



IRS-SJSU Small Business Tax Institute
Worker Classifications (Federal & Calif)

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Definition of Employment

- A business becomes an employer when wages in excess of \$ 100 are paid
- Services performed in course of trade or business are considered employment regardless of amount or length of service

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Casual Labor



- Services **NOT** in the course of the employer's business
- Remuneration is less than \$50
- Length of service is less than 24 days

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Common Misconceptions

- Filing Form 1099-MISC transforms a worker into an independent contractor
- Workers paid less than \$ 600 are independent contractors
- Temporary or substitute workers are independent contractors

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Corrections to Misconceptions

- The \$600 rule refers to a filing requirement for Form 1099-MISC
- This rule has nothing to do with the payment of wages for services
- Length of service does not affect employee status



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Corrections to Misconceptions



- The “less than \$50” rule refers to services **NOT** in the course of an employing units trade or business
- Definition of “common law” employee identifies employee status

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Common Misconceptions

- Written contracts transform workers into independent contractors
- Possession of a business license proves independent contractor status
- Payment by commission proves independent contractor status

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Corrections to Misconceptions



- Written contracts do not override facts and circumstances
- Performance payments like commissions do not override facts circumstances
- “Contrived” self-employment will be investigated in audit

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Common Law Employees

**“Right to Control”
is Key Concept**



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IRS Determination Methods

- IRS uses California’s common law factors, but refers to them as three categories of evidence
- Categories of Evidence:
 1. Behavioral **Control**
 2. Financial **Control**
 3. Relationship of the parties

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Behavioral Control

- Facts that show whether the business has the right to direct and control
- Employees are usually trained to perform services in a particular manner
- Independent contractors uses their own methods

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Financial Control

- Facts that show whether the business has the right to control business or financial aspects of the job
- More than whether paid hourly
- Extent of worker’s investment, risk of loss, and makes services available to relevant market

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Relationship of Parties

- Facts that show how the business and worker perceive their relationship
- Evidences of employment
 - Benefits
 - Ability to discharge
 - Permanency

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Common Law Employees



1. "Right to Control" (whether exercised or not)

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California's Common Law Factors

2. Whether services are in a distinct occupation
3. Whether work is usually done with or without supervision
4. Skill required
5. Whether worker supplies own tools

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Common Law Employees

- 6. Length of time services are performed
- 7. Whether payment is by time or by the job
- 8. Whether work is part of regular business (integral concept)

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Common Law Employees

- 9. The parties' understanding of their relationship
- 10. The capacity in which the principal receives benefit (business or individual)
- 11. Whether the worker can make business decisions that affect profit or loss.

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Current Case Law Used

- *S.G. Borello & Sons v. Dept of Industrial Relations (1989)*
- *Empire Star Mines v. Calif Employment commission (1946)*
- *Isenberg v. Calif Employment Stabilization Commission (1947)*
- *Tieberg v. Calif Unemployment Insurance Appeals Board (1970)*

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Dynamex Decision (CA Supreme Court)

- Concern over any change to determination of employment criteria
- A-B-C Test actually more stringent than current California standard
- Only affects Calif Dept of Industrial Relations' wage orders...not EDD...yet

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Dynamex Decision: A-B-C Tests

- A. Worker free from control and direction of the hiring entity in connection with the performance of the work
- B. Worker performs work that is outside the usual course of the hiring entity's business; and
- C. Worker is customarily engaged in an independently established trade or business

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Dynamex Decision (CA Supreme Court)

- Pending CA Assembly Bill 5 (Gonzalez) seeks to codify worker status decision in **Dynamex** case
- Bill is currently in amendment process

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Distinctive "Stat EE" Occupations

WORKER CATEGORY	FITW	FICA	FUTA	EE Benefits
Real estate agents or direct sellers	No	No	No	No
Corporate officers	Yes	Yes	Yes	No
Agent/commission drivers	No	Yes	Yes	No
Certain traveling salespersons	No	Yes	Yes	No
Certain full-time life insurance salespersons	Yes	Yes	No	Yes
Certain homeworkers	Yes	Yes	No	No

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California Statutory Employees

- Defined as employee by law or specific statute
- Generally are employees for **UI and DI only**
 - **3 Exceptions (State EEs subject to PIT):**
 - Corporate Officers
 - Members of LLC with corporate election
 - Construction industry

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Construction Workers (DE 231G)



- Valid contractor's license required to treat as IC
- Can result in a federal independent contractor and a California employee

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Common Calif Statutory Employees

- Certain agent or commission drivers
- Certain traveling or city salespersons
- Home worker
- Artists and authors
- Full-time life insurance salespersons
- Unlicensed contractors

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Stat Employee Characteristics

- Substantially all of work performed personally by that worker
- Worker's lack of substantial investment in facilities
- Continuing services

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Artists and Authors

- Are stat employee in motion picture, radio, TV:
 - Union worker defined as an employee
 - Employer has the right to control and direct

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Statutory Nonemployee

- Real estate agents and direct sellers are statutory nonemployees or (independent contractors)
- No further testing required for these two occupations

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Family Employment

- Minor son or daughter under 18 years employed by parent(s)
- Spouse employed by spouse
- Parent employed by son or daughter

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Family Employment

- Register as a PIT-only employer, if withholding PIT
- EDD assigns PIT-only employer #
- DE 9C: Report "PIT wages", not "subject wages" (no UI, DI, ETT)

D. SOCIAL SECURITY NUMBER	E. EMPLOYEE NAME (FIRST NAME)	(M) (J) (LAST NAME)
F. TOTAL SUBJECT WAGES	G. PIT WAGES	H. PIT WITHHELD

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Independent Contractor

- Devoid of common law characteristics
- Not covered under Statutory employee descriptions



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Improper Worker Classifications

- More costly than just employment tax
 - Failure to provide other benefits
 - Labor law violations
- Workers can request IRS status determination and file Form 8919 to reduce exposure to unpaid SS/Med
- Similar to CA, worker filings produce audit leads

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Federal Section 530 Relief

- Prevents IRS reclassification if certain requirements are met
- When it applies, IRS cannot collect federal payroll taxes, even if workers are common law employees
- Also applies prospectively
- Not part of IRC, but a tax bill section from 1978 legislation

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Federal Section 530 Requirements

1. The workers have been treated as IC during all prior tax years
2. For all periods after 1977, workers performing same/similar job have been treated as IC
3. Forms 1099 were filed
4. Reasonable basis exists for employment determination used

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Reasonable Basis Considerations

- Court case or published ruling
- Technical advice has been issued
- Previous IRS employment tax audit with no assessment
- Longstanding industry practice
- Any other reasonable basis exists

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Federal Section 530 Application

- IRM takes seriously; auditors must:
 - Explore applicability
 - Distribute Pub 1976 when audit begins
- Section 530 overrides:
 - Statutory employee occupation rules
 - Common law "control" rules
- California does not conform!!!

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Section 530 Relief After Federal Audit

- Continues to apply provided:
 - Employer continues to file 1099s
 - Employer continues consistent treatment
 - Employer does not file employment returns or W-2s
- Treatment is lost beginning with the first year requirements not met

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530 Relief is Limited Relief

- Not part of IRC, but 1978 Revenue Act
- Business may be in violation of:
 - Employee benefit coverage
 - Labor Law violations
 - State employment tax and work comp
- ACA provisions may further limit relief once IRS begins audits for ESRP


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“Section 530 Employee”

- Employers report on Form 1099
- Worker does **not** report on Schedule C
- Worker reports on Form 1040 wage line and completes Form 8819, using **Code C**


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IRC § 3509 Relief

- Reduces severity of assessment due to misclassification
- Applies to employee withheld taxes
- Applies only to prior years
- Is mandatory when applies

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IRC § 3509 Rates

- Two rate schedules dependent on whether 1099s were filed
- Rate doubles when 1099s not filed
- IRS can collect unpaid employee tax from the employer, regardless of the employee's financial position

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IRC § 3509 Rates (1099s Filed)

Tax	Wages Up to Social Security Wage Base	Wages above Social Security Wage Base
FITW	1.5%	1.5%
EE Social Security (20%)	1.24	-0-
EE Medicare (20%)	.29	.29
Total EE Tax	3.03%	1.79%
ER Social Security	6.2	-0-
ER Medicare	1.45	1.45
Total ER Taxes	7.65	1.45
EE/ER TOTALS	10.68%	3.24%

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IRC § 3509 Rates (1099s Not Filed)

Tax	Wages Up to Social Security Wage Base	Wages above Social Security Wage Base
FITW	3.0%	3.0%
EE Social Security (40%)	2.48	-0-
EE Medicare (40%)	.58	.58
Total EE Tax	6.06%	3.58%
ER Social Security	6.2	-0-
ER Medicare	1.45	1.45
Total ER Taxes	7.65	1.45
EE/ER TOTALS	13.71%	5.03%

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IRC § 3509 Disqualification

- Intentional misclassification
- FIT only (not FICA) was withheld
- Misclassified worker is corporate officer
- Reclassification is to statutory employee

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IRC § 3509 Relief

- Employer not allowed to recover any amounts from employees
- Employer not allowed to claim a credit for taxes paid by employee
- Employee remains liable for unpaid FITW and employee FICA
- Employee **not** entitled to a credit for amounts paid by employer

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VCSP
IRS Voluntary Classification Settlement

- Voluntary worker reclassification
- Only pay 10% of employment taxes for most recent tax year calculated using IRC § 3509(a) reduced rates
- Payment due when IRS accepts

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VCSP
IRS Voluntary Classification Settlement

- VCSP concerns future years, with a current year discounted assessment
- IRS will not make a determination on prior years
- IRS will not make referrals to DOL or state employment agency

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VCSP
IRS Voluntary Classification Settlement

- No interest or penalties
- Audit protection for prior years
- Apply on Form 8952
- See Announcement 2012-45

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VCSP Eligibility

- Workers treated as nonemployees
- Consistently treated as nonemployees, with all required 1099s filed
- Cannot be currently under IRS employment tax audit (Worker SS-8 submission not considered an audit)

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VCSP

IRS Voluntary Classification Settlement

- Low cost method to reclassify workers for significantly reduced tax to pay
- Original deadline was 6/30/13, but program was extended
- Lack of state conformity makes this federal relief problematic

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California Employers?

- California does not conform to VCSP
- If employer can manage the 10% liabilities on federal side, most likely unable to manage associated CA liabilities, including interest/penalties



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Calif Employment Work Status Determination Assistance

1. DE 38 (Internal evaluation)—
created through efforts SBEAC
2. Employment Tax Consulting
3. DE 1870 (EDD determination
request-similar to SS-8)

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EDD ES Online Seminars

- Alternative to classroom seminars
- Work at your own pace
- Great client resource for clarification
 - Common law employment
 - Common misconceptions
 - Live example

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Common Reasons Employers Selected for Audit

- ✓ Worker files an “obstructed claim”
- ✓ Forms 1099-MISC
- ✓ Employer payment or report
delinquencies
- ✓ Collaborative information received
- ✓ Employer history of unreported
workers

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Penalties Increased 3rd Quarter 2014

CUIC Code Sec	Reason	Percent
CUIC § 1112.1**	E-file/E-pay failure	\$ 50 per return
CUIC § 1112(a)	Failure to timely pay	15%
CUIC § 1112.5	Filed late	15%
CUIC § 1114	Wage Item Penalty	\$ 20/Item
CUIC § 1126	Failure to File Returns	15%
CUIC § 1127	Return Dissatisfaction	15%
CUIC § 1135	“Finality Penalty”	15%
CUIC § 13052	W-2 Failure	\$ 50/Employee
CUIC § 13052.5	Failure to report amount	12.3%

Additional Penalties for Fraud

CUIC Code Section	Reason	Percent
CUIC § 1128(a)	Failure to file return	50%
CUIC § 1128(b)	Failure to provide information returns	50%
CUIC § 1128.1	Money laundering to conceal wages	100%

CUIC § 13071: Failure to Withhold

Section 13071 - Failure to deduct and withhold

13071
If the employer, in violation of the provisions of this division, fails to deduct and withhold the tax under this division, and thereafter the tax against which the tax may be credited is paid or the taxpayer reports to the Franchise Tax Board the wages or gross income against which the tax would have been imposed, the tax so required to be deducted and withheld shall not be collected from the employer, but this section shall in no case relieve the employer from liability for any penalties or additions to the tax otherwise applicable with respect to the failure to deduct and withhold.

(Amended by Stats. 1993, Ch. 402, Sec. 8. Effective January 1, 1994.)

California Appeals Process

- Appeal is to the California Unemployment Insurance Appeals Board (CUIAB)
- Called a “Petition for Reassessment”
- Appeal due 30 days from assessment
- Prevents assessment from becoming “final”

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CUIAB: Level One Hearing

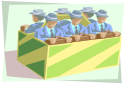
- Hearing conducted by ALJ, with petitioner presenting first
- Each party develops their case
- Either party may present witnesses
- In misclassified worker cases, EDD legal counsel may attend

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CUIAB: Level One Hearing

- ALJ will close hearing and take cause under submission
- Appeal to CUIAB itself within 30 days of ALJ decision also available if disagree with ALJ decision in level one hearing
- Generally, no new evidence can be submitted in appeal to the Board

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**Level Two:
Appeal to Board Itself**

- Must be in writing/state grounds
- Mailed within 30 days of ALJ decision
- Employer and EDD are not present during Board review
- No new evidence submitted
- Case number changes to "AO"

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**Level Two:
Appeal to Board Itself**

- Board reviews evidence and entire record/transcript and arguments
- Parties not present--done at scheduled meeting of the board
- The board issues written decision
- Further appeal requires payment of disputed tax

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**Further Appeal Rights
Pay tax and request refund**

- If CUIAB denies petition, employer may pursue appeal rights by paying the tax and filing a claim for refund with EDD
- If refund denied, employer may file a second petition with the Chief ALJ

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Further Appeal Rights Pay tax and request refund

- If employer disagrees with Chief ALJ, an appeal to the CUIAB may be made.
- After exhausting all **“administrative remedy”**, employer may take case to the Superior Court

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Settlements Program Eligibility

- Case timely petitioned to CUIAB or court
- Non-final tax liabilities
- Case cannot be still under audit, but denial of a claim for refund is under petition with CUIAB

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Settlements Program Basis for Consideration

- Risk of loss
- Cost of litigation
- Fairness
- Financial hardship
- Survival of the business
- Some agreements are subject to AG approval
- All settlements become public record

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Settlements Program Other Items

- Some agreements are subject to Attorney General approval
- Settlements become public record when amounts forgiven exceed \$ 500
- No prescribed application process

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Settlements Program Compared to OIC

- Neither consider fraud
- OIC based on ability to pay
- Settlement based on litigation risk
- OIC for final liability only
- Settlement for petitioned case

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Settlements Program Best time to File

- File concurrent to petition for reassessment
- Optimal time to file is before Level One hearing
- All agreements are final and cannot be appealed

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**Questions for Vicki?
Thank You!!**



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