

Tax News

August 2009

IRS Notice for Workers Reclassified as Employees

The IRS recently reminded individual taxpayers what important steps may be necessary to take upon being informed that their employment status is considered to be that of an employee, rather than an independent contractor. Notice 989 is entitled *Commonly Asked Questions When IRS Determines Your Work Status as "Employee."* What action a taxpayer may need to take depends on whether an income tax return was already filed reporting the income at issue, and if so, how the income was reported.

Common Scenarios

Some of the instructions set forth in the Notice include the following scenarios:

- If a federal income tax return has not yet been filed for the year(s) relating to income now categorized as employee wages, file Form 1040, U.S. Individual Income Tax Return, reporting the Form 1099-MISC income reported by the employer as wages on line 7. Social Security and Medicare tax (i.e., FICA) must also be computed and paid on this amount.
- File Form 1040X, Amended U.S. Individual Income Tax Return, for any affected years for which a federal income tax return was filed but the Form 1099-MISC income was not reported, and report that income as employee wages. FICA tax must also be computed and paid on the income.
- In situations where a federal income tax return has already been filed, and Form 1099-MISC income was reported as employee wages, but no FICA tax was computed on that income, taxpayers are advised that they must file Form 1040X to compute the FICA tax due for the affected years.
- For taxpayers who have already filed a federal income tax return for the affected years, but reported their 1099-MISC income as self-

employment income, and not employee wages, Form 1040X must be filed. No self-employment tax is due; however, the taxpayer's portion of FICA tax must be calculated and paid.

2007 Dividing Line for FICA

Note that for tax years prior to 2007, Form 4137, Social Security and Medicare Tax on Unreported Tip Income, should be used so that a taxpayer can properly compute FICA tax and receive the appropriate credit associated with the income from the Social Security Administration. For tax years 2007 and later, Form 8919 should be used for computation of FICA tax.

Payment of FICA Taxes Income

In the Notice, the IRS also reminds taxpayers that there may be situations where their employer provides a corrected Form W-2, reflecting payment of the employee's FICA tax. In that situation, the additional amount reflecting the employer's payment of the employee's FICA tax is income to the employee in the year it was paid.

The change in a worker's status from independent contractor to employee may affect not only payment of FICA taxes, but also the amount of federal income tax, due to the tax treatment of certain expenses.

For instance, self-employed individuals are allowed to take a deduction on Form 1040 in an amount equal to one half of self-employment tax paid. However, as an employee, this deduction is lost. A recharacterized employee must compute and pay FICA tax based on gross wages, as opposed to self-employment tax being computed on net self-employment income.

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Other deductions related to one's self-employed status may also be lost. Since wages earned by an employee are properly reported on line 7 of Form 1040, Schedule C cannot be used to report the income at issue. As a result, certain deductions, such as those for self-employed health insurance, may no longer be fully deductible, as they were when the individual was considered self employed. Instead, an employee may only be allowed to claim a miscellaneous itemized deduction on Schedule A, subject to the 2% floor.

Doeren Mayhew Can Help

If you have questions about the reclassification of a worker to an employee from being considered an independent contractor, please call the professionals at Doeren Mayhew today at (248) 244-3000.



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