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Comptroller

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TO: All State Agency Payroll Offices
FROM: Robert J. Murphy, Director
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SUBJECT: IRS Compliance Check - Worker Classification

Beginning in February, 2010, the IRS launched an examination of 6,000 randomly selected companies and government entities to focus on a broad range of employee and employer tax related issues. According to our information, the IRS plans to continue these types of random audits over the next three years, hoping to reach a total of 12,000 employers.

Most important of the many employment issues audited were employee classification. In an effort to help identify any possible misclassifications concerning employees vs. independent contractors within our State agencies, the Central Payroll Bureau (CPB) and the General Accounting Division (GAD) performed a match between last years 1099's (issued for independent contractors) and W-2's (issued to state employees). The attached listing shows the matches found for the 2010 tax year where both a 1099 and a W-2 were issued to the same individual working for your agency. This type of condition would definitely create a "red flag" during any IRS compliance check.

While CPB is not the governing authority on how your agency classifies employees we strongly recommend that you review your classification process for determining who is an employee vs. independent contractor. The IRS has many tools on their website (www.irs.gov) that will assist you in proper worker classifications. While classifying workers as independent contractors to perform temporary assignments may relieve agencies from considerable taxing expenses, please be aware of the following Internal Revenue Code guidelines concerning applicable tax assessments for any misclassifications.

Unintentional misclassifications are subject to:

- For not withholding federal income tax, the tax assessed is 1.5% of wages paid. Can be doubled to 3% under certain circumstances.
- For not withholding the employee's share of social security and Medicare taxes, the tax assessed is 20% of the employee's share. Can be increased to 40% under certain circumstances.

Intentional misclassifications are subject to these tax assessments:

- Employer becomes liable for 100% of the amount of federal income tax that should have been withheld and 100% of the employee's and employer's share of social security and Medicare
- Employer is also subject to other penalties for failure to file returns or pay taxes.

Please review the attached listing and make any corrections required immediately. Your agency may find it advantageous to seek the counsel of your Assistant Attorney General in determining any corrective action necessary.

If you have any questions regarding this matter please contact Helen Kane, Assistant Director, Accounting and Reporting by email (hkane@comp.state.md.us) or phone at 410-260-7045.