

Independent Contractors and Employment Tax Audits

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Did you know that at least four government agencies look over your shoulder when you use independent contractors in your business rather than employees?

The Internal Revenue Service (IRS), Arizona Department of Revenue (DOR) and Arizona Department of Economic Security (DES) would have you reclassify subcontractors as employees so that each can collect from you the employment taxes that "should have been withheld," as well as large fines, penalties and interest. The Arizona Industrial Commission and State Compensation Fund also have an interest in ensuring you do not skirt your workers' compensation responsibilities through the improper characterization of employees as independent contractors.

Why should you care? Not only might an audit result in fines, penalties and interest to the business, but employment taxes are so called "trust fund" taxes. This means that owners, officers and directors, as well as other "responsible persons" of the business, can be individually, personally liable for these taxes! Planning makes the difference between winning and losing.

What determines whether an independent contractor relationship exists? The facts of the relationship must strongly support non-employee status. At a minimum, you cannot exercise dominion and control over the work of the contractor. You can specify "what" is to be done, but not "how" it is to be done. Other important factors in determining independent contractor status are:

- whether a written agreement exists specifying the nature of the relationship, including each party's duties and responsibilities with respect to taxes (the agreement will need specific information to satisfy the Industrial Commission regarding workers' compensation issues);
- whether the contractor use his/her own tools and equipment;
- whether the contractor have his/her own business telephone number, business card, letterhead, invoices, and other printed items; and
- whether the contractor file tax returns showing self employment (such as the 1040 Schedule C).

It's never too early to help ensure your characterization and treatment of independent contractors will be upheld when challenged by a governmental agency having an interest in reclassifying these contractors as employees. Being sure the facts of the relationship truly support independent contractor treatment, and then properly documenting that relationship, is a big first step.