

## HOW TO HANDLE AN IRS AUDIT RECLASSIFYING INDEPENDENT CONTRACTORS AS EMPLOYEES

An attorney or other qualified agent who represents a business facing an IRS audit regarding classification of workers as independent contractors should immediately begin preparing for a hard and protracted struggle. In some cases, it may be possible to derail the audit before it starts. Check to see if it violated the IRS policies on repetitive examinations or reopening examinations, or the statutory limitation on a second examination of the taxpayer's records. Also, make sure the 3-year statute of limitations on assessments has not expired.

If the audit proceeds, review the return, especially any questionable items. Assemble and review the records needed for the audit, making sure no unnecessary information is volunteered. Develop a strategy with the client, such as what settlements are acceptable, and whether to adopt an aggressive or defensive approach to the audit. Identifying likely litigation issues is helpful in facilitating early preparation for trial, should that be necessary.

Make the agent submit all requests for records in writing. Check to see if the requested records are relevant to the audit and if they are privileged (i.e., self-incrimination, attorney/client).

Preferably, the audit should be at your office and at a convenient time. If it is at the taxpayer's office, isolate the agent. Also, postponing the audit is often advantageous, as it leaves the agent less time to complete it. If the agent is particularly difficult to work with, try to transfer the audit to another agent or office. Always ask to see the agent's ID and set ground rules for the audit.

You should be with the taxpayer at all interviews with the agent. Remember that the IRS can compel attendance at an interview only by a formal summons.

In reviewing the return, look for favorable adjustments which might have been overlooked in the original return. This is useful for negotiations.

If some records are missing, be honest about that and try to find other ways to supply the requested information. Non-attorney agents who find unreported income or other indications of fraud should advise the client to discuss these matters only with an attorney, so the attorney/client privilege can be invoked.

Some practitioners recommend the "safe haven" provision (Section 530 of the Revenue Act of 1978) as the first line of defense in employee reclassification cases. This provides that workers are independent contractors if: (1) the company filed all the required Form 1099's; (2) the employer consistently treated all similar workers as independent contractors; (3) the firm has a "reasonable basis" for treating the worker as a non-employee.

It may be necessary to contact and interview former workers for the client to determine and document that there has been similar treatment. This can present practical problems, such as when they have relocated or don't want to get involved. The "reasonable basis" requirement can be met by: (1) a judicial or other legal precedent; (2) a previous audit which resulted in no additional assessment, or (3) a long-standing industry practice (which does not have to be followed throughout the entire industry). Interviewing other employers can help establish an industry practice -- although many employers are reluctant to cooperate for fear they will be audited next. Although the "safe haven" provision should be liberally construed in favor of the taxpayer, the IRS probably won't.

The main consideration the IRS looks at in determining employment status is the "control test". This asks whether the employer has the right to control and direct the worker not only as to the final results but also in regard to the means and manner of

doing the work. It is irrelevant whether the employer actually does exercise this control; it only has to have the right to do so. In applying the control test, the IRS has a list of 20 common law factors it considers. See Rev. Rul. 87-41.

Certain types of workers are statutorily classified as employees or independent contractors, irregardless of the control test. Real estate agents and direct sellers are statutory independent contractors, provided their compensation is related to performance (such as volume of sales) rather than hours, and there is a written contract recognizing them as independent contractors. Conversely, certain workers are statutory employees, such as corporate officers, certain types of drivers, travelling salesmen, and home workers.

In this type of case, it is best to present all facts and law at the agent level, especially if you have a good factual case. If the agent's determination is unfavorable, you may request reconsideration by the group manager.

The next step is to protest to an Appeals Officer. If the IRS is to make any concessions, it will probably be at this level. Appeals officers have authority to settle and compromise the case which agents do not.

The taxpayer can appeal to the Tax Court if the Appeals Officer's ruling is adverse, or may bypass the Appeals Officer altogether. However, the Tax Court does not have jurisdiction over employment tax (FICA) issues. See Judd v. Comr., 74 T.C. 651 (1980).

Alternatively, your client may pay part of the additional assessment (full payment, which is generally required, is not required in employment reclassification cases), file a claim for refund with the IRS, and then file suit in District Court or the Court of Federal Claims for a refund. Even if the final decision is unfavorable, the effects may be mitigated. Section 3509 relief, if available, limits income tax liability to 1.5% of wages involved and cuts liability for the employee's share of FICA by 80%. The

taxpayer may also be able to offset the tax paid by worker under Section 3402(d), or eliminate interest costs under Section 6205(a)(1) and Reg. 31.6205-1(c)(2).

Finally the costs involved in fighting the IRS must be considered. Some employers have successfully defended reclassification in court, but went bankrupt in the process.