Employment Tax Litigation

ABA Tax Midyear Meeting
New Orleans, LA
January 18, 2019
Why is Misclassification a Problem?

- Amounts withheld from wages account for 72% of all revenues collected by Treasury
- Tax gap: $458 billion
  - Misclassification of workers annually “saves” employers $3,710 in employment taxes and $43,700 in income
  - $59 billion reported on employment tax returns is unpaid
- Top priority of the IRS and the Tax Division
Why is Misclassification a Problem, cont.

• Independent contractors cannot receive employee benefits or protections.
• Businesses who correctly classify are forced to subsidize counterparts who misclassify.
• Cost of living is shifted onto the general public (e.g., no unemployment insurance leads to higher demands for public assistance, which leads to higher taxes)
  – The federal government loses $3-4 billion in federal income and employment tax revenues annually due to misclassification
Why is Misclassification a Problem, cont.

• Hiring workers as independent contractors saves money
  – Department of Treasury estimates $3,710 in employment taxes and $43,007 in income annually (based on 2011 figures).

• A misclassified worker is often forced to pay money he does not owe (FICA taxes not subsidized).
Employee (Mis)Classification
Misclassification is on the Rise

• In 2012, over 700,000 workers were misclassified in New York alone
  – 1.8 million in New York, Maine, Massachusetts, and Illinois (national figures unavailable)
• Desire to reduce ACA insurance mandates results in additional misclassification issues.
• Worker misclassification may be a factor in referral for criminal prosecution
Misclassification is on the Rise

- In April 2017, worker classification issues yielded the highest wage adjustments.
- Wage adjustments of $44.3 billion were associated with worker classification issues.
Employee v. Independent Contractor
Employment Relationships

• Employer-employee
• Independent contractor
• Statutory employees
• Non-statutory employees
Employer-Employee Relationship

• Employer-employee relationship generally exists when
  – Employer has a right to control and direct the individual who performs the services
  – Employee is subject to the will and control of the employer not only as to what shall be done but as to how it shall be done.

Rev. Rul. 87-41; Treas. Reg. ‘31.3121(d)-1(c)(2)
Independent Contractors

• An independent contractor relationship may exist where a worker follows an “independent trade, business or profession in which they offer their services to the public.” Rev. Rul. 87-41, 1987-1 C.B. 296.

• Balancing test
Statutory Employees – I.R.C. 3121(d)(3)

- Drivers engaged in distributing meat, vegetable, fruit, or bakery products; beverages (other than milk); or laundry or dry-cleaning services;
- Fulltime life insurance salesmen;
- People who perform work from home according to the service consumer’s specifications, using materials or goods furnished by the service consumer that are required to be returned; and
- Fulltime traveling or city salespersons engaged in solicitation and transmission to the service consumer of orders of wholesalers, retailers, contractors, or operators of hotels, restaurants, or other establishments for merchandise for resale or supplies for use in their business operations.
Non-Statutory Employees

- Licensed real estate agents for whom a substantial part of their income is paid on commission under a contract specifying that they are not an employee for tax purposes;
- “Direct sellers” (i.e., those who sell consumer products in a place other than a permanent retail establishment, are engaged in selling consumer products to any buyer on a buy-sell basis, deposit-commission basis, or any similar basis for resale, or are engaged in newspaper or shopping news delivery); or
- Companion sitters (i.e., babysitters or careworkers for the elderly or disabled) who are not employees of a companion-sitting placement service.
Misclassification and the Gig Economy
Misclassification and the Gig Economy

• The gig economy also called the “sharing economy,” is the environment where workers engage in temporary jobs fueled by mobile apps and online platforms.

• The trend has led to an increase in employment tax controversies because many employers treat gig economy workers as independent contractors.
Misclassification and the Gig Economy

- As of August 2018, more than one third (36 percent) of U.S. workers are in the gig economy in some capacity.
- With the rise of technology and the growing acceptance of nontraditional, part-time, and temporary jobs, worker classification will be of increased importance.
Misclassification and the Gig Economy, cont.

- A common issue is the proper classifications of taxpayers that “drive” for a living.
- Some drivers for Uber, Lyft, etc. prefer to be classified as W-2 employees to avoid self employment tax.
- Others would prefer to be classified as independent contractors to claim deductions on Schedule C.
Misclassification and the Tax Cuts and Jobs Act

• Section 199A
• Elimination of the unreimbursed employee business expense.
Section 199A

- The Tax Cuts and Jobs Act of 2017 (TCJA) introduced Section 199A of the Internal Revenue Code.

- Section 199A provides many taxpayers a deduction for qualified business income from a qualified trade or business operated directly or through a pass-through entity.
Section 199A, Cont.

- Eligible taxpayers may be entitled to a deduction of up to 20 percent of qualified business income earned from a domestic business operated as a sole proprietorship, partnership, S corporation, trust or estate.
- Taxpayers with taxable income exceeding $315,000 for married couples or $157,500 for all other taxpayers are subject to limitations.
- C corporation income or income by an employee providing services are not eligible for a 199A deduction.
Section 199A, Cont.

• A qualified trade or business is eligible to take the deduction.

• A qualified trade or business is any trade or business with two exceptions:
  – 1) Specified service trade or business
  – 2) Performing services as a employee

• The specified service trade or business exception does not apply to taxpayers below the $315,000/$157,000 threshold.
Employee Business Expense Deduction

- Under prior law, employee taxpayers were able to deduct expenses related to their employment as miscellaneous itemized deductions.
- The deduction was subject to a 2% floor.
- TCJA eliminates the deduction.
Employment Tax Filing and Withholding Obligations
Filing Obligations

• Employers must file IRS Form 941 on a quarterly basis.
Deposit Obligations

• Employers must deposit Federal withholding taxes and the employer’s and employee’s portion of Social Security and Medicare taxes on either a monthly or semi-weekly basis.

• Employers who owed $50,000 or less in Form 941 taxes during the applicable look back period are required to deposit on a monthly basis.
Applicable Penalties
## Failure to Make Timely Deposit Penalty

- Failure to make timely deposit penalties accrue from the due date of the deposit as follows:

<table>
<thead>
<tr>
<th>Lateness of Deposit</th>
<th>Amount of Penalty</th>
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<tbody>
<tr>
<td>1 to 5 days late</td>
<td>2%</td>
</tr>
<tr>
<td>6 to 15 days late</td>
<td>5%</td>
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<tr>
<td>16 or more days late. Applies to payments received within 10 days from the date of the first IRS notice for payment.</td>
<td>10%</td>
</tr>
<tr>
<td>Payment made directly to the IRS or paid with the tax return.</td>
<td>10%</td>
</tr>
<tr>
<td>Amount remains unpaid more than 10 days after the first IRS notice for payment.</td>
<td>15%</td>
</tr>
</tbody>
</table>
Failure to Pay and Failure to File Penalties

• Failure to pay penalty
  – 0.5 percent of the amount of unpaid tax for each month of non-payment with a maximum potential penalty of 5 percent.

• Late filing penalty.
  – 5 percent of the amount of tax shown on the return for each month that the return is late with a maximum potential penalty of 25 percent.
Common Compliance Issues

• Failure to make timely deposits
• Employers pay “net payroll” to their employees
• Employers pay employees in cash
• Employers report employees as independent contractors
• Employers fail to file Forms 941 for the periods where deposits were not made.
  – The amount unpaid from Forms 941 and 944 as of October 2018 is $57 Billion (Source: IRS Compliance Data Warehouse).
Third-Party Payers and Risks

• Many employers outsource payroll and related tax duties to third-party payroll service providers
  – Payroll tax fraud
  – Late or unfiled tax returns
  – Underreported tax liabilities
  – Late or undeposited tax payments
• Responsible persons remain responsible
Audit Red Flags
Audit Red Flags

• IRS likely to discover misclassification through audit. Misclassification suspicions are raised if:
  – Businesses employing large numbers of independent contractors
  – Businesses issuing Forms 1099-MISC with large sums reported in Box 7 ("Nonemployee compensation")
  – Workers have only one IRS Form 1099-MISC
  – Forms 1099 with a missing or wrong TIN (highest audit potential)
Audit Red Flags, cont.

- Forms W-2 are filed, but Forms 941 are not
- Low tips.
- Employment Tax Examination (ETE) program targets types of businesses that commonly misclassify—e.g., temporary staffing agencies, nursing registries, building contractors.
- Many audits are initiated when the IRS discovers an independent contractor filed claims for benefits that only an employee would be allowed.
IRS Audit Techniques

• During an audit, the IRS will
  – Compare W-2 and 1099 lists to identify workers whose status changed during the year;
  – Identify workers who received continuing payments during the year;
  – Question the status of all individuals who were compensated via 1099.

• IRS employment tax agents generally base their findings on written Form SS-8 responses or oral interviews of workers. (Disgruntled workers are often willing to talk.)
Examination and Determination
During Exam Process

• Misclassified workers who have not yet filed returns for the year should report nonemployee compensation as wages (line 7 of IRS Form 1040), rather than on Schedule C.

• Misclassified workers who have already filed returns for the year should file amended returns under IRS Form 1040X with the recomputed tax.
During Exam Process

- Employer will request that misclassified workers complete IRS Form 4669, Statement of Payments Received, stating that the worker paid his half of the FICA tax for each year.
IRS Review and Determinations

• Case will be assigned to a technician, who will review all Forms SS-8 in light of the law and promulgate a decision.
  – An SS-8 technician applies the law to the facts and circumstances submitted with Form SS-8
  – “Formal determinations” are binding on the IRS for all future cases with the same set of facts.
IRS Form SS-8
Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding

Information about Form SS-8 and its separate instructions is at www.irs.gov/formss8

Name of firm (or person) for whom the worker performed services
Worker's name

Firm's mailing address (include street address, apt. or suite no., city, state, and ZIP code)
Worker's mailing address (include street address, apt. or suite no., city, state, and ZIP code)

Trade name
Firm's main address
Worker's daytime telephone number
Worker's main address

Firm's fax number
Firm's website
Worker's alternate telephone number
Worker's website

Firm's telephone number (include area code)
Firm's employer identification number
Worker's social security number
Worker's employer identification number (if any)

Disclosure of Information

The information provided on Form SS-8 may be disclosed to the firm, worker, or payer named above to assist the IRS in the determination process. For example, if you are a worker, we may disclose the information you provide on Form SS-8 to the firm or payer named above. The information can only be disclosed to assist with the determination process. If you provide incomplete information, we may not be able to process your request. See Privacy Act and Paperwork Reduction Act Notice in the separate instructions for more information. If you do not want this information disclosed to other parties, do not file Form SS-8.

Parts I-V. All filers of Form SS-8 must complete all questions in Parts I-V. Part V must be completed if the worker provides a service directly to customers or to a salesperson. If you cannot answer a question, enter "Unknown" or "Does not apply." If you need more space for a question, attach another sheet with the part and question number clearly identified. Write your firm's name (or worker's name) and employer identification number (or social security number) at the top of each additional sheet attached to this form.

Part I General Information

1. This form is being completed by: ☐ Firm ☐ Worker; for services performed beginning date to ending date.

2. Explain your reason(s) for filing this form (for example, you received a bill from the IRS, you believe you erroneously received a Form 1099 or Form W-2, you are unable to get workers' compensation benefits, or you were audited or are being audited by the IRS).

3. Total number of workers who performed or are performing the same or similar services.

4. How did the worker obtain the job? ☐ Application ☐ Bid ☐ Employment Agency ☐ Other (specify)

5. Attach copies of all supporting documentation (for example, contracts, invoices, memos, Forms W-2 or Forms 1099-MISC issued or received, IRS closing agreements or IRS rulings). In addition, please inform us of any current or past litigation concerning the worker's status. If no income reporting forms (Form 1099-MISC or W-2) were furnished to the worker, enter the amount of income earned for the year(s) at issue $.

6. If both Form W-2 and Form 1099-MISC were issued or received, explain why.

Describe the firm's business.

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions.
IRS Form SS-8: Part I

1. This form is being completed by:
   ___ Firm   ___ Worker
   ... for services performed _________ (DATE RANGE).

2. Explain your reasons for filing this form

3. Total number of workers who performed or are performing the same or similar services?

4. How did the worker obtain the job?
5. Attach copies of all supporting documentation
6. Describe the firm’s business.
7. If the worker received pay from more than one entity because of an event such as the sale, merger, acquisition, or reorganization of the firm for whom the services are performed, provide further information.
8. Describe the work done by the worker and provide the worker’s job title.
9. Explain why you believe the worker is an employee or an independent contractor.

10. Did the worker perform services for the firm in any capacity before providing the services that are the subject of this determination request?

11. If the work is done under a written agreement between the firm and the worker, attach a copy (preferably signed by both parties). Describe the terms and conditions of the work arrangement.
IRS Form SS-8: Part II – Behavioral Control

1. What specific training and/or instruction is the worker given by the firm?

2. How does the worker receive work assignments?

3. Who determines the methods by which assignments are performed?

4. Who is the worker required to contact if problems or complaints arise and who is responsible for their resolution?
IRS Form SS-8:
Part II – Behavioral Control (cont.)

5. What types of reports are required from the worker? Attach examples.

6. Describe the worker’s daily routine such as his or her schedule or hours.

7. At what location(s) does the worker perform services? (for example, firm’s premises, own shop or office, home, customer’s location)? Indicate the appropriate percentage of time the worker spends in each location, if more than one.
IRS Form SS-8: Part II – Behavioral Control (cont.)

8. Any meetings the worker is required to attend and any penalties for not attending (for example, sales meetings, monthly meetings, staff meetings).

9. Is the worker required to provide the services personally?

10. If substitutes or helpers are needed, who hires them?
11. If the worker hires the substitutes or helpers, is approval required? If “Yes,” by whom?

12. Who pays the substitutes or helpers?

13. Is the worker reimbursed if the worker pays the substitutes or helpers? If “Yes,” by whom?
IRS Form SS-8: Part III – Financial Control

1. List the supplies, equipment, materials, and property provided by each party. [The firm, the worker, other party]

2. Does the worker lease equipment, space, or a facility? If yes, what are the lease terms?

3. What expenses are incurred by the worker in the performance of services for the firm?

4. Specify which, if any, expenses are reimbursed by the firm, or another party.
IRS Form SS-8: 
Part III – Financial Control (cont.)

5. Type of pay the worker receives: Salary, Commission, Hourly Wage, (specify). If type of pay is commission, and the firm guarantees a minimum amount, specify amount.

7. Whom does the customer pay, the firm or the worker? If worker, does the worker pay the total amount to the firm?

8. Does the firm carry workers’ compensation insurance on the worker?

9. What economic loss or financial risk, if any, can the worker incur beyond the normal loss of salary (for example, loss or damage of equipment, material)?
10. Does the worker establish the level of payment for the services provided or the products sold? If “No,” who does?
Form SS-8: Part IV – Relationship of the Worker and Firm

1. Please check the benefits available to the worker: Paid vacations, Sick pay, Paid holidays, Personal days, Pensions, Insurance benefits, Bonuses, Other (specify).

2. Can the relationship be terminated by either party without incurring liability or penalty? If “No,” explain.
Form SS-8: Part IV – Relationship of the Worker and Firm (cont.)

3. Did the worker perform similar services for others during the same time period? If “No,” explain your answer.

4. Describe any agreements prohibiting competition between the worker and the firm while the worker is performing services or during any later period. Attach any available documentation.

5. Is the worker a member of a union?
Form SS-8: Part IV – Relationship of the Worker and Firm (cont.)

6. What type of advertising, if any, does the worker do (for example, a business listing in a directory or business cards)? Provide copies, if applicable.

7. If the worker assembles or processes a product at home, who provides the materials and instructions or pattern?

8. What does the worker do with the finished product (for example, return it to the firm, provide it to another party, or sell it)?
9. How does the firm represent the worker to its customers (for example, employee, partner, representative, or contractor), and under whose business name does the worker perform these services?

10. If the worker no longer performs services for the firm, how did the relationship end (for example, worker quit or was fired, job completed, contract ended, firm or worker went out of business)?
Signing IRS Form SS-8

• All IRS Forms SS-8 are signed under penalty of perjury.
• IRS will then send a blank Form SS-8 for the business to complete.
  – Unless the form is attached to IRS Form 211 (see whistleblower section). Then the SS-8 is considered “confidential” under Section 6103 and only an audit is conducted instead.
Lessons Learned from SS-8 – Drafting the Independent Contractor Agreement

• The agreement with an independent contractor should:
  – Require the contractor to submit invoices.
  – Require the contractor to pay travel or other business expenses directly.
  – Require the contractor to treat the relationship with the company as an independent contractor relationship for all purposes of the Internal Revenue Code and applicable state tax laws.
Lessons Learned from SS-8 – Drafting the Independent Contractor Agreement

– Require the contractor to report on his federal and state income tax returns all income received by him pursuant to the contract as income received from a trade or business subject to self-employment tax.

– Require the contractor to pay all federal self-employment taxes shown on his federal income tax return that are attributable to the contract.

– Require the contactor to indemnify and hold harmless the company for all federal and state withholding and employment taxes that the company pays with respect to the agreement.
Appealing an IRS Determination
Appealing IRS Determination

• Administrative appeals are available once the IRS renders a decision.

• Workers can bring action in the Tax Court after the IRS Determines a Deficiency
Filing a Protest Letter

• Taxpayer may file a protest letter with IRS Appeals.

• If no protest letter is filed within 30 days, or if the taxpayer fails to settle the case in Appeals, IRS will issue a Letter 3523, Notice of Determination of Worker Classification (NDWC).
Review by IRS Appeals

Before filing Section 7436 claim, taxpayer may seek review in IRS Appeals:

- IRS will first issue Letter 950-C, Employment Tax 30 Day Letter-WC, (the “30-day letter”) advising service consumers of adjustments to their employment tax liabilities, related to worker misclassification issues.

- Letter 950-C may also include an IRS Form 13683, Statement of Disputed Issues, for cases where the amount in dispute does not exceed $25,000 for each tax period.
Requesting a Tax Court Determination Under Section 7436

• Section 7436 allows businesses to review employment tax determinations involving:
  – Classification of taxpayer’s workers as employees
  – Entitlement to Section 530 relief
  – The proper amount of employment tax due
Requesting a TC Determination Under Section 7436, cont.

- Only the individual or business receiving the service can petition the Tax Court under § 7436
- Workers that disagree with an IRS determination resulting from a Form SS-8 filing cannot petition the Tax Court under § 7436
If Petition Is Filed Before NDWC...

- Taxpayer may still petition Tax Court under Section 7436 even if no NDWC is issued if a previous letter determining employment status had been issued following an audit, because an “actual controversy involving a determination” has arisen.

- See SECC Corp. v. Commissioner, 142 T.C. No. 12 (2014) (also noting that because the letter was not sent via certified or registered mail, the 90-day filing requirement did not apply).
On the Other Hand...

- Employment status determinations must arise “in connection with an audit or examination” in order for the Tax Court to have jurisdiction.

- See *Staffmore v. Commissioner*, T.C. Memo. 2013-187 (Tax Court lacked jurisdiction under Section 7436 because the IRS determination arose in response to submission of a Form SS-8 request, analogous to a Private Letter Ruling request.)
Classification Criteria

• Tax Court uses a seven-factor test to determine classification criteria:
  – the degree of control exercised by the principal over the details of the work;
  – which party invests in the facilities used by the worker;
  – the opportunity of the worker for profit or loss;
  – whether the principal can discharge the worker;
  – whether the work is part of the principal's regular business;
  – the permanency of the relationship; and
  – the relationship the parties believed they were creating.
Employer Relief Under Section 530
Employer Relief Under Section 530

• Employers whose misclassification was done in good faith can potentially receive protection under Section 530

• Section 530 is a safe harbor from retroactive taxes and penalties due upon reclassification.

• Burden on employer to establish prima facie case.

• Three requirements:
  – Reasonable Basis
  – Substantive Consistency
  – Reporting Consistency
Reasonable Basis

- **Reasonable Basis** for treating workers as independent contractors:
  - Employer reasonably relied on a relevant court case about federal taxes, or an IRS ruling;
  - Employer was audited for employment misclassification issues and the IRS did not reclassify its employees;
  - Employer treated the workers as independent contractors based on knowledge that was how a significant segment of the industry treated similar workers; or
Reasonable Basis, cont.

– Employer relied on some other reasonable basis, such as the advice of a business lawyer or accountant familiar with the employer’s business.

• Reasonable basis is construed liberally in favor of the taxpayer.
Substantive Consistency

• **Substantive consistency**: Employer must have treated all workers holding substantially similar positions as independent contractors.

• “Substantially similar positions”
  – Degree of supervision and control
  – Managerial responsibilities
  – Reporting requirements
  – Job duties
  – Contractual relationship
  – Employee benefits
Reporting Consistency

• **Reporting consistency**: Employer must have filed all required federal tax returns

• Burden on employer to prove that Forms 1099 were filed and received by IRS.
Employer Relief Under Section 530, cont.

• Employers qualifying under Section 530 relief can continue to avoid paying employment taxes

• But such workers are not considered “independent contractors” for income tax purposes, merely “non-employees,” for employment tax purposes.
Employer Relief Under Section 530, cont.

• Section 530 does not apply to the hiring of certain technical workers, such as engineers, designers, drafters, computer programmers, systems analysts, or other similar workers.

• Section 530 claims can be filed with IRS Appeals or in U.S. Tax Court, or via the IRS Classification Settlement Program (CSP).
Voluntary Classification Settlement Program
Voluntary Classification Settlement Program (VCSP)

• Incentive for individuals or businesses who voluntarily come forward and reclassify their workers before the IRS or DoL initiates an audit or discovers misclassified workers.
• Tax liabilities are reduced to 10% of the amount over the most recent tax year.
• Penalties and interest are abated.
• Taxpayers accepted into VCSP will not be audited for potentially unpaid employment taxes from prior years.
VCSP Requirements

• Businesses must have consistently treated workers as independent contractors (or nonemployees) for the three years prior.

• All IRS Forms 1099 must have been filed for those years.

• Businesses cannot currently be under audit by the IRS, DoL, or any state agency.

• To enter VCSP, file IRS Form 8952, Application for Voluntary Classification Settlement Program
VCSP Issues

• VCSP focuses on employer’s tax liability; no similar provision for employees.
• State tax ramifications are not addressed through VCSP.
  – Few states have corresponding programs
  – Note that several states do have memoranda of understanding with the DoL to promote compliance with both state and federal laws.
Section 7434
Suing the Dishonest Employer
IRC § 7434

• Civil remedy for victims of business that “willfully files a fraudulent information return with respect to payments.

• Civil damages range from $5,000 minimum to actual damages directly resulting from the fraudulent filing, plus the costs to bring the action, and “in the court’s discretion, reasonable attorneys’ fees
Winning a Section 7434 Claim

• To win a Section 7434 claim, worker must prove by “clear and convincing evidence”:
  – the employer issued an information return;
  – the information return was fraudulent; and
  – the employer willfully issued the fraudulent return.

Seijo v. Casa Salsa, 2013 WL 6184969 at *7 (S.D.Fla. 2013)
“Willfulness” Defined

• “Willful” requires “proof of deceitfulness or bad faith in connection with filing an information return.

• A mere “error or mistake” in filing an information return does not establish fraud.

• Absence of good-faith belief that the correct return was filed or that correct payments were made is evidence of willfulness.
Bringing a Section 7434 Claim

• **Statute of limitations**: 6 years from the date the fraudulent return was filed, or 1 year after the date the “fraudulent information return would have been discovered by exercise of reasonable care.” IRC § 7434(c).
• IRS must receive a copy of the complaint. IRC § 7434(d).
• When the court awards damages, it must provide a finding of the correct amount of tax that should have been reported. IRC § 7434(e).