ALERT - IRS Steps Up Employment Tax Audits

September 17, 2010

Practice Areas

Corporate and Business Law

Background

Companies are required to withhold income and payroll taxes for their employees, but are not required to do so for independent contractors. In addition, a business must fulfill requirements under labor laws for employees that generally would not apply to contractors. The distinction between an employee and a contractor is therefore important for the withholding of taxes and reporting of income – which are crucial for ensuring tax compliance – and for applying labor laws, such as minimum wages, work place safety or eligibility for unemployment benefits.

The principles for distinguishing between independent contractors and employees are complicated. They are based on long-standing common law, and depend on as many as 20 factors related to the relationship between the worker and the business and must be applied on a case-by-case basis. Moreover, some rules apply to all workers, while other rules exclude specific categories of workers, such as engineers, designers or programmers.

For businesses that have historically classified workers as independent contractors, a special provision (Section 530 of the Revenue Act of 1978) provides a "safe harbor" exception from the usual 20-factor test. Under this safe harbor, the IRS may not reclassify workers as employees – even prospectively or for newly hired workers.

The issue of proper classification of workers as employees or independent contractors can have severe financial consequences to the business that misclassifies its workers. Not only is the company subject to retroactive tax withholding, but also penalties and interest if the classification is incorrect. In many cases, the liability adjustment made in an employment tax audit could bankrupt the business.

Employment taxes are "trust fund taxes." This means that officers and owners of the company have personal liability for these taxes and cannot discharge them in bankruptcy, if the business cannot pay. Thus, the IRS takes no prisoners. If employment taxes are misappropriated in any way and there is a misclassification, the owner is generally personally liable.

The potential liability for misclassification of workers is already frightening and it may become more expensive. The classification of workers is also under legislative scrutiny by Congress and the Minnesota Legislature. Although the use of independent contractors is completely legal and legitimate, some believe there has been abuse;

and therefore legislative proposals are made to restrict, if not eliminate, independent contractor status.

Employment Tax Audits
The IRS conducts 60,000 employment tax audits per year. An employment tax exam audits the following Federal taxes:

1. Federal Income Tax Withholding
2. Social Security Tax ("FICA")
3. Medicare Tax
4. Federal Unemployment Tax Act ("FUTA")

Federal employment tax examinations determine whether or not:

1. Workers are properly classified.
2. The employment tax liability is substantially correct.
3. Whether IRS information returns and W-2 wage statements are substantially correct and have been filed.

Employment tax audits are very fact intensive and time consuming.

20-Factor Test
Historically, the IRS uses what has become known as the "20-factor" test to determine whether a worker is an independent contractor or an employee. Over the years, the IRS has attempted to simplify and refine the test. The IRS has consolidated the "20 factors" into eleven main tests and organized them into three main groups: behavioral control; financial control; and the type of relationship between the two parties.

The IRS uses three characteristics to determine the relationship between businesses and workers:

1. **Behavioral Control** covers facts that show whether the business has a right to direct or control how the work is done through instructions, training or other means.
2. **Financial Control** covers facts that show whether the business has a right to direct or control the financial or business aspects of the worker's job.
3. **Type of Relationship** relates to how the workers and the business owner perceive their relationship.

If a business has the right to control or direct, not only what is done, but also what how it is to be done; then the workers are most likely employees.

If the business can direct or control only the result of the work – and not the means and methods accomplishing the result – then the workers are probably independent contractors.

Section 530 Relief
In certain circumstances, Section 530 can relieve businesses of employment tax liabilities resulting from worker misclassification, but the business must meet specific requirements under the law.The business must meet the following three requirements in order to receive relief under Section 530:

- a reporting consistency,
- a substantive consistency, and
- a reasonable basis for treating the workers as independent contractors.

A business must meet all three tests. Making these tests means that the business will not owe employment taxes for the workers in question.

The New National Research Program Audits
In addition to its regular employment tax audits, for the next three years, 2000 companies per year will be randomly selected to provide data for the IRS' National Research Program ("NRP"). The results of these audits will be used by the IRS to study employment tax compliance. The NRP is the first such intensive IRS employment tax audit in 25 years. The NRP exam is comprehensive in scope and more rigorous than a typical employment tax audit. IRS agents will look at related documents such as Form 1120 corporate returns and IRS 1099 forms.

In addition to reviewing payroll taxes, the NRP program will examine:

1. Worker Classification. Independent contractor and worker classification issues, including executives rehired as consultants, dual status employees, and employee leasing arrangements;
2. Fringe Benefits and Employee Expense Reimbursement Plans. Fringe benefits, including the usual "planes, trains, and automobiles", as well as other expense reimbursement arrangements. For example, credit cards, cell phones, use of personal digital assistance (PDAs) provided by employers, and other noncash benefits;
3. Officer Compensation. Executive compensation and fringe benefits issues, such as use of corporate aircraft, executive retirement contracts, golden parachutes, stock options, and other compensatory issues of executives; and
4. Non filers. Determine if the independent contractor has reported his Form 1099 income on his tax return.

The NRP has two major goals:
To secure statistically valid information for computing the amount of the employment "tax gap" and
To determine the salient compliance characteristics of businesses so the IRS can focus future employment tax audits on the most noncompliant employment tax areas.

Why the Scrutiny on Independent Contractors?
Simply put, narrowing the tax gap is the key motivation behind proposals to crack-down on misclassification of employees as independent contractors. Businesses must withhold income taxes, withhold and pay social security and Medicare taxes, and pay unemployment taxes on wages paid to employees. By contrast, businesses do not have to withhold or pay any taxes on payments to independent contractors. Employers are more likely to withhold and submit taxes than independent contractors are to voluntarily pay their liabilities. The latest IRS study on the subject found that 15% of employers misclassified 3.4 million workers as independent contractors, causing an estimated total tax loss of $2.7 billion in inflation-adjusted 2006 dollars.

The same IRS study also found that workers misclassified as independent contractors for whom employers

did not report compensation on Form 1099-MISC reported only 29% of their compensation on their tax returns. Left unsaid in the report, but clearly implied, is that independent contractors organized as corporations did not report their compensation. This will be cured under the recently enacted Health Care law of 2010 that requires the issuing and filing of Form 1099 to an independent contractor organized as a corporation.

Steps Businesses Should Take to Avoid Worker Classification Problems

Given these potential risks, the overriding lesson to learn from the recent IRS audit focus, is that it is increasingly dangerous to misclassify an employee as an independent contractor to avoid paying taxes, health benefits, overtime liability, and other costs. With increased scrutiny from both the State and Federal levels, employees should audit their independent contractor agreements to ensure that they will withstand inspection. This is an area in which a little prevention can be better than the cure.

1. Review all worker-written contracts to clarify worker status;
2. Follow the "common law" tests carefully;
3. Obtain a Form W-9 from the worker, pay by check, and issue a Form 1099-MISC;
4. If an individual is really an employee, do not try to classify the person as an independent contractor;
5. Ensure and preserve Section 530 relief and eligibility;
6. Watch for "Form SS-8" IRS request, payroll audit questions, or other signs of any IRS worker classification audit;
7. Once the proper employment status is determined, do not flip flop and change the status in an inconsistent fashion. Maintain consistent treatment to the extent possible;
8. Monitor IRS changes in its worker "Classification Settlement Program" ("CSP") and announcements on its ongoing study of employee/independent contractor issues;
9. Lobby for legislative changes to clarify status of independent contractors; and
10. If you have questions, immediately seek the assistance of counsel.

Action Point

In light of the above, businesses need to be careful in documenting how they treat their workers and what type of compensation is being paid to them. Businesses need to be very careful and should review their employment practices so that, if the IRS does commence an audit, they will be in the best position to defend themselves, under the "common law" test or other legislative exceptions to employment status. By understanding the issues and undertaking internal compliance reviews, employers may be able to satisfy the relief provisions available in Section 530 for worker classification issues or the "reasonable belief" standard for payroll tax, worker compensation, and fringe benefit issues.

If you have any questions on an IRS employment tax audit or any questions on independent contractor issues, please contact a member of our Tax section or Business Law section.