TAG! YOU'RE IT!:
IS YOUR BUSINESS NEXT IN LINE FOR AN IRS WORKER CLASSIFICATION AUDIT??

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In a coordinated effort to improve employment tax compliance, and as part of the National Research Program, the Internal Revenue Service (the "Service") has begun randomly selecting U.S. employers for employment tax audits. The Service selected the first 2,000 employers for audit in February 2010. The next 2,000 employers will be identified and contacted as early as November 2010 for audits that will take place during the 2011 examination cycle. The Service advised that 6,000 employers will be selected for this program, including large, medium and small for-profit businesses and tax-exempt organizations. Because the selection process is random, any U.S. employer is a potential audit candidate.

If an employer is selected for an employment tax audit, IRS Revenue Agents will thoroughly review issues related to:

(1) Worker Classification
(2) Employee Benefits
(3) Executive Compensation
(4) Non-Filers; and
(5) Employee Reimbursement Plans

For many employers, a review of worker classifications will present the greatest challenge. A worker may be classified as either an employee or as an independent contractor. These classifications have significant tax and labor law implications. Revenue Agents will review a company's independent contractors to determine if those individuals should be classified as employees and, as a result, be subject to income tax withholding and employment tax. If the Service finds that the workers are misclassified, the determination will impact the employer's state tax and unemployment insurance obligations and may expose the employer to claims for unpaid wages and overtime. Thus, it is crucial that employers take a proactive approach, review their internal policies regarding independent contractors, and make any necessary classification changes in anticipation of audit selection.

I. The Risk of Audit is High Even if an Employer is Not Randomly Selected

Even if an employer avoids random selection under the National Research Program, it may still face a worker classification audit if individual workers, competitors or informants alert the Service to possible misclassifications. For example, a worker may file Form SS-8, "Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding," with the Service. This form requests that the Service make a formal determination of the individual worker's classification and may trigger a more extensive audit of the employer's worker classification practices. Forms SS-8 are typically filed by disgruntled former workers seeking Maryland unemployment benefits, current workers filing claims for

worker's compensation, or current or former workers who have been treated as independent contractors and are now facing income tax liabilities due to failure to make estimated tax payments. Such worker claims are common and often result in contact between the Service and the employer.

II. Federal and State Authorities Have Different Standards and Share Information

The test to determine worker classification varies depending on the nature and purpose of the inquiry. Different facts and circumstances are considered by the Service, the U.S. Department of Labor, the Comptroller of Maryland, and the Maryland Department of Labor, Licensing and Regulation ("DLLR"). A worker may be an independent contractor for purposes of federal employment tax, but classified as an employee for purposes of Maryland unemployment insurance contributions.

In determining worker classification, the Service looks to the common-law rules governing employer-employee relationships.[1] Generally, an employer-employee relationship is found when the business has the right to control and direct the worker with regard to the result as well as the details and means used to reach that result.[2] "If the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial."[3]

The common-law rules evolved into 20 factors to be considered when determining worker classification. These factors consist of the following:

(1) instructions to the worker,
(2) training,
(3) integration into business operations,
(4) requirement that services be rendered personally,
(5) hiring, supervising, and paying assistants,
(6) continuity of the relationship (permanency),
(7) setting the hours of work,
(8) requirement of full-time work,
(9) working on employer premises,
(10) setting the order or sequence of work,
(11) requiring oral or written reports,
(12) paying workers by the hour, week, or month,
(13) payment of worker's business and/or traveling expenses,
(14) furnishing worker's tools and materials,

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[1] 26 U.S.C. § 3121(d)(2).
[2] 26 C.F.R. § 31.3121(d)-1(c)(2). Virtually identical provisions regarding employer-employee relationships for tax purposes are found in 26 C.F.R. § 31.3121(d)-1 (social security and Medicare taxes), 26 C.F.R. § 31.3306(i)-1 (unemployment tax), and 26 C.F.R. § 31.3401(c)-1 (income tax withholding).
[3] 26 C.F.R. §31.3121(d)-1(a)(3).

(15) significant investment by worker,
(16) realization of profit or loss by worker,
(17) working for more than one business at a time,
(18) availability of worker's services to the general public,
(19) the employer's right to discharge the worker, and
(20) the worker's right to terminate relationship with the employer.

No one factor is determinative and not all factors are relevant in every case. Instead, all facts regarding the employer's right to control the worker are relevant and the final determination will be based on the employer's particular facts and circumstances. The Service emphasized the importance of "control" when it organized the common-law factors into three general categories of evidence:

> **Behavioral control**: This is the amount of control the business has over how the worker performs the task. Factors include the type and degree of instructions provided to the worker as to when, where and how to perform the work. They also include the amount of training provided to perform the work in a specific manner.
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> **Financial control:** This is the amount of control the business has over the business aspects of the job. Factors that indicate a worker should be classified as an employee include reimbursed business expenses; little to no financial investment in the job; an inability to seek out other job opportunities; a regular periodic wage instead of a flat fee per job; and an inability to realize a profit or loss.
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> **Type of relationship:** This category looks at the relationship between the parties as the parties perceive it. Evidence illustrating the perceived relationship includes the intent of the parties as evidenced through written contracts; whether employee benefits are provided; the permanency of the relationship; and the extent to which the worker's services are integral to the business.

IRS Publication 15-A (Employer's Supplemental Tax Guide), p. 6-7.

Generally, if an employer has the *right* to control or direct not only what *is* to be done by the worker, but also *how* it is to be done, then the worker is more likely to be classified as an employee. If, on the other hand, an employer can direct or control only the *result* of the work done, and not the means and methods of accomplishing the result, then the worker is more likely to be classified as an independent contractor.

In the event that the Service classifies a worker as an employee, the employer may appeal that determination and/or seek relief under section 530 of the 1978 Revenue Act as modified by § 269(c) of the Tax Equity and Fiscal Responsibility Act of 1982 ("Section 530").

An employer is entitled to relief from withholding taxes and related penalties pursuant to Section 530 if it (i) can establish a reasonable basis for classifying its workers as independent

contractors for the period at issue, (ii) filed all required federal tax returns in a manner consistent with the independent contractor classification, and (iii) consistently treated the worker as an independent contractor for all periods after 1977.[4] An employer falls under a reasonable basis "safe haven" if the classification is a "long-standing recognized practice of a significant segment of the industry in which the individual was engaged," but failure to establish such industry practice does not prevent the employer from demonstrating an alternative reasonable basis for the classification.[5]

Although the Service requires timely filing of information returns (Forms 1099) for the periods at issue before it will grant Section 530 relief, the U.S. Tax Court recently held that Section 530 imposes no such requirement, and as long as the required returns were filed and were consistent with the business's classification, failing to timely file does not preclude relief. *Medical Emergency Care Assoc. S.C. v. Commissioner*, 120 T.C. 436 (2003). Thus, if an employer is treating its workers as independent contractors and has failed to timely file Forms 1099, it should immediately come into compliance in this regard.

The Service shares information obtained in employment tax audits with other federal and state agencies. Maryland returns the favor by sharing information developed in its worker classification investigations. As noted, federal and state agencies impose different tests for worker classification, but an adverse finding by any agency can result in the commencement of an employment tax audit by the Service. As a result, employers should take each contact regarding worker classification seriously, regardless of what appears to be the amount at issue in any particular examination.

If you wish to discuss the Service's employment tax examinations or other worker classification issues, or simply wish to have your current practices reviewed for potential exposure, please contact Caroline D. Ciraolo (410-547-7852 or cciraolo@rosenbergmartin.com) or any attorney in our tax group:

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[4] Rev. Proc. 85-18, § 2.01.
[5] *Id*. at § 3.01.