



Robert W. Wood

THE TAX LAWYER

Apr. 12 2011 – 9:19 am

IRS Nightmare: What Employment Taxes?

You probably fear an IRS audit. See [What's Your IRS Audit Risk?](#) That's only natural, like fearing heights or spiders, no matter how high or low your income. See [IRS Audit Risk If You're "Rich."](#) If you're in business you may especially worry about a payroll tax audit.

Having employees inevitably involves withholding income and employment taxes. You must promptly pay taxes over to the IRS (and state tax authorities too). Employees must be paid via net check on which tax withholdings are taken. The business must send an [IRS Form W-2](#) to each employee in January the following year.

Having employees also means filing quarterly employment tax returns with the IRS. You can hire a payroll service to do some or all of this. Opting for the latter can be a nice way to avoid temptation. Your payroll service can cut the checks to your employees, withhold the taxes and transmit the taxes immediately to the IRS.

In that way, you couldn't use the withheld tax money for *anything* else even if you wanted to. Huge numbers of businesses each year get caught in this no-win situation. See [Personal Tax Liability When A Business Goes Under](#). I'm a big fan of payroll tax services for this reason.

1099 or W-2? But when it comes to payroll taxes, there's an elephant in the room tax issue many people ignore. If all your employment tax returns and withholdings are pristine, do you have anything to fear? Increasingly, the answer is yes.

Even if your employment tax compliance seems spotless, what about people you **aren't** employing? Suppose you have five employees and five part-time workers you pay on an independent contractor basis. By definition, you don't have employment tax responsibilities for workers who aren't your employees! See [IRS "Responsible Person" Label Hurts](#).

However, the IRS may audit you and say you must treat all those independent contractors as employees too. The IRS started a new audit program in February 2010 focused on worker misclassification. See [Independent Contractor Versus Employee Issues: Bad, Ugly, and Uglier](#). You might pay the worker as an independent contractor and report on a Form 1099 but **still** end up with several years of withholding tax liability and penalties.

One target is dual-status workers who get some of their pay as employees (reported on [Form W-2](#)) and some as an independent contractor ([Form 1099](#)). This may occur where an exec terminates employment in June but begins consulting in July. Watch out for possible recharacterization.

Another danger spot: employees and independent contractors who perform the same job. The "independent contractors" may be recast as employees. See [Employee v. Independent Contractor—Seven Tips For Business Owners](#) and [Some Control Won't Convert Independent Contractors To Employees](#).

For more, see:

[1099 Or W-2?](#)

[With Taxes "Responsible" Means Holding The Bag](#)

[Personal Tax Liability When A Business Goes Under](#)

[Criminal Penalties For Misclassifying Independent Contractors?](#)

*Robert W. Wood practices law with [Wood & Porter](#), in San Francisco. The author of more than 30 books, including *Taxation of Damage Awards & Settlement Payments* (4th Ed. 2009, [Tax Institute](#)), he can be reached at wood@woodporter.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.*