



MAKE SURE YOUR CONSTRUCTION WORKERS ARE PROPERLY CLASSIFIED: *NEW LAW IMPOSED HEFTY FINES FOR NONCOMPLIANCE*



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New Jersey business headlines have been filled with articles about Governor Corzine's crack-down on misclassifying construction workers. A recently-signed bill imposes hefty fines on construction companies who misclassify workers to avoid payroll taxes. While worker misclassification has always been a source of concern for tax professionals, the new state-imposed fines (as high as \$75,000) have some construction company owners and financial officers worried. The proper classification of workers is not always straightforward and is further complicated by the various payroll statutes. There are separate Federal and state payroll statutes and classification criteria for each type of tax. As a result, an employer could have a worker who is classified as an employee for state unemployment and disability purposes but as an independent contractor for one or all of the other types of payroll taxes.

To grasp the complexity involved in this determination, business owners need to gain an understanding of the tests outlined in each payroll statute.

FEDERAL CLASSIFICATION

Since Federal income tax withholding, Social Security and Medicare Tax, and Federal Unemployment Tax are each governed under separate statutes, an analysis of each tax is generally necessary for most types of workers.

Federal regulations provide for three classification rules: statutory employee and non-employee rules, common law control rules and Section 530 relief rules.

Certain occupations, such as qualified real estate agents, are automatically classified as statutory non-employees, and thus are treated as independent contractors under all three Federal payroll tax statutes. It is not necessary to perform any further evaluation in this case. Similarly, some occupations are classified as statutory employees as a matter of law. However, unlike statutory non-employees, these classifications differ between the payroll tax statutes, making it necessary to review each statute separately.

Many employers believe that a written employment contract stating that a worker is an independent contractor will protect them upon audit, but such a document only offers evidence concerning the intent of the relationship. Although this type of document provides no guarantees, if properly structured, it can help to establish other important evidence essential to meeting the common-law control test. However, the most well-written contract in the world holds no value if the facts and circumstances of the actual relationship do not support it. An auditor will look at different types of control between an employer and his workers, including behavioral and financial control, as well as the relationship of the parties.

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Behavioral controls may be demonstrated by such factors as the employer's ability to dictate the exact manner in which a job is performed or the hours that must be worked. Providing workers with office space at the employer's location or supplying them with tools to perform services may indicate financial control. Other factual evidence may also be considered, such as the worker's formation of a separate legal entity and the manner in which income and expenses related to the activity are reported for tax purposes. While any of these factors may be indicative of the type of relationship between the employer and the worker, no one factor determines the outcome. All evidence should be looked at in its entirety.

Since not all industries operate the same way in the marketplace, some employers may find relief under Section 530 of the Revenue Act of 1978, which was enacted due to complaints that the Internal Revenue Service used the common-law control test to arbitrarily reclassify workers as employees. An employer may treat a worker as an independent contractor if these four eligibility requirements are met:

1. Consistently treating the worker in question as an independent contractor. Alternately or simultaneously treating a worker as an independent contractor and an employee from year to year violates this requirement.
2. Consistently treating all other workers within the same job class as independent contractors for all periods beginning after 1977.
3. Consistently reporting all amounts paid to workers being classified on Forms 1099-MISC, when required.
4. Demonstrating a reasonable basis for treating the worker as an independent contractor. An employer may rely on one or more safe harbors or other reasonable basis for meeting this requirement. The safe harbors are: court cases or published rulings, prior IRS audits or industry practice.

If an IRS auditor determines that an employer meets some of the eligibility requirements for relief under Section 530, he/she will offer a settlement under the Federal Classification Settlement Program (CSP). A CSP offer is graduated based upon how many requirements are satisfied and range from 25% to 100% of one year's tax liability. The real benefit to these settlements is that there is no assessment on prior years provided the employer properly classifies the worker as an employee prospectively.

NEW JERSEY CLASSIFICATION

Not unlike the Feds, New Jersey has separate classification rules for income tax withholding and unemployment and disability taxes. To further complicate matters, they are administered by two separate governmental agencies.

Although the IRS determination of a worker's classification is a factor, NJ utilizes its own 14-point test for income tax withholding purposes. Many of the factors are the same or similar to the Federal tests, but they may not always yield the same result. In the case of construction contractors, income tax withholding may be necessary even if a worker is an independent contractor. A recent law change made a seven percent income tax withholding mandatory for unincorporated, unregistered construction contractors effective January 1, 2007.

The NJ Department of Labor imposes the "ABC Test" upon employers to make a determination for unemployment and disability purposes. The factors of this test are:



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- A. **Control.** The same control factors as used in the Federal common-law control test are analyzed – behavioral, financial and relationship.
- B. **Outside the usual course of business.** To meet this test, workers must not perform the same job as other workers who are treated as employees.
- C. **Customarily engaged in independently established trade or business.** The worker must demonstrate that independent business is conducted by any factual means possible, including establishment of a separate business entity, business cards and advertising.

What are the red flags that can trigger an audit? Barring specific industry practices, businesses issuing large numbers of Forms 1099-MISC relative to Forms W-2 are prime targets for an audit. Using independent contractors who receive only one or very few Forms 1099-MISC from other employers may also increase the risk of an audit. Although most independent contractors want to avoid employee classification just as much as the employer does, audits can arise as a result of complaints from workers and labor unions. Some workers may want to be treated as employees in order to be entitled to benefits. An unfavorable finding in this instance may affect the employer's cost of health insurance, pension contributions and any other benefits to which employees are entitled, in addition to the payroll tax assessment. The construction industry, in particular, bears its own inherent risk of audit since the IRS and Governor Corzine have targeted this sector.

The IRS and the State of New Jersey are aggressively seeking to create more tax revenue, and this area of taxation provides a terrific opportunity to do just that because of its complexity. As they say in sports, the best defense is a good offense. Employers should review their own individual situations to determine if worker classification is an issue. If so, engaging a tax professional to perform an analysis of your employment practices and workers can highlight areas of concern, help to minimize risk and provide strong audit support.

As one of the leading accounting and consulting firms for the construction industry, Cowan, Guteski & Co., P.A. provides clients with advice and counsel on how Federal and state tax laws could impact your business. Our goal is to position your construction company to take advantage of all legitimate strategies to minimize your tax obligation. Contact Dawn Greenberg, CPA, Tax Principal, at 732-349-6880 extension 118 or dgreenberg@cowanguteski.com to discuss your particular situation.

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