

Federal Government Focuses on Employee Misclassification and Employment Tax Avoidance

By: Neil V. Birkhoff

Both the Government Accountability Office (GAO) and the Congressional Research Service (CRS) have released reports and recommendations on the issue of employee misclassification of workers as independent contractors. Further, the IRS reportedly is commencing employment tax audits of selected employers nationwide, and a recently introduced bill would revamp so-called "Section 530" relief for employers who misclassify workers.

GAO Report. In August, the GAO issued a report that includes several recommendations for reducing the number of workers that are incorrectly classified as independent contractors (GAO Report, "Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention," August 2009). The report notes that while the IRS enforces worker classification compliance primarily through examinations of employers, it also offers settlements through which eligible employers under examination can reduce taxes they might owe if they maintain proper classification of their workers in the future. The GAO report concludes that the IRS faces challenges with its compliance efforts because (a) of resource constraints and limits that the tax law places on its classification enforcement and education activities; (b) IRS and the Department of Labor (DOL) typically do not exchange the information they collect on misclassification, in part because of certain restrictions in the Code that limit IRS's ability to share tax information with federal agencies; and (c) DOL agencies do not share information internally on misclassification. The report notes, however, that IRS and 34 states share

information on misclassification-related audits.

The GAO report includes 19 specific recommendations for reducing employee misclassification:

(1) Clarify the distinction between employees and independent contractors under federal law.

(2) Allow workers to challenge a classification determination in the Tax Court.

(3) Ensure that workers have adequate legal protection against retaliation after filing Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.

(4) Define misclassification as a violation under the Fair Labor Standards Act (FLSA).

(5) Narrow the definition of "a long-standing recognized practice of a significant segment of the industry" so that fewer firms qualify for penalty relief under the reasonable basis standard in Section 530 of the Revenue Act of 1978.

(6) Lift the ban on IRS/Treasury issuing regulations or revenue rulings clarifying the employment status of individuals for purposes of employment taxes.

(7) Require service recipients to provide standardized documents to workers that explain their classification rights and tax obligations.

(8) Expand IRS outreach to service recipient, worker, and tax advisor groups to educate them about classification rules and related tax obligations, targeting groups IRS

(Continued from page 1)

deems to be "at risk."

(9) Create an online classification system, using factors similar to those used in the SS-8 determination process, to guide service recipients and workers on classification determinations.

(10) Increase the use of IRS notices to service recipients in industries with a potentially high incidence of misclassification to educate them about classification rules and ask them to review their classification practices.

(11) Require service recipients to withhold taxes for independent contractors whose TINs IRS cannot verify, or who IRS has determined are not fully tax compliant.

(12) Require universal tax withholding for payments made to independent contractors, using tax rates that are relatively low (e.g., 1% to 5% of payment amounts).

(13) Require service recipients to withhold taxes from payments made to independent contractors who request withholding in writing.

(14) Measure the extent of misclassification and related impacts on tax revenues at the national level.

(15) Require each independent contractor to apply for a separate business TIN.

(16) Expand IRS's Classification Settlement Program (CSP) to include service recipients that voluntarily contact IRS about their misclassified workers.

(17) Require service recipients to submit Forms SS-8 for all newly retained independent contractors.

(18) Enhance coordination between IRS, DOL, and other federal agencies to share data and address misclassification.

(19) Enhance coordination between IRS, states, and selected local governments to share data and address misclassification.

CRS Report. The CRS summarized the employee-vs-independent contractor issue and reported that the last IRS estimate was that 15% of employers misclassified 3.4 million workers as independent contractors rather than as employees, causing an estimated total loss of

\$1.6 billion in taxes. The CRS report noted however, that this estimate dated to 1984, and called for more updated information before deciding whether the benefits of curtailing misclassification of workers outweighs the costs.

IRS employment tax audit program. IRS is preparing to roll out an employment tax National Research Program (NRP) that will involve a significant number of randomly selected employers in the next few years. The program was suggested in the 2008 report of the Internal Revenue Service Advisory Council (IRSAC), which urged IRS to embark on a NRP because "historical data seems to be out of date with the current Internet economy," and because such a study would help IRS focus limited resources within "employment tax challenged industries."

New legislation. Congressman James McDermott has introduced legislation that would make it more difficult for employers to receive protection from a potentially large employment tax assessment after incorrectly classifying a worker as an independent contractor. The "Taxpayer Responsibility, Accountability, and Consistency Act of 2009," would also increase information reporting penalties. The legislation primarily focuses on Section 530 of the Revenue Act of 1978. Under Section 530, employers that meet the following three requirements are protected from potentially large employment tax assessments, even though they incorrectly categorized a worker as an independent contractor: (1) reasonable basis, (2) substantive consistency, and (3) reporting consistency. An employer can meet the "reasonable basis" requirement if judicial precedent, IRS rulings, a past IRS audit, or industry practice supports the classification of a worker as an independent contractor. An employer meets the substantive consistency requirement if it (and any predecessor business) consistently treated the workers in question as independent contractors. The reporting consistency requirement is met if the employer has not classified the workers as employees on any required federal tax returns, including information returns.

The new legislation would repeal Section 530 and establish new rules that limit an employer's chance to avoid employment tax liability if the

(Continued on page 3)

employer misclassified a worker as an independent contractor. Those new rules would require employers to have a “reasonable basis” for classifying a worker as an independent contractor, and the “reasonable basis” standard would be met only if:

- (1) The employer classified the worker as an independent contractor based on a:
 - (i) written determination that addresses the employment status of either the worker in question, or another individual holding a substantially similar position with the employer; or
 - (ii) concluded employment tax examination of the worker, or another individual holding a substantially similar position with the employer, that did not conclude that the worker should be treated as an employee; and
- (2) The employer (or a predecessor) has not treated any other individual holding a substantially similar position as an employee for employment tax purposes for any period beginning after Dec. 31, 1977.

Under the new legislation, an employer could not rely on an examination commenced, or a written determination issued, if: (a) the controlling facts

and circumstances that formed the basis of a determination of employment status have changed or were misrepresented by the taxpayer, or (b) IRS subsequently issues contrary guidance related to the determination of employment status that has a bearing on the facts and circumstances that formed the basis of the determination of employment status. IRS would issue its determination of worker status no later than 90 days after the filing of a petition with respect to employment status in any industry where employment is transient, casual, or seasonal. The new rules will only apply prospectively, to services rendered more than one year after the date that the legislation is enacted.

Conclusion: Any business that operates with both employees and independent contractors should conduct a review of its classification of those workers to determine if its classification system is in compliance with federal employment tax requirements.

This article is only a summary of the detailed provisions of the GAO and CRS reports. If you have questions concerning worker classification for federal employment tax purposes, please call Neil Birkhoff (540-983-7699).

Woods Rogers Tax Group:

NEIL V. BIRKHOFF, Chair
540.983.7699
birkhoff@woodsrogers.com

R. NEAL KEESEE, JR.
540.983.7627
keese@woodsrogers.com

J. LEE E. OSBORNE
540.983.7516
losborne@woodsrogers.com

BRIAN MICHAEL BROWN
804.343.5023
bbrown@woodsrogers.com

TALFOURD H. KEMPER
540.983.7622
kemper@woodsrogers.com

ALEXANDER I. SAUNDERS
540.983.7607
saunders@woodsrogers.com

CLAUDE D. CARTER
540.983.7588
ccarter@woodsrogers.com

TALFOURD H. KEMPER, JR.
540.983.7552
fkemper@woodsrogers.com

CHRISTINE FRENTZ UNDERWOOD
540.983.7512
cunderwood@woodsrogers.com

NICHOLAS C. CONTE
540.983.7630
conte@woodsrogers.com

ALTON L. KNIGHTON, JR.
540.983.7632
knighton@woodsrogers.com

JOSHUA C. WYKLE
540.983.7562
jwykle@woodsrogers.com

10 South Jefferson Street, Suite 1400
Roanoke, Virginia 24011

540.983.7600
www.woodsrogers.com

