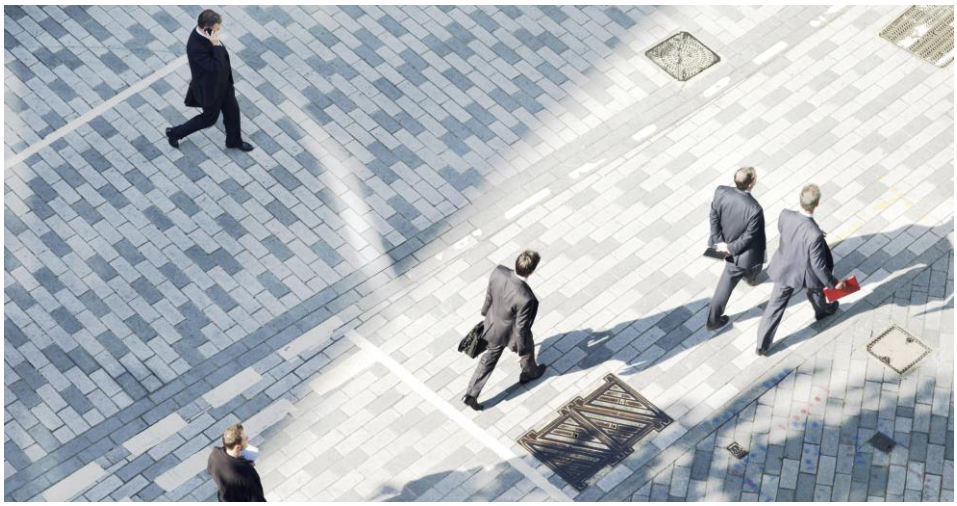
PwC's Tax

salt trends

A state and local tax publication from PwC



A General Accounting Office report estimates that the federal and state governments lose $20 billion each year to employees who are misclassified as independent contractors. The IRS estimates only 15% of independent contractors pay the proper amount of tax due, while 90% of W-2 employees properly report the amount they owe. Accordingly, there is intense scrutiny on contractor arrangements as well as the proper and timely reporting of the related compensation (Form 1099-MISC) paid by US companies.

Gaining a foothold in state and local 1099 compliance while all eyes focus on closing the tax gap

Forms 1099 are used to report amounts paid in the course of a trade or business generally to individuals and unincorporated entities with some exceptions. Form 1099 reporting is usually required whenever payments aggregating $600 or more are made in the form of: (1) commissions, fees, and other compensation for services, or (2) interest, dividends, rents, royalties, annuities, pensions and other gains, profits, or income paid by a person in the course of a trade or business. If a 1099 is required, a copy must be furnished to the individual who receives the payment, and filing copies must be submitted both to the Internal Revenue Service (IRS) and respective state agencies. The purpose of these information returns is to assist the IRS and state departments of revenue in determining whether a taxpayer has properly reported all taxable income. A company's failure to comply with these requirements may result in the imposition of penalties.

A recent trend at the state and local level is the increase in activity surrounding various Forms 1099. While the cause at its core is a general lack of state revenue and the belief that many employees are misclassified as independent contractors, the changes are currently driven by multiple approaches to addressing the issue of revenue shortfalls. Whether through legislation, a change in enforcement, or better collaboration between the IRS and state agencies, efforts to collect more tax dollars are increasing the burdens put on employers and making compliance difficult to manage.

States are motivated to increase revenues in the hope of alleviating fiscal concerns. Law makers are helping by pursuing options via legislative changes to better equip their revenue agents with access to electronic information, electronic funds transfer (EFT) deposits, and backup withholding funds. In addition, state and local departments of revenue are focusing on compliance initiatives surrounding Forms 1099 and increasing audit activity. On a separate front, the IRS and Department of Labor (DOL), among other entities, are creating multi-agency initiatives, which often involve state counterparts. For example, since 2007, there has been an increase in cooperation between federal and state agencies as it relates to employment tax matters and employee

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classification issues. [1] This cooperation is evidenced by information sharing initiatives and collaborative intent of a memorandum of understanding (MOU) between the DOL and at least 37 state labor agencies. An MOU is an exchange agreement that allows participating states to exchange audit reports and associated case information, audit plans, best practices, training, outreach, and education with the IRS. MOUs may be used for side-by-side examinations and represent the first centralized and uniform mechanism for employment tax data exchanges.

Until recently, most companies felt they had a handle on 1099 reporting if they participated in the IRS' Federal/State Combined Filing Program, described below. Unfortunately, changes at the state and local level to raise revenue via new rules and enforcement around information reporting are impacting an employer's ability to comply, despite the combined filing program. Accordingly, now is the time for companies to review their 1099 policies and procedures to identify areas of weakness, implement changes to strengthen positions, and gain a foothold in the compliance arena.

[1] Employee classification impacts Form 1099 reporting, as a nonemployee determination results in an independent contractor relationship whereby fees paid in exchange for services in the amount of $600 or more are reported on Form 1099-MISC.

The historic paradigm

Companies with significant 1099 reporting responsibilities likely participate in the Federal/State Combined Filing Program. The program was established to simplify information return filing processes for taxpayers. Under the program, the IRS will forward original and corrected information returns filed electronically to participating states for all approved filers, thus relieving the need in many circumstances to file separately at the state level.

Participating States in CF/SF Program		
Alabama	Indiana	Nebraska
Arizona	Iowa	New Jersey
Arkansas	Kansas	New Mexico
California	Louisiana	North Carolina
Colorado	Maine	North Dakota
Connecticut	Maryland	Ohio
Delaware	Massachusetts	South Carolina
District of Columbia	Minnesota	Utah
Georgia	Mississippi	Virginia
Hawaii	Missouri	Wisconsin
Idaho	Montana	

1099 Information Returns that may be filed under CF/SF Program	
Form 1099-DIV	*Dividends and Distributions*
Form 1099-G	*Certain Government Payments*
Form 1099-INT	*Interest Income*
Form 1099-MISC	*Miscellaneous Income*

1099 Information Returns that may be filed under CF/SF Program	
Form 1099-OID	*Original Issue Discount*
Form 1099-PATR	*Taxable Distributions Received From Cooperatives*
Form 1099-R	*Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*

Unfortunately, only 32 states participate in the program and, while it covers many of the 1099 forms, it does not cover all of them. It is also important to understand that traditionally 14 of the participating states had required a direct filing of any 1099 form to the state agency when state taxes have been withheld. That is, these states require a separate 1099 filing regardless of participating in the Federal/State Combined Filing Program. Despite these exceptions, this program had helped to simplify the information return filing process and as a result likely bred a false sense of security. Now however, the exceptions are growing and, as a result, increasing an employer's burden to the point of making 1099 compliance very difficult to manage. The current state and local environment now highlights how important it is for employers to be proactive in understanding when participation in the combined filing program covers their state compliance responsibilities and when it does not.

For example, there is a new 1099 form to consider, as highlighted below, which is not part of the program and thus will require an understanding of state expectations with respect to transmitting this form. In addition, new compliance

concerns regarding more stringent e-filing and electronic funds transfer deposit requirements as well as pressure to comply with separate filing requirements at a local level further contribute to the compliance burden. Lastly, companies are beginning to see expanded reporting requirements pertaining to certain contractual relationships that require year end 1099 reporting. That is, while these requirements do not impact the actual 1099 they are associated in that the filing of one triggers the necessity of the other. For example, if a company hires an independent contractor, it used to track only the payment threshold of $600 or more in a calendar year to determine whether filing a Form 1099-MISC was appropriate. Now, by virtue of hiring an independent contractor, that company must analyze the contract and if it satisfies certain thresholds, notify respective state agencies of the relationship by filing a report that reflects certain tax identification items in a timely fashion. Thus, if the company files a Form 1099-MISC at the end of a year for a contractor but neglects to file the state notice at the beginning of contracting relationship, it will be out of compliance with state law and subject to the consequences. In this case, the Form1099-MISC filing triggers the flag to determine whether the company lacks compliance with another agency.

Heightened scrutiny — National Research Project

Increased scrutiny often accompanies enhanced compliance burdens, as is the case with independent contractors and Forms 1099-MISC. While not related to the practical application of the combined filing program but to 1099 compliance in general, the use of Form 1099-MISC, which is frequently employed to report income paid to independent contractors, is under scrutiny. This scrutiny is based on the governments belief that billions of dollars are lost each year to misclassification issues, and is evidenced by being one of three major focus issues in the IRS' National Research Project. The National Research Project is a comprehensive study of employment tax compliance involving the audit of 6,000 companies between 2010 and 2012 for purposes of examining worker classification, employer-provided fringe benefits, and officer compensation. In addition, state and federal task forces are concentrating on companies that file Forms 1099-MISC for independent contractor arrangements and recovering significant tax dollars in the process due to the reclassification of workers as employees (as discussed below).

What you need to know

New Form1099-K

New Form 1099-K, Merchant Card and Third Party Network Payments, aimed at banks or other payment settlement companies that process credit cards, debit cards, and electronic payments, requires a subject bank or settlement entity to issue information returns telling the IRS what merchants receive. State Form 1099-K filing requirements are evolving. Currently, four states — California, Hawaii, New Jersey and New York — have provided a requirement for direct reporting of 1099-K information to their tax departments. At this time, Form 1099-K is not a form currently supported by the Federal/State Combined Filing Program.

As time passes and states begin to understand the information captured on Form 1099-K, there will likely be an increase in direct state reporting requirements.

Misclassification Initiatives

A precursor to 1099 reporting is worker classification. Regardless of an employer's participation in the Federal/State Combined Filing Program, if classification is incorrectly assigned at the outset of the service arrangement then compliance is considered compromised. Thus, all companies should examine the Misclassification Initiatives to understand their potential for compliance exposure. A newly proposed DOL initiative — the Misclassification Initiative — aims to strengthen and coordinate federal and state efforts to enforce labor violations that result from the misclassification of employees as independent contractors and to deter such violations in the future. Specific focus is on misclassified workers who are deprived of benefits and protections to which they are legally entitled as employees, such as overtime and unemployment benefits.

In the 2012 federal budget, the DOL requested $46 million to combat worker misclassification through a new multi-agency initiative that would include the DOL's Wage and Hour Division, the Office of Federal Contract Compliance Programs, the Occupational Safety and Health Administration, the Office of the Solicitor, and the Employment and Training Administration. This includes $15 million for the Wage and Hour Division for purposes of adding headcount, providing field investigator trainings, and performing 3,250 additional investigations. According to the DOL website, these investigations will be directed toward industries that have higher rates of misclassification, such as construction, healthcare, educational services, food services, professional services, amusement and recreation, and credit services.

Components of the initiative provide states with an opportunity to apply for grants to:

- increase their ability to participate in data sharing initiatives with the IRS and other federal/state agencies
- implement audit strategies
- establish multi-agency task forces to target egregious employer misclassification schemes (for purposes of avoiding taxation) and
- develop educational and training programs.

In addition to these grants, a High Performance Awards program, structured to provide bonuses to states that are most successful in improving their worker misclassification efforts, is getting favorable attention. Ideally, these states would receive incentive funds to upgrade their misclassification detection and enforcement programs.

This federal initiative comes at a time when many state legislatures have enacted laws seeking to curb employee misclassification by imposing strict requirements and severe penalties for employers. For example, Massachusetts enacted an independent contractor law that creates a presumption of employee status for purposes of the state's wage laws. Companies must satisfy a strict three-part test to overcome this presumption. New York also imposes significant penalties for misclassification and other states such as Illinois, New Jersey, Minnesota, and Wisconsin have enacted specific misclassification statutes.

Another approach taken by states, including New York, California, Connecticut, Iowa, Maryland, Massachusetts, Michigan, Minnesota, Nevada, New Hampshire, New Jersey, Oregon, Rhode Island, Utah, Vermont, and Wisconsin has been to organize misclassification task forces to combat employers who seek to circumvent state and federal wage-hour, health and safety, unemployment, and workers' compensation laws. This strategy has seen great success.

As data sharing initiatives and federal/state collaborative efforts grow, there will be more worker classification audits. Both federal and state agencies are seeing the benefits to investing in worker-classification task forces, as evidenced by Massachusetts' 09-10 and New York's 2009 recovery of unpaid taxes in the amount of $6,489,549 and $35,900,000, respectively.

More stringent requirements

It is important to keep abreast of the variations between federal and state filing thresholds even when participating in the Federal/State Combined Filing Program. States continue to move toward mandatory e-filing requirements and electronic funds transfer deposits in cases where state taxes are withheld. Also some states are looking to reduce the number of Forms 1099 that trigger e-filing requirements. For example, Indiana recently enacted a "25-statement" trigger whereby all employers who submit 25 or more withholding statements are now required to submit the WH-3 and related 1099-R/W-2s electronically for any statements filed after December 31, 2010. Kansas and Maine require electronic filing in cases in which state taxes have been withheld; while Oklahoma and New Mexico require it after their state liability exceeds a given threshold. With respect to e-filing thresholds, Illinois, Massachusetts and Nebraska have new EFT deposit thresholds that vary depending on amount or whether one is required to file electronically for federal purposes. As a best practice, it is important to annually review states' law changes to ensure current systems can accommodate new rules.

With respect to stricter filing requirements, expect a growing trend of states that follow the federal backup withholding rules. That is, when a payor does not collect a proper name, address and taxpayer identification number on Form W-9 from a 1099 recipient or when a payor receives a B-Notice (a specific mandate for a specific individual) from the IRS, then that payor is required to

withhold 28% federal income tax from the payment prior to distributing to the recipient. To date, California, Colorado, Iowa, Maine, Minnesota, South Carolina, and Vermont currently follow this practice and require backup withholding at respective state rates, if federal backup withholding is required. This list is expected to expand over the next few years to include other states. Also, the number of states requiring withholding on nonresidents or certain labor services is expected to increase. Considering 36 states currently require 1099 reporting for various types of nonpayroll compensation and other miscellaneous income, changes to backup withholding requirements or withholding on nonresidents can quickly add to the 1099 compliance burden.

Enforcement at the local level

There has been an increase in audit activity from certain localities in Michigan and Kentucky as it relates to 1099-MISC reporting. Companies are often surprised to learn that if 1099 recipients are residents of local taxing jurisdictions, there may be a separate filing requirement at the local level. For example, taxpayers, making nonemployee compensation payments of $600 or more to recipients (other than employees) for services performed within certain Kentucky counties are responsible for maintaining records of those payments. Moreover, taxpayers making such payments are responsible for completing and submitting local versions of Form 1099 (e.g., Form 1099-LX, 1099-SF, etc.) to the respective county government. Likewise, payors who are required to file form 1099-MISC with the Internal Revenue Service, must also file with the state of Michigan and with the payee's city of residence if that city imposes an income tax. Thus, it is important to keep local jurisdictions in mind when reviewing 1099 policies and procedures.

New contractor reporting

There is a growing pattern in new contractor reporting requirements stemming from state efforts to better manage and collect child support payments. For example, Alabama now requires employers who hire independent contractors to report the contractor's name, address and date of hire. California requires similar reporting within 20 days of making payment, or entering into a contract for $600 or more, which differs from Maine's rule to report within seven days of making payment of $2,500 or more. Diligence in keeping up with the other state reporting requirements will contribute to compliance sustainability.

Patient Protection and Affordable Care Act of 2010 - Implications on Worker Classification

The Patient Protection and Affordable Care Act of 2010 (ACA) could significantly increase potential liabilities associated with worker misclassification of independent contractors. Specifically, the ACA imposes a monthly excise tax upon certain employers that fail to provide healthcare coverage to full-time employees. In the worker classification area, an independent contractor that is misclassified could potentially be deemed a full-time employee that would be entitled to coverage had they been classified correctly.

Under existing statutes, an employer that does not offer benefits to certain full-time employees (i.e., misclassified independent contractors) could be subject to a monthly excise tax equal to the number of full-time employees (minus 30) times 1/12th of $2,000. As such, worker misclassification could potentially result in an annual ACA penalty of approximately $2,000 times the entire full-time headcount of the company. Further, under current statutes, it does not appear that section 530 relief would negate the imposition of ACA penalties as ACA penalties are assessed under a Subtitle of the Internal Revenue Code for which section 530 relief does not apply.

A foothold for the future

It should no longer be a surprise why one of the more burdensome challenges facing large companies today is effectively managing their 1099 reporting requirements. To complicate the issue, companies now must contend with the barrage of new or changing state and local rules surrounding 1099 compliance. This landscape, coupled with the increase in audit frequency due to federal and state data-sharing programs and joint-task initiatives, should encourage companies to review their 1099 policies and procedures. Proactively identifying weaknesses and implementing change to address the new requirements is a great step toward gaining a foothold in the compliance arena.

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