Tax Impact

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Tax Tips

Independent contractor vs. employee

Is your business classifying workers properly?

The "gig economy" has affected nearly every industry and profession. From Uber to Instacart, new business models have sprouted in recent years that build upon workforces treated as independent contractors. And even traditional businesses have been relying more heavily on freelancers and other contract workers, a trend that has accelerated during the COVID-19 pandemic.

From a business's perspective, there are several tax and other advantages of classifying workers as independent contractors rather than employees. But it's important to remember that workers aren't independent contractors simply because you say they are or because you and the workers have written agreements to that effect. The IRS and other government agencies look at all the facts and circumstances to determine whether workers are misclassified.

What are the advantages?

For tax purposes, companies that properly treat workers as independent contractors avoid several tax obligations that apply to employees. For example, a company generally isn't required to withhold federal or state income taxes, pay the employer's share of Social Security and Medicare (FICA) taxes, withhold the workers' share of FICA taxes, or pay federal or state unemployment taxes.

In addition, companies that use independent contractors may avoid several nontax obligations, including requirements to pay minimum wages and overtime under the federal Fair Labor Standards Act and similar state laws, furnish workers' compensation insurance (in many states), make state disability insurance contributions, or provide employee benefits.

How is worker status determined?

To determine whether a worker is an employee or independent contractor, the IRS looks at several factors in three categories:

1. Behavioral control. Does the company control or have the right to control what the worker does and how the worker performs his or her job? Generally, the more control, the more likely a

Watch out for conflicting standards

Even if you're comfortable with your classification of workers for federal tax purposes, evaluate your compliance with federal wage and hour regulations as well as various state laws. These may apply different standards or look at different factors in determining a worker's status. The U.S. Department of Labor, for example, in assessing worker status for Fair Labor Standards Act purposes, analyzes a set of factors that are similar but not identical to those used by the IRS. And several states have laws that make it more difficult for employers to treat workers as independent contractors.

To avoid a situation in which a worker is treated as an employee for some purposes and as an independent contractor for others, consider all applicable standards as part of the classification process.

worker is an employee. Relevant factors include the extent to which the company provides instruction and training.

2. Financial control. Does the company control the business aspects of the worker's job, such as how the worker is paid, whether expenses are reimbursed, and who provides tools and supplies? Again, the more control, the more likely a worker is an employee. Relevant factors include:

- The extent of a worker's investment in items such as equipment and tools (a bigger investment tends to favor contractor status),
- The extent to which the worker has unreimbursed business expenses (contractors tend to have a higher level of unreimbursed expenses),
- A worker's opportunity for profit or loss (the risk of incurring a loss generally indicates that a worker is a contractor),
- Whether a worker makes services available to others (contractors are generally free to seek out other business opportunities in the relevant market), and
- The method of payment (employees generally receive a guaranteed wage per hour, week or other time period; contractors are usually paid a flat fee — although some contractors are paid by the hour).

3. Relationship of the parties. Workers are more likely employees if the company provides them with employee benefits, such as health or disability insurance, pension plans, paid vacation, or sick days. The permanency of the relationship is also a significant factor: Employees are more likely to be hired indefinitely, while independent contractors are more likely to be engaged for a specific project or time period. Also, companies are more likely to use employees to provide services that are a key aspect of their business.

The terms of a contract that designates a worker as an independent contractor or employee aren't controlling. However, they may be relevant in showing the parties' intent to form a specific type of relationship.

IRS penalties for misclassification

The consequences of misclassifying employees as independent contractors can be severe. Among other things, the IRS may assess back taxes against the company (including employees' shares of unpaid payroll and income taxes), plus penalties and interest.

Notably, the IRS can impose significant penalties on an employer, even if workers wrongly classified as independent contractors met all of their tax obligations. And don't overlook nontax implications. For example, a company that misclassifies workers as independent contractors may be liable for unpaid benefits, minimum wages, overtime pay or workers' compensation premiums.

Review your hiring policies

Given the significant cost of misclassifying workers, it's a good idea for businesses to review the current status of their workforces and evaluate their hiring policies to ensure that they're meeting all of their obligations under federal and state law. If you believe that you've misclassified workers, look into voluntary classification settlement programs that allow you to resolve these issues with the government at the lowest possible cost. ■

How tax-affecting can benefit estates with pass-through entities

If you have a larger estate, asset valuation should be an important aspect of your estate plan. This is especially true if a closely held business is part of the estate. The valuation of your business for gift and estate tax purposes is critical to determining how much of your estate goes to your family and how much goes to the government.

"Tax-affecting" is a term you should become familiar with if your business is structured as a pass-through entity. A tax-affecting strategy can reduce the business's value — which, in turn, can possibly reduce your estate tax liability.

Widely accepted, but often challenged

Tax-affecting — which involves discounting a pass-through entity's projected earnings by an assumed corporate income tax rate — is widely accepted in the valuation community, but the IRS routinely challenges the practice. Historically, the U.S. Tax Court has sided with the IRS. In a recent estate tax case, however, the Tax Court accepted the use of tax-affecting by a valuation expert. Although the practice remains controversial (at least from the IRS's perspective) the court's decision may signal a greater willingness to accept it in future cases.

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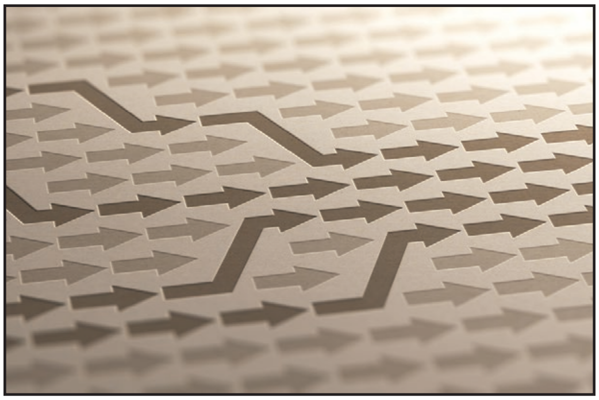
When valuing businesses or business interests, valuation professionals often rely on one of two types of methods. The income-based method projects the business's future earnings or cash flow and



discounts them to present value. The market-based method applies earnings multiples derived from public or private company market data. In either case, the subject company's earnings are critical.

Pass-through entities and taxes

Pass-through businesses pay no entity-level taxes. Rather, as the name suggests, their profits and losses are passed through to the owners, who report their shares on their personal income tax returns. Nevertheless, valuation professionals often discount a pass-through entity's earnings to reflect an assumed corporate income tax rate. Why? Because, despite the lack of entity-level taxes, owners still pay taxes on their shares of the entity's profits at their individual rates, and pass-through entities commonly distribute sufficient earnings to cover those taxes.

Another rationale for tax-affecting is that it accounts for the risk that a pass-through entity will convert to a C corporation in the future. This conversion may happen, for example, if the pass-through entity loses its S corporation status or merges into a C corporation.

Although it's important to recognize the real impact of taxes on a pass-through entity, applying an assumed corporate rate, without more, may undervalue the entity because it ignores the tax advantage such a structure provides. Because there's no entity-level tax, pass-through entities avoid the double taxation experienced by traditional C corporations.

A C corporation's earnings are taxed twice, once at the corporate level and again when they're distributed to shareholders in the form of dividends. Thus, valuators often add a premium when valuing pass-through entities to reflect this tax advantage. But note that, since the Tax Cuts and Jobs Act cut corporate income tax rates, this advantage isn't as significant as it once was.

Tax Court ruling

In a recent Tax Court case — *Estate of Jones* — the court approved tax-affecting in the valuation of two family-owned timber businesses. One was structured as an S corporation and the other as an LLC, for gift and estate tax purposes.

The court found that the estate's valuation professional's approach best accounted for the tax impact of pass-through status. He tax-affected the entities' earnings, using a 38% rate for combined federal and state taxes, to arrive at an initial value, and then added back a premium to reflect the benefit of avoiding a tax on dividends. Tax-affecting was only one of several issues. But because the estate's expert's position prevailed, the family saved tens of millions of dollars in gift taxes.

Turn to a qualified professional

If your estate includes a closely held business, it's worth your time to learn more about a valuation that incorporates tax-affecting. The key to a tax-affecting strategy is to work with a qualified valuation professional. ■

Selling your home?

Be sure you understand the home sale exemption

Sky-high demand for homes, driven in large part by rock-bottom interest rates, has created a seller's market. If you're thinking about selling your home, it's important to determine whether you qualify for the home sale exemption. The exemption is one of the most generous tax breaks in the tax code, so be sure to review its requirements before you sell.

Exemption requirements

Ordinarily, when you sell real estate or other capital assets that you've owned for more than one year, your profit is taxable at long-term capital gains rates of 15% or 20%, depending on your tax bracket. High-income taxpayers may also be subject to an additional 3.8% net investment income (NII) tax. If you're selling your principal residence, however, the home sale exemption may allow you to avoid tax on up to $250,000 in profit for single filers and up to $500,000 for married couples filing jointly.

Don't assume that you're eligible for this tax break just because you're selling your principal residence. If you're a single filer, to qualify for the exemption, you must have owned and used the home as your principal residence for at least 24 months of the five-year period ending on the sale date.

If you're married filing jointly, then *both* you and your spouse must have lived in the home for

24 months of the preceding five years and at least one of you must have owned it for 24 months of the preceding five years. Special eligibility rules apply to people who become unable to care for themselves, couples who divorce or separate, military personnel, and widowed taxpayers.

Limitations apply

You can't use the exemption more than once in a two-year period, even if you otherwise meet the requirements. Also, if you convert an ineligible residence into a principal residence and live in it for 24 months or more, only a portion of your gain will qualify for the exemption.

> ***If you're selling your principal residence, the home sale exemption may allow you to avoid tax on up to $500,000 in profit for married couples filing jointly.***

For example, John is single and has owned a home for five years, using it as a vacation home for the first three years and as his principal residence for the last two. If he sells the home for a $300,000 gain, only 40% of his gain ($120,000) qualifies for the exemption, and the remaining $180,000 is taxable. (Note: Nonqualified use prior to 2009 doesn't reduce the exemption).

Partial exemption

What if you sell your home before you meet the 24-month threshold due to a work- or health-related move, or certain other unforeseen circumstances? You may qualify for a partial exemption.

For example, Paul and Linda bought a home in California for $1 million. One year later, Paul's employer transferred him to its New York office, so the couple sold the home for $1.2 million. Although Paul and Linda didn't meet the 24-month threshold because they sold the home due to a work-related move, they qualified for a partial exemption of 12 months/24 months, or 50%. Note that the 50% reduction applied to the *exemption*, not to the couple's gain. Thus, their exemption was reduced to 50% of $500,000, or $250,000, which shielded their entire $200,000 gain from tax.

Crunch the numbers

Before you sell your principal residence, determine the amount of your home sale exemption and your expected gain (selling price less adjusted cost basis). Keep in mind that your cost basis is increased by the cost of certain improvements and other expenses, which in turn reduces your gain. Also, be aware that capital gains attributable to depreciation deductions (for a home office, for example) will be taxable regardless of the home sale exemption. ■

Tax Tips

Retirement saving strategies: the "mega backdoor" Roth IRA

Income limits for Roth IRAs prevent many high earners from contributing directly to these tax-advantaged accounts. But there are strategies you can use to bypass these limits. For example, a "backdoor" Roth IRA enables you to make nondeductible contributions to a traditional IRA and then quickly convert it into a Roth IRA before it generates taxable earnings. One drawback to this strategy is that your total contributions to IRAs (including nondeductible contributions) are limited to $6,000 per year ($7,000 if you're 50 or older).

Another technique — the "mega backdoor" Roth IRA — may allow you to fund a Roth IRA with considerably more each year, but it's available only under limited circumstances. You must participate in an employer's 401(k) plan that permits after-tax contributions and allows rollovers or withdrawals while you're still working.

If that's the case, here's how you can take advantage of a mega backdoor Roth IRA: Each year, you make the maximum pre-tax contribution to the 401(k) plan (currently $19,500, or $26,000 if you're 50 or older). Then, you make after-tax contributions up to the limit on total contributions (currently $58,000). So, for example, if you're under 50 and your employer doesn't make matching contributions, you can make after-tax contributions up to $38,500 ($58,000 - $19,500). This amount is then rolled over into a Roth IRA. ■

IRS guidance on the 100% business meal deduction

Generally, otherwise allowable business meal expenses are only 50% deductible. But legislation passed in 2020 temporarily lifted the 50% limitation. Now, businesses can deduct 100% of the cost of food or beverages "provided by a restaurant" in 2021 and 2022.

In Notice 2021-25, the IRS provided some guidance on when the 100% deduction is available. According to the IRS:

- "Restaurant" is defined as a business "that prepares and sells food or beverages to retail customers for immediate consumption," whether or not they're consumed on the premises.
- "Restaurant" doesn't include businesses that primarily sell pre-packaged food or beverages not for immediate consumption — such as grocery stores, specialty food stores, liquor stores, drug stores, convenience stores, newsstands, vending machines or kiosks.
- For purposes of the 100% deduction, employers may not treat the following as a restaurant: 1) any eating facility located on the employer's premises that provides meals that are excluded from employees' income as "furnished for the convenience of the employer," and 2) any employer-operated eating facility treated as a *de minimis* tax-free fringe benefit, even if it's operated by a third party under contract with the employer. ■