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National Research Project on Employment Tax Focusing on Filing, Not Payment

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Speaking at a District of Columbia Bar Taxation Section luncheon sponsored by the section's Tax Audits and Litigation Committee, Faris Fink, deputy commissioner in the IRS Small-Business/Self-Employed Division (SB/SE), and John Tuzynski, chief of employment tax operations at SB/SE, provided a detailed outline of the goals and procedures of the NRP.

Fink said the overall goal of the NRP is "to help us to do our jobs better," but it will also measure employment tax noncompliance and the employment tax gap. Ultimately, the IRS hopes to get a statistically valid sample that will make employment tax audits more efficient, he said. (For prior coverage, see *Doc 2010-10317* or *2010 TNT 89-24*.)

Another question that the NRP will answer is how revenue would shift if section 530 of the Revenue Act of 1978 were repealed, Tuzynski said.

Section 530 of the Revenue Act was the congressional response to the IRS's aggressive application of the common-law 20-factor test for employment status. Under that provision, as long as the employer has a reasonable basis for not treating the worker as an employee and has consistently applied nonemployee status, the worker will not be treated as an employee for employment tax purposes. The language was intended to be a temporary measure that would allow Treasury to develop bright-line standards, but Treasury never responded, and the language has never been added to the code.

Daniel B. Rosenbaum of Caplin & Drysdale said pressure has increased in the past decade to repeal section 530 entirely, in part because of a "desperate need for revenue." He said Congress may require universal withholding taxes as a partial solution.

The 20-factor test was not developed within a tax context, but it has been adopted in employment tax cases. The IRS in Rev. Rul. 87-41 interpreted the test, stating that it is not to be applied mechanically and that each factor may receive different weight. (For Rev. Rul. 87-41, 1987-1 C.B. 296, see *Doc 87-3104* or *87 TNT 100-1*.)

The IRS has grouped the 20 common-law factors into three areas: behavior control, financial control, and the relationship between the employer and the worker. According to Tuzynski, the right to control the worker and the worker's opportunities for profit and risks of loss are the most significant, although not determinative.

The IRS last undertook a study of employment tax issues in the early 1980s, and Fink noted that business and pay practices have changed in the past 25 years. Field agents have received information from 90 percent of the first 2,000-employer cohort included in the NRP, and around one-third of those cases have been opened, he said.

According to Tuzynski, the first 2,000 samples were chosen semi-randomly from employers' quarterly federal tax returns (Forms 941) filed in 2008 in a way that guaranteed all geographical areas and all sizes of employer would

be covered. Although industry was not a selection criterion, the resulting sample is representative of all employers in the industries it covers, he said.

The next 2,000 audits will begin in November and will be based on Forms 941 filed for 2009, Tuzynski said. "It's what's not on payroll [forms] that we're most interested in," he said, including unreported fringe benefits. The tax year for each cohort is only a starting point, he added. As appropriate for each audit, IRS agents will examine other tax years.

Tuzynski said that officials "don't want these to be invasive examinations." Because of limited resources -- about 200 SB/SE agents have been assigned to the NRP -- and the three-year schedule, the goal is to have NRP audits last no longer than typical employment tax audits, he said.

Fink agreed that the IRS has "more than enough work to go around" and that "the goal is not to have this be a protracted engagement," but he warned that the NRP process "will be somewhat more invasive" than typical employment tax audits.

Interviews of workers are one technique agents will use to determine worker status, Tuzynski said. The IRS will also review communications between the workers and the employer, he said.

In accordance with the Revenue Act, the NRP audits will first consider whether Forms 1099 or Forms K-1 were timely filed, and then whether similarly situated workers were treated similarly, Tuzynski said. The reasonable basis test applies only when those two standards are satisfied, but the NRP will address that test next, he said.

Because of diverse business models throughout industries and across regions, using industry practice to establish a reasonable basis is likely to be contentious, Tuzynski added.

Satisfying the Revenue Act test is not the end of the Service's work. Tuzynski said agents will use the information acquired during the section 530 phase to establish whether they believe the worker would have been an employee under the 20-factor test.

Rosenbaum questioned whether the continued study is valuable to the IRS. The process can take a long time, and without developing the case further, it will be difficult to determine worker status accurately, he said. Tuzynski responded that once the section 530 test is satisfied, he is legally precluded from continuing the examination, and so cannot develop the case further.

According to Rosenbaum, employers have been comfortable playing the "audit lottery" on employment tax issues thanks to the small penalties involved and how infrequently they are applied. Interest-free adjustments under section 6205 are available, reduced employment tax rates are applied when a worker is reclassified as an employee, and the classification settlement program offers relief when a worker's status becomes an issue in an IRS audit, he said.

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