

Practice

By Kathryn Keneally and Charles P. Rettig

Worker Classification: IRS Launches Questionable Employment Tax Practice Initiative

Under pressure from Congress, the IRS has been aggressively attempting to reduce the tax gap—the annual shortfall between taxes owed and taxes paid. Nonpayment and underpayment of employment taxes has been identified by IRS and other federal agencies as contributing \$54 billion to the approximate \$285 billion tax gap. The IRS has been receiving leads on cases in which workers may have been misclassified, with 19,000 requests since 2004 to make a determination on whether a worker is an employee or an independent contractor (“SS-8” inquiries). By treating workers as independent contractors, some employers attempt to avoid paying unemployment insurance, workers’ compensation, Social Security taxes and the cost of withholding income taxes. Compliance increases significantly for payments that a third party reports to the IRS.

In an election year, pursuing unpaid/under-reported taxes is a better political move than raising taxes. Congress is expected to increase the IRS’s budget, especially for enforcement activities such as audits and investigations. The Treasury asked Congress to appropriate a record \$11.36 billion for the IRS for the current fiscal year (a 4.3-percent increase from the amount enacted for fiscal 2008, with spending on enforcement increasing by more than seven percent). The overall tax-compliance rate in 2001 was estimated at more than 86 percent, following late payments and recoveries from ongoing IRS enforcement activities. Congress is pressing the IRS to increase the tax-compliance rate to 90 percent by 2010. The Questionable Employment Tax Practice (QETP) is believed to be a significant step towards increasing overall employment tax compliance.

The IRS recently announced a new employment tax initiative with other federal agencies and 29 state agencies aimed at deterring misclassification of workers and attempts to evade or reduce employment tax



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liabilities.¹ The QETP initiative enables the exchange of audit reports and audit plans and participation in parallel examinations, as well as monitoring Form 1099 compliance for independent contractors and Form W-2 compliance for employees. As part of the QETP, a memorandum of understanding (MOU) was entered into by the IRS, the Department of Labor, state revenue agencies and state workforce agencies providing for the sharing of employment tax examinations and information regarding potential employment tax noncompliance. These agreements provide a centralized, uniform means for the IRS and state employment officials to exchange data, leveraging resources and encouraging compliance with federal and state employment tax requirements. In addition to coordinating compliance activities, the agreements call for collaborative outreach and education activities intended to help businesses better understand their employment and unemployment tax responsibilities.

QETP Defined

Questionable employment tax practices are employment tax practices that generally have no objective other than to avoid federal and/or state employment taxes. The QETP initiative provides a centralized and uniform mechanism for the exchange of information among the IRS and the state employment tax data exchanges.

General Overview of the QETP Initiative

The QETP initiative is a nationwide program intended to identify wrongful employment tax practices and increase voluntary compliance with employment tax rules and regulations. The IRS, the National Association of State Workforce Agencies, the U.S. Department of Labor, the Federation of Tax Administrators and the state workforce agencies of California, Michigan, New Jersey, New York and North Carolina worked together to develop the QETP initiative and endorse the MOU to increase employment tax compliance at the federal and state levels. A QETP oversight team oversees all program activities. The team is comprised of representatives from each of the participating agencies. The states participating on the oversight team include California, Michigan, New Jersey and North Carolina.

So far, 29 states have entered into individual information-sharing agreements with the IRS, including

Arizona, Arkansas, California, Colorado, Connecticut, Hawaii, Idaho, Kentucky, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Nebraska, New Hampshire, New Jersey, New York, North Dakota, Ohio, Oklahoma, Rhode Island, South Carolina, South Dakota, Texas, Utah, Vermont, Virginia, Washington and Wisconsin.²

Purpose of the MOU

The MOU facilitates cooperation and information sharing between the IRS and state workforce agencies; increases compliance with federal and state employment tax filing and payment regulations; increases compliance with Form 1099 and Form W-2 filings; increases collection of federal and state employment/unemployment tax liabilities; enhances efforts to reduce the tax gap at the federal and state levels and ensure that businesses are all operating on a competitive level playing field by ensuring reporting compliance for employment taxes; and leverages IRS, state and other federal agency resources to improve compliance with employment tax laws.

MOU Participants

The MOU is intended to facilitate information sharing between the IRS and state workforce agencies that have an existing Agreement on Coordination of Tax Administration (Basic Agreement) with the IRS and an Implementing Agreement on Coordination of Tax Administration with the IRS. The IRS SB/SE Specialty Tax Division will participate in the MOU with the state workforce agencies. Currently, 29 states have signed the exchange agreement with the IRS, including Arizona, Arkansas, California, Colorado, Connecticut, Hawaii, Idaho, Kentucky, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Nebraska, New Hampshire, New Jersey, New York, North Dakota, Ohio, Oklahoma, Rhode Island, South Carolina, South Dakota, Texas, Utah, Vermont, Virginia, Washington and Wisconsin.

Impact of the MOU

The IRS and the participating state workforce agencies will exchange employment tax information for civil cases which appear intended to evade or inappropriately reduce employment tax liabilities. The IRS and the states may exchange information using either actual employment tax reports or a template compatible with federal and state information that the oversight

team has developed. The IRS and the states may participate in coordinated enforcement efforts. The MOU will allow the IRS and the state workforce agencies to share independently conducted examination results or work side-by-side on an examination.

The IRS and the states will attempt to be consistent with their examination results, reducing the chances that states might classify a worker as an employee while the IRS classifies the worker as an independent contractor, or *vice versa*. The IRS and the states will share employment tax training opportunities and materials. The IRS and the states will also share outreach opportunities to the business community whenever practical.

The QETP and Taxpayer Privacy

The MOU is stated to meet all disclosure provisions to ensure the privacy of taxpayer information. Additionally, all participating states must demonstrate they have systems in place to ensure the safety of any IRS data they receive as a part of the information exchange agreement.

QETP Beyond the MOU

The members of the oversight team will meet on a regular basis to discuss issues of concern, review MOU actions and make recommendations for improvements in partnership activities. The team will monitor trends and develop issues. The members of the oversight team will also attempt to create uniform processes. The team will draft and promote legislative changes in an effort to achieve nationwide standardization and to create a level playing field for all employers. Recommendations for legislative proposals will focus on reducing taxpayer burden and confusion, promoting fairness and confidence in the tax system and reducing noncompliance with federal and state employment tax laws.

Potential QETP Issues

There are many reasons employers don't withhold or pay employment taxes. For some, it may be an attempt to use the government as a bank to "borrow the money for a short while" with good intentions to pay it back later. For others, it may be a situation where an employer collects the taxes and elects to keep it during a period of financial difficulty rather than pay it to the IRS. Regardless of the reason, federal law requires employment tax withholding and payment by employers.

Employment taxes consist of federal income tax withholding along with Social Security and Medicare taxes and unemployment taxes. Also, many states have withholding requirements for various employment related taxes, such as contributions to a workers' compensation fund. Improper reporting or payment of employment taxes affects the ease with which employees can claim future benefits from these programs. Employers are required to withhold employment taxes from their employees. Federal employment taxes include the following:

- **Federal income tax withholding, Social Security and Medicare taxes.** The federal income tax is a "pay as you go tax." Employees must pay the tax as they earn or receive income during the year. For most employees this takes the form of income taxes withheld from their paychecks. Self-employed persons are also required to make estimated tax payments during the year. The withholding system was designed to ensure that taxpayers meet their tax obligations in a timely fashion.
- **Social Security and Medicare taxes provide benefits for workers received under the Federal Insurance Contributions Act (FICA).** Social security taxes are intended to provide benefits for old age, survivors and the disability insurance part of FICA. Medicare taxes pay for hospital benefits. Each employee contributes part of these taxes and the employer pays a matching amount. Self-employed taxpayers must also pay social security and Medicare taxes in the form of self-employment taxes. The Federal Unemployment Tax Act (FUTA) tax, together with state unemployment systems, provides for payments of unemployment compensation to workers who have lost their jobs.

The IRS takes a variety of steps to attack employment tax noncompliance, including civil examinations, the filing of tax liens against property the taxpayer owns and criminal investigations.

To encourage prompt payment of withheld income and employment taxes, including social security taxes, railroad retirement taxes or collected excise taxes, Code Sec. 6672 authorizes the imposition of the Trust Fund Recovery Penalty (TFRP) against the individually responsible persons within a corporate entity who fail to take appropriate steps to assure payment of certain employment tax related amounts to the government. The amount of the penalty is equal to the unpaid balance of the trust fund tax and is based on the unpaid income taxes withheld, plus the employee's portion of the withheld FICA taxes. For collected taxes, the pen-

alty is based on the unpaid amount of collected excise taxes. These taxes are called “trust fund taxes” because the employer holds the employee’s money in trust until they make a federal tax deposit in that amount. The TFRP may apply to you if these unpaid trust fund taxes cannot be immediately collected from the business. The business does not have to have stopped operating in order for the TFRP to be assessed.

IRS Criminal Investigation investigates and refers for prosecution individuals and businesses that have willfully attempted to avoid filing and paying employment taxes. These efforts have led to significant criminal convictions resulting in incarceration and fines. During the past three years, 117 individuals have been sentenced to confinement in a federal prison, a halfway house or home detention for criminal violations related to employment taxes. Approximately 77 percent of the persons sentenced for evading employment taxes served an average of 17 months confinement and were ordered to make restitution to the government for the taxes evaded, plus interest and penalties.

According to the IRS, the most common types of employment tax noncompliance include the following:

- **Pyramiding.** “Pyramiding” of employment taxes is a practice where a business withholds taxes from its employees but intentionally fails to remit them to the IRS. Often there is a lack of profit or capital for operating costs, so the business owner uses the trust funds to pay other liabilities. The quarterly employment tax liabilities accumulate (or “pyramid”) until the employer has little hope of catching up. Businesses involved in pyramiding frequently shut down or file for bankruptcy and then start a new business under a different name repeating the cycle.
 - **Unreliable third-party payers.** The primary categories of third-party payers are Payroll Service Providers and Professional Employer Organizations. Payroll Service Providers typically perform services for employers such as filing employment tax returns and making employment tax payments. Professional Employer Organizations offer employee leasing meaning that they handle administrative, personnel, and payroll accounting functions for employees who have been leased to other companies that use their services. Most of these companies provide valuable legal services to employers. Unfortunately, in some instances, companies have failed to pay over to the IRS the collected employment taxes. When these employment service companies dissolve,
- significant delinquent employment tax liabilities are often left behind. Employers should exercise extreme diligence in selecting and monitoring a third party payer. For example, when choosing a third party payer, employers should look for one that is reputable and uses the Electronic Federal Tax Payment System (EFTPS). This allows the business owner to verify payments made on their behalf. Also, an employer should not allow their address of record with the IRS to be changed to that of the third-party payer.
- **Offshore employee leasing.** Offshore Employee Leasing was designated as a Listed Transaction by Notice 2003-22, 2003-1 CB 851 (Apr. 4, 2003; certain arrangements involving leasing companies that have been used to avoid or evade federal income and employment taxes). Under the typical promotion, an individual taxpayer arguably resigns from his or her current employer or professional corporation and signs an employment contract with an offshore employee leasing company. The offshore company indirectly leases the individual’s services back to the original employer using a domestic leasing company as an intermediary. The individual performs the same services as before after entering into the leasing arrangement. While the total amount paid for the individual’s services stays the same or increases, most of the funds are sent offshore as “deferred” compensation. The “deferred” compensation is frequently repaid to the individual as a “loan” or ends up in an account under the individual’s control. Promoters of these arrangements claim that neither employment taxes nor income taxes are owed on the “deferred” compensation. Because it is a Listed Transaction, participants are required to disclose their participation on current tax returns, could be liable for the unpaid tax and are subject to penalties and interest. Civil and criminal sanctions may arise against promoters and participants in offshore leasing activities
 - **Misclassifying worker status.** Sometimes employers inappropriately treat employees as independent contractors to avoid paying employment taxes. Generally, if the payer has the right to control what work will be done and how it will be done, the worker is an employee. Facts that provide evidence of the degree of control and independence include behavioral control, financial control and the type of relationship with the worker. Behavioral control relates to whether the business has a right to direct and control how the worker performs the task for which they are

hired. Financial control looks at whether a worker has the ability to affect financial decisions. Relationship of the parties looks to whether or not there is a contract between the worker and the business and how it is worded; whether the worker gets any type of benefits—vacation and sick pay, pension plan, and health or life insurance; and the permanency of the relationship, such as continuing indefinitely or only for a specific project or period. Employers who misclassify employees as independent contractors (and are not eligible for relief under Section 530 of the Revenue Act of 1978) will be liable for the employment taxes on wages paid to the misclassified worker and subject to penalties.

- **Paying employees in cash.** Paying employees in whole or partially in cash is a common method of evading income and employment taxes. There is nothing wrong with compensating an employee in cash, but employment taxes are due regardless of how the employees are paid. And the IRS is often able to develop a compelling case even if there are no payroll records or checks.
- **Filing false payroll tax returns or failing to file payroll tax returns.** Preparing false payroll tax returns intentionally understating the amount of wages on which taxes are owed or failing to file employment tax returns are methods commonly used to evade employment taxes.
- **S corporation officers compensation treated as corporate distributions.** In an effort to avoid employment taxes, some S corporations improperly treat officer compensation as a corporate distribution instead of wages or salary. By law, officers are employees of the corporation for employment tax purposes and compensation they receive for their services is subject to employment taxes.
- **Frivolous arguments.** Promoters use a variety of false or misleading arguments for not paying employment taxes. These arguments are often based on an incorrect interpretation of “Section 861” and other parts of the tax law and have

been refuted in court. One variation involves the improper use of Form 941c, *Supporting Statement to Correct Information on Form 941*, to attempt to get a refund of previously paid employment taxes. Employer participants could be held responsible for back payments of employment taxes, penalties and interest and possible criminal sanctions.

Reporting Tax Fraud

The IRS encourages employees to report any concerns that an employer is failing to properly withhold and pay federal income and employment taxes. Taxpayers can contact the IRS at 1-800-829-1040 or report suspected tax fraud by calling 1-800-829-0433.

Summary

Last year the IRS established the Whistleblower Office³ to receive information that helps uncover tax cheating and to provide appropriate rewards to whistleblowers. In 2003 the IRS and state tax officials brokered a nationwide information-sharing agreement attacking abusive tax avoidance transactions⁴ leading to an unprecedented level of civil examinations and criminal investigations of taxpayers, tax practitioners, professional service firms and promoters. The results have been legendary. Whether the QETP initiative working in conjunction with leads provided to the Whistleblower Office will lead to similar results is yet to be determined. Those with a QETP should seriously consider a potential voluntary disclosure. By publically announcing the QETP initiative, the IRS has provided fair warning to all.

ENDNOTES

¹ IRS News Release IR-2007-184 (Nov. 6, 2007) and Fact Sheet FS-2007-24.

² See *id.*

³ IR-2007-25 (Feb. 2, 2007).

⁴ IR-2003-111 (Sept. 16, 2003).

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