



Bean, Kinney & Korman, P.C.

IRS NATIONAL PROJECT TO CONDUCT EMPLOYMENT TAX AUDITS IN 2010-2012

© Ronald A. Feuerstein and Bean, Kinney & Korman, P.C. 2010

Ronald A. Feuerstein, Esquire

2300 Wilson Boulevard, 7th Floor

Arlington, VA 22201

(703) 525-4000

www.beankinney.com



IRS Circular 230 Disclosure: To ensure compliance with requirements imposed by the U.S. Internal Revenue Service, we inform you that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, by any taxpayer for the purpose of (1) avoiding tax-related penalties under the U.S. Internal Revenue Code or (2) promoting, marketing, or recommending to another party any tax-related matters addressed herein.

IRS Announced National Program to Conduct Employment Tax Audits for 2010, 2011 & 2012

- November 9, 2009 – IRS announced its first “Employment Tax National Research Project” in 25 years.
- February 2010 – IRS started conducting audits under the new IRS stated goals:
 1. *To obtain statistically valid information to compute the so-called “Employment Tax Gap”*
 2. *To determine compliance characteristics enabling IRS to focus on the most non-compliant employment tax areas*
- IRS will “randomly” select 2000 taxpayer-employers each year for 2010, 2011 and 2012 to audit under this special initiative. The 2000 per year is in addition to the 60,000 regular employment tax audits IRS conducts yearly.
- IRS has described the audits it plans to conduct under this initiative as “comprehensive in scope”
 - will target 2007 & 2008 returns;
 - 200-300 of IRS’ best and most experienced employment tax auditors will receive special, additional training;
 - 80% will target small businesses.

IRS & States Focus on Abuses through Use of Independent Contractors

- One issue IRS is expected to focus upon with great scrutiny is so-called “worker classification”
- IRS senses a large “Tax Gap” of \$200 Billion related to Federal payroll and self-employment tax

§ 530 of Revenue Act of 1978

- intended as a temporary relief provision
- became a safe harbor provision
- some think too restrictive and others consider too overboard
- has been indefinitely extended, but so far not enacted as part of IRC
- though not in IRC, § 530 has created a sea-change
- purpose of § 530 – to prevent IRS from retroactively reclassifying workers from independent contractor if employer meets certain tests
- § 530 is a statutory prohibition that does not determine the actual status of the worker in question, but merely relieves employer of liability for employment taxes even if the true status of the worker is an employee
- if employer can come within § 530 safe harbor, it would be relieved of having to bear burden of demonstrating the appropriate status
- intention of Congress was to provide relief to employers facing economically unfair challenges by IRS and to prevent IRS from issuing Regulations and Revenue Rulings intended to delineate common law employee status

For § 530, need to meet 3 tests

- (1) “Reasonable Basis” Test – for using independent contractor status after 1977
- (2) “Tax Return” Test – (reporting consistency) – filed all required Federal tax returns consistent with independent contractor status
- (3) “Position” Test (substantive consistency) – employer must not have treated a worker in a “substantially similar employment” as an employee for any period after 1977

§ 530 litigation – fact dependent

- Employer has burden of proof, but once employer makes prima facie case, burden shifts to IRS – BUT ONLY if employer has fully cooperated with IRS’ reasonable requests for information
- Legislative history and case law requires that the REASONABLE BASIS standard be liberally construed in favor of the taxpayer and IRS accepts this
- affidavits are enough to force a trial and avoid summary judgment by IRS

REASONABLE BASIS TEST

Can meet any 1 of 4 tests

1. judicial precedents, IRS published rulings, private letter ruling issued to the taxpayer
2. past audits where there was no assessments relating to workers holding substantially similar position
3. industry custom – must be long-standing (need not be greater than 10 years) and apply to a “significant segment” of the industry (no more than 25%)
4. “Other Reasonable Manner”
 - professional advice
 - evaluation of common law factors

Tax Return Test

Failing to file 1099 fatal

- but IRS can deny it has and difficult to prove; perhaps not even necessary for timely filing, although IRS contends it is necessary
- in this area, taxpayer should not react to IRS letter and notices concerning worker classifications without first obtaining advice of tax counsel, since filing returns in response to intimidation by IRS might foreclose § 530 relief
- state return filings treating a worker as an employee will not preclude § 530 relief, so long as no 941 and W-2 filed for that worker

Position Test

- requires consistency
- goes to duties performed and relationship between work and taxpayer

Exceptions to § 530

Engineers, designers, computer programmers, system analysts and similarly “skilled” positions

IRC § 3509 – if certain tests are met, if worker is reclassified as employee, employer gets reduced rates of Federal income tax withheld and Social Security tax liability

Common Law Tests

In 1996, IRS conceded that its 20 factors test from 1987 are not the only important considerations

New IRS “6 Indicator Zones” position:

Indicator Zones and their specific factors

1. Details of Work Performance

- a) Instructions
- b) Training
- c) Set Hours of Work
- d) Full Time Required
- e) Order or Sequence Set
- f) Oral or Written Reports
- g) Skill
- h) Label

2. Expenses of Work Performance

- a) Payment of Business and/or Traveling Expenses
- b) Furnishings of Tool and Materials Significant Investment
- c) Licenses and Taxes

Indicator Zones and their specific factors (continued)

3. Compensation for Work Performance

- a) Payment by Hour, Week, Month
- b) Realization of Profit or Loss
- c) Insurance
- d) Benefits

4. Duration of Work Position

- a) Right to Discharge
- b) Right to Terminate
- c) Continuing Relationship

Indicator Zones and their specific factors (continued)

5. Structure of Work Position
 - a) Integration
 - b) Services Rendered Personally
 - c) Hiring, Supervising and Paying Assistants
 - d) Working for More than One Firm at a Time
 - e) Making Service Available to General Public
 - f) Principal in Business
 - g) Intent
 - h) Governmental or Regulatory Rules
 - i) Industry Custom
 - j) State Law Characterization
 - k) Incorporation

6. Location of Work Performance

Other Issues to be Examined

- Owner Compensation
- IRC § 409A
- Fringe Benefits
- Reimbursed Expenses

Audits of Tax-Exempt Organizations

- 500 of the 2000 audits in 2010 will be of tax-exempt entities
- Same issues as faced by profit entities, with added risk of losing tax-exemption or facing “intermediate sanctions” under IRC §4958

How Can Tax Audits Arise?

- Employment tax audits can be triggered (other than randomly) numerous ways, including:
 1. *Former “employees” who were treated (correctly or incorrectly) as independent contractors who seek unemployment, workers compensation, overtime, health insurance, Social Security or qualified plan benefits*
 2. *Audits of the employer (whether random or not) or of the worker classified as an independent contractor who fails to file tax returns or fails to report or pay tax on Form 1099*

What Should Employers Do?

- Be proactive
- Do an Internal self-audit
- Assess your exposure and risk to use of independent contractors, executive compensation agreements involving deferred compensation agreements or stock options and expense reimbursements and fringe benefits
- Consult tax counsel for guidance if risks apparent

What To Do If You Will Be Audited

- Engage tax counsel to represent your business and be interposed between IRS and you
- Review all your independent contractor relationships and independent contractor agreements
- Itemize a list of fringe benefits provided and how they are taxed
- Review accountable plan rules
- If executives are highly compensated, try to determine what similar size companies in the same field pay their executives

Bean, Kinney & Korman, P.C.

- Founded in 1959 in Arlington, Virginia
- One of Northern Virginia's largest and most trusted law firms
- More than 40 lawyers; comprehensive array of practice areas
- Nine LEED Accredited Professionals—more than any other firm in D.C. metro area
- Serve clients throughout Virginia, Maryland and D.C.
- Regularly appear in all Federal and State Courts in the D.C. metro area

Contact Ronald A. Feuerstein, Esquire

Bean, Kinney & Korman, P.C.
2300 Wilson Boulevard, 7th Floor
Arlington, Va. 22201
703-525-4000, extension 288
rfeuerstein@beankinney.com
www.beankinney.com