Morrison & Foerster Monthly News Volume 22, No. 4 April 2010

Employment Law Commentary

How to Deal with Worker Classification Tax Audits

By Edward L. Froelich and James Merritt

In last month's issue of the Employment Law Commentary in Part I of our series on independent contractors, we noted that the Internal Revenue Service has recently rolled out a three-year audit initiative targeting 6,000 businesses randomly selected from across the country, 2,000 per year. The first group of businesses has already started to receive audit appointment letters notifying them of the IRS's intent to conduct a general review of their worker classifications and related employment tax issues. Some states are following the IRS's lead and are conducting their own worker classification studies though we are not currently aware of any formal audit initiative yet in any state. We focus in this issue on what to expect should your company come under audit by the IRS and offer advice on some best practices for managing your audit.

Background of the IRS Initiative

The IRS initiative is a research effort under the auspices of the IRS's National Research Project or NRP. In general, these research projects, sometimes also called research programs, are designed to measure compliance levels within a particular targeted group. According to the IRS, the two main goals of this employment tax NRP are:

- To secure statistically valid information for computing the Employment Tax Gap, and
- To determine compliance characteristics so the IRS can focus on the most noncompliant employment tax areas.

See www.irs.gov/businesses/small/article/0,,id=215350,00.html, Headliner Volume 280 (November 9, 2009). The main focus of audits under this NRP will be the worker

(Continued on page 2)

San Francisco
Lloyd W. Aubry, Jr. (Editor) (415) 268-6558 laubry@mofo.com
James E. Boddy, Jr. (415) 268-7081 jboddy@mofo.com
Karen Kubin (415) 268-6168 kkubin@mofo.com
Linda E. Shostak (415) 268-7202 lshostak@mofo.com
Eric A. Tate (415) 268-6915 etate@mofo.com

Palo Alto
Christine E. Lyon (650) 813-5770 clyon@mofo.com
Joshua Gordon (650) 813-5671 jgordon@mofo.com
David J. Murphy (650) 813-5945 dmurphy@mofo.com
Raymond L. Wheeler (650) 813-5656 rwheeler@mofo.com
Tom E. Wilson (650) 813-5604 twilson@mofo.com

Los Angeles
Timothy F. Ryan (213) 892-5388 tryan@mofo.com
Janie F. Schulman (213) 892-5393 jschulman@mofo.com

New York
Miriam H. Wugmeister (212) 506-7213 mwugmeister@mofo.com

Washington, D.C./Northern Virginia
Daniel P. Westman (703) 760-7795 dwestman@mofo.com

San Diego
Craig A. Schloss (858) 720-5134 cschloss@mofo.com

Denver
Steven M. Kaufmann (303) 592-2236 skaufmann@mofo.com

London
Ann Bevitt +44 (0)20 7920 4041 abevitt@mofo.com

Worker Classification

(Continued from Page 1)

classification issue, i.e., whether a company's independent contractors should be treated as employees. The "employment tax gap" stems from the Government's belief that workers who are independent contractors are not self-reporting at an acceptable compliance level. Otherwise, given that independent contractors pay income tax and the self-employment tax under Internal Revenue Code sections 1401-1403, there would be no appreciable difference between the amount of income and FICA tax paid into the Federal Treasury by employees through payroll tax withholdings and by independent contractors through self-reporting and payment.[1]

The IRS conducted a similar audit initiative 25 years ago. Targeted businesses ranged at that time from large corporations to smaller companies. Although for the current NRP the IRS has said it would audit a random sampling of companies, IRS officials have suggested that most of the focus will be on mid- and small-sized businesses with less emphasis on large companies. The IRS has given no indication whether a particular industry or industries will be targeted. However, the IRS believes that "[b]usiness practices regarding employment tax issues may have changed significantly since the last IRS employment tax study in the 1980s, necessitating the need for this study." *Id*. Clearly a more mobile and technologically-enabled workforce as well as increasing reliance on outsourcing certain business functions has changed all aspects of work in our country and this likely plays a part in the IRS's perception of increased levels of non-compliance. Companies whose workforces are comprised substantially of independent contractors would presumably receive a more skeptical treatment from the IRS in view of its apparent presumption regarding current workplace practices.

What to Expect if You Are Audited

The NRP audit initiative will focus on the classification issue, and additional areas including fringe benefits, Internal Revenue Code section 409A deferred compensation (which issue is already being coordinated by the IRS at a national level), executive compensation, backup withholding, and Forms 1099. We expect there will be a fair amount of coordination of these audits so that individual audit teams are following the same audit methods throughout the country. The NRP audits will be thorough and time-consuming and may run concurrently with an income tax audit or precipitate an income tax audit if the auditor should learn information suggesting that income tax items need a closer look. But clearly the main focus of the audit will be the classification issue.

The Initial Contact and Meeting

As with any audit, the NRP audit will commence with an appointment letter and request for an initial meeting. The letter will request the company bring certain initial information to the meeting relating to the company's employment tax compliance history. At the meeting the examining agent will give an overview of the audit and establish expectations such as the length of the audit, how information is conveyed, timelines for audit milestones, etc. These audit expectations are usually memorialized in an audit plan which is signed by the taxpayer. The agent will likely audit the first open year going forward, i.e., the prior three years. Thus, for audits starting this year, calendar years 2007-2009 likely will be examined.

The agent is required in this first contact to inform the taxpayer of the safe harbor provisions of section 530 of the Internal Revenue Act of 1978. We will discuss section 530 at more length below. Generally the agent will also initially request background information regarding the taxpayer's worker arrangements. The initial meeting can be viewed as a get-to-know-you opportunity and a taxpayer should not hesitate to ask the agent about his background and experience as well as that of his manager.[2] Above all, the taxpayer should endeavor to show an amenable, cooperative attitude.

The agent will have received training relating to employment tax issues, including specific training regarding the classification issue. A training manual published by the IRS in 1996 remains the general guide for employment tax agents. *See* http://www.irs.gov/pub/irs-utl/emporind.pdf. This manual is a good blueprint for the approach of agents in the NRP audit program. Moreover, the agent may have received training regarding the taxpayer's particular industry and, importantly, the industry's utilization of independent contractors.

A taxpayer should be able to discern at this early stage whether the agent has certain information and/or preconceptions about the taxpayer's business and particularly its worker relationships. For example, an agent may have obtained information through internet searches. Accordingly, the company should be aware of what might be in the public domain, including, for example, any litigation involving the company which relates to worker classification issues. It is possible that the IRS has already developed certain profiles of various industries. A taxpayer should inquire at the appropriate time whether the agent has any such information.

A taxpayer should consider preparing a relatively thorough written description of its various worker arrangements. This description would ideally provide enough detail to correct any misconceptions the examining agent may have about the business and its workforce. Taxpayers may draft such a description merely for talking points purposes at the first meeting or for handing to the agent; however, as a general rule, anything that is provided in writing to the agent should be reviewed by counsel.

In our experience a successful audit tactic is for the taxpayer and its counsel to develop as many factual differences as possible in various categories of workers. The IRS agent will likely be starting from the point of view that there is a substantial

Worker Classification

(Continued from Page 2)

number of similarly situated workers all of whom may be reclassified as employees. To the extent that the taxpayer can establish that there are many subcategories of workers with materially different fact situations, it makes it more difficult for the IRS to make a single significant adjustment. It may also support the view that many of the subcategories are properly viewed as independent contractors. For example, do some of the workers provide services to other persons? Do some workers buy computers, cell phones, and other equipment and pay expenses? The list of potential differences is limited only by counsel's imagination. To develop these facts and to identify workers who may be favorable (or unfavorable) witnesses, the taxpayer and counsel should determine the best means of contacting specific workers. This may be a sensitive issue and the taxpayer and counsel should address it early in planning for the audit as persons generally, and independent contractors particularly, are hesitant to call attention to themselves for a variety of reasons. For example, workers may fear that such involvement may cause the IRS to question their reporting of income and expenses or lead to concerns about immigration status, etc. At the beginning of the audit process it is also critical for the taxpayer to establish that there were sound contracts for the workers in which the workers agreed that they were independent contractors and would comply with the attendant tax and other reporting requirements and that proper Forms 1099 were issued to each of the workers by the taxpayer.

Key to the outcome of a successful audit is having a good relationship with the examining agent. Meeting deadlines, providing complete information and generally being responsive to the agent helps to build this relationship. Cooperation is moreover important to shift the burden of proof to the IRS in the event the taxpayer seeks to resolve any adverse adjustments through litigation under section 530.

The Audit Process

After the initial meeting, most of the formal communication with the examining agent will occur through an Information Document Request or "IDR." An IDR is a request for information on IRS Form 4564 which asks for company documents (including employment agreements, independent contractor agreements, payroll documentation, relevant correspondence, emails, memorandums etc.) as well as narrative responses to questions. IDRs will be used to develop the agent's factual understanding of the taxpayer's workforce and will proceed from more standardized questions to more specific questions as the agent learns more about the taxpayer's business and workforce. The agent will focus on the facts relating to the company's ability to direct and control a particular group of workers.

In our experience the IRS agent will focus on "control" and tend to ignore other factors which may suggest that the workers are independent contractors. It is important to make clear that the service recipient has the ability to control the quality of the work product of persons who are clearly independent contractors to emphasize that the other factors are relevant. The other factors which are important to develop and which the taxpayer and counsel are likely to focus upon include such facts as: (1) do the workers invest in equipment (any such investment including cell phones, computers, home office including utilities and supplies are important); if so, the workers may have the opportunity to make a profit or loss, which is an important factor; (2) can and do the workers provide services for other persons; (3) can the workers provide the services from locations other than the taxpayer's principal place of business, such as their home or a third-party location; (4) can the workers determine the amount of time which they choose to devote to the taxpayer's project; and many other potentially relevant factors based upon the rulings, case law and logic. Inevitably, there may be facts which are not particularly helpful such as that the workers must report the amount of time they devote to the taxpayer's project. The taxpayer and counsel should develop positive responses to any such possibly unhelpful factors. For example, as to reporting time expended, the taxpayer may point out that persons who are clearly independent contractors such as the auto repair mechanic, plumbers and contractors usually report the amount of time expended and charge a rate per hour in addition to materials.

It is important to note that the IRS cannot require a company to create new documents to respond to a question. If a document does not exist, it is appropriate to say so, though in some instances it may be helpful to the relationship with the agent and to the position of the taxpayer to create documents specifically in response to an IDR. Of course, accuracy in the information provided is always imperative.

There may come a point during the audit when the agent asks the taxpayer to provide privileged information. For example, the agent may request any opinions from tax advisors, including legal counsel, the taxpayer obtained regarding the nature of its relationship with a group of workers. Any such opinion and related communications would be privileged. The IRS is not entitled to obtain information protected by the attorney-client privilege, the Internal Revenue Code section 7525 tax practitioner privilege, or the work product doctrine. Thus it is a perfectly acceptable response to the examining agent that the opinion in question is not being provided because it is privileged. The agent may ask for a show of proof, sometimes called a privilege log or *Vaughn* index, which a taxpayer would need to provide to establish a prima facie case for asserting any of the above-referenced protections. Normally, appropriately supported claims of privilege are respected by the IRS.[3]

The examining agent may also seek information through interviews with key

Worker Classification

(Continued from Page 3)

personnel within the taxpayer such as the human resources manager or similar personnel. The agent may also seek to interview workers. To the extent that the agent decides to interview workers whom the taxpayer has identified as independent contractors, there is little the taxpayer can do to control that interview. The taxpayer can request to be present at any such interview; however, given that the worker is not actually a part of the taxpayer, but presumably a third-party contractor, the IRS is not required to allow the taxpayer to participate in any interview. With regard to interviews of workers whom the taxpayer has treated as employees, the taxpayer has more discretion and can refuse any such interview though it is generally advisable to allow such an interview after appropriate preparation by counsel. The IRS must notify the taxpayer under Internal Revenue Code section 7602(c) in advance of contact with third parties and must periodically provide the taxpayer with a record of specific contacts. A taxpayer should request that the IRS provide such record on a regular, such as monthly, basis.

The Conclusion of the Examination

Generally, agents try to complete their audits within 18 months. Prior to the conclusion of the audit, the agent may propose audit adjustments. The way in which an agent formally communicates these proposals is through IRS Form 5710 "Notice of Proposed Adjustment," sometimes called a NOPA. The agent sets forth his understanding of the facts and applicable law in the NOPA, proposes audit adjustments for the years under audit, and solicits the taxpayer's agreement or disagreement with the proposed adjustments.

In an NRP audit, the agent will develop facts and analysis in order to answer the following questions before drafting the NOPA: (i) does section 530 provide relief to the taxpayer? if not, (ii) should the workers be classified as employees under the common law test developed by the courts which generally look to the right of the taxpayer to control and direct the worker's performance? if so, (iii) is the taxpayer eligible for relief under the Classification Settlement Program or CSP, an optional settlement program administered by the examination team which allows for some concession on the amount of tax due in return for the taxpayer's agreement to treat the workers as employees going forward, and further (iv) is the taxpayer eligible for relief under a) Internal Revenue Code section 3509(a) for a reduced rate of tax and b) for an interest-free adjustment under Internal Revenue Code section 6205(a) for underwithheld income and FICA taxes? The NOPA will then contain the agent's evaluation of each of these questions based on his understanding of the facts.

THE DECISION WHETHER TO PROCEED IN THE U.S. TAX COURT OR ONE OF THE OTHER COURTS DEPENDS ON A VARIETY OF FACTORS INCLUDING FAVORABLE PRECEDENT AND COST OF LITIGATION.

Where the agent has concluded that there was a misclassification and the taxpayer is not entitled to section 530 relief, the proposed adjustments will include income tax, FICA and FUTA withholding for each independent contractor who should have been treated as an employee during the audit years. The amount of taxes proposed by the agent can be significant and penalties may also be asserted. It is generally advisable at this stage to attempt to correct any material factual and legal errors in the NOPA in order to persuade the examining agent that there is no basis for the proposed adjustment.

In our recent experience, the IRS provided a NOPA to a company whose workforce was almost entirely composed of independent contractors. In the NOPA, the agent discounted many of the substantial facts in the company's favor regarding the indicia of independent contractor status, including most importantly the inability of the company to significantly control the conduct of the workers. Perhaps more surprisingly, the agent gave little credit to the company's arguments under section 530. In any event, it is generally worthwhile to attempt to resolve the audit on favorable terms before the agent finalizes the audit adjustments. Depending on the litigation hazards of the taxpayer's position, a favorable audit may include settlement under the CSP; however, section 530 remains the most potent of defenses for any company and should be vigorously argued during the examination phase of the audit where appropriate. Perhaps also a company can make a good case under section 530 or the common law test for a group of its workers, but a lesser case for another group of workers. In that circumstance, taxpayers should consider crafting a settlement at the examination level which preserves one category of workers as independent contractors and allows for CSP treatment for another category.

Congress enacted section 530 to prevent economically ruinous retroactive adjustments proposed by the IRS upon its determination of a misclassification. In general, taxpayers must satisfy three criteria to be eligible for safe harbor treatment under the statute: (i) a taxpayer must show that it had a reasonable basis for treating its worker as an independent contractor; (ii) a taxpayer must show that it treated workers with substantially similar positions consistently; and (iii) the taxpayer must have filed all required federal tax returns consistently with its treatment of the

Worker Classification

(Continued from Page 4)

workers as independent contractors. Most importantly, and perhaps most annoyingly to the IRS, relief under section 530 is also prospective. Thus, so long as the taxpayer continues to satisfy the section 530 criteria the IRS cannot assert classification adjustments against it.

The majority of controversy and litigation about a taxpayer's eligibility for the safe harbor relief of section 530 focuses on the reasonable basis criteria. Reasonable basis under section 530 can be shown in one of four ways: (i) reasonable reliance on judicial or administrative precedent, (ii) reasonable reliance on a past IRS audit of the business for employment tax purposes, (iii) reasonable reliance on a long-standing recognized practice of a significant segment of the relevant industry, and (iv) other reasonable basis, which can include reliance on the advice of a qualified tax professional. Any and all of these grounds should be carefully considered by the taxpayer and argued where appropriate.[4]

Early Referral to the IRS Office of Appeals

Should the taxpayer and agent continue to disagree regarding the availability of section 530 or the classification of workers under the common law test, a taxpayer can proceed to the IRS Office of Appeals through what is called the "early referral process" provided by Revenue Procedure 99-28, 1999-29 I.R.B. 109. The mission of the Appeals Office is to settle cases based on litigation hazards, including worker classification disputes. The Appeals Office reviews cases as an impartial tribunal. If the examining agent's position has little support, an Appeals Officer will generally settle the case favorably or outright concede the case. Key to a successful Appeals resolution is a well-developed factual record, well-written arguments supported by relevant cases and other authorities which show analytically and practically that the Government has substantial litigation hazards, and good advocacy before the individual Appeals officer who is assigned the case.

After the Audit?

In the event that the Appeals Office and the taxpayer cannot agree to a settlement of the case, the IRS will issue a Notice of Determination under Internal Revenue Code section 7436. This Notice allows the taxpayer to seek United States Tax Court review of the proposed IRS employment tax adjustments. A taxpayer must file a petition with the Tax Court within 90 days of the date of the Notice. Section 7436(b). A taxpayer suing in the Tax Court is not required to pay any of the tax asserted to be due, and the IRS is prevented from collecting any tax during the Tax Court litigation.

Should the taxpayer wish to pay a portion of the tax attributable to one worker per taxable quarter, the taxpayer can proceed to either the appropriate Federal district court or the United States Court of Federal Claims. The Government will counterclaim for the balance of the tax due and consider suspending collection action during the pendency of the action.

The decision whether to proceed in the U.S. Tax Court or one of the other courts depends on a variety of factors including favorable precedent and cost of litigation. Tax litigation counsel should be consulted prior to any decision regarding forum. In any of these courts, Government trial counsel will consider settlement of the case prior to trial and should be approached shortly after the filing of the action to gauge their overall reaction to the case. ■

1 The apparent genesis for this IRS initiative was the GAO Report in August 2009, titled "Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention," which criticized the IRS for failing to aggressively conduct classification audits pointing to the fact that misclassification of workers contributed to the "tax gap." Non-tax reasons, such as increasing the number of workers eligible for unionization or employment dependent benefits may also underlie the current focus on classification of workers.

2 Every field agent is supervised by an audit team manager. It may become necessary on occasion to include the manager in handling the audit should the agent become too aggressive or there is simply an impasse between the company and the agent. *h J. Sciamanna, Inc.,* 2009 U.S. Dist. LEXIS 46380 (N.D. Ill. June 3, 2009).

3 It may be advisable at some point to provide privileged information if, for example, the agent indicates he may assert accuracy-related or other penalties. Reliance on the advice of a professional tax advisor is a generally accepted defense to such penalties. Of course, in most jurisdictions disclosing a privileged document results in a subject-matter waiver of the attorney-client privilege and such a decision should be carefully considered.

4 Section 530 is an embattled statute. There is legislation pending in the Senate introduced last year by Sen. John Kerry (S. 2882) which would generally limit section 530 relief to situations where the taxpayer has a letter ruling from the IRS. Such a change would drastically limit the usefulness of section 530. A similar bill is pending in the House – H. 3408. The Administration has separately proposed the elimination of section 530 relief in its Fiscal Year 2011 budget. Interestingly, the IRS's response to the GAO criticism noted earlier was that section 530 severely limited their ability to reclassify workers. Thus, it is possible that an unstated aspect of the current NRP audit initiative is to develop a factual basis to support repeal or limitation of the section 530 safe harbor. We were actively involved in seeking enactment of section 530 and other relief provisions and anticipate that we and our clients will likely be involved in any attempts to limit such provisions by legislation. In a related development, Sen. Sherrod Brown of Ohio recently introduced legislation (S. 3254) which would require businesses to maintain records regarding non-employee workers and impose penalties for misclassifications.

Edward L. Froelich is of counsel in our Washington D.C. office and can be reached at (202) 778-1646 or efroelich@mofo.com.

James E. Merritt is senior counsel in our Washington D.C. office and former chair of the ABA Section of Taxation's Committee on Employment Taxes. He can be reached at (202) 887-8780 or jmerritt@mofo.com.