

IRS Employment Tax Audit
AASBO Certificate Program
February 12, 2018

IRS – Office of Federal, State & Local Government (FSLG) , established in 2000

The first years of the FSLG existence were spent on training and awareness, now the focus is on enforcement.

Mobile County Public School System was the first Alabama school system to be audited.

SPOTLIGHT: Contractors vs. Employees
Other areas reviewed include: Cell Phone Policy, Vehicle Policy, Employee Fringes & Cafeteria Plan

Extensive Data Provided

- ❖ Electronic files: Payroll, Chart of Accounts, General Ledger, Cash Disbursements Journal, W-2, 1099, Vendor, etc.
- ❖ Vendor W-9
- ❖ Quarterly 941
- ❖ Contracts with Individual Contractors
- ❖ Superintendent Contract
- ❖ Policies–Vehicle, Inventory, Employees Driving, Uniforms
- ❖ Employee Handbook
- ❖ Employee Fringes
- ❖ 125 Cafeteria Plan
- ❖ Employee Assistance Programs
- ❖ Travel Reimbursement Backup

IRS Findings

- ▶ A small number of instances were found where a 1099 was not issued and should have been (Vendor not tagged as "1099 Vendor" in NextGen).
- ▶ We have various situations in which we contract with an individual to perform services rather than adding a fulltime position. These individuals were paid as self-employed contractors via Accounts Payable and issued a 1099. The IRS determined that all of these individuals should be paid via payroll and the applicable taxes should apply.



The contractor payments which the IRS did not agree with can be broken into the following groups:

- Parent Organizers
- Non-Public School Service Providers
- Tutors
- Therapists (Speech/Language & OT/PT)
- Other consultants
- Known Employees

Parent Organizers

- ▶ These individuals were purposefully retained via contract so that they would not become tenured employees.
- ▶ Parent Organizers are individuals who work with the parents to increase parental involvement in schools with this deficiency.
- ▶ Future options offered were: contract with an agency, set up as part time employees, or eliminate the 'position.'

Tutors

- ▶ We utilize college students and retired teachers as tutors.
- ▶ They provide intermittent services and will be paid via payroll in the same manner as that of a substitute.



Therapists

- ▶ This group includes Speech/Language, Occupational, and Physical Therapists
- ▶ In the past we used a mix of agencies and individuals.
- ▶ Going forward we will only utilize organized businesses.



Individual therapists can set up an LLC to continue as our provider.

Other Consultants

- ▶ We will continue to contract with consultants who provide short term workshops and staff development as this is their business and they provide the same service to a number of other clients.
- ▶ We will no longer contract with an individual to provide long term on-site services, such as managing one of our grants or programs.
- ▶ Utilizing an individual with an organized business, such as an LLC, will be reviewed independently by case.

Known Employees

- ▶ We unknowingly paid some regular employees for tutoring and/or other extra work via accounts payable. They were turned in by schools/departments as part of a list of contracted individuals.



Taxes Assessed by IRS

- ▶ The Board was charged for the employee and employer share of the following taxes on the contracted individuals:
 - Federal Income Tax
 - Social Security Tax
 - Medicare Tax



Section 530 Relief

- ▶ To receive relief, you must meet all three of the following requirements:
 1. You had a reasonable basis for not treating the workers as employees.
 2. You must have treated the workers, and any similar workers, as independent contractors. [If you treated similar workers as employees, this relief provision is not available.](#)
 3. You must have filed all required federal tax returns (including information returns) consistent with your treatment of each worker as not being employees.

IRS Publication 1976

Appeal ? – Factors to Consider:

- ▶ Chances of winning
- ▶ Legal Fees
- ▶ Audit of subsequent years



It was in our best fiscal interest to settle/agree with IRS.

GOOD NEWS?

- ▶ **No Willful Intent**
- ▶ Because the IRS realized there was no willful intent by Mobile County and the system did not intentionally disregard IRS rulings, reduced rates were applied to our assessment.
- ▶ The application of these reduced rates cut the total assessment significantly.



Compliance Self Assessments

- **IRS Form 14581-A**
Fringe Benefits Compliance
- **IRS Form 14581-D**
Other Tax Issues

Common Errors

- ▶ Totals shown on Forms 941 do not reconcile with totals on Forms W-2 and W-3, or between these forms and the accounting records.
- ▶ Forms W-9 and W-4 are not being used or are not being updated when necessary.
- ▶ Failure to backup withhold on payments to vendors when required.
- ▶ Failure to correctly complete or file Forms 1099.
- ▶ Failure to apply accountable plan rules to reimbursements and allowances.

Common Errors

- ▶ Incorrect or missing employment tax deposits.
- ▶ Failure to follow electronic filing requirements.
- ▶ Treatment of certain groups of workers as independent contractors instead of as employees.
- ▶ Failure to pay and withhold Medicare-only tax on rehired annuitants.
- ▶ Failure to include taxable noncash benefits in employee wages.

Why an Independent Contractor?

- ▶ School boards are not required to withhold taxes, make social security and Medicare contributions, provide health insurance or TRS.
- ▶ School boards can more easily expand or contract their workforces to accommodate workload and student enrollment fluctuations.

Why an Independent Contractor?

- ▶ Workers who have specialized talents or technical expertise, and hence are in demand, may insist or indicate a strong preference that they be retained on an independent contractor basis which will provide higher pay than school board salary schedules.
- ▶ Political pressure.

IRS Position

- ▶ The IRS has abandoned its old 20-point test for a more streamlined test of 3 factors an employer should consider when deciding on the status of a worker or a group of workers, but IRS acknowledges that there is no “magic” formula that makes the worker an employee or independent contractor, and no one factor can stand alone. All information that provides evidence of the degree of control and the degree of independence must be considered.

IRS Position

- The key is to look at the entire relationship and to document each of the factors in making the independent contractor determination. The factors are:**
- **Behavioral:** Does the employer control **or have the right to control** how the worker does his/her job?
 - **Financial:** Are the economic aspects of the worker’s job, including expenses and tools or supplies, controlled by the employer?
 - **Type of Relationship:** Is the work performed a key aspect of the operation; will the relationship continue; are there written contracts or employee-type benefits?

IRS Position

▶ Behavioral Control

-if the worker receives extensive instructions on how work is to be done, this suggests that the worker is an employee.

-if the school board provides training about required procedures and methods, this indicates that the school board wants the work done in a certain way, and this suggests that the worker may be an employee.

IRS Position

▶ Financial Control

-if the worker has a significant investment in the work, the worker may be an independent contractor.

-if the worker is not reimbursed for some or all business expenses, then the worker may be an independent contractor, especially if unreimbursed business expenses are high.

-if the worker can realize a profit or incur a loss, this suggests that the worker may be an independent contractor.

Independent Contractor

The control factor should not be given undue weight. The factors should be considered in totality to determine whether a worker is economically dependent on the employer.

If a school board's main goal is for the task to be completed at a certain time but does not care how the job is accomplished between Point A and Point B - that is a good indicator that the worker is an independent contractor.

U. S. Labor Department

- ▶ The economic realities factors guide the determination of whether the worker is truly an independent business or is economically dependent on the employer.
- ▶ The courts have described independent contractors as those workers with economic independence who are operating a business of their own.

U. S. Labor Department

- Is the work an integral part of the employer's business?
- Does the worker's managerial skill affect the worker's opportunity for profit or loss?
- How does the worker's relative investment compare to the employer's investment?
- Does the work performed require special skill and initiative?
- Is the relationship between the worker and the employer permanent or indefinite?
- What is the nature and degree of the employer's control?

IRS Position

- ▶ For many years employers tried to argue that simply because they had identified the worker as an independent contractor that this, in and of itself, was sufficient, but the courts and the workforce agencies have rejected that argument. Just because you call it a duck does not make it a duck.

IRS Position

- ▶ It is easy to see why a school board would want to classify a worker as an independent contractor, but, if the school board is wrong, all of the expenses it was trying to avoid it will have to be paid.
- ▶ If you gamble and are wrong, the stakes are very high.

Independent Contractor?

- ▶ Just because an individual has a LLC or a contract that says the school board is employing the individual as an independent contractor does not mean the school board is exempt from withholdings and matching benefits.

QUESTIONS ?
