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An Analysis of Recent Developments & Trends

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The President's New Employment Tax Proposals Create Potential Challenges for Employers

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Summary: All of these legislative proposals have significant and far-reaching consequences for employers from the perspectives of systems, compliance, withholding and others. Continued monitoring of these proposals is recommended.

The President's recent 2008 budget proposal contains several important changes that are aimed at improving taxpayer compliance.¹ The proposal offers several strategies to reduce the amount of unpaid taxes that should have been paid but were unintentionally under-reported or altogether omitted from taxpayers' returns (also known as the tax gap). This proposal would:

- Expand Form 1099-MISC reporting to most incorporated vendors/contractors.
- Require businesses to verify vendor/contractor identification (Federal Employer Identification Number or Social Security Number) or withhold for federal income taxes.
- Allow vendors/contractors to request the payer to withhold and remit income taxes.
- Increase penalties for failure to provide information reports, such as W-2s and Form 1099-MISCs.
- Accelerates the collection process for unpaid employment taxes
- Gives the IRS access to National Directory of New Hires (NDNH) for the purposes of taxpayer verification and data matching.
- Establish standards for holding PEOs and their clients jointly and severally liable for unpaid federal employment taxes.

Information Reporting

In an effort to promote taxpayer compliance by requiring third-party payers to file additional information returns, the budget contains the following proposed legislative changes:

Payments to Corporations

Currently, a taxpayer making payments to a recipient aggregating \$600 or more for services or determinable gains in the course of a trade or business in a calendar year is required to send to the IRS an information return, generally using IRS Form 1099-MISC stating the amount, name and address of the recipient. Information returns are generally not required if the payee is a corporation, tax-exempt organization or a government entity.

Under the new proposal, a business would be required to file an information return for payments aggregating \$600 or more in a calendar year to a corporation (except a tax-exempt corporation). For example, a company that engages another for services such as marketing or product development must issue a Form 1099-MISC for any payments of \$600 or more under this proposal. If enacted, the number of Form 1099-MISC issued would potentially increase significantly and would require some reprogramming of automated systems.

Certified Taxpayer Identification Number

Generally, businesses that make payments aggregating \$600 or more in a calendar year to any non-employee service providers or contractors that is not a corporation are required to furnish information returns to the IRS. The returns, which are required annually after the end of the year, are made on Form 1099-MISC based on identifying information furnished by the contractor but not verified by the IRS. Withholding is generally not required on such payments to contractors. Contractors are expected to make quarterly payments of estimated income taxes and self-employed income taxes and self-employ-

¹ The full proposal can be accessed at <http://www.ustreas.gov/offices/tax-policy/library/bluebk07.pdf>

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ment taxes (SECA). Since SECA tax is 15.3%, the combined estimated tax liability often reaches 25% of a contractor's gross receipts. Currently, contractors who receive \$600 or more from businesses are required to furnish a Taxpayer Identification Number (TIN) on a W-9 Form.

Under the new proposal, businesses are obligated to verify the TIN with the IRS. The IRS would then be authorized to disclose to the payer, solely for this purpose, whether the certified TIN and name combination matches IRS records. If the contractor fails to furnish an accurate certified TIN, payers would be required to withhold a flat rate from gross payments.

In addition, contractors with valid TINs who receive \$600 or more in a calendar year from a particular payer could also require the payer to withhold and remit to the IRS a flat rate percentage of 15, 25, 30, or 35 as selected by the contractor.

If enacted, such a requirement will significantly increase the reporting and withholding obligations of payers as well as potentially impact the cash flow of the contractor. This is not altogether a new proposal. Several years ago, the IRS's Taxpayer Advocate made a similar proposal that met stiff resistance.

Information Return Penalties

Taxpayers are subject to a number of information reporting requirements, including W-9s, W-2s and Form 1099-MISCs. Failure to adhere to those requirements may lead to penalties. Generally, there is a penalty of \$50, not to exceed \$250,000 in a calendar year, for each failure to file timely and accurate information return. For small filers with annual average gross receipts of \$5,000,000 or less, the limit is \$100,000 instead of \$250,000. If failure is due to intentional disregard of a filing requirement, the minimum penalty for each failure is \$100 with no calendar year limit.

The proposal would increase the \$50 and

\$100 penalty amounts to \$100 and \$250, respectively. The \$250,000 and \$100,000 caps would be increased to \$1,500,000 and \$500,000, respectively. Apart from payments to employees and contractors, similar penalties would also impact tax reporting of payments such as non-wage settlements for emotional distress. Consequently, the proposed change would affect the characterization and reporting of settlements.

Enforcement Powers to the IRS

The government also attacks the perceived tax gap problem by allotting more enforcement and regulatory powers to the IRS.

Collection Due Process Procedure

Generally, employers are required to withhold and/or pay income, Federal Insurance Contribution Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes. In order to ensure the payment and collection of employment taxes, the IRS is authorized to take various collection actions, including issuing federal tax levies. Before a tax levy can be issued, the IRS generally must provide a taxpayer with notice and an opportunity for an administrative collection due process (CDP) hearing followed by judicial review. Some employers who request a CDP hearing for one tax period will continue to accrue or "pyramid" their employment tax liabilities during the CDP proceedings. Liabilities for these subsequent periods cannot be levied until after the employer has been given notice and opportunity for hearing and judicial review for each period in question.

The proposal will allow the IRS to collect first and set up CDP hearings within a reasonable period after the levy. Collection by levy would be allowed to continue during the CDP proceedings. Perhaps the most far-reaching of the proposals, this would add a "pay-to-play" component not currently present at the federal tax level.

Access to Information in the National Directory of New Hires

The Office of Child Support Enforcement of the Department of Health and Human Services maintains the National Directory of New Hires (NDNH), which collects and maintains newly-hired employee data reported by the states. The NDNH was created to help state child support enforcement agencies enforce obligations of parents across state lines. Currently, the IRS may obtain data from the NDNH only for the purpose of administering the Earned Income Tax Credit (EITC) and verifying employment reported on a tax return. The IRS can access other employment records only through state-maintained databases on a state-by-state basis.

The proposal would amend the Social Security Act to expand IRS access to NDNH data for general tax administration purposes, including data matching, verification of taxpayer claims during return processing, preparation of substitute returns for noncomplaint taxpayers and identification of levy sources. Data obtained by the IRS from NDNH would be protected by existing taxpayer privacy law, including criminal and civil sanctions.

Effectively, access to this data could be leveraged by the IRS. If allowed, one can assume that federal law might be further changed to allow states to access the same information for tax purposes as well.

Tax Treatments of PEOs

Currently, employers are required to withhold and pay Federal Insurance Contribution Act (FICA) and Federal Unemployment Tax Act (FUTA). Liability for FICA and FUTA taxes generally lies with the taxpayer who is deemed to be the employer under a multi-factor common law test or statutory provisions. In certain instances, a third-party payer, who does not qualify as the employer under the common law control of the payment of wages, is treated as the

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employer for tax withholding and reporting purposes under Internal Revenue Code section 3401(d). Given the increasing popularity of PEOs, uncertainty often arises as to whether the companies that engage workers through PEOs are also liable for employment taxes when PEOs failed to issue W-2 Forms or withhold federal income, FICA and FUTA taxes.

Under the proposal, standards would be set forth for holding PEOs jointly and severally liable with their clients for federal employment taxes. The proposal would also provide standards for holding employee leasing companies solely liable for such taxes if they meet specified qualifications. This is an area that both the IRS (through regulation) and Congress have been struggling with unsuccessfully for a number of years.

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