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Tax Audits

As the Internal Revenue Service works to recoup \$72 billion in unreported and unpaid payroll taxes, IRS employment tax auditors are targeting errors made by businesses on when and how to withhold and pay federal income tax, as well as FICA and FUTA taxes on employee wages. This article by Ruth Wimer and Jeffrey M. Holdvogt of McDermott Will & Emery LLP examines two important reporting issues: application of the FICA and FUTA wage bases to employees at multiple legal entities and proper classification of workers as common law employees rather than independent contractors.

IRS Payroll Tax Audits Highlight Importance of Proper Payroll Tax Reporting

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A recent Treasury Inspector General for Tax Administration report indicated that more than \$72 billion attributable to payroll taxes are unreported and unpaid to the IRS.¹ To recoup some of this revenue, specially trained IRS employment tax auditors are targeting errors made by businesses on when and how to withhold and pay federal income tax, as well as Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes on employee wages. An employer that fails to properly withhold taxes becomes liable for the full amount of taxes not withheld, plus interest and penalties. This article highlights two important payroll tax reporting issues that have been the focus of IRS audit attention: the application of the FICA and FUTA wage bases to employees at multiple legal entities and the proper classification of workers as com-

¹ Department of the Treasury Memorandum for Office of the Deputy Commissioner for Services and Enforcement, July 3, 2014, available at <http://www.treasury.gov/tigta/auditreports/2014reports/201410012fr.pdf>. TIGTA reported a net tax gap of \$385 billion for the most recently available data, with \$72 billion attributable to payroll tax not reported and paid.

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I. Payroll Tax Reporting And the FICA and FUTA Wage Bases

Employers generally must withhold payroll taxes (FICA, Medicare and FUTA) from employees' wages. The FICA Social Security tax must be withheld at the rate of 6.2 percent, but is only imposed on wages up to a certain amount, referred to as the Social Security wage base or simply the "wage base." Once an employee earns wages in excess of the Social Security wage base (\$117,000 in 2014), wages are no longer subject to the Social Security tax. Similarly, the 6 percent FUTA tax is only paid by an employer on the first \$7,000 of wages paid to an employee.²

As a general rule, the wage base is applied separately among legal entities based on the common law employer. The recent *Cencast* case reverberated through the payroll community because it confirmed this general rule: the amount of taxes owed is determined on the common law employer level.³

In *Cencast*, the Federal Circuit Court of Appeals held that a payroll service provider that computed and paid compensation to motion picture production workers couldn't reduce the scope of FICA and FUTA employment taxes by utilizing a single FICA and FUTA wage base cap for all employees for which it provided payroll services. Instead, the court held that FICA and FUTA must be calculated based on the employees' relationship with their common law employers, i.e., the production companies that hired and supervised them. As a result, the court required separate application of the FICA and FUTA wage base because the employees worked for different common law employers.

A recurring payroll tax issue for employers is whether the employer must restart the \$117,000 Social Security and \$7,000 FUTA wage bases if an employee moves among separate related employers. Even though movement among related employers generally causes a restart of the FICA and FUTA wages bases, there are at least three restart exceptions: certain concurrent employees, transferred employees in acquisitions and leased employees.

A. Payroll Tax Reporting for Concurrent Employees. The first payroll exception where a single FICA and FUTA wage base is permitted occurs when an employer complies with the "common paymaster" provisions of the Internal Revenue Code of 1986, as amended (the "Code").⁴ The common paymaster provisions allow certain types of related companies to use a single wage base for FICA and FUTA purposes for individuals employed concurrently by more than one company.⁵ These provisions apply only where two or more related com-

panies employ the same person concurrently, and where only one of the companies pays that person. In this case, the company that disburses compensation to employees of two or more of those corporations, and that is responsible for keeping records for those employees' payroll, is referred to as the "common paymaster." Where a corporation qualifies as a common paymaster, it may use an agent to perform its payroll functions.⁶

As an example, assume Parent Z, Sub 1, Sub 2, Sub 3 and Sub 4 are related corporations with 100 employees collectively. Of these employees, 30 are concurrently employed by two or more of the corporations, during a calendar quarter. The four corporations arrange for Parent Z to disburse compensation to 25 of 30 concurrently employed individuals. Under these facts, Parent Z is the common paymaster only with respect to the 25 employees.

The related entities with concurrent employees must be corporations, including associations, joint-stock companies and insurance companies.⁷

A business entity organized under a federal or state statute can also be a concurrent and related employer, if the statute refers to the entity as incorporated or as a corporation.⁸

Corporations are considered related corporations if they satisfy one of four tests: (1) the corporations are members of a controlled group of corporations generally related through 50 percent common ownership; (2) in the case of a corporation that doesn't issue stock, either 50 percent or more of the members of one corporation's board of directors (or other governing body) are members of the other corporation's board of directors, or the holders of 50 percent or more of the voting power to select such members are concurrently the holders of 50 percent or more of that power with respect to the other corporation; (3) where 50 percent or more of one corporation's officers are concurrently officers of the other corporation; or (4) where 30 percent or more of one corporation's employees are concurrently employees of the other corporation.⁹

Misclassification of workers as independent contractors is a major focus of IRS attention, but the IRS provides several forgiveness programs.

To apply a single FICA/FUTA wage base, employees also must be concurrently employed. The term "concurrent employment" means the contemporaneous existence of an employment relationship (within the meaning of Section 3121(b) of the Code) between an individual and two or more corporations. Such a relationship contemplates the performance of services

amounts actually disbursed by it to such individual and shall not be considered to have paid as remuneration to the individual amounts actually disbursed to the individual by another of the corporations.

⁶ Treasury Regulations Section 31.3121(s)-1(a).

⁷ Treas. Reg. Section 301.7701-2(b).

⁸ Treas. Reg. Section 301.7701-2(b)(1).

⁹ Treas. Reg. Section 31.3121(s)-1(b)(1).

² In contrast, the Medicare tax is paid on all wages without limit.

³ *Cencast Services, L.P. v. United States*, 112 AFTR 2d 2013-6029 (Fed. Cir. 2013).

⁴ Internal Revenue Code Sections 3121(s) and 3306(p).

⁵ I.R.C. Section 3121(s) provides that, for purposes of Sections 3102, 3111 and 3121(a)(1), if two or more related corporations concurrently employ the same individual and compensate that individual through a common paymaster that is one of the corporations, each such corporation shall be considered to have paid as remuneration to such individual only the

by the employee for the benefit of the employing corporation (not merely for the benefit of the group of corporations), in exchange for remuneration which, if deductible for the purposes of federal income tax, would be deductible by the employing corporation.¹⁰

As an example, assume M, N and O are related corporations that use N as a common paymaster with respect to their officers. Their respective headquarters are located in three separate cities several hundred miles apart. A is an officer of M, N and O who performs substantial services for each corporation. A doesn't work a set length of time at each corporate headquarters, and when A leaves one corporate headquarters, it isn't known when A will return, although it is expected that A will return. Under these facts, A is concurrently employed by the three corporations.

It is crucial that employers understand the common paymaster exception to avoid restarting the \$117,000 FICA and \$7,000 FUTA wages. Many controlled groups of companies use a common paymaster to disburse payroll to employees of the related companies. Unfortunately, many of these employers don't satisfy all of the strict common paymaster requirements that allow application of a single wage base, and therefore must restart the wage base when employees move from one entity to another during the year, unless these controlled group employers meet the successor employer rules discussed below.

B. Payroll Tax Reporting Following Transactions (Acquisitions and Dispositions). Another common issue for employers is whether to restart the \$117,000 Social Security and \$7,000 FUTA wage bases following a transaction. In a stock acquisition or disposition, where one company purchases the stock of a second company and the second company becomes a subsidiary of the purchaser, the acquired/disposed legal entity remains intact and FICA and FUTA withholding shouldn't be disrupted.

Administrative complications can arise, however, when the stock transaction involves a subsidiary, but the parent (or an outside vendor through the parent's contract) maintained payroll and won't transfer payroll as part of the acquisition/disposition. Again, however, if there is no change in employment status the employer would not restart the wage bases with respect to the employee.

In the case of an asset transaction, where one entity purchases the assets of a company, but not the entire legal entity, the situation is different. The \$117,000 Social Security and \$7,000 FUTA wage bases may continue, but only if the "successor" employer rules are met. The successor employer rules allow the second employer during the course of a taxable year to count the wages paid by the prior employer in determining FICA and FUTA obligations. Like the common paymaster rules, the successor employer rules have a three-part test:

- The successor during a calendar year must acquire substantially all the property used in a trade or business or used in a separate unit of a trade or business.¹¹ This includes all the property used in the performance of an essential operation of the trade or business, or may consist of substantially all the property

used in a relatively self-sustaining entity which forms a part of the trade or business. If a successor employer acquires the use of property used by a predecessor employer in an essential operation of the trade or business, it is immaterial that the successor employer didn't acquire an interest in the property.¹²

- The employee for whom the successor employer rules would be applied must be employed in the trade or business of the predecessor immediately prior to the acquisition and be employed by the successor in its trade or business immediately after the acquisition.

- The wages paid by the prior employer must be paid during the calendar year in which the acquisition occurred and prior to the acquisition for the successor employer to count the wages paid by the prior employer in determining FICA and FUTA obligations.

If these three requirements are met, the employer doesn't need to restart the \$117,000 Social Security and \$7,000 FUTA wage basis following a transaction.¹³

C. Payroll Tax Reporting For Leased Employees. A third situation where employers can avoid restarting the \$117,000 Social Security and \$7,000 FUTA wage bases can occur with leased employees. When there are leased employees, one wage base generally applies because only one legal entity is actually the "common law" employer of the "leased" employees who move among legal entities to provide services.

The IRS has consistently interpreted the FICA and FUTA wage base calculations to apply to common law employers, regardless of which entity actually paid the employee's wages. The difficulty, of course, is determining whether there is in fact just one legal entity that is the common law employer. Leasing companies, professional service organizations and payroll services companies each may be the common law employer of the employees for which the payroll and administrative services are provided. However, the trend is for these organizations to not be viewed as the common law employer.¹⁴

The determination of common law employer status is based on all the facts and circumstances. The IRS has stated:

*"[g]enerally, such relationship exists when the person for whom the services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an 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. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he or she has the right to do so."*¹⁵

As a result, for employers with leased employees it is crucial to determine who the common law employer is.

¹² See Rev. Rul. 72-269, 1972-1 C.B. 313, where the successor employer obtained from the predecessor employer, by means of a subcontract, the use of government-owned property.

¹³ In our experience, the IRS typically has been flexible in applying these rules to asset acquisitions.

¹⁴ See Rev. Proc. 2002-21, 2001-1 C.B. 911, where the PEO must treat the benefit plans as multiemployer plans.

¹⁵ Chief Counsel Advice 200017041 (April 28, 2000), citing Treas. Reg. Section 31.3121(d)-1(c)(2), and referencing Treas. Reg. Sections 31.3306(i)(b)-1(b) and 31.3401(c)-1(b).

¹⁰ Treas. Reg. Section 31.3121(s)-1(b)(3).

¹¹ Treas. Reg. Section 31.3306(b)(1)-1(b)(4).

The challenge for leasing organizations is to be able to show that they have control or the legal ability to exercise control over the day-to-day activities of the leased employee.

II. Payroll Tax Reporting For Independent Contractors

Generally, workers are classified as either common law employees or independent contractors for employment tax purposes.¹⁶

Employee remuneration is reported on Form W-2, Wage and Tax Statement, and is subject to withholding for federal income and FICA taxes and employer liability for FICA and FUTA taxes. In contrast, independent contractor remuneration is reported on Form 1099-MISC and isn't subject to withholding.

Naturally, the IRS is very inclined to impose common law employee status on workers wherever possible and has had great success in recent years in getting employers to switch their workers' classification.

Although there are many established factors that determine whether a worker is an employee or independent contractor,¹⁷ essentially if the service recipient has the right to determine both the manner and method of the tasks performed, then the individual is an employee.

However, if the individual has formed his own professional corporation or separately formed legal entity, then the presumption swings the other way and that separate employer and corporate form is likely to be respected,¹⁸ leaving the service recipient "off the hook" for employment tax duties. Nonetheless, even if an individual forms his own legal entity to provide services, officers of a service recipient are by statute considered employees.

If an employee is misclassified by an employer as an independent contractor, penalties may be assessed by the IRS. The penalties vary depending on whether the misclassification was willful or not, and if not willful, whether proper returns were filed.

In the case of honest mistakes where the employer filed Forms 1099-MISC, Miscellaneous Income, the penalty will equal 1.5 percent of wages paid to the employee, plus 20 percent of the amount that should have been withheld for Social Security and Medicare tax from the employee, plus 100 percent of the employer's share of Social Security and Medicare tax (the employer "match").

¹⁶ In addition to employment tax liability regarding worker classification, there are labor and employment law, employee benefits, worker's compensation, unemployment insurance, and state income tax and unemployment legal issues.

¹⁷ I.R.C. Section 3121(d)(2) defines "employee" only for Social Security and Medicare tax purposes as "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee." The U.S. Supreme Court has cited selected factors that suggest whether an individual should be classified as an "employee," for employment tax purposes. See *Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318, 323-24 (1992). Rev. Rul. 87-41, 1987-1 C.B. 296, lists 20 common law factors that the courts and the IRS generally consider in classifying a worker as an employee or independent contractor.

¹⁸ See *Sargent v. Commissioner*, 929 F.2d 1252 (8th Cir. 1991).

If the mistake wasn't willful but Forms 1099-MISC weren't filed, the 1.5 percent and 20 percent penalties are doubled, and the 100 percent match remains.

If the employer willfully misclassified the worker, the penalties will be equal to the full amount of taxes that should have been withheld (income, Social Security, Medicare and the additional employee portion of these taxes). The IRS may assess this penalty simultaneously on the company and on its officers personally, if they are deemed to be responsible. Additional fines related to the failure to file required tax reporting forms and the failure to pay required employment taxes may result, as well as interest on the balance due.

Misclassification of workers as independent contractors rather than employees is a major focus of IRS attention, but fortunately the IRS has seen fit to provide several forgiveness programs. First, the IRS will examine whether relief under Section 530 of the Revenue Act of 1978 ("Section 530") is available, which would permit the employer to escape penalties altogether. Section 530 prevents the IRS from retroactively reclassifying independent contractors as employees if the organization meets each of the following tests:

- **Reasonable Basis Test.** This test determines whether the entity's classification as an independent contractor was reasonable, by determining whether the organization relied upon: (1) case law, published IRS guidance or a private letter ruling issued to the business; (2) a previous IRS audit (for audits in 1997 or later, the audit must have included an examination of the worker classification of substantially similar workers); or (3) established industry practice.

- **Position or "Consistency" Test.** This test assesses whether the independent contractor classification has been consistently utilized by the entity. Under this test, individuals holding substantially similar positions with the business, as well as its predecessors, must have been consistently treated as independent contractors.

- **Tax Return Test.** This test determines whether tax reporting has been consistent with the independent contractor classification. Under this test, the organization must have filed information returns (IRS Forms 1099-MISC, Box 7) reporting remuneration as "nonemployee compensation."

In addition to Section 530 relief, the IRS has implemented a Voluntary Classification Settlement Program, where the employer will agree to prospectively treat the class or classes of workers as employees for future tax periods. The employer files Form 8952, Application for Voluntary Classification Settlement Program (VCSP), with the IRS. In exchange, the taxpayer will:

- pay 10 percent of the employment tax liability that would have been due on compensation paid to the workers for the most recent tax year, determined under the reduced rates of tax code Section 3509(a);

- not be liable for any interest and penalties on the amount; and

- not be subject to an employment tax audit with respect to the worker classification of the workers being reclassified under the VCSP for prior years.

The VCSP, however, has recently come under scrutiny from TIGTA. In a report released Sept. 24, 2014, TIGTA concluded that, although well-intentioned, the

IRS fails to collect worker information that would make the VCSP application process easy, quick and inclusive for employers to encourage them to voluntarily enter in to the program.¹⁹ The IRS has stated that it intends to improve the VCSP by March 15, 2015.

In summary, the IRS generally presumes workers are employees rather than independent contractors. Employers that think they have made an error should explore Section 530 relief and the VCSP program.

¹⁹ TIGTA: Better Worker Identification Data Are Needed For the Voluntary Classification Settlement Program, Sept. 24, 2014, available at http://www.treasury.gov/tigta/press/press_tigta-2014-22.htm.

III. Conclusion

The IRS is focused on payroll tax issues and is seeking to recoup what it considers to be lost revenue attributable to payroll taxes that are unreported and unpaid. As described in this article, employers should review their payroll tax processes to make sure they comply with requirements with respect to the payroll tax wage bases and independent contractor status. An employer that fails to properly withhold taxes becomes liable for the full amount of taxes not withheld, plus interest and penalties.