Potpourri of Self-Employment Tax Pitfalls

May 12, 2020

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Agenda

- Pitfall #1 – Worker Classification Issues
- Pitfall #2 – Problems with Payroll Tax / TFRP
- Pitfall #3 – Estimated Tax Payments
- Pitfall #4 – Expense Deduction Documentation Danger
Pitfall #1 – Worker Classification Issues

- **Independent Contractor vs. W-2 Employee.**
  - Benefits and protections
  - Taxes

- **Why Are Workers Misclassified?**
  - Business decision - less paperwork; reduced financial burden
  - Lack of understanding

- **Impact of misclassification.**
  - Audit
  - Potential assessment of unpaid federal and state income tax, payroll tax, workers compensation ins. etc.
  - Financial burden on business
  - Time spent dealing with govt agencies trying to comply with audit / compliance issues.
  - Implications for employees
Pitfall #1 – Worker Classification Issues

- **Independent Contractor vs. W-2 Employee.**
  - No single test used among agencies.
  - Common law principles used
  - Factors, generally:
    - Behavioral Control.
    - Financial Control.
    - Relationship of the Parties.
Pitfall #1 – Worker Classification Issues

- **Best Practices / Guidance.**
  - **Education** about potential issues, financial impact.
  - **Correct worker misclassification.**
    - IRS Form SS-8, Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding.
    - Section 530 Safe Haven Safe Harbor Relief.
    - CSP - Classification Settlement Program.
    - VCSP – Voluntary Classification Settlement Program
Pitfall #2 – Problems w/ Payroll Tax/TFRP

- **Payroll/Employment Taxes.**
  - Quarterly
    - Federal tax deposits.
    - Form 941, Employer’s Federal Tax Return
  - Annually
    - Form 940, Employer’s Annual Federal Unemployment (FUTA) Tax Return
    - Form W-2, Wage and Tax Statement
    - Form W-3, Transmittal of Wage and Tax Statements
- **IRC 3402** - requires that tax be deducted and withhold from wages
Pitfall #2 – Problems w/ Payroll Tax/TFRP

- **Problems.**
  - Failure to pay employment taxes b/c wrong worker class.
  - Failure to pay employment taxes due to business financial problems.

- **Impact.**
  - Trust Fund Recovery Penalty (“TFRP”) assessment.
    - Form 4180 Interview
    - IRC 6672 – Civil penalties IF fail to withhold, & pay trust fund taxes to IRS
    - Responsible & Willful
  - Employee considerations.
Pitfall #2 – Problems w/ Payroll Tax/TFRP

- **Best Practices / Guidance.**
  - **Proactive Guidance.**
    - Ensure proper worker classification & come into compliance with payroll tax req’ts
    - Use payroll service to ensure filing / payment compliance
    - Keep separate “payroll” bank account. No commingling.
    - Be thoughtful in who performs payroll duties.
  - **Reactive Guidance.**
    - Legal representation in case of proposed TFRP assessment highly advised
    - Collection alternatives
Pitfall #3 - Estimated Tax Payments

- SE Taxpayer’s income is subject to:
  - Income Tax. Based on all sources of income.
  - Additional Medicare Tax. IF SE net earnings exceeds certain thresholds, based on filing status.

- Estimated Tax Payments (“ETPs”) should be made quarterly IF expect to owe $1K or more in income & SE tax, combined.
  - Form 1040-ES, Estimated Tax for Individuals

- ETP can be paid: online, mail check, over phone, auto EFT
Pitfall #3 - Estimated Tax Payments

- **Problems:**
  - Not keeping current with business bookkeeping.
  - Not paying Quarterly ETPs → Pattern of non-compliance.
  - Penalties (FTF, FTD, FTP) & Interest.
  - IRS Collection activities.
Pitfall #3 - Estimated Tax Payments

- **Best Practices - Guidance.**
  - Maintain records regularly.
  - Prepare quarterly P&L.
  - Set aside funds for tax every time pay self.
  - Bank accounts
    - Dedicated business/tax-related bank account.
    - No commingling business with personal bank / expenses.
  - Pay ETP quarterly – recommend overpay.
Pitfall #4 – Deduction Documentary Dangers

- Deductions are allowed for ordinary and necessary expenses paid or incurred during the taxable year in carrying on a business or trade. IRC § 162(a).
  - **Ordinary** – “customary or usual and of common or frequent occurrence in the taxpayer’s trade or business.”
  - **Necessary** – appropriate or helpful to the development of the taxpayer’s business.
  - **Reasonable** – is “inherent in the phrase "ordinary and necessary."
  - No deduction for personal, living, or family expenses. IRC §262.
Pitfall #4 – Deduction Documentation Danger

- **Substantiation.**
  - **Burden of Proof.** TP has burden to prove s/he is entitled to claim deduction.
  
  - **General Rule.** TPs “shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.” Treas. Reg. 1.6001-1(a).
  
  - **Cohan Rule.** If TP establishes eligibility for some deduction but the exact amount is unknown, the court may allow an estimated amount.
    - *Cohan v. Commissioner,* 39 F.2d 540, 544 (2d Cir. 1930).
    - N/A as to IRC 274 expenses re travel, meals, and entertainment
    - N/A when TP maintained books/records, but did not provide them.
Pitfall #4 – Deduction Documentary Dangers

• **Challenges.**
  • Time constraints.
  • Lack of understanding as to expense deduction requirements.
  • Unorganized/incomplete expense documents.
  • Commingling bank accounts.
Pitfall #4 – Deduction Documentary Dangers

- **Best Practices – Guidance.**
  - TPs should read IRS publications & seek guidance from tax professionals. Reliance on Form 1040 / Schedule C Instructions not always adequate.
  - Maintain adequate records.
    - Must be able to prove each element of deduction.
    - Maintain journal, calendar, or other doc
    - Credit card statements and P&L Statements – helpful, but not generally adequate w/o more.
    - Organize records by expense type.
  - Keep records for 7 years in case of audit.
  - If audited:
    - Ask Qs re documents that TP may not consider relevant.
    - Present docs in organized fashion.
Thank You.

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