The Internal Revenue Service (IRS) has undertaken initiatives to close the so-called tax gap—the difference between taxes owed by taxpayers and what actually is paid to the federal government. The most recent federal data estimates the tax gap at about $450 billion annually of which $141 billion is attributed to underreporting from small businesses.

As part of its initiatives, the IRS is sending letters to small businesses regarding possible underreported income and performing audits to verify worker classification.

**THE LETTERS**

Recently, the IRS sent Notification of Possible Income Underreporting letters to about 20,000 small businesses. This has raised serious concerns within the small-business community.

According to the IRS, the letters are being sent in response to the new Form 1099-K that reports business receipts from credit card companies and other third-party merchants to the agency. It is an attempt by the IRS to determine whether businesses are underreporting their gross receipts to evade tax liability. The IRS letter opens with, “Your gross receipts may be underreported” and goes on to instruct the taxpayer “to explain why the portion of your gross receipts from non-card payments appears unusually low” within 30 days.

The issue of small businesses reconciling their gross receipts developed when Form 1099-K was created by a provision in the Housing and Economic Recovery Act of 2008. After discussions with IRS officials, small-business owners were told they would not be required to take on this massive paperwork burden. However, credit card and third-party merchants still are required to submit Form 1099-Ks to the IRS for each business, and it appears the IRS is using this new information to increase revenue and has selected a few thousand businesses as test cases.

The IRS says it’s taking steps to minimize the burden to small-business owners, but any additional compliance requirements already are a burden for employers. The IRS sees this as a way to upgrade compliance and level the playing field for businesses that are playing by the rules and following the law.

**ACTIONS ON CAPITOL HILL**

In August, the chairman of the House Small Business Committee, Rep. Sam Graves (R-Mo.), sent a letter to the IRS highlighting the concerns of small-business owners who received such letters and asked the agency to modify this initiative in the future.

In September, the IRS responded and pointed out this is the first time it is using the information from the new Form 1099-K. The agency indicated it intends to use the information as a tool to help maximize tax compliance but it is willing to work with small-business owners and Congress to ensure information collected is used in a balanced manner.

**WHAT TO DO IF YOU RECEIVE A LETTER**

If you receive such a letter from the IRS, there is no reason to be alarmed. It is not an audit but rather a request for more information. However, do not ignore the letter. Failure to reply could result in compliance action against your business by the IRS.

Following are some tips provided by the IRS for letter recipients:

- If you receive a notice, be sure to read it thoroughly and complete any worksheets.
- Gather your tax records, including any 1099-Ks you have received, and determine whether you agree with the notice about any potential underreporting of gross receipts.
- If you have questions, use the contact information provided on the notice.
- If appropriate, consult your tax professional or someone familiar with construction businesses for assistance.

In your reply, you’ll need to report why your gross receipts from cash and checks appear low for your industry and business type. If you find errors in your tax returns, you are able to make corrections by submitting an amended Form 1040X. If you have found no errors, simply explain the reason for higher card and third-party merchant payments.

For more information, visit the IRS website at www.irs.gov/businesses/small-businesses-&-self-employed/new-notices-related-to-form-1099-K.
Worker misclassification is another factor IRS officials contend contributes to the nation’s tax gap. A recent report by the Treasury Inspector General for Tax Administration (TIGTA) found 19 percent of employers don’t accurately classify their workers. Employers do not need to withhold income, Social Security, Medicare and unemployment taxes for independent contractors as they do for employees. The TIGTA report also found for each misclassified worker, an employer can save $3,710 annually in payroll taxes.

President Obama’s budget for the 2014 fiscal year, which began Oct. 1, calls for $14 million to be allocated to combating worker misclassification by auditing businesses that may be classifying workers as independent contractors rather than employees. His request included $10 million in grants for states to identify misclassification and recover unpaid taxes and $4 million for personnel at the Department of Labor’s (DOL’s) Wage and Hour Division to investigate misclassification. This follows an initiative started in 2010 in which the IRS began a three-year program to audit 6,000 businesses with respect to proper worker classification.

The penalties for misclassifying workers can be substantial. When the IRS or a state agency rules an employer incorrectly classified an employee as an independent contractor, the employer may be liable for thousands of dollars in fines, back taxes and benefits.

The lines between an employee and independent contractor are not always clear. The Revenue Act of 1978, Section 530 created a safe-harbor provision that provides an employer with some protection from liability for accidental misclassification if the employer acted with a reasonable basis and treated workers consistently.

In a broad sense, an employee is someone who performs services for the business and the business controls what will be done and how it will be done. An independent contractor is an individual who the payer has the right to control or direct only the result of the work, not how it will be done.

Employee or independent contractor?

At the federal level, there are a number of factors that determine the difference between an employee and an independent contractor. Additionally, some states have set forth a more rigid standard than the federal government. There are three commonly used tests to determine whether a worker should be classified as an employee or independent contractor.

The first test is the common-law test. This is a 20-point checklist the IRS uses in its determination. The individual employed does not need to meet all 20 points to be classified one way or the other, and this can lead to confusion among employers. The IRS’ common-law rules can be found at www.irs.gov/publications/p15a/ar02.html#en_US_2013_publink1000169489.

Another test used by the DOL and some states is the economic reality test. This test consists of five determining factors to determine whether an individual is economically dependent on the employing business. Information about this test is available at www.dol.gov/whd/regs/compliance/whdfs13.htm.

The third test is the ABC test and is used by several states to determine unemployment compensation and tests only three factors. An example of an ABC test can be found at labor.vermont.gov/default.aspx?tabid=453.

However, none of these tests have hard and fast rules for determining classification; they mainly are guidelines to help employers determine how to classify their workers.

TIPS TO AVOID MISCLASSIFICATION

Unfortunately, there is no easy answer to determine who is an independent contractor. It is important you think through the relationship and take steps to justify your decision to use an individual as an independent contractor rather than an employee. If you are selected for an audit and have documentation demonstrating a thorough review of the determination was made, it will show you were acting in good faith.

The following tips will help you avoid worker misclassifications:

• Have signed contracts that state the nature of relationships and the level of control you have as a business owner
• Clearly communicate expectation and goals
• Keep detailed financial records
• Treat employees and independent contractors differently but fairly


Retain documentation

The key to working with the IRS is having proper documentation. Whether you receive a letter from the IRS regarding underreported income or are audited for worker misclassification, having a paper trail of all your decisions will ensure you are ready and prepared to defend yourself and your business.

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