

ACHIEVING SUCCESS IN A WORKER CLASSIFICATION AUDIT

NICOLE OCCHUIZZO

Facing increased scrutiny, employers who use independent contractors as a part of their workforce should be prepared to demonstrate to the IRS that their workers' classifications are correct

In the first quarter of 2010, the IRS kicked off the Employment Tax National Research Project, a large scale employment tax audit program that will focus heavily on worker classification. Under this new program, the IRS will audit 6,000 randomly selected businesses over the next three years—in addition to those businesses selected for worker classification audits under the IRS's general audit program—to determine whether workers treated as independent contractors have been properly classified as such.¹ Due to the potential liabilities associated with a determination that employees have been improperly classified as independent contractors, it is thus now more crucial than ever that employers who use independent contractors as a part of their workforce are prepared to demonstrate to the IRS that their workers' classifications are correct.

To illustrate some of the obstacles employers may face during an IRS worker classification audit, as well as some techniques that may be used to overcome those obstacles, this article will: (1) give a brief background on the new audit program, (2) summarize the rules the IRS generally looks to when examining worker classification on audit, and (3) provide an ex-

ample of a recent audit in which an employer successfully demonstrated to the IRS that it was entitled to continue classifying its workers as independent contractors.

The audit program

The IRS's increased scrutiny on worker classification is due largely to the perceived effect of misclassification on the federal "tax gap." Generally speaking, the tax gap is the difference between what taxpayers should have paid under federal law and what they actually paid on a timely basis.² The most recent IRS estimates place the gap at \$345 billion.³ The IRS further estimates that at least \$2.72 billion of that amount is attributable to employers misclassifying approximately 3.4 million employees as independent contractors;⁴ or, more specifically, to losses associated with the employment taxes that the employers were required to pay with respect to the employees' compensation but did not because they treated the employees as independent contractors, with respect to whom there are generally no such obligations.⁵

The amount of the tax gap attributed to worker misclassification, however, is based on a study of tax year 1984, and the IRS believes it to be much higher at present.⁶ But, there has not been another comprehensive study on the

NICOLE OCCHUIZZO, LL.M., is an attorney with Ivins, Phillips & Barker, Washington D.C., where she practices in the firm's employee benefits group.

effect of worker misclassification on the tax gap since the 1984 data was obtained—until now.

The main goal of the current audit program is to give the IRS a better understanding of the compliance characteristics of employment tax filers, so that it can focus on the most non-compliant employment tax areas, and thereby help reduce the tax gap.⁷ Accordingly, the 6,000 worker classification audits ultimately conducted under this program will be used to provide regular estimates of employment tax compliance levels and drivers of non-compliance through the compilation of trend information on worker classification (as well as fringe benefits, non-filers, and officer compensation).⁸

The audits will be initiated based on Forms 941, Employer's Quarterly Federal Tax Returns, at a rate of 2,000 audits per year, and they will be distributed fairly equitably across the different types of business entities filing those returns.⁹ Using a broad scope, a legion of specially trained IRS auditors will build their cases starting from these returns.¹⁰ Then, to the extent an auditor determines that an employer has indeed misclassified its workers, and the employer is unable to convince the auditor otherwise, the traditional classification settlement and appeals processes will be set into motion.¹¹

The worker classification rules

As a fundamental part of the worker classification case building process, IRS auditors look to the general tax rules governing worker classification, which are both subjective and complicated, to determine whether employers have properly classified their workers. Auditors are also required to take into consideration section 530 of the Revenue Act of 1978 (hereinafter, "section 530"), which provides a special set of "safe harbor" rules under which an employer may continue classifying workers as it has done so in the past—regardless of the workers' actual relationship to the employer.¹² Both the general tax rules and the section 530 rules are summarized below.

General rules The statutory provisions and regulations relating to federal employment taxes do not generally establish an independent tax rule controlling the determination of whether a particular individual is an employee or independent contractor. Instead, for purposes of federal employment taxes, the Code defines an "employee" as "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee."¹³ Common law, then, looks to the questions of how much and what type of control is placed on the worker by the employer, with an employer-employee relationship generally found

¹ Hughes, "Payroll Audit Project Covers 6,000 Firms, Includes Executive Compensation Issues," *Pension & Benefits Daily* (11/30/09); SSA/IRS, "Tips on Dealing with an IRS Audit," SSA/IRS Reporter (Spring 2010), p. 2, available at www.irs.gov/pub/irs-pdf/p1693.pdf.

² Dept. of Treas., "Update on Reducing the Federal Tax Gap and Reducing Voluntary Compliance" (7/8/09), p. 2, available at www.irs.gov/pub/newsroom/tax_gap_report_final_version.pdf.

³ T.I.G.T.A., "While Actions Have Been Taken to Address Worker Misclassification, an Agency-Wide Employment Tax Program and Better Data Are Needed" (2/4/09), p. 8, available at www.treas.gov/tigta/auditreports/2009reports/200930035fr.pdf.

⁴ *Id.*; Dept. of Treas., *supra* note 2 at p. 8.

⁵ With respect to employee compensation, employers are generally required to: (1) withhold Medicare and Social Security taxes (or, FICA) as well as pay a matching amount; (2) pay the full amount of the employees' federal unemployment tax (FUTA); and (3) withhold federal income taxes. By contrast, with respect to independent contractor compensation, employers generally have no responsibility to pay or otherwise withhold FICA, FUTA, or federal income taxes. See, e.g., Government Accountability Office, "Employee Misclassification: Improved Coordination, Outreach and Targeting Could Better Ensure Detection and Prevention" (August 2009), p. 5, available at www.gao.gov/new.items/d09717.pdf.

⁶ Dept. of Treas., *supra* note 2 at p. 4. Note that the amount attributable to employers misclassifying their employees as independent contractors was originally estimated at \$1.6 billion based on the 1984 data; however, in 2006, that amount was adjusted for inflation to \$2.72 billion. See *id.* at p. 8.

⁷ Gardner, "NRP Employment Tax Audit Program to Examine 6,000 U.S. Companies," *Pension & Benefits Daily* (9/23/09); IRS, "IRS Will Begin Employment Tax Research Study in Feb-

ruary 2010" (11/9/09), available at www.irs.gov/businesses/small/article/0,,id=215350,00.html.

⁸ Dept. of Treas., *supra* note 2 at p. 13; Gardner, *supra* note 7.

⁹ Gardner, *supra* note 7 (quoting Chief of Employment Tax Operations in IRS's Small Business/Self-Employed Division, John Tuznyski). The IRS will typically notify an employer that it has been selected for participation in the audit program using letter "3850-B." See Gardner, "IRS to Send Employment Tax Audit Letters on Benefits, Exec. Comp. by Late February," *Pension & Benefits Daily* (1/26/10).

¹⁰ See, e.g., Gardner, *supra* note 7. While these IRS agents seek to crack down on worker misclassification, they will not be doing so in isolation. For example, as a part of its fiscal 2011 budget request, the Department of Labor is seeking \$25 million for a multi-agency initiative to coordinate federal and state programs to deter employers from misclassifying their workers. The Department of Labor also requested an additional \$12 million and 90 new investigators for the Wage and Hour Division to "support targeted investigations that focus on industries where misclassification is most likely." Cinquegrani, "Labor Department Budget Request Includes EBSA Hike, Funds to Deter Misclassification," *Pension & Benefits Reporter* (3/16/10) (quoting Labor Secretary Hilda Solis).

¹¹ See, e.g., IRM 4.23.6 (last updated 10/30/09) for a more detailed explanation of these procedures.

¹² Although originally intended as a temporary measure, section 530 was extended indefinitely by the Tax Equity and Fiscal Responsibility Act of 1982. Section 530 has been amended subsequently by section 1706 of the Tax Reform Act of 1986 and section 1122 of the Small Business Job Protection Act of 1996.

¹³ Section 3121(d)(2). Certain limited categories of workers are statutorily defined as either employees or non-employees. These workers are outside the scope of this article. See, e.g., Sections 3121(d)(1) and (3) (re: statutory employees); see also Sections 3506 and 3508 (re: statutory non-employees).

to exist when the employer has the “right to control and direct” a worker not only as to the result of the work but as to the manner in which that result is accomplished.¹⁴

To analyze which party, i.e., worker or employer, has the right to exercise the control and direction over the work that differentiates employees from independent contractors, the IRS issued Rev. Rul. 87-41.¹⁵ In this ruling, the IRS set forth 20 factors that it has determined are relevant to this analysis, ranging from when and where the workers provide their services to the ability of the workers, and the employer, to terminate the service relationship. More specifically, the 20 factors are:

1. The level of instruction provided by the employer.
2. The extent of training provided by the employer.
3. The integration of the worker's services into the employer's operations.
4. Whether services are required to be rendered personally by the worker.
5. Whether the worker can or does hire, supervise, and pay assistants.
6. The continuity of the relationship between the employer and the worker.
7. Who sets the hours of work.
8. Whether the employer requires the worker to work full time.
9. Whether the work is performed on the employer's premises.
10. Who sets the order or sequence of work.

11. Whether oral or written reports are required by the employer.
12. Whether the employer pays the worker by the hour, week, or month.
13. Who pays for business and/or traveling expenses.
14. Who furnishes tools and materials.
15. Whether the worker has a significant investment in the firm.
16. Whether the worker realizes profit or loss as a result of his or her services.
17. Whether the worker may perform services for more than one firm at a time.
18. Whether the worker makes services available to the general public.
19. The employer's right to discharge the worker.
20. The worker's right to terminate his or her relationship with the employer.

In its worker classification training materials,¹⁶ however, the IRS later modified this 20-factor analysis by generally grouping the factors into the following three categories:

- *Category 1: Behavior control.* Key behavioral control factors include the instructions and training provided to the worker by the employer.¹⁷ For this purpose, the more instructions and training the employer provides with respect to how the work is done (rather than the end result), the more behavioral control the employer will generally be considered to have exercised.¹⁸
- *Category 2: Financial control.* With respect to financial control, key factors include the extent of the worker's own investment in the services he or she provides, the worker's ability to make

¹⁴ See, e.g., Reg. 31.3121(d)-1(c)(2).

¹⁵ 1987-1 CB 296.

¹⁶ IRS, “Independent Contractor or Employee? Training Materials” (October 1996) (hereinafter, “IRS Training Materials”). When Congress enacted section 530 in the Revenue Act of 1978, the IRS was barred from issuing any regulations or revenue rulings pertaining to worker classification. As a result, the IRS “cannot...even modify existing revenue rulings to reflect new developments.” IRS Training Materials at 1-4. The IRS has provided some subsequent direction, however, in the form of these IRS Training Materials, which were issued as guidance for IRS examiners and other IRS representatives who are required to make worker classification determinations. *Id.* at i. While the IRS Training Materials provide valuable insight into the worker classification audit process, however, it is important to note that they were not issued as guidance for the general public and they do not have the force of law.

¹⁷ *Id.* at 2-8, 2-9.

¹⁸ *Id.*

¹⁹ *Id.* at 2-20.

²⁰ *Id.* at 2-22 through 2-28.

²¹ *Id.* at 2-28.

²² *Id.* at 2-25, 2-26.

²³ Note that the IRS does acknowledge that either classification—employee or independent contractor—can be a “valid and appropriate business choice.” IRM 4.23.5.3(2).

²⁴ National Association of Tax Reporting and Professional Management (Weissman, Principal Author), “Section 530: Its History and Application in Light of the Employer-Employee Relationship for Federal Tax Purposes” (2/28/09), p. 6, available at www.irs.gov/pub/irs-utl/irpac-br_530_relief_-_appendix_natrm_paper_09032009.pdf.

²⁵ Section 530(a)(1). This rule applies with respect to periods after 12/31/78.

²⁶ Section 530(a)(3). This rule applies for any period after 12/31/77.

²⁷ See Section 530(e)(6); IRS Training Materials, *supra* note 16 at 1-9.

²⁸ Section 530(a)(2).

²⁹ *Id.*

³⁰ IRS Training Materials, *supra* note 16 at 1-33.

³¹ See Rev. Proc. 85-18, 1985-1 CB 518 (citing H.R. Rep't No. 95-1748, 95th Cong., 2d Sess. 5 (1978)).

³² See section 530(e)(3); IRS Training Materials, *supra* note 16 at 1-3. Note that section 530 applies only to an employer's employment tax obligations. Section 530 will not absolve any worker of the employment tax obligations he or she may have based on his or her proper classification under the general tax rules. Section 530 also fails to provide relief even for an employer if the workers at issue are certain designated technical workers. See section 530(d).

services available to the relevant market while also providing services to the employer, and the worker's own opportunity for profit or loss with respect to his or her services (as evidenced by reimbursement of expenses, method of payment, and the like).¹⁹ The more economically independent the worker is of the employer, the less likely the employer will be considered to be exercising financial control over the worker.

- **Category 3: Relationship of the parties.** With respect to the relationship of the parties, the key factors include the actual intent of the parties with respect to how the worker is to be classified, as shown, for example, through the parties' contractual relationship, the employer filing Form 1099 information returns or W-2 employee wage statements with respect to the worker, and the employer providing (or not providing) the worker with benefits traditionally associated with employee status.²⁰ In this category, the extent to which the worker's services are a crucial aspect of the regular business of the employer will also be considered, with the IRS viewing services that are more heavily integrated into the employer's regular business as more likely to be controlled by the employer.²¹ The extent to which either party may terminate the relationship is also designated as a key factor in this category, but the IRS has recognized that the significance of this factor is often unclear and should be considered only with great caution.²²

Using these three categories as a guide, IRS auditors will examine the facts and circumstances of the relationship between workers and an employer to determine whether the workers are properly classified as either employees or independent contractors for federal employment tax purposes.²³ Before even starting this analysis, however, auditors should determine whether an employer is entitled to retain its workers' classification—proper or not under the general tax rules—under the section 530 safe harbor standard.

Section 530 rules Enacted in response to taxpayer complaints that the IRS was handling worker classification issues too aggressively,²⁴ section 530 provides that, for purposes of determining an employer's employment tax obligations, a worker "shall be deemed not to be an employee" of the employer if the employer meets each of the following three requirements:

- **Requirement 1: Reporting consistency.** The employer will satisfy the reporting consistency requirement if it filed all required federal tax returns with respect to the workers at issue in the audit,

including information returns such as Form 1099, on a basis consistent with the employer's treatment of the workers as non-employees.²⁵

- **Requirement 2: Substantive Consistency.** To satisfy the substantive consistency requirement, the employer must not only have consistently

The IRS's increased scrutiny on worker classification is due largely to the perceived effect of misclassification on the federal 'tax gap.'

treated the workers themselves as non-employees for employment taxes purposes, but the employer must not have treated any worker in a "substantially similar" position as an employee for employment taxes purposes.²⁶ For a substantially similar position to exist between workers, their job functions, duties, and responsibilities must be substantially similar, as well as their relationships with the employer.²⁷

- **Requirement 3: Reasonable Basis.** Finally, the employer will satisfy this third requirement if it had a reasonable basis for not treating the workers as employees.²⁸ In general, an employer will be treated as having a reasonable basis if such treatment was in reasonable reliance on industry practice, judicial precedent, published IRS rulings (or unpublished IRS rulings issued to that particular employer), or a prior IRS employment tax audit.²⁹ The employer may also be able to satisfy the requirement if it can demonstrate reasonable basis in some other manner. For example, if an employer made a reasonable effort to establish independent contractor treatment for its workers under the general tax rules, this may also provide a valid reasonable basis even if the IRS concludes that the employer's interpretation of the rules was wrong.³⁰ Note that this particular requirement is to be construed liberally in favor of the employer.³¹

If an employer meets each of these consistency and reasonableness requirements, section 530 will provide the employer with relief from employee tax obligations regardless of the employer's actual relationship with the workers as determined under the general tax rules.³² As

Incorporate for as little as **\$99**

Visit www.incorporate.com or call 800-624-6431

THE
COMPANY
CORPORATION[®]

INCORPORATING WHAT'S RIGHT FOR YOU

The main goal of the current audit program is to give the IRS a better understanding of the compliance characteristics of employment tax filers.

a result, in any worker classification audit, the IRS agent should explore the applicability of section 530, even if the employer itself does not claim entitlement to such relief.³³

Example of a recent successful worker classification audit

In a recent audit, an employer successfully demonstrated to the IRS that it was entitled to continue classifying its workers as independent contractors based on section 530 as well as the general tax rules. In this particular case, the employer had engaged both workers it classified as employees and workers it classified as independent contractors in the same general job category during the years in issue. (For purposes of this article, this group of employees and independent contractors will be referred to as the "Group 1" workers to distinguish them from a second group of workers, discussed below.)

Although the Group 1 workers all provided services in the same general job category, the Group 1 employees differed from the Group 1 independent contractors in several ways. For example, the employees were relatively less skilled workers who provided services integral to the employer's core business on a fairly predictable, day-to-day basis. The employees signed employment contracts, as well as non-compete agreements, and worked for the employer on an on-going, indefinite basis. Additionally, the employees could not refuse projects given by the employer and were provided with strict instruction and supervision with respect to both when and how they completed those projects.

The Group 1 independent contractors, on the other hand, were highly-skilled workers who provided services for the employer on unique, short-term projects. These workers, who held themselves out to the public as independent contractors, were also able to work for

others in the same industry while working for the employer. In further contrast to the Group 1 employees, the Group 1 independent contractors were also given only limited instruction with respect to their work, were rarely supervised, and could refuse projects outside the scope of their own work agreements. Accordingly, while both sets of workers in Group 1 provided services in the same general job category, due to these and other differences, the employer classified certain of these workers as employees and certain others as independent contractors.

Adding further complexity to the case, this employer had also engaged a small group of workers whose positions with the company changed such that the workers were classified as both independent contractors and employees during the years in issue (the "Group 2" workers). In general, these Group 2 workers had first provided consulting services for the employer on an independent contractor basis, similar to that described above. Then, due to the success of their initial efforts, the employer decided to integrate these workers' services more fully into its operations. As a result, the Group 2 workers' relationship with the employer changed to one more closely resembling that of the employees described above, and the workers generally received both Form 1099 information returns and Form W-2 employee wage statements for the period at issue.

Focusing on what made both the Group 1 workers and the Group 2 workers similar, namely, the overlaps in their job categories and classifications, rather than on the differences in the workers' relationships to the employer and the services they provided, the IRS became concerned that employees were being improperly classified as independent contractors with respect to either all or some of their services. Thus, the employer was selected for audit.

The IRS's initial review and proposal During the preliminary stages of the audit, the IRS auditor assigned to the case focused primarily on internal case building. For example, the agent reviewed the employer's Forms 941, as well as the Forms 1099 and the Forms W-2 that the employer had filed. The IRS auditor also reviewed Form SS-8 requests for determination of worker classification status, which had been filed by a small number of the employer's workers to assist in their determinations of their own employment tax obligations. Additionally, the IRS auditor reviewed samplings of various other employer documents, such as the

³³ IRS Training Materials, *supra* note 16 at 1-4. Although the IRS does not typically consider whether an employer has classified its workers properly under the general tax rules once it has determined the employer is entitled to section 530 relief, employers selected for audit under the Employment Tax National Research Project due to the program's data gathering goals may find that they are nevertheless subject to some scrutiny with respect to this question even when they are entitled to such relief. See Gardner, "IRS Examiners Will Continue NRP Audits Despite Section 530 Protection," *Pension & Benefits Daily* (6/30/10) (citing statements made by Janine Cook, Branch 1 Chief, Associate/Division Counsel (Tax-Exempt/Government Entities Divisions) during a 6/29/10 ABA-JCEB webcast).

independent contractor agreements and employment contracts the employer executed with its workers.

After completing an in-depth review of these documents, the IRS auditor proposed reclassifying all of the Group 1 independent contractors as employees. In support of this proposal, the auditor asserted both that the employer had failed the substantive consistency prong of section 530 because the employees and independent contractors were in substantially similar positions yet classified differently, and that the employer had behavioral and financial control over the independent contractors that required their reclassification as employees.

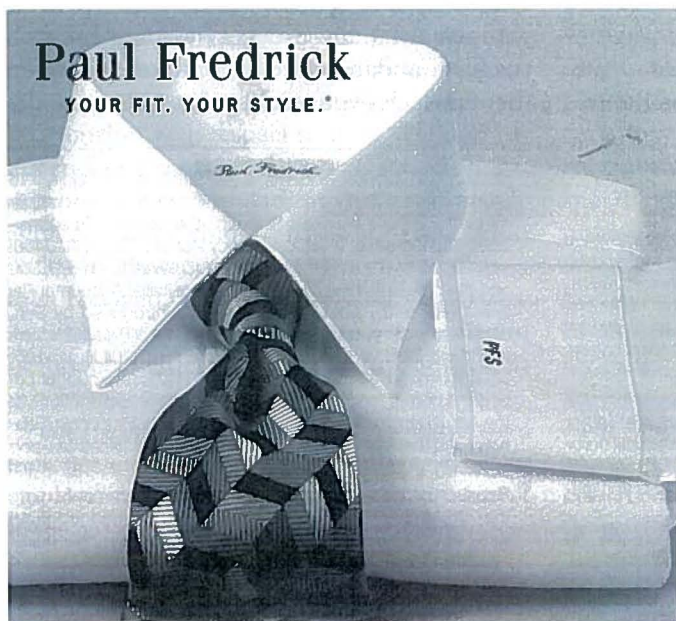
With respect to the Group 2 workers, the IRS auditor proposed reclassifying the workers' Form 1099 compensation as Form W-2 employee wages, so that the workers would be effectively classified as employees for the entire period at issue. In support of this proposal, the auditor asserted that the employer had failed both the reporting and the substantive consistency prongs of section 530 because individual workers had been treated as both non-employees and employees for tax purposes, and that the employer again had such behavioral and financial control over the workers at all times that their reclassification was required.

A successful response to the IRS Preparing a persuasive response to the IRS auditor's initial proposal required a fact-intensive approach. This

was both because of the inherently factual nature of the worker classification rules, and because the auditor made clear that the proposal would not be reconsidered unless the employer produced hard facts to support its workers' classifications. Accordingly, the next phase of the employer's case dug deep into the details of the workers' job duties and responsibilities and their relationships with the employer that had not been sufficiently revealed to the IRS by the auditor's internal case building.

To bring these details to light, the employer had interviews conducted with many representatives familiar with its operations, including in-house legal counsel, human resource and payroll department personnel, and supervisors, among others. These representatives were asked extensive questions based on the worker classification rules including, for example:

- Who could decide when and where the workers performed their services?
- Who could decide what tasks were performed and how those tasks were accomplished?
- What benefits, if any, did the employer provide to the workers?
- Did the employer or the workers bear the cost of the workers' expenses?
- Did the workers hold themselves out to the employer as independent contractors?
- Did the workers hold themselves out to other employers as independent contractors while working for the employer?
- How did the employer classify the workers for federal tax purposes?



Crisp, comfortable white 100% cotton pinpoint oxford dress shirts in **Regular, Big & Tall or Trim Fit** at a

SPECIAL INTRODUCTORY PRICE...

\$19.95

Reg. \$44.50-\$49.50

Plus, **FREE monogramming!** (an \$8.50 value)

Add this Silk Quilted Herringbone Tie for only \$19.95!
Item #THD1550 (Regularly \$49.50)

Specify promotional code **TZHSTA**
New customer offer. Limit four shirts per customer. Shipping charges extra.
Cannot be combined with other offers. **Free exchanges.**
Expires 12/31/10.

Order Today! Call **800-309-6000**
or visit **paulfredrick.com/special**

In any worker classification audit, the IRS agent should explore the applicability of section 530, even if the employer itself does not claim entitlement to such relief.

- What, if anything, did the employer rely on in making its classifications?
- How did the answers to each of these questions differ when the workers were classified as independent contractors and when the workers were classified as employees?

The representatives also were asked for any and all documentation that they could provide in support of their answers. By asking itself these hard questions, the employer was able to gather and assess the detailed facts, such as those described at the beginning of this section, which were available to support its classifications.

Once this information gathering process was complete, however, it was still critical that the employer provide the facts to the IRS auditor in a convincing manner. To do so, the employer first walked through the application of section 530 to the Group 1 independent contractors. (Remember that whether an employer is selected for audit under the IRS's general audit program or the Employment Tax National Research Project, an IRS worker classification auditor should determine whether the employer satisfies section 530 before attempting to determine if the employer's classification was proper under the general tax rules.)³⁴

The auditor did not contest that the employer satisfied the section 530 reporting consistency and reasonable basis requirements with respect to these independent contractors. Accordingly, as is often the case, the focus of the audit was on whether the employer had satisfied section 530's substantive consistency requirement with respect to the independent contractors, or more specifically, on whether the employer had consistently treated any workers in "substantially similar" positions to

the independent contractors as employees for employment taxes purposes.

To address the auditor's concerns, the employer provided specific evidence of how it satisfied this requirement. The employer did so primarily by demonstrating that, despite the fact the Group 1 independent contractors and the Group 1 employees shared the same general job category, the workers were not in substantially similar positions. For example, the employer highlighted that although these workers, as well as their respective work contracts, did share some superficial similarities by nature of the fact they shared the same job category, their differing responsibilities and relationships with respect to the employer precluded a finding of substantial similarity.³⁵ Pointing to particular facts and documentation such as supervisor statements, training manuals, and non-compete agreements to support its treatment of these workers, the employer established the disparities in the types of work the workers were required to provide, in their abilities to control when and how their work was done, in their abilities to turn down work and work for others while working for the employer, and in a number of the other control and relationship factors generally used to determine whether a common law employer-employee relationship exists.

By providing these kinds of specific details with respect to the Group 1 workers' responsibilities and relationships, the employer was able to demonstrate to the IRS auditor that the employer satisfied the substantive consistency requirement and was entitled to section 530 relief with respect to the Group 1 independent contractors—and therefore, to continue classifying them as such. As a result, it was not necessary

³⁴ *Id.*

³⁵ See *supra* notes 26-27 and accompanying text.

³⁶ Note that if a worker performs services for an employer in two legitimately separate capacities, that fact in and of itself will not cause the employer to fail the consistency requirements of section 530. See, e.g., IRS Training Materials, *supra* note 16 at 1-12. In this case, however, certain clerical errors were made with respect to the dual-capacity workers, which did cause the employer to fail these requirements.

³⁷ Remember, however, when an employer is selected for audit under the Employment Tax National Research Project rather than the IRS's general audit program, the IRS may still scrutinize whether the employer's classification satisfies the general tax rules even in clear-cut cases of section 530 applicability. See *supra* note 33.

³⁸ Although section 530 has been in existence for more than 30 years, note that recent executive and legislative proposals have been introduced that would significantly curtail, if not eliminate, the relief available under the section. Accordingly, even those employers who are certain they meet the current

section 530 requirements might in the future be required to demonstrate that their worker classification is also proper under the general tax rules. See, e.g., the Taxpayer Responsibility, Accountability and Consistency Act of 2009 (H.R. 3408) introduced by Rep. Jim McDermott (D.-Wash.) on 7/30/09 and the corresponding Taxpayer Responsibility, Accountability and Consistency Act of 2009 (S. 2882) introduced by Sen. John Kerry (D.-Mass.) on 12/15/09. See also Pres. Obama's proposed Budget of the U.S. Government (2011), p. 100, www.whitehouse.gov/omb/budget/fy2011/assets/budget.pdf and the corresponding U.S. Treasury General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals (February 2010), pp. 107-109, www.treas.gov/offices/tax-policy/library/greenbk10.pdf.

³⁹ Because of the persuasive power of such documents, note that the employer should not wait until it is engaged in an audit to consider how these documents reflect its workers' classifications. Instead, these documents should be drafted to demonstrate that the employer cannot and does not exercise control over its independent contractors that would give rise to an employer-employee relationship.

for the employer to demonstrate that it was also entitled to continue classifying these workers as independent contractors under the general tax rules.

With respect to the Group 2 workers, the challenge was different. Because the employer had not consistently treated these workers as non-employees in the manner required for section 530 relief, the IRS auditor was correct that the section 530 safe harbor did not apply.³⁶ Consequently, it was necessary to show that when the employer had treated these workers as independent contractors, the employer had been justified under the general tax rules.

While a different legal argument was needed to justify the employer's classification with respect to this group, however, the employer used similarly specific factual evidence to demonstrate to the auditor that the classification of the Group 2 workers had been correct. For example, here, the employer was able to point to the independent contractor agreements the workers had signed as evidence that the parties intended a non-employee relationship with respect to the services covered by those agreements. The employer also pointed to the contracts, payroll records, human resource records, and other information yielded during the interview process, to show that it had generally placed no restrictions on how the tasks assigned to these workers in their independent contractor capacity were performed (and had no right to do so), had provided no benefits to the workers in their independent contractor capacity, had not reimbursed the workers for their expenses while working as independent contractors, and had otherwise failed to exercise the behavioral and financial control required for a showing of an employer-employee relationship with respect to these workers' independently contracted services. Based on this demonstration, the auditor again ultimately agreed that the employer was not required to reclassify these workers, or the compensation they received, with respect to these services. Accordingly, the employer's case was closed and no further settlement negotiations or appeals processes were required.

What can employers selected for audit learn from this example? Once the IRS has selected an employer for a worker classification audit, except in the most clear-cut cases of section 530 applica-

bility, the auditor will be guided by the basic question of whether that employer has classified its workers properly under the general tax rules.³⁷ Because of this, and the overlap in the kinds of facts needed to show that the employer's classification is permitted under either section 530 or the general tax rules, an employer selected for audit will want to be able to demonstrate, to the extent possible, that it is entitled to retain its workers' classification under both sets of rules.³⁸

To make these demonstrations, the employer will need to engage in an intensive fact gathering process. Because the IRS auditor will require specific facts in support of the employer's classification of its workers, but the auditor's internal case building may not bring all such salient facts to light, this process should include document gathering as well as interviews of employer representatives. For example, the employer should arm itself not only with its tax and payroll records, but with any applicable work contracts, non-compete agreements, training manuals, handbooks, etc.³⁹ Additionally, members of the human resources and payroll department could and should be interviewed, as well as worker supervisors, and even the workers themselves (or a sampling thereof) if needed.

Throughout this process, the employer should also attempt to apply the data it collects to the section 530 requirements and general tax factors to help ensure that the appropriate kinds of information are being gathered. By doing so, the employer can also be more confident that the information will be presented to the IRS auditor in a meaningful and persuasive way. This is important because a "data dump" alone will likely be insufficient to convince an auditor that the worker classification rules have been applied properly. Instead, the auditor will want to see specifically how the employer meets (or does not meet) each of the worker classification rules. As a result, an employer familiar with both the details of its own worker classification process *and* the section 530 and general tax rules can be in the best position to show an IRS auditor how the employer satisfies each applicable requirement—and, correspondingly, how the employer who has properly classified its workers is entitled to retain those classifications. ■