

# **The Questionable Employment Tax Practices Initiative Progress Report**

April, 2011

## **QETP Oversight Team Members Include:**

Internal Revenue Service  
U.S. Department of Labor  
National Association of State Workforce Agencies  
Federation of Tax Administrators  
State of California  
State of Michigan  
State of New Jersey  
State of New York  
State of North Carolina

## Executive Summary

In November 2007, the IRS and participating states announced that they had entered into the Questionable Employment Tax Practices (QETP) initiative to help the IRS and states leverage resources and improve compliance with federal and state employment tax laws.

A questionable employment tax practice is an employment tax scheme or practice that has no objective other than to avoid federal and/or state employment taxes.

The IRS, five states, the US Department of Labor (DOL), the National Association of State Workforce Agencies (NASWA), and the Federation of Tax Administrators (FTA) have formed an Oversight Team to:

1. Increase and strengthen cooperation to improve compliance efforts,
2. Emphasize the importance to employers of properly classifying workers and complying with all state and federal employment tax laws.

To date, the IRS and 37 participating states have entered into Memoranda of Understanding (MOU) that protect all taxpayer privacy rights and:

- Facilitate cooperation and information sharing between the IRS and state workforce agencies;
- Increase compliance with federal and state employment tax filing and payment regulations;
- Increase compliance with Form 1099 and Form W-2 filing;
- Increase collection of federal and state employment tax debts
- Enhance efforts to reduce the tax gap at the federal and state levels and ensure that all employers pay their proper share of employment taxes; and.
- Leverage state, IRS and other federal agency resources to improve compliance with the employment tax laws.

The IRS and the participating states have begun exchanging information under QETP. The early results have been encouraging:

- The states have reclassified more than \$1.3 billion in wages and assessed almost \$21 million through the use of federal examination results, SS-8 determinations and 1099 extract information;
- The partners have shared research and examination techniques;
- The IRS has worked with the Financial Crimes Enforcement Network (FINCEN) to provide states with the ability to access FINCEN data;
- The partners have developed a process to initiate joint outreach and education to help employers voluntarily meet their employment tax responsibilities; and
- The IRS has assessed almost \$23 million in taxes from state referrals.

These initial results indicate the potential of the QETP initiative. However, there is still much work ahead to ensure data exchanges are as productive as possible; to improve outreach and education; and to find new ways to leverage resources to increase federal and state employment tax compliance.

## **Introduction**

### **Background and Definition of QETP**

A questionable employment tax practice is an employment tax scheme or practice that has no objective other than to avoid federal and/or state employment taxes.

On November 6, 2007, the Internal Revenue Service and participating state workforce agencies announced that they had entered into the Questionable Employment Tax Practices initiative. The IRS, its partnering states, the US Department of Labor, the National Association of State Workforce Agencies, and the Federation of Tax Administrators are all collaborating partners in the QETP initiative and members of the QETP Oversight Team.

The exchange agreements, or Memoranda of Understanding, allow participating states to exchange audit reports and associated case information, audit plans, best practices, training, and outreach and education with the IRS. They also allow for side-by-side examinations when appropriate. For the first time, the IRS and the states have a centralized, uniform mechanism for employment tax data exchanges.

The QETP initiative is a true partnership between the states, the IRS, DOL, NASWA and FTA. All of the partners had considerable input in the development of the QETP MOU and remain contributing partners in the QETP Oversight Team's continuing activities.

California, Michigan, New Jersey, New York and North Carolina have represented the states on the oversight team. They have answered questions about QETP regarding the process and implementation of the exchange agreements.

### **Before QETP**

Before the initiative, the IRS and many of the SWAs worked together in a loose coalition known as the State Unemployment Tax Relationship. The SUTR initiative proved that the IRS and the states could work together.

When the IRS Employment Tax unit joined with the IRS Governmental Liaison function as IRS representatives in the SUTR effort, everyone involved realized the potential for a much stronger partnership. This realization paved the way for QETP. In August of 2005, representatives from IRS, NASWA, US DOL, FTA and four SWAs (MI, CA, NC, and NJ) met and determined that the scope of collaborative activities should include information exchanges, leveraged compliance activities and joint outreach.

## **Why is there a need for QETP?**

The QETP Program is a key component in a cooperative multi-agency and cross-jurisdictional effort aimed at addressing employment tax fraud and abuse where it occurs, uncovering schemes and working collaboratively with partner agencies

All participating partners believe that an MOU will provide the appropriate framework and facilitate an increase in employment tax compliance at the federal and state levels. It is believed that a joint effort will raise the financial risk for employers who choose to be noncompliant with their federal and state employment tax responsibilities. Noncompliant employers should be made to understand that they could potentially owe liabilities and penalties to both the states and the IRS. As a result, many employers could choose to voluntarily comply.

In the past, respective agency enforcement and compliance efforts have focused on egregious violations of the law, the cost/benefit of overall enforcement efforts, and fulfilling mandates for audit coverage .

While those goals have value, they did not adequately address the new compliance risks associated with schemes that intentionally misclassify employees to avoid employment taxes while arranging the financial transactions of the employers to make these schemes almost undetectable.

QETP focuses on the issue of misclassification which provides the broadest protection for workers since they are harmed by misclassification. Unprincipled businesses have made a concerted effort to avoid all obligations designed for the benefit of employees, including: payment of legally mandated wages and overtime, health care coverage, employment taxes and workers' compensation coverage. Since misclassified workers are not treated as employees, they are denied the safeguards and benefits that should be afforded them. .

The QETP Oversight team is aware of the taxpayer privacy issues inherent in information exchanges. The MOU satisfies all disclosure provisions and ensures the privacy of taxpayer information. All participating states have demonstrated that they have systems in place to guarantee the safety of any IRS data they receive as a part of the information exchange agreement. The IRS assesses a state's safeguard systems annually, and audits the system every three years. If the state safeguard systems are not sufficient, they do not receive information from the IRS.

### **QETP Helps Improve Compliance**

While federal and state employment tax laws do vary, sharing examination results provides consistency and ensures that fewer workers are classified differently at the state and federal levels. This consistency should be less confusing for workers and level the playing field between similar businesses.

The increased collaboration between the QETP partners is designed to reduce fraudulent filings and schemes. One result of this collaboration is increased publicity of such filings and schemes and the opportunity for a coordinated response to end such activities.

Compliance with the employment tax laws means not only identifying and assessing taxes when appropriate, it also means collecting those taxes and QETP can assist in that effort. Information exchanges will help both the states and the IRS locate assets owned by noncompliant businesses and help identify those parties liable for paying the employment taxes. This will help focus collection activities appropriately.

### Worker Misclassification

Most of the IRS and state workforce agency efforts under the QETP initiative will concentrate on the proper classification of workers as either employees or independent contractors. Worker misclassification falls into two general categories:

#### 1. Misclassification as an Independent Contractor:

Certain employers may classify workers as 'independent contractors.' That classification may be based on a well-founded belief that those workers are indeed independent of their direction and control. The workers receive Forms 1099 for tax reporting purposes while the businesses avoid responsibility for employment taxes, such as the employer's share of FICA and Medicare, Unemployment Insurance, FUTA, and Workers' Compensation coverage.

#### 2. Unreported (Off-the-Books) Employment:

Some businesses fail to provide either Forms 1099 or Forms W-2 to their workers. They simply fail to acknowledge that they have workers. These businesses pay their workers "off-the-books" and structure their financial records in an attempt to hide these payments. In this way, these businesses avoid taxation, wage and hour compliance, worker safety requirements, workers' compensation coverage and other benefits typically provided to employees.

### Impact on Social Security, Medicare, Unemployment and Services

Ensuring proper worker classification is one of the main objectives of the QETP initiative. Employers who properly classify their workers as employees ensure that their workers receive the proper credits for Social Security and Medicare taxes and are properly covered under state unemployment taxes. As a result, these workers will be entitled to the correct federal and state benefits if and when they need them.

State workforce agencies are dealing with the consequences of a downturn in the economy and high rates of unemployment. Misclassification of workers depletes state

unemployment insurance trust funds of needed revenues and increases the tax burden on compliant employers.

### QETP Removes Economic Incentives for Unscrupulous Employers

QETP seeks to identify businesses that have chosen not to comply with both federal and state employment tax laws. It is critical to remove economic incentives for unscrupulous employers and to take steps to level the playing field for legitimate employers.

### QETP Enhances Education & Outreach

One of the initiative's goals is partnering whenever possible to provide taxpayers with the outreach and education they need to help them comply with various state and federal employment tax laws and regulations. Both the participating states and the IRS will strive to ensure that their stakeholders have the information they need to comply with all laws. The IRS and various states have made presentations at many of the same outreach and education events

Outreach efforts are important because they help businesses understand and proactively comply with their tax responsibilities. Proactive compliance with employment tax laws help businesses avoid additional costs, such as interest or penalties as the result of examinations or due to self corrections.

Educating businesses that want to voluntarily comply with the law will allow the IRS and the states to concentrate limited resources on businesses that choose to be noncompliant, thus utilizing those resources more effectively.

The QETP team will continue to explore potential outreach and education efforts to ensure it is balancing compliance efforts with education that will help businesses voluntarily comply with their responsibilities.

## **What QETP Has Accomplished So Far**

QETP has taken an expanded leadership role in identifying fraudulent schemes, enhancing data exchanges, sharing best practices and addressing cross-border non-compliance. This sharing has particularly strengthened participating State Workforce Agency abilities to recognize and combat noncompliant schemes and practices

Generally, QETP has built the solid partnership the Oversight Team envisioned. QETP has served as a model for stronger enforcement and a wiser use of limited resources.

Many states are exchanging examination results with the IRS and vice versa. This exchange of audit information is one of the key goals of the initiative. The information exchanges allow the SWAs and the IRS to leverage resources and reach more

businesses than they might otherwise. The IRS or the SWAs can often use the information from the exchanges to propose actual tax changes and thereby use less of their own compliance resources.

The IRS has provided training to several states regarding the federal employment tax laws. In addition, the IRS and several states have drafted and implemented procedures for side-by-side examinations.

### Participating States

All of the accomplishments began with the signing of the QETP MOU. Thus far, 39 agencies from 37 states have signed MOUs. Those states are:

Arkansas	Maryland	Oregon
Arizona	Massachusetts	Pennsylvania
California	Michigan	Rhode Island
Colorado	Minnesota	South Carolina
Connecticut	Mississippi	South Dakota
Florida	Missouri	Texas
Hawai	Nebraska	Utah
Idaho	New Hampshire	Vermont
Iowa	New Jersey	Virginia
Kansas	New York	Washington
Kentucky	North Dakota	Wisconsin
Louisiana	Ohio	
Maine	Oklahoma	

The participating states are in different stages of implementing their agreements. There are many factors that go into the data exchanges with the IRS, such as resources, data security, the best types of data to exchange, methods of exchange, outreach opportunities and other relevant topics. The IRS meets with each participating state to discuss these needs and then proceeds accordingly.

Data security is of paramount importance. Before any state can receive information from the IRS, it must demonstrate that its data security systems meet all IRS standards to ensure that information is safe and is used only for its intended purposes.

### QETP Business Results So Far

Business results from QETP cases have been encouraging, but we are still in the beginning stages of this initiative. Much more needs to be done.

To date, the IRS results on QETP cases are as follows:

Total Returns Worked: 4,362

Total Dollars Assessed: 22,809,165

These figures represent only the cases originated from state QETP referrals.

Participating states have also completed examinations on QETP referrals they received from the IRS, and the results thus far from those exchanges are as follows:

Total Dollars Assessed	\$20,873,017
Total Wages Reclassified	\$1,320,973,305
Total Workers Reclassified	71,732
Number of Businesses Examined	6,981

These figures only include the results of direct referrals under QETP. They are primarily from investigations undertaken during the piloting of the program to ensure the details and exchange processes were working correctly. As the IRS and participating states complete and refine their exchange practices, we expect the results to improve.

Even though these are relatively early results, they are encouraging because they show that the examinations have proven to be productive. On average they generate:

- o \$2,990 assessed per examination
- o 10.28 workers reclassified per examination
- o \$189,224 in reclassified wages per examination

The states are also receiving other benefits through QETP cooperation. For example, through the QETP process, many states have learned that they may be able to obtain information from Treasury's Financial Crimes Enforcement Network to help in their investigations. FinCEN has a database of information from forms that deal with cash payments such as Form 8300, Report of Cash Payments Over \$10,000 Received in a Trade or Business, and Suspicious Activity Reports. This information may help identify businesses that are paying their workers "under the table" since these types of workers are usually paid in cash.

Increased communication between the IRS and the states has also informed many states that they may sign agreements with the IRS to allow them to receive results from the IRS' SS-8 unit determinations. An SS-8 Determination of Worker Status Request is used by employees and employers to request a determination from the IRS on the status of workers, as to whether they are employees or independent contractors. These determinations provide the states with a large reservoir of information they can draw upon as part of their investigations.

Some participating states and the IRS have initiated side-by-side examinations in which the IRS and the states appear jointly for an examination. These side-by-side examinations send a strong signal to employers that the IRS and the states are

coordinating their activities and that they are determined to ensure employers are complying with both state and federal laws.

The discussions under QETP have also led to increased, reciprocal learning by the states and the IRS through exchange of analysis techniques and best practices for examining businesses that file Forms 1099. By analyzing these forms, the IRS and the states may be able to identify employers who are not filing all of the correct forms or paying the proper state and federal employment taxes. Even though the information from these extract analyses does not specifically come from QETP, the open lines of communication QETP has fostered have helped provide the techniques and allowed the partners to identify and address other areas of noncompliance.

Finally, and in the true spirit of cooperation under QETP, the states and the IRS have begun exchanging research and training techniques that both entities should find effective in their operations. By exchanging these “best practices” the IRS and the states are making sure they are helping each other with all employment tax investigations, and not just activities covered specifically by the QETP MOU.

### **Next Steps**

Since the QETP initiative concept was born in late 2005, the team has made great progress. Thus far, 37 states have signed the exchange agreements and several states have begun exchanging information with the IRS. In spite of the initial successes, the work has really just begun. Ensuring that all of the participating states and the IRS are sharing information that meets everyone’s needs will continue to be an ongoing process.

QETP has been a true partnership from the start, with the partners providing their input on virtually all facets of the initiative, from the establishment of the oversight team, to developing and promoting the MOU, to executing the requirements in the MOU. For the initiative to meet its many challenges and continue to enjoy success, it is essential that the partners retain their current open line of communication.

The IRS and the states need to keep an ongoing exchange of information to ensure the information exchange is beneficial to both sides. This communication is vital since state and federal laws do differ. Information that may be invaluable to one party may have far less value to the other. By communicating regularly, the states and the IRS can also make sure they account for law changes and shifts in priorities.

The QETP Oversight team will continue to hold regular meetings and conference calls to ensure the initiative stays on track and adapts to any changes.

In addition to the regular meetings with individual participating states, another way to keep the momentum going is to hold regional summits. In December of 2008 the IRS held a summit for the participating eastern states that was very successful. It created a

perfect opportunity for the IRS and the states to update each other on QETP-related news, to discuss needs and to exchange a host of ideas and tips. The IRS hopes to host similar summits in other areas as budgets and priorities allow.

Another logical next step for the QETP team is to establish joint outreach teams. As discussed above, outreach is vitally important to help taxpayers who want to voluntarily comply with their state and federal employment tax responsibilities. Presently, the IRS and the states may appear at some of the same outreach events, but that is left to chance. Due to differences in laws, the IRS and the states may not always be able to make joint presentations, but they should do so whenever possible. When the IRS and the states can present a united front together at outreach events, the message is more complete and therefore more meaningful.

In addition to the problem of conflicting laws, budget or staffing limits can prevent the IRS and the states from making joint presentations. In this case, QETP can help to leverage resources to allow either the state or the IRS to direct audiences to information sources that will help them fulfill their responsibilities. This type of information sharing – IRS directing employers to state information or vice versa, will help QETP partners to present a united front and reach more stakeholders.

In the future, the QETP Oversight Team may consider the possibility of expanding the initiative to include other agencies that may be working with QETP issues. For example, some state revenue agencies handle issues related to worker classification. The IRS and these revenue agencies may benefit from information exchanges, just as the IRS and participating SWAs are benefiting now. The initiative has a sub-team reviewing potential benefits and the feasibility of such an expansion. If the team determines that an expansion is feasible and beneficial, it will consider the appropriate timing and move forward.

## **Conclusion**

Enforcing employment tax laws has always been challenging at both the federal and state levels. Business practices and environments are constantly changing. Enforcement efforts must keep pace with those changes while dealing with resource and other issues.

Thus far, the preliminary compliance results from the information exchanges are positive and indicate the value in exchanging taxpayer information and leveraging resources. According to the early results, the IRS and the states have been able to identify thousands of employees who were being incorrectly treated as independent contractors and have assessed millions of dollars in additional employment taxes. As the IRS and the participating states better refine the data exchange processes, these amounts should increase.

The value of QETP goes beyond mere compliance results. The initiative sends a message that the government is doing all it can to enforce employment tax laws at the

federal and state levels. Equally important is the message being sent to compliant business taxpayers that the QETP partners are working to make sure they are not put at a competitive disadvantage.

The successes of QETP are due, in large part, to the dedication of the partners in the initiative. A cooperative spirit and open communications have fostered an environment ideal for the exchange of ideas and for innovative ways to improve compliance with state and federal employment tax laws. The QETP team believes that this cooperative blueprint will serve them well in their future efforts, and may benefit other cooperative efforts between governmental agencies. QETP should serve as a model for all joint projects.