

October 27, 2009

MEMORANDUM TO CLIENTS

RE: IRS Worker Classification Initiative

According to a February 2009 audit report released by the Treasury Inspector General for Tax Administration, the IRS' most recent estimate of the federal tax gap is \$345 billion (based on tax year 2001 data). Notably, employment tax underreporting accounts for approximately \$54 billion of the \$345 billion tax gap.

Concerns about the expanding tax gap have focused increased attention on employment tax issues. Thus, the IRS is launching a National Research Program ("NRP") study of employment taxes to assess the impact of worker classification and other employment tax issues on the tax gap. According to IRS' chief of employment tax, John Tuzynski, the IRS will conduct random audits of approximately 6,000 employers over a three-year period, scheduled to begin in February 2010. It appears that these audits will be focused on the SB/SE division, which covers employers with under \$10M in assets, but may well extend to larger employers under the LMSB division. IRS has reportedly trained 200 new agents in the field on these issues.

Focus of Employment Tax Audits

The classification of workers as independent contractors instead of common law employees raises numerous tax and legal implications for both employers and workers. Employers must pay federal employment taxes on, and withhold federal and state income taxes from, their employees. Hefty penalties potentially apply to violators – including potential liability for all of the income and FICA taxes that should have been withheld. Additionally, employers must comply with other employment laws, such as statutes regulating workers' compensation, minimum wage, employment discrimination and, of course, ERISA. Still more liability may arise under state tax and other laws.

The key focus of the NRP study is to measure the impact of worker classification on the employment tax gap and review how the IRS addresses employer misclassification of employees as independent contractors. According to the IRS' Tuzynski, in addition to worker classification, the random audits will also focus on executive compensation and fringe benefits.

Section 530 Relief Under Attack

Section 530 of the Revenue Act of 1978 (the "Act") generally provides relief from retroactive employment tax liability for employers who consistently treated workers as independent contractors and had a reasonable basis for doing so. Over the past few years, several bills have been introduced that would make it difficult for employers to obtain relief from such taxes. In August 2009, the Taxpayer Responsibility, Accountability, and Consistency Act of 2009 (H.R. 3408) was introduced by Rep. Jim McDermott (D-Wash), Chairman of the Income

Security and Family Support Subcommittee of the House Ways and Means Committee. Like its predecessors, H.R. 3408 would replace the existing safe harbor provision under section 530 of the Act with a new, very restrictive "safe harbor," and would provide workers with procedures to determine their employment status and substantial protections against misclassification. The proposed legislation also directs Treasury to issue annual reports on worker misclassification enforcement actions, substantially increases penalties for misclassification, allows workers to petition the IRS for a review of an employer's classification status determination, and establishes a framework for DOL and IRS cooperation. The Obama Administration supports the repeal of Section 530 relief.

Next Steps for Employers

As worker classification comes back into focus, we recommend employers take steps to review their current practices and limit their potential exposure for employment taxes – as well as claims for benefits under their pension and welfare programs. Key steps include the following:

- **Health and Retirement Plans:** Review plan documents to ensure that potentially misclassified workers are excluded from participation in the plans. Otherwise, amend the plans to do so (retroactively, to the extent permitted).
- **Employee Handbooks/Personnel Policies:** Review employee handbooks and administrative manuals to ensure they provide a consistent message that these workers will not be eligible for benefits, even if reclassified by a court or agency, or voluntarily by the company.
- **Consultant/Independent Contractors:** Review the contract used for consultants and other independent contractors that receive payments reported on Form 1099-MISC. Make sure it clearly states the impact of the services on social security taxes and employee benefit programs. Use extra care where retired employees are rehired in some capacity.
- **Third-Party Arrangements.** Review the organization's use of temp agencies, leasing companies and professional employer organizations to minimize risk of employee status and benefit eligibility.
- **SS-8 Review:** Consider filing a Form SS-8 with the IRS to receive a determination as to the proper classification of workers whose status is unclear. Alternatively, work with counsel to review the 20-factors in Revenue Ruling 87-41, along with IRS Publication 15-A and the IRS training materials on worker classification, to assess the level of comfort on the facts and circumstances test.
- **Section 530 Relief:** Review documentation supporting determinations to treat workers as independent contractors, including prior IRS examination, industry standards, IRS or court ruling, or counsel opinions.

How Groom Can Help

If you have any concerns regarding your worker classification approach, or need assistance in the event of an IRS audit or participant claim for benefits, please contact one of the attorneys listed below or your regular Groom attorney. We have extensive experience in virtually all relevant areas, including:

- assessing potential employment tax liability exposure,
- structuring appropriate guidelines for worker classification and third party arrangements,
- advising on availability of Section 530 relief,
- review of worker classification determinations and obtaining Form SS-8 determination letters,
- review and amendment of welfare and pension benefit plans and applicability of IRS correction programs (e.g., EPCRS),
- representation in IRS audits and closing agreement process, and
- handling benefit claims and class action litigation.

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Please call one of the following, or the Groom attorney you regularly contact, if you have any questions about this or any other matter.

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