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Once Again Employment Tax Compliance at the Forefront of IRS's Enforcement Agenda*

Article Contributed by Charles M. Ruchelman, Esq., Caplin & Drysdale, Chartered

In November 2009, the Internal Revenue Service (IRS) announced that it will begin its first Employment Tax National Research Project in 25 years. According to the IRS press release, "[e]xaminations comprising the study will be conducted to collect data that will allow the IRS to understand the compliance characteristics of employment tax filers." Once again, employment tax issues are at the forefront of the IRS's enforcement agenda.

Long History of Complex Laws and Fact-Intensive Issues

The collection and payment of employment taxes has long been a critical aspect of the IRS's tax administration efforts. Yet the complexity of the employment tax laws, as well as the fact-intensive nature of the issues, has led to a great deal of uncertainty on a variety of reporting and tax withholding fronts. Even within the IRS itself, the issues have caused uncertainty and, at times, schizophrenia. For example, at the start of my career, as a new trial attorney for the IRS, I was responsible for trying the small-dollar cases in the U.S. Tax Court. One such case involved the issue of whether a salesperson was an employee or independent contractor. The alleged tax deficiency amounted to only about $1,500.00. The IRS set the case for litigation and put the case on my docket. Although the case was worth only $1,500.00, it was subject to a rigorous review process by the IRS National Office. The IRS National Office reviewed the pre-trial memorandum and post-trial briefs in order to make sure that a victory in my case would not create adverse precedent in other cases.

Purpose of the Employment Tax National Research Project

The Employment Tax National Research Project (the "Project") is intended to analyze and address the sometimes schizophrenic nature of employment tax issues, as well as the

growing complexity of employment arrangements. The Project study will collect data through an extensive audit of 6,000 randomly selected employers over the next three years. The IRS will use this data to develop a more comprehensive understanding of employment tax non-compliance. In theory, the IRS will use this increased understanding to increase compliance through more effective education and outreach programs and more efficient targeting of non-compliant employers for future audits. In the broader tax policy sense, the Project is aimed at reducing the tax gap caused by non-compliance with the employment tax rules.

6,000 Employment Tax Audits on the Way

The Project randomly targets 2,000 employers per year for the next three years. Employers are selected across all sectors and sizes including large, small, and closely held businesses and tax exempt organizations. The IRS began contacting the first 2,000 employers in March and will focus the audit on Forms 941 filed for tax year 2008. Selected employers will receive a Letter 3851-B or 3850-B notifying them that they have been selected to participate in the Project and will have approximately 30 days to prepare their records prior to the commencement of the review. The IRS is slated to select the second 2,000 employers at the end of 2010 and will primarily focus on tax year 2009 for those employers.

The IRS has trained a team of 200 auditors to conduct this study. These auditors are tasked with conducting reviews that are more comprehensive than a standard audit to ensure that sufficient data is collected for the study. According to the IRS Chief of Employment Tax Operations, most of the employment tax compliance audits will be conducted "face-to-face" at the employer's place of business, with additional information gathered from IRS internal sources and the internet. The IRS estimates each auditor will spend 7–8 months auditing each employer selected. Auditors will not only review normal tax records including W-2s, Forms 1099, and Forms 941 but also the business's accounting records such as check ledgers and accounts payable. Targeted employers should ensure all records are updated and available, and prepare to substantiate in detail all tax treatments falling under any of the key areas of the study.

Substantive Issues Under the Microscope

Although the auditors will conduct a full review of all employment tax related issues, the Project study will focus on collecting data in the following key areas: (1) worker classification (employee versus independent contractor); (2) executive compensation; (3) failure to properly report fringe benefits; and (4) failure to properly issue and file Forms 1099.

Worker classification has always been a primary IRS concern. The IRS strongly favors employee status because this classification subjects compensation to the withholding system and assures reporting of income and payment of income and social security taxes. Unfortunately, there is no bright-line standard for classifying a worker as an independent contractor or employee. Instead, the auditors perform a review of the 20 common law factors that establish an employer/employee relationship. The IRS has grouped the various common law factors into three categories: (1) behavioral control – whether or not the taxpayer has control over how the worker completes tasks; (2) financial control – whether or not the worker has financial control over the business aspects of their work; (3) type of relationship – whether or not the worker and taxpayer have established substantive contractual agreements detailing the scope of the relationship.

The analysis of these factors is highly subjective and often involves protracted fact-intensive disputes with the IRS. Even in cases where the classification of a worker as an independent contractor appears obvious to a taxpayer, the common law factors often provide the auditor grounds to argue for reclassification. For example, in the past the IRS has challenged the classification of insurance agents and franchisees as independent contractors because the amount of control the parent company exerts over the conduct of their business leads to many of the factors weighing in favor of an employee classification. Other industries that are subject to IRS scrutiny include construction, ground delivery, car service, trucking, and consulting. Additionally, classifying part-time personnel, "temporary" workers, certain technical workers, or former employees (including executives) as independent contractors will draw IRS review.

Other areas to be covered by the Project study include executive compensation (reasonableness of the compensation and treatment of certain portions as non-qualified

deferred compensation under Section 409A) and taxable fringe benefits. The examination of fringe benefits will involve a hunt for benefits not disclosed on a Form 941. IRS Agents have been trained to audit the past year's cancelled checks looking for "perks" paid by the employer. They will also look for indications of the most common undisclosed fringe benefits including the personal use of company vehicles by executives, their spouses, or driving age children and of company real estate or vacation properties by employees.

The Project study will also review data on non-compliance with the requirements for issuing Forms 1099. Specifically, the IRS is seeking comprehensive data on the following: (1) if Forms 1099 are properly issued to all relevant parties; (2) if Forms 1099 contain a taxpayer identification number (TIN); and (3) if there is a prevalence of mismatches between the TIN listed on Forms 1099 and the actual TIN for the recipient.

Section 530 Relief Still Available to Employers

An important tool in the tax practitioner's arsenal is an off-Code provision, Section 530 of the Revenue Act of 1978. Section 530 provides a safe harbor for employers seeking to classify workers as independent contractors (so-called "Section 530 relief"). During the Project study, auditors will review the Section 530 eligibility. If the employer is found to qualify for Section 530 relief, it will receive a "no-change" letter. However, for informational purposes, the auditors will proceed to analyze the case under the 20-factor common law test. The latter exercise is supposed to be conducted without imposing any additional audit burden on the employer since the IRS is prohibited by law from applying the common law test if the employer qualifies under Section 530.

To qualify for the Section 530 safe harbor, employers must meet three requirements with respect to each worker. First, the employer must file all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to that worker. Specifically, failure to provide the worker with a Form 1099 will disqualify the employer from the Section 530 safe harbor. Second, the taxpayer must have a reasonable basis for not treating the worker as an employee. A reasonable basis is provided by judicial precedent, IRS audits in which there were no assessments attributable to the treatment, and long-standing recognized practice of a significant segment (at least 25%) of the industry.

Taxpayers most frequently appeal to the long-standing practice element; however, this position can be contentious because determining the appropriate scope of the industry (geographic region, size of corporate players, etc.) is often difficult and subjective. Finally, the employer will fail to meet the requirements if it has treated a different worker in a substantially similar position as an employee. If the Section 530 safe harbor is unavailable, the worker classification is resolved using the common law principles.

Protective Steps

Employer participants in the Project are selected at random. Employers who are concerned about the issues raised by the Project examinations are well advised to review their facts and make adjustments to arrangements as necessary. For example, if worker classification is an issue, employers should consider modifying the terms of the relationships with the particular individuals going forward. If taxpayers consider their position weak and irremediable, they should consider converting the individuals to employees and attempting to work out a favorable settlement with the IRS. There are several Code provisions (*e.g.* reduced employment tax rates, interest-free adjustments) and an IRS settlement initiative that could make the conversion less painful. In the event that a taxpayer is selected for the Project, employers are well advised to seek the assistance of a tax professional to ensure that the employer's particular facts and the relevant legal arguments are presented to the IRS in the most favorable light possible.

**The information presented in this article was gathered from Internal Revenue Service announcements and press releases, as well as information presented during a panel presentation before the D.C. Bar Tax Section's Tax Audits and Litigation Committee.*

Charles M. Ruchelman is a member of the law firm of Caplin & Drysdale, Chartered. His practice focuses on representing clients before the IRS examination division, the IRS Appeals division, and in litigation. Mr. Ruchelman would like to thank William Fournier, a law student at Georgetown University Law Center and a summer associate at Caplin & Drysdale, for his research and drafting assistance with this article and his colleague, Daniel Rosenbaum, for his review of this article and his helpful comments