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The high cost of worker misclassification

Independent contractors (ICs) offer businesses several advantages. Unlike with employees, you don't have to withhold income and payroll taxes; make Social Security, Medicare and unemployment insurance contributions; pay overtime; or provide employee benefits.

Treating an employee as an IC has always been risky. But in the last few years, these relationships are being looked at more closely and more often. Revenue-strapped tax authorities are scrutinizing worker relationships and often reclassifying ICs as employees.

What are the risks?

Generally, the biggest risk in worker misclassification is liability for unpaid federal and state income tax withholding; unpaid Social Security, Medicare and unemployment insurance contributions; and penalties and interest. As an employer, you can be held liable for both the company's share and the employee's share. And if you don't have the money, the government may attempt to

collect from "responsible persons," such as certain owners, partners, officers, directors, limited liability company (LLC) members and key employees (such as bookkeepers).

Employees misclassified as independent contractors may sue your company to recover employee benefits, overtime pay, unreimbursed business expenses or other amounts associated with employee status.

There's a popular misconception that, as an employer, you'll avoid liability so long as you've filed Form 1099 and the worker has paid all taxes due. But when the IRS concludes that a worker should have been treated as an employee, you can get hit with a 20% penalty even if all the taxes have been paid, among other consequences.

Another serious risk is that employees misclassified as ICs may sue your company to recover employee benefits, overtime pay, unreimbursed business expenses or other amounts associated with employee status.

How can you check if ICs are properly classified?

The first step is to review your relationships with workers who receive Form 1099. Consider that,



when assessing worker classifications, the IRS looks at the:

Level of *behavioral control*. This means the extent to which the company instructs a worker on when and where to do the work, what tools or equipment to use, whom to hire, where to purchase supplies and so on. Also, control typically involves providing training and evaluating the worker's performance. The more control the company exercises, the more likely the worker is an employee.

Level of *financial control*. ICs are more likely to invest in their own equipment or facilities, incur unreimbursed business expenses, and market their services to other customers. Employees are more likely to be paid by the hour or week or some other time period; ICs are more likely to receive a flat fee.

Relationship of the parties. ICs are often engaged for a discrete project, for example, while employees are typically hired permanently (or at least for an indefinite period). Also, workers who serve a key business function are more likely to be classified as employees.

The IRS examines a variety of factors within each category. No single factor controls the result, though. You need to consider all of the facts and circumstances surrounding each worker relationship.

How can you protect yourself?

Once you've completed your review, there are several strategies you can use to minimize your exposure:

- ⊙ When in doubt, reclassify questionable ICs as employees. This may increase your tax and benefit costs, but it will eliminate reclassification risk.

Worker classification "insurance"

The Revenue Act of 1978's Section 530 safe harbor is like an insurance policy against the risks of worker misclassification. The safe harbor doesn't ensure that the IRS won't reclassify independent contractors (ICs) as employees, but it will protect you against liability for back taxes, penalties and interest.

To qualify for the safe harbor, you must demonstrate that:

- ⊙ You've consistently treated all similar workers the same way; in other words, you didn't treat the worker in question — or any other workers in similar positions — as an employee during any prior period,
- ⊙ You've consistently filed all required tax returns for all prior periods, and
- ⊙ You had a reasonable basis for treating a worker as an IC; this may include reliance on court opinions or IRS rulings, a prior employment tax audit, an established industry practice, or advice from a qualified accountant or lawyer.

- ⊙ Modify your relationships with ICs to help ensure they're considered ICs. For example, you might exercise less behavioral control by reducing your level of supervision or allowing workers to set their own hours or work from home.

- ⊙ Qualify for the Internal Revenue Code Section 530 safe harbor of the Revenue Act of 1978. (See "Worker classification 'insurance'" above.)

Also, consider using an employee-leasing company. Workers leased from these firms are employees of the leasing company, which is responsible for taxes, benefits and other employer obligations.

Handle with care

There's nothing wrong with continuing to use ICs, so long as they're properly classified as such. But it's important to take steps now to minimize your exposure to government claims and worker lawsuits. ⊙

Address ownership transfer issues with a buy-sell agreement

There are a number of reasons why owners of closely held businesses put off discussing how ownership interests will be transferred when an owner exits the firm. For one, owners may be concerned about conflicts that could arise if an owner wants to transfer interests to family members or sell them to outsiders.

For another, issues such as how fellow owners (or the business itself) will be able to pay for an exiting owner's interests or the effect of the agreement on estate taxes can seem overwhelmingly complex. Fortunately, a buy-sell agreement can address these issues and more, provided it's drafted carefully.

Resolving transfer issues

A buy-sell agreement sets up the guidelines for the transfer of business ownership interests under certain predefined events, such as death, legal incapacity, retirement, loss of professional license, bankruptcy and divorce. Agreements usually address such issues as the method that will be used to value the interests and to whom ownership can be sold or transferred.

Buy-sell agreements are particularly beneficial for closely held businesses. Why? Because they create a ready market for shares that would otherwise be difficult or impossible to sell.

For instance, when you die, your heirs might otherwise be hard pressed to find a buyer for your shares. With a buy-sell agreement in place, rather than being saddled with having to find someone on their own, your heirs would simply



go to the other owners or the company itself to redeem your ownership interest.

At the same time, an agreement can protect the remaining owners from having a new, unwanted owner — such as an exiting owner's heirs or an outside buyer — thrust upon them.

Funding it

Insurance is a common funding vehicle for buy-sell agreements, and there are three types of agreements that use it. One is the cross-purchase agreement, under which each owner buys life or disability insurance (or both) on each of the other owners. At one owner's death or incapacity, the other owners collect on their policies and use the proceeds to buy the deceased or incapacitated owner's shares.

Another is the redemption agreement. In this situation, it's the business — not each individual owner — that buys the insurance. So the company would acquire the shares of the deceased or incapacitated partner. Redemption agreements can be particularly beneficial when there are a lot of owners, because fewer insurance policies are needed than under a cross-purchase agreement.

Last is the hybrid agreement, which is a combination of the cross-purchase and redemption agreements. Generally, the agreement requires that the shares first be offered to the business for redemption. If the company is unable to pay for the shares, the other owners are then responsible for buying the exiting owner's interest.

Estate tax considerations

Many owners also use buy-sell agreements as a tool to determine an ownership interest's value for estate tax purposes. But the IRS may challenge a value derived from a buy-sell agreement.

To design a buy-sell agreement that will pass muster with the IRS for estate tax purposes,

look at Section 2703(b) of the Internal Revenue Code. It states that value as defined for estate tax purposes is valid so long as the agreement:

- ⦿ Is a bona fide business arrangement,
- ⦿ Isn't a device to transfer such property to members of the deceased's family for less than full and adequate consideration in money or money's worth, and
- ⦿ Has terms that are comparable to similar arrangements entered into by persons in an arm's length transaction.

If the agreement fails these tests, the value claimed for estate tax purposes may be challenged.

An ideal tool

Under the right circumstances and with the proper guidance, a buy-sell agreement is an ideal tool for transferring ownership. But be sure to proceed carefully, because an improperly constructed agreement can cause more problems than not having an agreement in place. ⦿

The pros and cons of 401(k) loans

In today's tough economy, many people are struggling to meet their day-to-day expenses. At the same time, the credit crunch has made it harder to obtain traditional loans. One enticing alternative may be to borrow against your 401(k) account, if your plan permits it. This can be a risky strategy, though, so it's generally best considered only as a last resort.

Pros and cons

Many 401(k) plans allow participants to borrow as much as 50% of their vested account balances, up to \$50,000. These loans are attractive because:

- ⦿ They're easy to get — you don't have to worry about your income or credit score,



- ⊙ There's minimal paperwork,
- ⊙ Interest rates are low, and
- ⊙ You pay interest back into your 401(k) account rather than to a bank.

Despite their appeal, 401(k) loans present significant risks and disadvantages:

- ⊙ Even though you pay the interest to yourself, you lose the benefits of tax-deferred compounding on the money you borrow.
- ⊙ You may have to reduce or eliminate 401(k) contributions during the loan term, either because you can't afford to contribute or because your plan prohibits contributions while a loan is outstanding. Either way, you lose any future earnings and employer matches you would have enjoyed on those contributions.
- ⊙ Loans, unless used for a personal residence, must be repaid within five years. Generally, the loan terms must include level amortization, which consists of principal and interest, and payments must be made no less frequently than quarterly.

Additionally, if you're laid off, you'll have to pay the outstanding balance quickly, typically within 30 to 90 days. Otherwise, the amount you owe will be treated as a distribution subject to income taxes and, if you're under age 59½, a 10% early withdrawal penalty as well.

The hardship withdrawal

Another option is to find out whether you can take a "hardship" withdrawal. For example,

a plan may allow hardship withdrawals to pay certain expenses related to medical care, college, funerals and home ownership — such as first-time home purchase costs and expenses necessary to avoid eviction or mortgage foreclosure.

Keep in mind that, even if your plan allows such withdrawals, you'll have to show that you've exhausted all other resources. Also, the amounts you withdraw will be subject to income taxes and, except for certain medical expenses or if you're over age 59½, a 10% early withdrawal penalty.

Like plan loans, hardship withdrawals are costly. In addition to owing taxes and possibly penalties, you lose future tax-deferred earnings on the amounts you withdraw. But, unlike a loan, hardship withdrawals need not be paid back. And you won't risk any unpleasant tax surprises should you lose your job.

A last resort

Given the high cost and risk involved, you should borrow or take hardship withdrawals from your 401(k) account only if you have a real emergency, you've exhausted your other financing options and you feel that your job is relatively secure. ⊙

tax TIPS

Self-directed IRA withdrawals

For 2009, required minimum distributions (RMDs) from IRAs and other retirement accounts have been suspended for people age 70½ and older. For many, skipping this year's RMD is a good idea because investments might have to be sold at distressed prices to generate the cash needed to make the distribution.

If you have a self-directed IRA, however, you may be better off taking a distribution this year, even if it's not required. Why? Because you're permitted to make withdrawals from a self-directed IRA "in kind" — that is, by taking possession of the assets rather than converting them to cash. For example, if your self-directed IRA holds stock, it can simply transfer some of the stock directly to you rather than selling it and making a cash distribution. The amount of the distribution for tax purposes is based on the asset's depressed value; plus, you get to hold on to your investment. ☺

A good time for a QPRT

A qualified personal residence trust (QPRT) allows you to transfer a principal residence or vacation home to loved ones at a reduced tax cost and retain the right to live in the home for a specified term. The home is removed from your estate, so any future appreciation in value goes to your beneficiaries estate-tax free, provided you survive the trust term.

Typically the best time for a QPRT is when interest rates are high. That's because when you transfer



your home to the trust you make a taxable gift equal to the present value of your beneficiaries' future interest. The higher the interest rate, the lower the present value and, therefore, the lower the gift tax.

Even though interest rates are relatively low, you may still be better off establishing a QPRT now, while real estate values are depressed, because that will also reduce your gift's value. The right timing depends on your particular situation but, in many cases, if you wait for interest rates to rise, the tax advantages of a higher interest rate may be erased by rising home prices. ☺

Get your refund early

Has your corporation overpaid its estimated taxes? If so, it can request a "quick refund" if its excess estimated tax payments are more than \$500 and more than 10% of its expected tax liability for the year. To request a quick refund, file Form 4466 before the 16th day of the third month after the end of the tax year, and before the corporation files its income tax return. ☺

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