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TAX REPORT

IRS and States Team Up on Payroll Taxes

Target Is Employers That Don't Pay Share for Workers

The Internal Revenue Service is joining with more than two dozen states in an intensified effort to crack down on employment-tax violations. Among the key issues is whether a worker should be classified as an employee or an "independent contractor"—a difference with significant tax implications for both businesses and workers.

By Tom Herman

The IRS recently signed information-sharing agreements with state labor or work-force agencies in 29 states, including California, New York, Michigan and Ohio. Combining resources will help the IRS and the states "reduce fraudulent filings, uncover employment tax avoidance schemes and ensure proper worker classification," said Kathy Petronchak, head of the IRS's small business/self-employed division.

Employers generally must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee. But they generally don't have to withhold or pay taxes on payments to independent contractors, the IRS says. If an employer incorrectly classifies an employee as an independent contractor, it can be held liable for employment taxes for that worker, plus a penalty, the IRS warns.

Figuring out the difference between an employee and an independent contractor can be very tricky. The IRS provides this rule of thumb: Anyone who performs a service for you is your employee "if you can control what will be done and how it will be done." That's the case "even when you give the employee freedom of action," the IRS says. "What matters is that you have the right to control the details of how the services are performed."

The complexity of worker classification "has long caused headaches for many businesses," says Elizabeth Milito, a lawyer for the legal foundation for the National Federation of Independent Business. She says Congress should be focusing on developing a "clearer and simpler" definition of an independent contractor. But despite some lawmakers' proposals to overhaul the law, Congress hasn't acted.

The IRS-state initiative goes well beyond worker-classification issues. It aims to detect businesses attempting to avoid employment-tax obligations "by operating in the underground economy and making cash payments to workers and not reporting those payments to the IRS and to the states," says Robert Affleck, deputy director, tax branch, of the California Employment Development Department.

That could be an important factor in narrowing the nation's "tax gap," or taxes that are owed each year but not paid. IRS officials have estimated the overall tax gap at about $290 billion.

State officials say they have high hopes for the new initiative. California's Employment Development Department said the "memorandum of understanding" with the IRS "provides, for the first time a centralized and uniform mechanism" for the two agencies to swap employment-tax data.

Michigan has "already begun to forge a much closer working relationship" with the IRS, which has "significantly increased the sharing of tax and audit information between the IRS and our unemployment insurance program," says Keith W. Cooley, director of Michigan's department of labor and economic growth.

The states that have joined so far are: Arizona, Arkansas, California, Colorado, Connecticut, Hawaii, Idaho, Kentucky, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Nebraska, New Hampshire, New Jersey, New York, North Dakota, Ohio, Oklahoma, Rhode Island, South Carolina, South Dakota, Texas, Utah, Vermont, Virginia, Washington and Wisconsin.

TAX FACTS

Revenues from federal estate and gift taxes fell this year.

Revenues, in billions		% change from 2006
2007	$26.04	–6.6%
2006	$27.88	

Note: Cumulative for 12 months through Sept. 30 of each year.

Source: U.S. Treasury Department

As federal and state agencies share more information, "businesses are going to be held to a higher standard, and that's going to have an impact" on both employers and workers, says Scott Mezistrano, senior manager of government relations at the American Payroll Association in Washington.

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BIPARTISAN SUPPORT GROWS in Congress to ban patents on tax strategies.

Earlier this year, the House approved a bill to block tax patents. Now, several influential senators have introduced similar legislation.

Among the backers are Finance Committee Chairman Max Baucus, a Montana Democrat, and Sen. Chuck Grassley of Iowa, the committee's ranking Republican member. They and several other senators proposed a bill last week that would prohibit the Patent and Trademark Office from granting patents for tax-planning methods, the senators said.

Tax patents "undermine the integrity and fairness of the federal tax system," Sen. Grassley said. "They put taxpayers in the undesirable position of having to choose between paying more than legally required in taxes or paying a royalty to a third party for use of a tax planning invention that reduces those taxes."

Among the trade associations that support a ban is the American Institute of Certified Public Accountants. "Taxpayers should not have to worry about infringing patents when preparing their tax returns," said Barry C. Melancon, AICPA president and chief executive officer. "Neither should the tax professionals who prepare millions of tax returns each year."

The Grassley-Baucus bill includes an exception for the use of tax-preparation software to help tax preparers and taxpayers with returns.

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DIDN'T GET YOUR REFUND? You have company.

The IRS says it is searching for 115,478 taxpayers whose refund checks were returned as undeliverable. Those checks total about $110 million—an average of about $953 apiece. Some taxpayers have more than one check waiting, the IRS said.

Taxpayers can claim their refunds as soon as they update their address with the IRS. Go to the agency's Web site (www.irs.gov), click on the "Where's My Refund?" feature, and follow the instructions. Or call 1-800-829-1954.

If you're worried about undelivered refunds or lost or stolen tax-refund checks, sign up to have your refund deposited directly to your personal checking or savings account. The IRS's "direct deposit" program is available for taxpayers who file on paper or electronically.

This year, the number of undelivered refunds rose about 21% from 95,746 last year. This sharp increase was due in part to the telephone excise-tax refund, a one-time payment available on 2006 federal income-tax returns, the IRS said.

But this list represents a tiny fraction of the nearly 105 million refunds, totaling about $240 billion, that have been delivered this year.