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IRS Employment Tax Audits: Spotlight on Worker Classification and Deferred Compensation Arrangements

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The Internal Revenue Service's employment tax National Research Project is currently underway with 2,000 audit letters already in the hands of various corporate, tax-exempt and governmental entities and a second wave of audit letters likely to arrive in mailboxes later this year. While the audits will be comprehensive in scope, the IRS has identified the following issues for particular focus: worker classification, fringe benefits, payroll tax reporting and executive compensation. This advisory focuses on deferred compensation payable to independent contractors. To be prepared for such audits, companies should review the deferred compensation rules under Internal Revenue Code (the "Code") section 409A as they apply to workers classified as independent contractors.

Code section 409A

Code section 409A was enacted in 2004 as a broad-based statutory reform of the taxation of nonqualified deferred compensation. Deferred compensation is any compensation earned in one taxable year by the "service provider,"[1] which is or may be payable in a later taxable year. While deferred compensation arrangements are more likely in the context of employer/employee relationships with executives and upper-level management, independent contractors may have deferred compensation arrangements in connection with payments that are contingent on successful completion of a particular project or task, or the company hitting certain targets and benchmarks.

[1] A "service provider" who is an independent contractor subject to Code section 409A can be an individual as well as a corporation, S corporation, partnership or personal services corporation.

All deferred compensation subject to 409A had to meet the documentary and operational rules set forth in final regulations by December 31, 2008. Failure to adhere to these comprehensive rules can result in severe penalties to the service provider (i.e., the independent contractor or employee)—the amount in violation is subject to immediate taxation, a 20% additional tax and interest at 1% above the underpayment rate. For the employing entity, such violation may result in failed reporting and withholding obligations on the deferred amounts.

In connection with the employment tax audits, the IRS is likely to scrutinize any deferred compensation arrangement that may be subject to Code section 409A to determine if it complies with the final regulations or has been properly corrected in accordance with the recently issued IRS Notice 2010-6.

Independent Contractors & 409A

Due to the exemption discussed below, Code section 409A may not apply to many deferred compensation arrangements with current independent contractors; however, such relationships and arrangements should be reviewed to ensure that this general exemption from 409A applies and that the worker has been properly classified.

Unrelated Services Exemption. A deferred compensation arrangement between an independent contractor and an "unrelated"[2] service recipient is exempt from 409A if during the taxable year in which the independent contractor obtains a legally binding right to the compensation (i.e., the year of deferral), the independent contractor:

- is actively engaged in the trade or business of providing services (excluding services as an employee, director or any management services[3]); and
- provides "significant services" to two or more service recipients that are not related to each other or to the independent contractor.

Significant Services. The determination of whether the independent contractor has provided "significant services" to two or more service recipients is based on a facts and circumstances test. However, the 409A regulations provide a safe harbor if the revenues generated from services by the independent contractor to any service recipient (or group of related service recipients) does not exceed 70% of the total revenues generated by the independent contractor for providing such services. Additionally, the regulations provide for a look-back safe harbor if the independent contractor meets this 70% safe harbor test for at least three consecutive years. Such an independent contractor will be deemed to meet the 70% safe harbor for the current year as long as the independent contractor did not know or have reason to anticipate that the 70% safe harbor would not be met for the current taxable year.

All arrangements with unrelated independent contractors should be reviewed now to determine whether the "significant services" requirement is met and whether the independent contractor is providing such services to two or more unrelated service recipients. If these requirements are not met, the deferred compensation arrangement is subject to all the documentary and operational requirements of Code section 409A.

[2] For purposes of the 409A regulations, a person is "related" if the relationship tests under Code sections 267(b) or 707(b)(1) are met, except that a 20% test is used in lieu of the 50% test.

[3] If the independent contractor is performing "management services," any deferred compensation connected to such management services will not qualify for the exemption under 409A. Management services includes any "actual or de facto direction or control of the financial or operational aspects of the trade or business of the service recipient, or investment management or advisory services provided to a service recipient whose primary trade or business includes the investment of financial assets, such as a hedge fund or real estate investment trust."

Related Services. If the independent contractor has entered into a deferred compensation arrangement with a "related" service recipient, the arrangement will be exempt from 409A only if:

1. the service provider is properly performing services as an independent contractor (i.e., the service provider can not actually be classified as an employee);

2. the independent contractor otherwise qualifies for the 70% safe harbor described above (i.e., the independent contractor provides services for at least two unrelated service recipients (in addition to the related service recipient) and meets the 70% revenue threshold);

3. the deferred compensation arrangement is a "bona fide agreement, method, program or other arrangement" that arose in the ordinary course of the independent contractor's trade or business; and

4. the arrangement (and its corresponding practices, such as billing and collection practices) is substantially similar to arrangements with unrelated services recipients to whom the independent contractor provides "substantial services" and that produce a majority of the total revenue the independent contractor earns that year in the corresponding trade or business.

Therefore, among other requirements, any independent contractor arrangement with a related party must be properly classified as such and cannot constitute a majority of the independent contractor's revenue for the taxable year. Employers should review such arrangements now to ensure that the classification of any independent contractor is appropriate and the other requirements are met; otherwise, the arrangement is subject to all the requirements of Code section 409A.

Worker Classification Changes & 409A

At times, an independent contractor arrangement may end because the individual becomes an employee of the service recipient, or an employee may terminate from employment and begin providing independent contractor services to the former employer. These changes in worker classification may affect any prior or new deferred compensation arrangements and implicate whether 409A applies to such arrangements. This makes proper worker classification and compliance with the independent contractor exemptions from 409A critically important in determining the taxation of deferred compensation arrangements.

If a deferred compensation arrangement properly qualifies for the exemption from 409A, then the deferred amounts under that arrangement will not become subject to 409A in a later year if the independent contractor becomes an employee or contractor that is subject to 409A. For example, if a bona fide independent contractor who meets the 70% safe harbor enters into a deferred compensation arrangement in 2010, the amount deferred in 2010 will not later become subject to 409A rules because the independent contractor becomes an employee of the service recipient in 2012. Thus, provided that the arrangement was properly exempt from 409A in the year of deferral, it will not become subject to 409A merely because the independent contractor becomes an employee or no longer meets the 409A exemption rules in a later year; however, any new deferrals may not qualify for the independent contractor exemption from 409A.

However, an employee often will retire or be laid off, but immediately be rehired as an independent contractor of the service recipient. In this event, the individual will not be deemed to have a "separation from service" (for the purposes of determining whether any payment under a deferred compensation arrangement subject to 409A is made due to a separation from service that meets the 409A requirements) until the individual has separated from both the employee and independent contractor relationships. This means

that proper worker classifications and understanding what a "separation from service" means for both classifications under the 409A regulations is key before any deferred compensation payment is made to such individual.

Next Steps

In light of the IRS's current focus on employment tax issues, including deferred compensation and worker classifications, companies should review (i) all independent contractor arrangements to ensure that such classification is proper and (ii) all deferred compensation arrangements to determine whether the arrangement is truly exempt from 409A or must meet the documentary and operational requirements of 409A. If the independent contractor exemption does not apply, any deferred compensation arrangement must be corrected under the available corrections programs and brought into compliance with 409A.

Pillsbury has created an Employment Tax Audit Task Force to focus on the IRS's Employment Tax National Research Project, and related tax, executive benefits, and employment law issues. This advisory is one in a series of publications being issued by our Task Force.

If you have any questions regarding this advisory, please contact the Pillsbury attorney with whom you regularly work or the authors below:

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