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The Internal Revenue Services (IRS) announces its latest National Research Program focusing on employment taxes. The IRS intends to audit 5,000 or more randomly selected employers with first notices to be issued in November 2009 for a three-year audit program with focus on the misclassification of workers, fringe benefits, employee reimbursement and owner compensation issues.

IRS to Launch Employment Taxes Audit of 5,000 Employers – Is Your Company Ready?

By GJ Stillson MacDonnell

The Internal Revenue Services (IRS) has announced that beginning in November 2009 it will launch its latest National Research Program (NRP). This NRP will be focused on conducting detailed employment taxes examinations. Approximately 5,000 or more employers are to be randomly selected for audit. In addition to potential “assessments,” these audits will provide the IRS with the statistical sample of overall employment taxes compliance. The audit program will be conducted over a three year period with at least 2,000 employment tax audits conducted per year. Audits likely will include both for profit and non-profit employers.

Background

The IRS periodically conducts NRP audits in conjunction with its continuing efforts to evaluate compliance and assess its own procedures. These programs not only generate revenue but provide the IRS with information to measure both IRS performance as well as develop base-lines for taxpayers’ voluntary compliance. The last NRP study started in October 2007 when 13,000 individual returns from 2006 were randomly selected for audit.

This past July,¹ the Treasury Department released an updated study on the “tax gap.” The tax gap represents the difference between taxes that are owed and taxes that were not fully paid because of taxpayers’ underreporting, underpayment and non-filing. The most recent 2001 Treasury estimated a gross tax gap of \$345 billion and net gap (after enforcement) of \$290 billion. From an employment taxes perspective, underreporting figured greatly in the gross estimate - FICA (\$14 billion), unemployment (\$1 billion); self-employment (\$39 billion); underpaid taxes (\$5 billion) and employment taxes for non-filers (inestimable).

From the IRS’s perspective, the employment tax gap is significant and appropriate for further examination. While we can expect further legislative adjustments to the tax laws as Congress struggles to raise revenue to reduce the deficit and fund government

programs, immediate attention should be given by all employers to reviewing compliance with employment tax laws. Employers need to be prepared now for a potential IRS employment tax audit.

What Will IRS Employment Tax Audits Cover?

There are three federal taxes collected, paid and/or remitted by employers. Income taxes are generally deducted from an employee's wages and remitted to the IRS by employers throughout the year. Likewise FICA (Social Security and Medicare) is deducted from employee's wages and also matched by the employer. FUTA or federal unemployment taxes is paid solely by the employer. FUTA is presently capped at the first \$7000 of an employee's annual wages.

An employer has the obligation to both withhold and promptly remit taxes collected from employees. Failure to do so can result in the employer having liability for such taxes as well as interest and penalties thereon. Also, with respect to income and FICA taxes, if the employer fails to meet its obligations, individuals who are responsible for collecting (withholding), accounting for and remitting (depositing) income and FICA taxes can be personally responsible for such taxes as "responsible persons."²

The focus of employment tax NRP will be in four areas:

- Worker classification
- Fringe benefits
- Reimbursed expenses
- Compensation of owner employees

Worker Classifications [since the issue is related to IRS exams, attention should be paid to the test used by IRS]

Determining whether a worker is classified correctly as an employee or independent contractor has been a recurring audit theme. Who is or is not an independent contractor is not easily determined. Many factors, including common law and statutes, as well as how such relationship works in practice and the manner in which the work relationship terminates, are relevant to any analysis. Furthermore, there is no universal test applicable to determining employment status. The standards differ greatly under various federal laws (*i.e.* wage and hour vs. employment taxes). Additionally, a worker's status may vary between state and federal law and among different laws of the same state. Consequently, the engagement of services of a worker as an independent contractor should be carefully reviewed both at the outset and during the course of the relationship. Because of the absence of bright-line standards, examinations of independent contractor status are likely to be a fertile area for audit.

Fringe Benefits

Fringe benefits can be tax-free or taxable. Common fringe benefits include: accident and health benefits, educational assistance, employee discounts, employer provided lodging and meals, moving expenses, transportation benefits and working condition fringes. The standards and documentation requirements vary greatly for each type of fringe benefit. The complexity of specific benefit-driven rules can often lead to traps for the unwary. The consequences can be adverse to both the employer and its employees as non-conforming benefits will generally be considered as wages subject to employment taxes.

Reimbursed Expenses

In order for employee-incurred reimbursed expenses to be tax-free to the employee and deductible to the employer, such expenses must generally be processed through an "Accountable Plan" that meets three requirements:

1. There must be a business connection and the expenses must be reasonable.
2. There must be a reasonable accounting for the expenses.
3. All excess reimbursement must be repaid in a reasonable time.

Failure to comply with these requirements creates further taxable wages for the “reimbursed” employee.

Compensation of Owner Employees

Reasonableness of officer or owner compensation when such persons receive both wages and dividends is the last audit area identified for particular scrutiny in the NRP audit. It is likely to be primarily an issue for closely held, or one-person corporations. There are no precise standards for reasonableness or allocation between officer compensation that should be treated as wages, which are subject to employment taxes, and distributions to owners of dividends, which are taxed as ordinary income and not generally subject to withholding. This audit area is likely to be more shaded than others.

Other Potential Audit Targets

In addition to these focus areas, an employer should expect a general review of the completeness and accuracy of W-2 forms, the calculation of withholding as well as the timeliness of tax deposits and reports.

Steps to Preparing for an Employment Tax Audit

- Since these audits will be unfolding over a three-year period and audits typically cover a period of three tax (calendar) years, initiating an internal review of employment taxes compliance now is the first step to consider. Where appropriate, an employer may want to make adjustments to practices prospectively as well as consider corrective action. A program to identify these potential issues up front will also help the employer evaluate its risks and potential financial exposure.
- Identify an internal point person to manage the audit preparation process. Notices of audits can simply be addressed to the company at the address used for filing recent tax returns. If not directed to an informed contact person such notices may not be timely or completely responded to. Review current procedure for routing tax-related notices and correspondence. Establish a process for speedy routing to the designated point person.
- Identify and budget for internal and other resources to gather, organize and analyze such records and provide appropriate representation.
- Engage experienced employment tax and audit experts before having an initial audit meeting with the IRS. Legal counsel should generally be able to provide assistance protected by the attorney-client privilege. Whether such expertise is engaged to either visibly represent the employer or simply to advise the employer in the background, it is important to engage these services early. Early involvement usually lends to a more efficient audit process.
- Do not rush into an audit schedule. Do not commit to a date before the adequate resources are in place and there has been an opportunity to gather, review and analyze all initially requested documents. It is important for the employer to have an overview of the company's strengths and weaknesses.

Open Season for Other Audits

Beyond the IRS, states, as well as local taxing authorities, are scrambling to generate revenue. At the state level in particular, the “workforce” agencies that administer the unemployment programs are aggressively pursuing revenue sources. One such focus is on

the reclassification of workers, if no other reason than to replenish their depleted unemployment funds. Sister state agencies have been encouraged to exchange audit leads. In 2007 and more recently in 2009, New York³ and Massachusetts, as two examples, are exchanging information, particularly between the state taxing agencies and the labor and workers' compensation agencies, with particular focus on pursuing employers who misclassify workers as independent contractors.

Since late 2007 there has been a Memorandum of Understanding ("Agreement") between many of the state "Workforce" (unemployment) agencies and the IRS to exchange employment taxes related information. The objective of the Agreement is to increase compliance with employment taxes laws, reduce fraudulent filings, limit abusive tax schemes, and worker misclassification. This Agreement is also endorsed by the U.S. Department of Labor (DOL). Under this Agreement the IRS and a state both share audit results and leads as well as potentially conduct joint audits. So independent of the NRP, there is a heightened prospect of status audits under these economic conditions with the aid of this interagency Agreement.

In September 2009, the U.S. Government Accountability Office (GAO) released a report⁴ urging US DOL and IRS to increase "their efforts to probe the improper classification of workers" as independent contractors, educate employers and use penalties to deter misclassification. The GAO was particularly critical of the DOL's Wage and Hour Division for its very limited enforcement activity.

Given all of the above discussed state and federal protocols and initiatives in place and all levels of government seemingly sharing an insatiable need for revenue for the foreseeable future, it is now the opening of the "Employment Taxes Hunting Season," a season with no limit.

Recommendations for Employers

- Immediately update mail processing procedures to monitor for audit notice.
- Designate an "Employment Taxes Czar" with suitable support to review current employer compliance, manage audits and make recommendations for adjustments.
- Engage the assistance of outside expertise as early in the process as possible.
- Proactively review current employment taxes (state and federal) procedures/practices.
- Defer scheduling any IRS (or other) employment taxes audit appointment until an internal analysis can be conducted and necessary records reviewed and organized.

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¹ U.S. Department of the Treasury, *Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance*, July 9, 2009.

² IRC § 6672(a).

³ New York Times, Sept. 8, 2009.

⁴ <http://www.gao.gov/new.items/d09717.pdf>.