

PENALTIES INCREASED FOR NOT FILING FORMS 1099

Congress has increased the penalties for failure to file or late filing of Forms 1099 effective January 1, 2016.

■ **Information Return Penalties Increased for 2016**

Currently, the penalty to file correct information returns or to provide a correct payee statement is \$100 for each return for which such penalty occurs, up to \$1.5 million per calendar year. The Trade Preferences Extension Act of 2015 increased the penalties to \$250 per failure, up to \$3 million per calendar year. The penalties are doubled to \$500 for intentional disregard. The increased penalties are effective for returns to be filed after December 31, 2015.

■ **Corrective action**

If the payor takes corrective action, penalties are reduced.

● *Old law.*

- ◆ If the failure is corrected within 30 days of the required filing date, the penalty is reduced to \$30 per failure if the total amount of the penalties after the corrective action is \$250,000 (\$75,000 for certain small businesses).
- ◆ If failures are corrected after 30 days but before August 1, penalties are reduced to \$60 per failure as long as the total penalties after corrective action are \$500,000 (\$200,000 for certain small businesses).
- ◆ If failures are corrected after August 1, penalties are reduced to \$100 per failure (\$500,000 for certain small businesses).
- ◆ For intentional disregard of the law the penalty is \$250 per failure.

● *New law.*

- ◆ The new legislation increases the penalty to \$50 per failure and increases the threshold to \$500,000 if the failure is corrected within 30 days of the required filing date.
- ◆ The new legislation increases the penalty to \$100 per failure and increases the threshold to \$1.5 million if failures are corrected after 30 days but before August 1.
- ◆ If failures are corrected after August 1, penalties are increased to \$250 per failure up to \$3 million.
- ◆ For intentional disregard of the law the penalty is increased to \$500 per failure.

For purposes of the lower penalty, a business is a small business for any calendar year if its average annual gross receipts for the most three most recent tax years (or for the

period it was in existence, if shorter) ending before the calendar year do not exceed \$5 million.

The presence of questions on Forms 1065, 1120, 1120S and 1040, Schedules C, E and F, asking whether the taxpayer made any payments in 2015 which would require the taxpayer to file Forms 1099, continues to cause concern for return preparers and clients alike, as do the penalties summarized above.

The 2015 Forms 1065, 1120, 1120S and 1040, Schedules C, E and F, all contain questions asking if the taxpayer made any payments in 2015 which would require the taxpayer to file Forms 1099. If the answer is "yes," then the IRS wants to know if the taxpayer did, or will, file the required Forms 1099.

The questions first showed up in 2011 and coincided with a sharp increase in the penalties for failing to file correct information returns and payee statements. Return preparers immediately expressed concern their clients may not be aware of the full ramifications of incorrectly reporting Form 1099 income and the impact on their own liability for checking these boxes. If a client reports all Form 1099s were filed when they were not, he or she is committing perjury (because the returns are signed under penalties of perjury). If the client reports not all Form 1099s were filed, then that's a red flag for an audit.

If a taxpayer has a business which uses sporadic labor, the Form 1099 questions can present a dilemma in certain situations. For example, how does a taxpayer who intermittently employs workers by picking them up at places where such workers congregate, answer the questions? If any of these workers are used several times during the year in the taxpayer's business, the amounts paid to that worker will most likely exceed \$600, and the taxpayer will be responsible for issuing a Form 1099-MISC to that independent contractor. What if the workers will accept only cash? Without proper documentation, how does the taxpayer prove no one individual was paid more than \$600?

Form 1099-MISC

Generally, any person, including a corporation, partnership, individual estate, and trust, which makes reportable transactions during the calendar year, must file information returns to report those transactions to the IRS. However, a payer does not need to file Form 1099-MISC for payments not made in the course of the payer's trade or business. A payer is engaged in a trade or business if it operates for gain or profit, thus, personal payments are not reportable. Nonprofit organizations are considered to be engaged in a trade or business and are subject to the reporting requirements. For other exceptions to filing a Form 1099-MISC.

The type of reportable transaction determines the specific Form 1099 which must be filed. Most of the issues revolving around the filing of Forms 1099, involve Form 1099-MISC and the reporting of non-employee compensation. In general, a payer must file Form 1099-MISC, Miscellaneous Income, for each person to whom the payer has paid during the year:

- at least \$10 in royalties or broker payments in lieu of dividends or tax-exempt interest;
- at least \$600 in rents, services (including parts and materials), prizes and awards, other income payments, medical and health care payments, crop insurance proceeds, cash payments for fish (or other aquatic life) purchased from anyone engaged in the trade or business of catching fish or, generally, the cash paid from a notional principal contract to an

individual, partnership, or estate;

- any fishing boat proceeds; or
- gross proceeds to an attorney.

In addition, Form 1099-MISC must be filed to report direct sales of at least \$5,000 of consumer products made to a buyer for resale anywhere other than a permanent retail establishment. Form 1099-MISC must also be filed for each person from whom a taxpayer has withheld any federal income tax under the backup withholding requirement (discussed below), regardless of the amount of the payment.

Compliance Tip: The deadline for filing paper Forms 1099-MISC is generally the last day of February following the calendar year for which the filing is made. The due date is extended until the last day of March for payers who file electronically. If the regular due date falls on a Saturday, Sunday or legal holiday, Form 1099-MISC is due the next business day.

Backup-Withholding Requirement

A backup withholding requirement applies to reportable payments where the payee does not furnish a taxpayer identification number (TIN). The backup withholding rate is equal to 28% of the amount paid. The requirement does not apply to payments made to tax-exempt, governmental or international organizations.

In determining whether a payee has failed to provide a TIN, a payer is required to process the TIN within 30 days after receiving it from the payee or in certain cases, from a broker. Thus, the payer may take up to 30 days to treat the TIN as having been received.

Penalties for Failing to File Correct Information Returns

If a payer fails to file a correct information return by the due date and cannot show reasonable cause for failing to do so, the payer may be subject to a penalty. The penalty applies if the person fails to file timely, fails to include all information required to be shown on a return or includes incorrect information on a return. The penalty also applies if a person files on paper when required to file electronically, reports an incorrect taxpayer identification number (TIN) or fails to report a TIN, or fails to file paper forms that are machine readable. The amount of the penalty is based on when the correct information return is filed. The penalties are summarized at the top of this *Hot Topic*.

Persons who are required to file information returns electronically but who fail to do so (without an approved waiver) are treated as having failed to file the return, and are therefore subject to a penalty of up to \$100 per return unless the person shows reasonable cause for the failure. However, they can file up to 250 returns on paper; those returns will not be subject to a penalty for failure to file electronically. The penalty applies separately to original returns and corrected returns.

Observation: For each fifth calendar year beginning after 2012, each of the dollar amounts described above is subject to indexing for inflation.

The penalty for failure to include the correct information on a return does not apply to a de

minimis number of information returns with such failures if the failures are corrected by August 1 of the calendar year in which the due date occurs. The number of returns to which this exception applies cannot be more than the greater of 10 returns or 0.5 percent of the total number of information returns required to be filed for the year.

The penalty for a failure to include the correct information on a return does not apply to inconsequential errors or omissions. If a failure to file a correct information return is due to an intentional disregard of one of the requirements (i.e., it is a knowing or willing failure), the penalty is the greater of \$250 per return (increased to \$500 per return January 1, 2016) or the statutory percentage of the aggregate dollar amount of the items required to be reported (the statutory percentage depends on the type of information return at issue). In addition, in the case of intentional disregard of the requirements, the \$1,500,000 limitation (\$3 million effective January 1, 2016) does not apply.

Can IRS Limit Deductions to \$600 Where No Form 1099 Is Filed?

Some return preparers have questioned whether or not the IRS can limit a compensation deduction to \$599, the cutoff for not reporting nonemployee compensation, where a Form 1099-MISC is not filed. While there is nothing in the Code or regulations on this, nor is there any case law on point, some return preparers have reported IRS agents following this theory.

What Constitutes a Trade or Business That Requires Reporting on Form 1099?

The characterization of an activity as a "trade or business" took on a new importance in 2013 with the implementation of the net investment income (NII) tax. Effective for tax years beginning after December 31, 2012, individuals are subject to a 3.8% tax on the lesser of net investment income or the excess of modified adjusted gross income over a threshold amount. Generally, income from a trade or business (with the exception of certain commodities trading income) is exempt from the net investment income tax.

As previously mentioned, taxpayers not in a trade or business are not required to file Form 1099s. Whether a taxpayer is considered to be in a trade or business has become a hot topic because of the NII tax. As a result, taxpayers may be claiming their activity is not subject to the NII tax because it rises to the level of a trade or business without considering the impact of Form 1099 filing requirements and the associated penalties if such forms are not filed.

Conclusion

Taxpayers in a trade or business should have non-employee workers or contractors complete a Form W-9 if they believe payments to any individual might add up to \$600 or more for the year. To the extent anyone is paid \$600 or more, a Form 1099-MISC should be issued at the end of the year. Similarly, taxpayers should consider the trade-offs for claiming they are in a trade or business in an effort to escape the NII tax and their responsibility for filing Form 1099s when they are in a trade or business.

This *Hot Topic* is an informative publication for clients and friends of the Firm. It is designed to provide accurate information on the subject matter covered. I recommend you consult with your legal and other advisors to determine if the information is applicable in your specific circumstances. If these advisors are not available to you, please feel free to contact Barry N. Finkelstein, CPA at 903/473-3540.