



National Research Program Comprehensive Employment Tax Examinations Are Here – Are You Prepared?

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Summary of Employment Tax NRP

- Background on the NRP
 - August 2009 GAO report
 - First comprehensive employment tax study since 1984
 - Coincides with other Administration efforts relating to worker classification
 - Attempt to measure tax gap caused by worker classification issues – as much as \$50bn
 - Goal is to gather data, not raise revenue



Summary of Employment Tax NRP

- Scope of the NRP
 - Focus on worker classification, fringe benefits, executive compensation, employment tax reporting/deposits
 - Three years
 - 6000 employers, including approximately:
 - 2000 total per year
 - Reportedly, 500 EOs per year
 - Reportedly, 30-50 of 500 EOs may be government
 - Trained approximately 200 agents



Summary of Employment Tax NRP

- Selection for NRP
 - Random selection, all types of organizations
 - Reportedly includes 20% large companies
 - Approximately 700 contact letters sent in March; remaining 1300 for 2009 by September



Summary of Employment Tax NRP

- Audit process
 - Focus on 941, but also corporate returns and executive 1040s
 - Use of checksheets
 - Likely less flexibility over scope and materiality for agents
 - Potential use of other IRS information sources (e.g., SS-8's)



Summary of Employment Tax NRP

- Years covered
 - Start with 2008
 - If find issues, may go back to 2007, forward to 2009



Key Issues

- Worker classification
- Fringe benefits
- Employee reimbursements
- Executive compensation



Key Issues – Worker Classification

- Issue: Whether workers are properly classified as employees or independent contractors
 - Common Law Test
 - Frequent Issues
 - Non-tax Consequences of Misclassification
 - Tax Consequences of Misclassification
 - Section 530 relief



Key Issues – Worker Classification

- Common Law Test: All of the facts and circumstances indicating the degree of control and independence must be considered. No one fact is determinative.



Key Issues – Worker Classification

○ IRS Analysis

- Revenue Ruling 87-41 provides twenty factors for determining a worker's proper employment classification.
- The IRS has refined the twenty factors to three categories:
 - Behavioral Control
 - Financial Control
 - Type of Relationship



Key Issues – Worker Classification

- Behavioral Control: Does the company control, or have the right to control, what the worker does and how the worker does his or her work?
 - Factors:
 - Does the business provide the worker with instructions about when, where and how to do work?
 - Does the business provide the worker with greatly detailed instructions?
 - Does the business evaluate the worker on his or her work performance or on the end result?
 - Does the business provide the worker with training on how to do the job?



Key Issues – Worker Classification

- Financial Control: Are the business aspects of the worker's job controlled by the business?
 - Factors:
 - Does the worker have a significant investment in the equipment used for the job?
 - Does the worker have unreimbursed expenses related to the job?
 - Does the worker have the opportunity to make a profit or loss with respect to the job?
 - Is the worker generally free to seek out other business opportunities in the relevant market?
 - Is the worker guaranteed a regular, periodic wage?



Key Issues – Worker Classification

- Type of Relationship: How do the worker and the business perceive their relationship?
 - Factors:
 - Is there a written employment contract?
 - Does the business grant the worker employee benefits, such as insurance, pension plans, paid vacations, sick days, and disability insurance?
 - Is the relationship expected to continue indefinitely?
 - Is the worker providing services that are key aspects of the business?



Key Issues – Worker Classification

- Non-tax Consequences of Misclassification
 - Claims for entitlement to employee benefits
 - Workers' compensation and unemployment liabilities
 - Subject to claims for violating state and federal labor laws



Key Issues – Worker Classification

- Tax Consequences of Misclassification
 - If a business has no reasonable basis for treating an employee as an independent contractor, the business may be held liable for back taxes and penalties.



Key Issues – Worker Classification

- Relief from Paying Employment Taxes for Misclassified Employees: Section 530 Relief
 - A business that misclassifies a worker may not owe employment taxes if it meets the following three requirements of Section 530 of the 1978 Revenue Act:
 - Reasonable Basis: The business reasonably relied on judicial precedent, IRS rulings, a past IRS audit, or a long-standing practice in the relevant industry.
 - Substantive Consistency: The business consistently treated the worker, and similar workers, as independent contractors.
 - Reporting Consistency: The business filed all required federal tax returns consistent with the business' treatment of the worker as an independent contractor.



Key Issues – Fringe Benefits

- Legal framework
 - All fringes taxable at FMV under Section 61 unless an exception applies
 - Exceptions are codified in Section 132
 - No additional – cost service
 - Qualified employee discount
 - Working condition fringe
 - De minimis fringe
 - Qualified transportation fringe
 - Qualified moving expenses
 - Qualified retirement planning services
 - Key issues will be:
 - Are the requirements for exclusion under Section 132 satisfied
 - If taxable fringe, is the right value assigned



Key Issues - Reimbursements

- Generally, expense allowances are taxable and subject to withholding
- Reimbursements under an “accountable plan” are not taxable/subject to withholding



Key Issues - Reimbursements

- Accountable plan requirements
 - Business connection and reasonable expense
 - Reasonable accounting (unless below federal per diem)
 - Excess reimbursements are repaid



Key Issues – Executive Compensation

- Spouse travel
- Common executive fringes
- Loans
- Section 409A/457(f)/4958



Key Issues – Executive Compensation

- Common Section 409A compliance issues
 - Separation from service
 - Employment agreements
 - Severance pay



Key Issues – Executive Compensation

- Section 457(f)
 - Applies to deferred compensation of tax-exempts and government entities
 - Substantial risk of forfeiture is common issue
 - Potential regulatory changes



Key Issues – Executive Compensation

- Audit will likely include request for executives' Form 1040s
- Purpose is generally to ensure matching employer and executive reporting



Key Issues – Other

- TIN solicitation
- Back-up withholding



Preparing for and Managing an Examination

- Audit readiness file
- Review activities for consistency with exempt purpose
- Monitor:
 - IRS area of interest
 - Congressional inquiries
 - State regulators
- Conduct an internal “mock” audit
- Review current practices – UBIT and FIN 48 disclosure, worker classification, tax treatment and reporting for fringe benefits, executive compensation and expense reimbursements
- Clean-up worker classification and other issues



Managing the Examination

- Taxpayer's Goals
 - Limit scope of the examination – likely not possible if selected for NRP
 - Facilitate expedited conclusion of the examination
 - Document what the auditor has reviewed
- Develop and maintain a professional rapport
- However . . . limit verbal and written responses to what was requested



Managing the Examination

- Initial meeting
 - Discuss scope of audit and initial IDR
 - Request that all future requests for records be in writing and establish procedure for handling requests
 - Identify the contact for the auditor – if outside counsel, Power of Attorney will be required
 - Determine any special office needs – do not provide access to copier!!
 - Locate auditor away from major centers of employee activity
 - Make certain employees are aware of IRS presence



Managing the Examination

- Document preparation
 - Assemble requested files and records in well-organized manner
 - Review all requested documents to spot any potential issues
 - Remove all attorney-client privileged documents or attorney work product
 - Keep a log of all documents reviewed by auditor and any copies provided to the auditor



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