EMPLOYMENT STATUS HOTLINE

How to Handle Independent Contractor Audit

A Six-Step Program for Beating A Huge Bill from the IRS

Michael Knight
Michael J. Knight & Co., CPAs

The employment status of workers hired as independent contractors remains one of the hottest areas of conflict between businesses and the IRS—with the IRS often arguing that such workers are in fact employees, for whom back employment taxes are owed.

Good news: New IRS rules are designed to help resolve these disputes more quickly and at less cost. The 1996 legislation shifts the burden of proof *to the IRS* in many employment-status disputes.

Here's how to best take advantage of the new rules and new law, to speed an employment-status dispute to the best possible resolution.

audit steps

Prepare for a worker-status audit by viewing it as a six-step process. I call this the hierarchy of proof. *Here are strategies to use at each of the six steps...*

•**Obtain "Section 530" notification.** The so-called Section 530 rules specify *safe-harbor defenses* that an employer can rely upon to defend the status of workers hired on a contract basis.

The *Small Business Job Protection Act* requires that employers be provided written notice of these rules, which are explained in IRS Publication No. 1976, entitled *Independent Contractor or Employee?*, at the start of an employment-tax audit.

Section 530 provides that contractor status will be upheld if the employer...

□ Filed all required 1099 forms for all contractors.

□ Was consistent in its practices—by treating persons doing the same work in the same manner, following consistent practices over time, etc.

□ Had a reasonable basis for treating its workers as contractors—such as by following a recognized industry practice.

Be sure to obtain IRS Publication No. 1976 at the beginning of the audit process and become entirely familiar with the Section 530 rules. If the IRS does not send you a copy of Publication No. 1976, ask for one—or obtain your own copy by calling 1-800-TAX-FORM, or by downloading it from the IRS Web site at http://www.irs.ustreas.gov/plain/bus_info/index.html.

•**Use the Classification Settlement Program.** To expedite employment tax audits, the IRS has established a new *Classification Settlement Program* (CSP) that authorizes auditors to settle these disputes.

This is a significant innovation, because in most other tax matters auditors do not have the authority to settle a dispute—they are restricted to determining

Tax Hotline interviewed Michael J. Knight, CPA, of Michael J. Knight & Co., CPAs, 116 Sherman St., Fairfield, Connecticut 06430. *Web address:* http://www.mjkcpa.com.

that either a tax liability exists or does not exist.

Under the CSP, the auditor examines whether the company satisfies the conditions of Section 530. *If the answer is...*

□ ***Yes:*** The company escapes taxes.

□ ***No:*** The auditor will assess one year of back taxes as being due.

□ ***Unclear:*** The auditor will assess a reduced penalty of 25% of one year's back taxes.

At this point you can accept the auditor's findings and settle the case—perhaps for the compromise 25% amount. Or, contest the findings and move on to the next stage of fighting the tax bill—the Appeals Division of the IRS and/or the courts.

•**Shift the burden of proof to the IRS.** If an acceptable settlement isn't reached through the CSP, the next step is to shift the burden of proof in the dispute to the IRS.

Key: New law provisions adopted in the *Small Business Jobs Protection Act of 1996* provide that an employer need make only a "prima facie" case in support of contractor status to place the burden of proof in the dispute on the IRS.

This is a significant benefit for the taxpayer, because after the burden of proof is shifted, it is assumed that the taxpayer's position is correct, and it is up to the IRS to prove otherwise—instead of the other way around, as it was under prior law.

A prima facie case is the lowest standard of proof used in the justice system, merely a "colorable argument."

Example: A company shows that it has satisfied two of the three conditions of Section 530 by filing all 1099s and treating its workers consistently. But it doesn't have any documentation showing that it has followed a recognized industry practice. Instead, it says it has followed oral advice received from persons in the industry on the matter.

This is a "colorable argument" sufficient to place the burden of proof on the IRS to show that the company has not followed a recognized industry practice.

Key: At the first sign of a dispute with the IRS, pull together the strongest arguments possible to defend your position and shift the burden of proof.

•**Use IRS training materials.** To learn the most persuasive arguments to use with the auditor, review the IRS's own training materials, which it uses to instruct its auditors on how to manage worker-status examinations.

Key: As the IRS has overhauled its approach to worker-status disputes, it has produced a new training program for its auditors who handle these examinations. These new training materials are available to the public.

The training materials can be a big help to a business. They enable it to anticipate and understand the auditor's likely approach to the audit. Companies that use the training materials are better prepared to answer the questions that may arise during an audit.

The IRS worker-status audit training program materials can be obtained from the IRS Web site at http://www.irs.ustreas.gov/plain/bus_info/training.html.

•**Make an early request for appeal.** In spite of all efforts to shift the burden of proof to the IRS, and to make best use of IRS training materials, the auditor may still stick to an unreasonable position.

In fact, in some cases auditors may not even follow the IRS's own new rules and procedures in employment-tax cases. Some auditors still haven't taken the IRS's new training program, and for some other auditors the IRS's new rules may not have yet "sunk in."

In such a case you have the right to take your case to the IRS *Appeals Division.*

In fact, the IRS says that it *expects* taxpayers to make early referrals of worker-status disputes to Appeals under its new rules for such cases. ("Early" means at any point in the process of an employment-status dispute.) It is recommended that this procedure be used as early as possible if a dispute arises. The early referral process is an expedited method that Appeals uses to resolve the worker classification controversy.

Main point: The Tax Court must take a "de novo"—i.e., brand new—look at the case. It is not just an administrative review of what the examiner thinks, but a whole fresh start to the process.

At the Appeals Division you will deal with more experienced IRS agents who are fully informed of the IRS's new approach to worker-status cases. IRS Appeals Officers

also have more leeway than auditors in settling cases—it's their job to settle cases in light of the "hazards of litigation" that ensue if a case proceeds to court.

•**Go to Tax Court.** If you are unable to resolve your case even at the Appeals Division, you have the right to take your case to court.

New: The recently enacted *Taxpayer Relief Act of 1997* creates a new right to take employment-status cases to *Tax Court.*

Until now, these cases were heard in a Federal District Court. *The difference...*

□ You can file a case in Tax Court without paying the disputed tax, and your case will be decided by a judge who is a tax specialist.

□ To file in a Federal District Court you must first pay at least part of the disputed tax and then sue for a refund. The judge probably will be a "generalist," and you may be entitled to a jury trial.

Whether the Tax Court option will offer practical advantages that cause it to become attractive for settling worker-status disputes is yet to be determined.

But it can't hurt to have an extra choice of legal venue.

best strategy

The *best* strategy for employment tax disputes is to head them off before they arise and put your reasons down for independent contractor status in writing. You should also have a written agreement between you and the independent contractor.

To do this, obtain copies of IRS Publication 1976 and the new IRS training materials now, and review them in light of your business practices.

Take steps right away to assure that all workers who are treated as employees actually qualify as such, or that they will qualify under the Section 530 safe harbor provisions—for instance, that all 1099 returns are being properly filed, and that the business's justification for treating workers as contractors has contemporaneous documentary support. **TH**