

Whiteman Osterman & Hanna LLP

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IRS to Ramp Up Worker Classification Audits in 2010

The IRS has announced that it will begin an employment tax National Research Program (“NRP”) beginning in February, 2010 which will include 6,000 worker classification audits. Worker classification audits focus on whether a business is properly treating its workers as “employees” (rather than as independent contractors) when such treatment is required under the federal tax laws, including the withholding of appropriate income and employment taxes (FICA and FUTA). The NRP audits will also focus on the proper treatment of fringe benefits, officers’ compensation and reimbursed expenses.

The IRS has indicated that the majority of the audits will be field audits, although revenue agents will also gather information from internal sources and the internet. The selection process for the NRP audits will be based on statistical sampling, and therefore selection will not necessarily mean that the business is filing improper returns.

The last time the IRS performed a significant analysis of worker classification compliance was in 1984. At that time, the IRS estimated that 15% of businesses were misclassifying 3.4 million employees as independents contractors, resulting in a tax shortfall of \$1.6 billion. In 2005, the Treasury Department estimated that unpaid FICA and FUTA taxes contribute approximately \$15 billion annually to the tax gap, of which worker misclassification is a contributing factor.

Worker classification audits are highly fact sensitive – typically revolving around (i) the ability of the business to control the activities of the worker; and (ii) the historical relationship between the business and the worker, among other things – and thus present many traps for the unwary. Statements or information given by business owners, officers and managers, usually prior to the involvement of tax professionals, can create unnecessary obstacles to overcome down the road, regardless of the underlying facts. This includes information displayed on the internet, including the business’s own website and those of third-parties, such as online trade magazines and marketing materials for trade shows, etc. It is not uncommon for businesses to make representations in such forums that are arguably inconsistent with their worker classification facts.

In the current climate, businesses that use the services of independent contractors (and the tax advisors of those businesses) should have a thorough understanding of the factual and legal elements essential to substantiating such treatment and build a file to establish that those elements are present.

If you have any questions, feel free to contact Damian Hovancik at (518) 487-7678, or Thomas Simcoe at (518) 487-7742.