FEDERAL AND STATE GOVERNMENTS TARGET EMPLOYMENT TAX COMPLIANCE

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The federal and state governments are moving on several fronts to counteract what they consider to be a significant contributor to the income tax gap—underreporting of employment taxes. The IRS has embarked on a major employment tax enforcement effort that will continue over a three-year period. The president's fiscal 2011 budget allocates funds for hiring additional agents to assist in this process. According to the budget report, increased enforcement in this area will increase Treasury receipts by more than $7 billion over ten years. For its part, Congress is expected to consider legislation (also proposed in the budget message) that in essence would prospectively eliminate section 530 of the Revenue Act of 1978, a provision that has severely hampered the Service's enforcement efforts in employee-independent contractor classification cases.[1] Finally, many state governments are stepping up their enforcement efforts, on their own initiative or in conjunction with the federal program. Employers who run afoul of these increased enforcement efforts on the part of federal and state authorities run the risk of not only hefty financial penalties but also potential criminal liability.

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Significance to tax-exempt organizations

Each of these developments is likely to have a significant impact on tax-exempt organizations. The IRS has made it clear that TE/GE taxpayers are among those that will be examined under the employment tax compliance program. Some states, as well, (most notably New York and California) have increased their employment tax audits of tax-exempt organizations, often without regard to the amounts involved. Worker classification will be the primary focus of the compliance audits. The categories of workers at tax-exempt organizations that are most likely to raise worker classification issues are temporary workers, part-time workers, workers engaged during an organization's start-up phase, and long-term consultants.

Unprecedented revenue needs could drive more restrictive rules and more aggressive enforcement.

Previous enforcement efforts

This is not the first time that the IRS has increased its enforcement efforts in the employment tax area. The new efforts come at a time when both federal and state legislative and executive branches have shown renewed interest in employment tax legislation. The area is characterized by a 35-year history of fits and starts, driven by revenue needs and periodic reports on the tax gap and underground economy. In the past, companies and affected individuals have successfully pushed back, with the re-

The 20 Factors

The IRS has traditionally relied on a 20-factor test in determining whether a worker is an employee or an independent contractor. Rev. Rul. 87-41, 1987-1 CB 296, sets out the factors indicating employee status as follows:

1. **The worker is required to comply with instructions.**
2. **The worker was trained by the organization.**
3. **The worker's services are integrated into the organization's operations.**
4. **The worker's services must be rendered personally.**
5. **The worker's assistants are hired, supervised, and paid by the organization.**
6. **There is a continuing relationship between the worker and the organization.**
7. **The organization sets the worker's hours.**
8. **The worker must work essentially full time for the organization.**
9. **The worker works on the organization's premises.**
10. **The organization sets the order or sequence of tasks.**
11. **The worker submits regular or written reports.**
12. **The worker is paid by the hour, week, or month.**
13. **The organization pays the worker's business or travel expenses.**
14. **The organization furnishes significant tools and materials.**
15. **The worker makes no significant investment in the facilities used to perform the work.**
16. **The worker cannot recognize any significant profit or loss from his or her services.**
17. **The worker performs no more than de minimis services for any unrelated organization or business.**
18. **The worker does not make his or her services available to the general public.**
19. **The organization has the right to discharge the worker.**
20. **The worker has the right to leave the organization's service without liability.**

Apparently for ease of application, the IRS has grouped the factors into three categories—behavioral control, financial control, and the relationship of the parties. (See IRS Pub. 15-A, "Employer's Supplemental Tax Guide," pages 6-7.)

sult that the IRS has been rebuffed in its efforts. For example, section 530 of the Revenue Act of 1978, enacted in response to aggressive enforcement efforts by the IRS in 1970s, effectively grandfathered existing independent contractor relationships in certain industries. Section 530 also bars the IRS from publishing new rules or regulations dealing with the classification of workers as employees or independent contractors. In certain worker reclassification cases, Section 3509 provides substantially reduced employment tax rates for proposed assessments involving prior year tax deficiencies, on the assumption that the company or organization will comply with applicable rules and regulations prospectively. It is unlikely that attempts to rein in the current enforcement efforts will meet with much, if any, success.

Employment Tax National Research Project

Under its Employment Tax National Research Project, the IRS has trained 200 employment tax agents and sent them into the field to gather information on, and audit, the employment tax practices of 6,000 companies and organizations, including nonprofits. According to the IRS, the companies and organizations to be examined were selected randomly, with refinements made by the Service to assure a broad geographic sample. Under the program, which began in March, each employment tax agent is expected to handle ten cases a year over a three-year period. The agents are equipped with detailed audit plans and a plethora of data on each taxpayer gleaned from internal IRS records and the public domain (e.g., the Internet). The agents have been instructed to focus on the following areas relevant to nonprofit organizations: employee-independent contractor classifications, fringe benefits, and certain deferred compensation matters under Section 409A. Even churches could be subject to these random audits, as the special audit protections provided to churches by Section 7611 do not extend to employment tax audits.

An organization will be advised that it has been selected for examination under the program through the issuance of an IRS Letter 3851-B or 3850-B. The initial examination will involve the 2009 tax year, but the Service has made it clear that if significant compliance issues are uncovered, the examination may be broadened to include other open years. Organ-

[1] See Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals" (February 2010), Pages 107-109.

izations can expect the examinations to include a thorough review of their employment tax records, including Forms W-2, 1099, and 941; supporting accounting records; and internal (including electronic) communications. The Service may also conduct face-to-face interviews of responsible executives, other employees of the organization, and people classified by the organization as independent contractors. According to the IRS, the average examination is expected to last for seven to eight months. However, given the intensely factual nature of the worker classification portion of the examination and the caseload of each revenue agent participating in the Project, this estimate appears overly optimistic.

The purpose of the Project is three-fold: To measure compliance, to develop information that may prove helpful in designing future audit programs as well as legislative proposals, and to augment the Service's audit function in this area.

Worker classification

A primary focus of the compliance audits will be the organization's classification of workers as independent contractors rather than employees. Worker classification has always been a primary IRS concern. The IRS strongly favors employee status because subjecting compensation to the withholding system assures more accurate reporting of income and more reliable payment of income and Social Security taxes. Unfortunately, there is no bright-line test for classifying a worker as an independent contractor or employee. The 20-factor common law test, applied in these circumstances, is confusing, uncertain of application, and susceptible to varying interpretation depending upon the philosophical bent of the decision maker. The 20 factors are listed in the sidebar on page 20.

In Rev Rul. 87-41, 1987-1 CB 296, the Service acknowledged that the 20-factor test should not be applied in a mechanical fashion: "The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed." Thus, a numerical count that shows 11 factors pointing to employee status does not necessarily mean that the individual should be characterized as such for employment tax purposes. Despite these seemingly favorable concessions by the Service, organizations must be prepared for an aggressive interpretation of the common law test by IRS examiners, resulting in long drawn-out, fact-intensive battles over classification that may prove burdensome in terms of internal time and costs and outside consultant fees.

Section 530 defenses

Section 530 of the Revenue Act of 1978 is an "off-Code" provision enacted in response to the Service's aggressive (and arguably unreasonable) application of the common law test. In the late 1970s, the Service was moving in the direction of reclassifying as employees large categories of individuals who had historically been treated as independent contractors. Section 530 allows companies to continue treating workers as independent contractors without regard to how they might be classified under the common law test, provided that the requirements for "substantive consistency," "reporting consistency," and "reasonable basis" are met.

Tax compliance audits initiated under the National Research Project will be handled differently.

The substantive consistency standard is met by demonstrating that the organization has consistently treated the workers in question and other "similarly situated workers" as independent contractors. The reporting consistency standard is satisfied by establishing that the organization has filed Form 1099s with respect to the workers in question. Finally, the reasonable basis standard is met by demonstrating that the organization has a reasonable basis for treating the workers as independent contractors. A "reasonable basis" includes reliance on (1) judicial precedent, a published ruling, or a private letter ruling or technical advice issued directly to the taxpayer; (2) a past IRS examination of the taxpayer in which the classification of the particular workers was considered and left unchanged; or (3) a long-standing recognized practice of a significant segment (at least 25 %) of the industry.

Revenue agents are obligated to apprise taxpayers of the availability of section 530 and accord them the opportunity to mount a defense under that section. In the normal employment tax audit situation, if the agent is persuaded that section 530 applies, he or she may not pursue any line of inquiry relating to the 20-factor common law test. However, tax compliance au-

dits initiated under the National Research Project will be handled differently. After determining that section 530 applies, the agent is authorized to make a determination as to whether, in the absence of section 530 protection, the workers in question would have been reclassified as employees. While this determination will not have any impact on the organization's employment tax liability, it presumably will be used by the Service to support the administration's legislative proposal to eliminate section 530.

Be prepared

First, be aware of an organization's vulnerabilities. Certain workers are more likely to be scrutinized than others. For example, each of the following situations is a red flag for a potential independent contractor reclassification issue.

- Workers engaged as part-time personnel.
- "Temporary" workers.
- Workers who spend most of their time in offices provided by the organization.
- Former employees (including executives) who have retired from or terminated their employment with the organization and have been hired back as consultants.
- Workers who receive continuing payments from the organization during the year or over several years.
- Workers who receive, in the same year or over several consecutive years, a Form W-2 and a Form 1099 from the organization.

In such cases, the organization should muster the facts and documents in support of its position that the worker is an independent contractor. It should consider modifying the terms and facts of its relationship with the particular individuals going forward to strengthen its position for independent contractor classification in future periods. If its position is weak and irremediable, it should consider converting the individuals to employees and attempting to work out a favorable settlement with the Service. There are several Code provisions (e.g. reduced employment tax rates, interest-free adjustments) and an IRS settlement initiative that might make this conversion virtually painless insofar as past years are concerned, and possibly avoid any criminal penalties associated with the misclassification.

The Classification Settlement Program (CSP) keys off of the requirements of section 530, offering favorable settlement terms to taxpayers who cannot make a "clear" showing that they qualify for section 530 relief but, nevertheless, have "colorable" arguments as to why they might qualify.[2] The program is outlined in the IRS Manual, and the Service tends to apply its procedures liberally to encourage future compliance. The CSP procedures are not available to an organization with respect to any workers who do not satisfy the reporting consistency requirement

If an organization qualifies for CSP treatment, the proposed tax deficiency for worker misclassifications for all prior years is limited to 25% of the most recent year's employment tax liability computed under the favorable rates provided by Section 3509(a). The limit rises to 100% if the "colorable argument" requirement is not met. The rates under Section 3509(a) are 1.5% for income tax withholding, 7.65% for Social Security taxes (FICA), plus federal unemployment taxes (FUTA) for the full year. (The last does not apply to Section 501(c)(3) organizations, which are exempt from FUTA). As part of the CSP settlement, the organization must agree to treat the workers in question as employees for all future periods.

The penalties for incorrect classification of workers as independent contractors can be substantial, particularly in situations where a reduced tax rate or another taxpayer-favorable exception is not available. They can include payment in full of the taxes that should have been withheld, interest, and significant penalties if the IRS determines there was negligent, intentional, or fraudulent behavior. (The 100% penalty of Section 6672 is applicable only in the limited situation in which individuals are classified as employees, taxes are withheld, but the taxes are *not* paid over to the IRS.) In egregious cases involving a willful failure to evade employment taxes, the federal government may also seek criminal sanctions against corporate officers and others responsible for the misclassification, exposing them to both fines and possible imprisonment.

Other areas of concern in compliance audits

Other areas to be covered by the employment tax compliance audits include Form 1099 compliance

[2] See IRM 4.23.6.

(e.g. whether Form 1099s have been issued to all workers classified as independent contractors), Form W-2 technical compliance (e.g. whether all employee compensation has been properly reported and withheld upon on Form W-2), treatment of certain compensation as non-qualified deferred compensation under Section 409A, and taxable fringe benefits. The Service's examination of the latter will focus on personal use of company-owned vehicles and lodging facilities and reimbursement by the organization of travel, lodging (including "temporary" lodging), and entertainment expenses.

Increased interest by the states

The states have also beefed up their employment tax compliance programs. Under a memorandum of understanding between the federal government and 31 states, information gleaned from employment tax audits will be shared by the relevant tax-authorities. Several states—including California, New Jersey, and New York—are not content to await the results of federal employment tax audits. They are increasingly initiating such audits on their own, doing so in certain cases where the amounts involved are relatively small. The state taxing authorities, like the IRS, may impose penalties in cases where, for example, they believe worker misclassifications are the result of negligence or intentional disregard of rules and regulations.

Conclusion

In light of the unprecedented revenue needs now facing federal and state governments, it is likely that there will be more restrictive rules on worker classification and more aggressive enforcement efforts in this area. Employers should not assume that attempts to rein in these efforts will be successful. If anything, Congress and state legislatures are likely to support and even push for more aggressive enforcement, and the tax authorities are likely to be more than willing to accommodate them. ■