



# Federal Employment Tax Oversight: Preparing for Heightened IRS Enforcement Strengthening Compliance to Withstand Tougher Audits and Avoid Civil and Criminal Penalties

**A Live 100-Minute Audio Conference with Interactive Q&A**

**Today's panel features:**

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**Thursday, August 13, 2009**

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# **Federal Employment Tax Oversight Teleconference**

**Aug. 13, 2009**

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# Today's Program

- Background On Federal Employment Tax Oversight To Date, slides 3 through 5 (*Daniel Rosenbaum*)
- The New IRS Organization And Posture, slides 6 through 13 (*GJ Stillson MacDonnell*)
- Employment Tax Compliance Issues, Part I, slides 14 through 23 (*Daniel Rosenbaum*)
- Employment Tax Compliance Issues, Part II, slides 24 through 28 (*Stephen Mopsick*)
- Preparing For Employment Tax Audits And Appeals, slides 29 through 35 (*GJ Stillson MacDonnell*)

# **Background On Federal Employment Tax Oversight To Date**

# Employment Tax Enforcement Efforts: Brief History

- 35-year history of fits and starts at legislative and administrative levels, driven by revenue needs and periodic reports on tax gap and underground economy
- Industry lobbyists have repelled attempts to tighten rules legislatively and administratively, the best example being Sect. 530 of the Revenue Act of 1978
- Employers are comfortable playing the audit lottery, because penalties are rarely imposed, interest-free adjustments under Sect. 6205 are available, reduced employment tax rates are applied in reclassification cases, and the classification settlement program provides substantial relief to employers where reclassification is raised in an IRS examination

# Employment Tax Enforcement Efforts: Brief History (Cont.)

- Recent interest in stricter employment tax rules and enforcement efforts in light of projected budget deficits; most recent tax gap studies attribute tens of billions in lost tax revenues to unreported income by “sole proprietors”
- Employment tax audits will likely increase in number and intensity, as funding has been made available for hiring and training additional IRS agents
- Legislation has been introduced in various forms to weaken or emasculate Sect. 530, including S.2044, introduced in 2007 by senators Obama and Durbin, and H.R. 3408, introduced by a number of House sponsors in July 2009
- A proposal bandied about for over 30 years has gained renewed interest --- extending the withholding regime to certain independent contractors

# **The New IRS Organization And Posture**

# IRS Audit And Enforcement Divisions

## SBSE – Small Business/Self-Employment Division

Jurisdiction: Individuals filing Schedules C, E, F or Form 2106  
Businesses with less than \$10 million in assets

## LMSB – Large and Medium Size Business Division

Jurisdiction: Corporations, Subchapter S Corps and Partnerships  
with assets greater than \$10 million

## CID – Criminal Investigation Division

Jurisdiction: Investigates for criminal prosecution (by Department  
of Justice) tax fraud

# Enforcement Priorities

- IRS estimates tax gap to be currently \$290 billion per year
  - Underreporting (82%)
  - Underpayment (10%)
  - Non-filing (8%)
  
- 2001 last tax gap analysis estimated that at least \$59 billion resulted from employment-related taxes

# National Research Project Tackles Employment Tax Gap

- May 2009, IRS announced that beginning Fall 2009, it will update employment tax gap statistics through at least a four-year audit program beginning fourth quarter 2009
- At least 5,000 random payroll tax audits anticipated
- Focus of audits:
  - Worker classification (employee or contractor)
  - Fringe benefits
  - Compensation paid to owner-employees

# Federal Employment Taxes Subject To Assessment

- Income tax (WIT) – Withholding generally determined by tax tables based on W-4 exemptions
- Social Security and Medicare (FICA) – Matching 7.65% tax subject to annual cap (in 2009 \$106,800) and 1.45% (also matching) on amounts over annual cap
- Unemployment (FUTA) – Employment paid tax currently on first \$7,000 of wages (2009). Taxed at rate of 6.2%, less credit for timely payment of corresponding state UI taxes, resulting in potential net FUTA of 0.8% on first \$70,000 of wages per employee
- Penalties/interest on assessed taxes

# Audit Climate

- National Research Project will increase IRS audit volume considerably
- SB/SE has memorandum of understanding with all state workforce agencies, providing for exchange of data regarding unemployment claims by contractors
- Congress considering legislation that would broaden types of payees that must receive IRS Form 1099 Misc. and potential increased penalties at state level

# Audit Climate (Cont.)

- August 2009 headlines: “Tax Receipts are on pace to drop 18% this year, the biggest single-year decline since the Great Depression . . . .” (KTVFox.com, Aug. 3, 2009)
- Revenue-starved states and federal governments inclined to aggressively pursue revenue through audit and legislation

# Criminal Investigation Division Activity

- Pursues criminal investigations
- Criminal laws have more significant penalties, including fines and possibility of imprisonment of management
- Employment investigation tax focus
  - Shell and serial companies and their management that divert payroll taxes
  - Intentional disregard of the law
- Prosecution handled by Department of Justice

# **Employment Tax Compliance Issues, Part I**

# Worker Classification Under The Common Law Test

- Worker classification is a major focus of IRS employment tax audits
- Common law 20-factor test is applied by the Service and courts to determine worker classification (see, for example, Rev. Rul. 87-41, 1987-1 cb 296)
- The factors are (1) instructions; (2) training; (3) integration into the business; (4) services rendered personally; (5) hiring, supervising and paying assistants; (6) continuing relationship; (7) set hours of work; (8) fulltime required; (9) doing work on employer's premises; (10) order or sequence set; (11) oral or written reports; (12) payment by hour, week or month; (13) payment of business or travel expenses; (14) furnishing significant tools and materials; (15) significant investment; (16) realization of profit or loss; (17) working for more than one entity; (18) making services available to general public; (19) right to discharge; and (20) right to terminate

# Worker Classification Under The Common Law Test (Cont.)

- Rev. Rul. 87-41 cautions against applying the 20-factor test 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 independent contractor status does not necessarily mean that the individual should be characterized as such for tax purposes
- As is the case with any test that involves applying and weighing numerous subjective factors, the analysis is often confusing, and the conclusion is frequently uncertain
- Experienced practitioners apply “smell test”; you know one when you see one. IRS agents are often result-oriented
- IRS audit techniques include (1) comparing W-2 and 1099 lists to identify persons whose status changed during the year, (2) identifying persons who received continuing payments during the year, and (3) questioning the status of all individuals who received compensation reported on Form 1099

# Worker Classification Under The Common Law Test (Cont.)

- Many audits are initiated as the result of claims filed by the workers for benefits to which only employees are entitled, such as unemployment compensation
- IRS employment tax agents generally base their findings on written responses to SS-8s or oral interviews of workers. Disgruntled workers often provide IRS with damaging statements
- It is generally disruptive, costly and time-consuming to mount a defense in these cases
- The additional cost of the employer's share of FICA, Medicare and unemployment taxes on compensation paid to the workers is a common excuse for treating them as independent contractors. Another significant consideration is the competitive situation in the industry, which is an issue as long as some members of the industry treat similar workers as independent contractors

# Worker Classification Under The Common Law Test (Cont.)

- Sect. 3509 provides reduced rates for computing the employment tax liability on reclassified workers treated as independent contractors in prior years
- Sect. 3508 mandates treatment of certain real estate agents and direct sellers as independent contractors

# Sect. 530 Of The Revenue Act Of 1978

- Off-Code provision enacted in 1978 as a temporary response to aggressive IRS enforcement efforts to reclassify independent contractors as employees in several major industries. Subsequently extended indefinitely
- Provision allows businesses to continue treating workers as independent contractors without regard to the common law test, so long as the requirements for substantive consistency, reporting consistency and reasonable basis are met
- Substantive consistency: The taxpayer has consistently treated the workers in question and other “similarly situated workers” as independent contractors. The term “similarly situated” means persons who perform the same duties as the workers whose classification is in question and have a similar relationship with the taxpayer as the workers in question, under the 20 common law factor test
- Reporting consistency: The taxpayer has filed Form 1099s with respect to the workers in question

# Sect. 530 Of The Revenue Act Of 1978 (Cont.)

- Reasonable basis: The taxpayer must demonstrate 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) Past IRS examination of the taxpayer in which the classification of the particular workers was considered and left unchanged; or (3) A longstanding, recognized practice of a significant segment (at least 25%) of the industry
- Revenue agent must apprise taxpayer of availability of Sect. 530 at the commencement of the examination
- Sect. 530 not available in the case of a worker who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer systems analyst or other similarly skilled worker engaged in a similar line of work

# IRS Classification Settlement Program

- The “CSP” guidelines are found in Sect. 4.23.6 of the Internal Revenue Manual. They apply if the classification issue is raised in an IRS audit or the taxpayer voluntarily seeks to reclassify a group of workers from independent contractor to employee status and gain protection for prior years. The Service takes a liberal approach in defining the situations in which taxpayers may avail themselves of the CSP procedures, because the primary objective of the program is to ensure future compliance
- The CSP keys off the requirements of Sect. 530, by offering favorable settlement terms to taxpayers who cannot make a “clear” showing that they qualify for Sect. 530 relief but nevertheless have “colorable” arguments as to why they might qualify
- The CSP procedures are not available to the taxpayer with respect to any workers who do not satisfy the reporting consistency requirement, except where the number of such workers subject to reclassification who did not receive Form 1099’s is *de minimis*. The illustrative example given in the manual for *de minimis* involves a group of 150 reclassified workers, of whom three did not receive Form 1099s because they were “missed by the processing department”

# IRS Classification Settlement Program (Cont.)

- The CSP 25% formula (described below) is available to those taxpayers who satisfy the reporting consistency requirement with respect to the particular workers and have “colorable” arguments regarding their satisfaction of the substantive consistency and reasonable basis tests. In all other cases, the CSP 100% formula applies
- 25% CSP formula: 25% of most recent year’s employment tax liability computed under the rules of Sect. 3509(a) (FWT at 1.5%, FICA at 7.98%) plus FUTA for the full year
- 100% formula: 100% of most recent year’s liability computed under the rules of Sect. 3509(a) (FWT at 1.5%, FICA at 7.98%) and FUTA for the full year
- Statutory interest apparently is not assessed with respect to a CSP settlement, but the Service may impose penalties

# IRS Classification Settlement Program (Cont.)

- A taxpayer that enters into a CSP settlement must start treating the workers in question as employees, in the first calendar quarter following the calendar quarter in which the CSP closing agreement is executed
- In cases resolved under CSP, the Service uses a closing agreement prepared specifically for these cases. The agreement provides that as long as the taxpayer complies with the treatment of the particular workers (and any similarly situated workers) as employees, “the Service will not disturb the taxpayer’s classification of such workers” as independent contractors in prior years

# **Employment Tax Compliance Issues, Part II**

# IRS Stance On Employment Tax Enforcement In FY09

- More than 35 major IRS prosecutions for employment tax violations, all over the country
- The IRS is not only after the “little guy.” Prosecution targets include large corporations and multi-million dollar cases
- Professional employee organizations: Heavy IRS focus
- Alleged abuse of independent contractor status
- Alleged misuse of outside payroll companies

# IRS Strategic Plan

- The IRS' current strategic plan specifically includes employment tax evasion as one of the areas where the IRS seeks to enhance its enforcement efforts
- Role of employment tax specialist in the audit process
- Guidance from IRS national office

# Fringe Benefit Issues

- IRS reads “fringe benefit” as employment tax abuse

## **General rule on taxation of fringe benefits**

- Statutory exceptions

## **Accountable plan issues**

- Next generation of tax shelters?

# Trust Fund Recovery Penalty

## Sect. 6672

- Who is NOT a “responsible person”?
- What is the duty of a corporate officer with knowledge of employment tax issues?
- Trust fund recovery penalty interview with revenue officer
- Application of voluntary payments to trust fund portion
- Installment agreements, temporarily uncollectible, enforced collection

# **Preparing For Employment Tax Audits And Appeals**

# Audit Triggers

- National research project
- Obstructed unemployment claims (more likely state audits)
- Disproportionate numbers of 1099 Misc. forms issued/filed compared to W-2 forms
- Targeted industry reviews
- Errors in filing required reports and delinquent filings of reports
- IRS SS-8 “rulings”

# Inter-Relationship Of State And Federal Employment Tax Audits

- States (typically agencies that administer UI programs) electronically and “automatically” advise IRS of state-level assessments
- States can also advise IRS of intention to audit creating prospect of “joint” or serial.
- IRS audits not historically as proactive regarding advising states of IRS audit activity
- Audits are not automatic, even with information exchange
- State agencies have announced heightened coordination (i.e., Department of Labor and Department of Revenue)
- Audits often motivated to recoup depleted state treasuries/funds, particularly increase in unemployment claims and underwater UI funds

# Preparing For Audits

- Take SS-8 determination letter correspondence seriously and engage senior management before responding
- Take audit notices seriously and immediately route notices to senior management, discourage “handling” by low-level employees
- Consult qualified tax professional immediately upon receipt
- Periodically conduct internal audits, with assistance from legal counsel to ascertain potential liability and proactively fix problem areas

# Preparing For Audits (Cont.)

- Perceived and actual misclassification of contractors may be widespread
  - Be conservative in using contractors' services
  - Evaluate contractors' status – before, during and at conclusion of services
- Periodically read reports by and evaluate services of company's payroll service
- Review reimbursement and fringe benefit programs for tax and other compliance
- Periodically survey for reasonableness of owner compensation, including conduct due diligence surveys

# IRS Audit/Appeal Procedures

- Step 1 – IRS tax agent (examiner) conducts audit
- Step 2 – Appeals Office
  - Appeals or settlement offices handles
  - Subject to review by appeals team managers
- Step 3 – Court options – Trial level
  - United States
    - Tax Court jurisdiction
  - United States
    - District Court jurisdiction (jury trial possible)

# IRS Audit Appeal Procedures (Cont.)

United States

- Court of Federal Claims
  
- Step 4 – Appellate Courts
  - Circuit Court
  - U.S. Supreme Court