

Did Right Case Take a Wrong Turn?

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Abstract

This case uses a relatively simple yet relevant income tax issue, worker classification, to introduce students to the financial reporting issues surrounding uncertain tax positions (ASC 740-10; commonly known as FIN 48). Worker classification is not only a hot topic in the U.S., it is being raised in tax audits and labor courts around the world. While income tax regimes vary greatly around the globe, the factors used to determine whether a worker is an independent contractor or employee are quite similar. The financial reporting implications can be significant due to government-mandated employee benefits, penalties, and the retroactive nature of tax adjustments. This case can be used in an intermediate financial accounting or corporate income taxation course to demonstrate the issues surrounding ASC 740-10 and the computations necessary to record the liability associated with it. This case can also facilitate a discussion of Schedule UTP in a tax course.

Introduction

Justin Wei sighed at the end of a long day. He has been the controller at Right Case, Inc. for almost six months and was beginning to feel comfortable in the role. Right Case (a publicly-traded U.S. corporation) manufactures and sells a wide array of office furniture and modular office systems (better known as cubicles). Because the firm's domestic sales were not growing, they expanded sales internationally four years ago.

Right Case's first international sales expansion was to India. Due to the growth rate of the Indian economy, Right Case was optimistic about their ability to expand sales into that market. But, in order to limit the firm's exposure and make it easier to withdraw from the country if necessary, the firm hesitated to hire employees in India. Instead, Right Case treated its sales force in India as independent contractors. Sales in India took off and three years ago Right Case expanded into two other countries with growing economies. Because of Right Case's success in India and their satisfaction with independent contractors, they structured subsequent operations in other countries in the same fashion.

The cause of Justin's long day was a notice from the Department of Income Tax (part of the Government of India's Ministry of Finance) challenging Right Case's treatment of its Indian sales force as independent contractors. The Department of Income Tax (DIT) claims the sales associates are misclassified and should be treated as employees. This concerns Justin because treating the Indian sales force as employees would mean Right Case would be responsible for paying both the employer and employee share of employment taxes, and providing various government-mandated benefits to its Indian workers retroactively to the date they started. The DIT notice also indicates the entire amount of any previously unpaid taxes and benefits is subject to interest and significant penalties.

Justin remembered being briefed about the independent contractors when he started at Right Case but he never actually reviewed the contracts. Justin recalled that the question of worker classification was an issue at his last employer but he was not directly involved. He remembers hearing about a list of 20 common law rules the U.S. Internal Revenue Service (IRS) uses to determine if a worker is an employee or independent contractor. Before he leaves for the day he

downloads a copy of the list and sets up a meeting with Sonny, Right Case's sales manager, to discuss the matter.

At their meeting the next morning, Sonny tells Justin he cannot understand why there is a problem because the contract between Right Case and each sales associate clearly states in several places that the sales associate is an independent contractor. The template contract used for the Indian sales force, which Justin and Sonny review at the meeting, is relatively short and comparable to other independent contractor agreements the company entered into in the past. The contracts entitle each sales associate to a modest flat monthly income plus commissions based on their monthly sales, and reimbursement for all sales-related expenses incurred by them. The contracts are open-ended, meaning either party can terminate the contract at any time without penalty, because Right Case wanted flexibility in case they decided to exit the market. The contracts also restrict the sales associate from holding similar sales positions with other companies while they are under contract with Right Case. Right Case added this provision to protect their proprietary intellectual property.

Sonny explains that he personally went to India to interview each sales associate and have them sign the contract before they were engaged. While in India, Sonny held a training session for the sales force, accompanied each sales associate on one or two sales calls to observe and critique their sales techniques, and made sure they each had business cards identifying them as Right Case representatives. Right Case also provides each sales associate with a cell phone and laptop computer loaded with the software necessary to facilitate the processing of sales orders, and preparation and submission of the monthly sales reports on which their commissions are based.

Every six months Sonny returns to India to interview and engage new sales associates as necessary, and host a two-day retreat for the entire sales force. On the first day they review the previous six-month's sales figures, attend a sales training seminar, and become familiar with Right Case's new products. On the second day, Sonny brings in a local motivational speaker to energize and motivate the sales force, and treats them to a round of golf in the afternoon. All sales associates are expected to attend the retreat.

Based on some research Justin did before their meeting, he discovered the DIT uses basically the same common law rules used by the IRS to differentiate between employees and independent contractors. He decides to review the international sales force arrangement in light of the 20 common law rules to determine why the DIT has questioned Right Case's classification of the Indian sales force.

Justin is not concerned about any corporate income tax issues in India because Right Case has been paying income tax on their sales in India all along. What does concern Justin is the significant cash outlay that will be required if Right Case has to pay back employment taxes, income tax withholdings, and fringe benefits for the Indian sales force, and the fact that any penalties owed will be significant and non-deductible for income tax purposes. Justin also realizes that Right Case used this same arrangement in the other countries they expanded into three years ago which could open the company up to similar issues in those countries.

Required

Help Justin to address these concerns by responding to the following questions:

1. Are the sales associates representing Right Case in India, and other countries, independent contractors or Right Case employees? When explaining your answer, you should specifically address at least five of the most relevant of the 20 common law factors identified by the IRS. (NOTE: Although worker classification factors vary slightly from country to country, they are remarkably similar. As a result, the IRS factors act as a proxy for the Indian factors).
2. Based on your analysis in question 1, what changes, if any, would you suggest the company make to ensure independent contractor status going forward?
3. Assuming the notice from the India Department of Income Tax is correct, help Justin by preparing the journal entry (or entries) needed for the current year and the prior three years. Assume that the current year is still open but remember that a prior period adjustment is required for changes affecting years in previously issued financial statements. Assume Right Case has an effective income tax rate of 30% for analysis of this issue and use the information in following Table for your analysis. To simplify your analysis, assume the financial results of the current year and the three prior years are the same. The financial results of the current year are shown in the Table. (The effective income tax rate has been adjusted because penalties are non-deductible.)

Table

Panel A: Selected Financial Information (Note: All information is annual.)

	U.S.	India	Other International	Total
Sales	\$ 1,000,000	\$ 600,000	\$ 400,000	\$ 2,000,000
Payments to independent contractors	-	60,000	40,000	100,000
Net income	40,000	24,000	16,000	80,000

Panel B: Estimate of Cost as a Percentage of Payments to Independent Contractors

Cost Component	
Back income tax withholdings (average of top two rates of 20% and 30%)	25%
Back Employees Provident Fund* (12% for employer and employee)	24%
Back benefits (employer’s pension contribution)	3%
Interest and penalties	10%
Total	62%

*Similar to social security in the U.S.

4. Although this issue has not been raised in the other two countries Right Case expanded into three years ago, Justin realizes that it is possible and he needs to account for this as an uncertain tax position under ASC 740-10.

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- a) Help Justin estimate the amount Right Case’s potential liability. You will need to use the financial information in the Table above for your analysis.
- b) Justin knows that accounting for uncertain tax positions involves a two-step decision process. Assume Right Case meets the “more likely than not” criteria from Step 1 of that decision process. Based on his prior experience dealing with the Indian taxing authorities, Justin believes Right Case can negotiate a lower tax liability in the other countries by voluntarily raising these issues with the appropriate taxing authorities. He estimates Right Case can reduce its liability to 80% of the amount that would otherwise be due (i.e., 80% of the potential liability you estimated in 4a above).

Help Justin by completing the following chart to estimate the tax benefit.

Dollar Amount	Probability that Position will be Upheld	Cumulative Probability
		100%
Total	100%	

5. Now, assume the sales force in question was the U.S. sales force instead of the international sales force. Would you recommend Right Case take advantage of the IRS’s Voluntary Classification Settlement Program (VCSP)? What impact would this have on Right Case’s potential ASC 740-10 disclosure, if any? Assume Right Case complied with all annual Form 1099 reporting requirements and is not currently under an employment tax audit by the IRS.

Case Appendices

Appendix A

20 common law factors identified by the IRS as relevant in determining worker classification (as contained in the 2007 U.S. Joint Committee on Taxation report entitled “Present Law and Background Relating to Worker Classification for Federal Tax Purposes”); accessible at <http://www.irs.gov/pub/irs-utl/x-26-07.pdf>.

Appendix B

Voluntary Classification Settlement Program (VCSP) information provided by the IRS; accessible at <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Voluntary-Classification-Settlement-Program>.