099-R, or (b) when an employer or payer has issued an incorrect Form W-2 or Form 1099-R. Attach this form to your income tax return.

You should always attempt to get Form W-2 or Form 1099-R from your employer or payer before contacting the IRS or filing Form 4852. After February 14, you may call the IRS at 1-800-829-1040 if you still have not received Form W-2 or Form 1099-R. Generally, do not file Form 4852 before April 15.

If you received an incorrect Form W-2 or Form 1099-R, you should always attempt to have your employer or payer issue a corrected form before filing Form 4852.

Note. Retain a copy of Form 4852 for your records. Check your Social Security Statement (received at least a full year after the date shown on line 4) against Form 4852. If the earnings you reported on Form 4852 are not shown in the statement, you should contact the Social Security Administration (SSA) at the telephone number shown on the statement. Alternatively, after

September 30 following the date shown on line 4, you may contact your local SSA office to verify wages reported by your employers.

Will I need to amend my return? If you receive a Form W-2, Form W-2c, or Form 1099-R, after your return is filed with Form 4852, and the information differs from the information reported on your return, you must amend your return by filing Form 1040X, Amended U.S. Individual Income Tax Return.

Penalties. The IRS will challenge the claims of individuals who attempt to avoid or evade their federal tax liability by using Form 4852 in a manner other than as prescribed. Potential penalties for the improper use of Form 4852 include:

- Accuracy-related penalties equal to 20 percent of the amount of taxes that should have been paid,
- Civil fraud penalties equal to 75 percent of the amount of taxes that should have been paid, and
- A \$5,000 civil penalty for filing a frivolous return or submitting a specified frivolous submission as described by section 6702 of the Internal Revenue Code.

2008 Workbook

EMPLOYER CHANGES ENTITY

There are times when a taxpayer changes the form of entity under which it operates. For example, a sole proprietor building contractor may form an LLC taxed as an S corporation. In these situations, employees are treated as if they had two separate employers. One is the sole proprietorship up until the time the LLC is formed, and the second is the new LLC. Consequently, these employees receive two Forms W-2 for the year.

The only effect on the employee, in addition to the two W-2s, is if he earns more than the ceiling amount for the social security withholdings. This starts over for the wages received from the new entity. Consequently, the employee may have more social security tax withheld than required. If this happens, the employee files for a refund of the excess social security tax withheld when he files his Form 1040.

The employer will not receive any refund for the excess social security which he paid. For this reason, an employer may choose to change entity types at the beginning of the new year. While the formation of a new entity causes the IRS to view the employee as having a new employer, it does not relieve the employer from any past payroll tax liability. Therefore, an employer who is delinquent in payroll tax deposits cannot avoid paying these taxes simply by incorporating.

Note. Certain employers may issue employees one Form W-2 which includes the wages paid by the predecessor and successor employers. See Rev. Proc. 2004-53 for more information. The predecessor employer's FEIN is reported in box h of Form W-3 filed by the successor employer.

EMPLOYER SELLS BUSINESS STOCK TO NEW OWNER

When an employer retires, he may sell the stock of his corporation to another person, or he may sell the assets of the business to the buyer. There are substantial differences in taxation between these two approaches.

Caution. From an employment tax standpoint, when stock is purchased, the buyer is stepping into the shoes of the existing business and is consequently responsible for all of the liabilities of the corporation. Therefore, if the prior owner was delinquent on payroll taxes, the new owner will be required to pay these old taxes. This is one reason a buyer must do a thorough due diligence investigation prior to the purchase.⁴⁸

⁴⁸ *Today's Child Learning Center, Inc., v. U.S.*, 97-1063 (East. Dist. Pa. Mar. 6, 1998), 40 F.Supp 2d 268 (Mar. 8, 1998)