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Taxpayers Beware: IRS Intensifies Employment Tax Audit Initiatives

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Last month, the Internal Revenue Service initiated an intensive employment tax research study of 6,000 randomly selected taxpayers as part of a national research program, or NRP, aimed at investigating tax compliance issues related to employment taxes, fringe benefits, independent contractor classification, expense reimbursements and other related "payroll" issues.

This is the first employment tax study the IRS has embarked on in over 25 years. The IRS has stated that it will utilize data obtained in this study to identify the areas with the highest potential for non-compliance and improve its standards and procedures for selecting returns for future audit.

These intensive examinations, which are effectively audits, can be particularly burdensome to those selected for inclusion in the study. Due to the initiative's broad scope, many lawyers and their clients may find themselves in the unenviable position of undergoing examination. If selected, taxpayers should secure the representation of a qualified tax professional to guide them through the often complex process.

A 2007 study performed by the General Accounting Office, or GAO, reported that the annual tax gap is over \$600 billion annually. The tax gap measures the difference between what taxpayers should pay if all income were reported properly and what they actually do pay. The IRS estimates that over \$15 billion of the tax gap is attributable to errors in worker classification, such as employees who are misclassified as independent contractors. Consequently, the IRS finds itself under increasing pressure from the Tax Policy and Issue Administration Area of the GAO to tackle this issue.

Focus of the Study

The NRP study commenced last month and is expected to progress over a three-year period with approximately 2,000 comprehensive audits being performed each year. It has been reported that the IRS will randomly select a group of returns and examine each to uncover any errors, omissions or other instances of non-compliance with federal tax laws. To gear up for the effort, the IRS is training approximately 300 uniquely trained agents.

The IRS will likely use various data sources as part of the audit process — including information from Forms 1099 and W-2 filed with the IRS — to determine audit strategies concerning the compliance characteristics of companies filing employment tax returns. The areas of abuse uncovered by the study will be used to refine the methods the IRS employs to select returns for audit. As of this writing, the IRS has already selected the first group of 2,000 taxpayers who will soon receive notice that their 2008 year will be examined. If these examinations uncover any issues, the IRS will likely open additional tax years.

The study will focus on traditional payroll issues such as withholding, and payments to employees outside of the payroll system with a special emphasis on the following areas: worker classification; fringe benefits; officer compensation; employee expense reimbursement plans; and non-filers.

In certain circumstances, payments of interest, dividends, rents, royalties, payments to independent contractors for services and broker payments are subject to income tax withholding that must be reported on Form 1099. The IRS recently declared that they will scrutinize compliance with back-up withholding regulations.

The IRS will require businesses to provide substantiation for tax positions taken on returns filed with the IRS. Appropriate support may include Forms 1099, Forms W-2, payroll records, invoices, plan documents, expense reimbursement policies and any other applicable documentation. The intensive nature of these audits and their use as part of a study usually means that if the required documentation cannot be provided, the agent will be required to make audit adjustments. It is critical that businesses have their documentation in order and that the documentation supports the filing positions taken.

Worker Classification

The IRS expects to uncover the largest percentage of errors related to misclassifications of workers as independent contractors. While either worker classification — independent contractor or employee — can be a valid and appropriate business choice, many businesses employ workers as independent contractors rather than as employees, in part to reduce the cost of employee benefits and the employer portion of payroll taxes during difficult economic times. The issue of whether a worker is properly classified as an employee or independent contractor is often complex since there is no clear definition of "employee."

As provided in Treasury Regulation Section 31.3121(d)-1(c)(2), IRS Manual – Audit, Part IV, Exhibit 4640-1 and IRS Revenue Ruling 87-41, a 20-factor test is used to determine whether a worker should be classified as an employee or

independent contractor. These factors are divided into a set of behavioral, financial and relationship common law rules for determination of employee status.

If, after reviewing the above, it is still unclear whether a worker is an employee or an independent contractor, consider examining IRS Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding. This is the form that businesses and workers file with the IRS to request a determination of the status of a worker for purposes of federal employment taxes and income tax withholding or to resolve a dispute between a worker and the business.

Potential areas for abuse include executives rehired as consultants, dual status employees, and employees working under employee leasing arrangements. Taxpayers utilizing these practices should expect an increased level of IRS scrutiny.

Fringe Benefits & Expense Reimbursement Plans

In the fringe benefit area, the IRS will analyze the use of company automobiles, credit cards and planes, as well as other noncash benefits. They see the enormous potential to uncover significant personal income from improper expensing of personal expenses.

Employee expense reimbursement plans are another area the IRS plans to investigate. Companies must maintain "accountable plans" for employee expense reporting and reimbursement and when not utilized reimbursements will be considered income to the employee.

The IRS will also focus on executive compensation including executive retirement contracts, golden parachutes and stock options to ensure these compensation arrangements are accurately reported. Non-filers of information returns, such as Forms 1099, will also be targeted. The IRS will examine business returns, scrutinizing various deductions including independent contractor and professional fee expenses that generally must be reported.

Minimizing Risk

Although there are no surefire ways to avoid being targeted, there are certain measures businesses can take to minimize risk.

Businesses, for example, should review their current payroll practices, specifically focusing on the areas identified by the NRP initiative. Documentation and record keeping procedures should be reviewed and updated if necessary. Businesses should also review their three most recent years' employment tax returns, including Forms 1099 and all supporting documents and records. In many cases, the company's third-party payroll administrator can assist with this process.

Taxpayers may also wish to engage a tax professional to conduct a "simulated audit" for the purpose of reviewing record-keeping policies and existing tax positions and obtaining advice on correcting problems or deficiencies that would be likely targets in the event of an actual IRS examination. Consider having a tax professional conduct a "simulated audit" or simply discuss your risks and the benefits of a "simulated audit" in your specific situation.

In the event that a business is selected for examination, good IRS examination management practices should be followed, including these steps:

- Designate a clear "chain of command" for responding to audit notices and other IRS communications.
- Retain expert outside advisors, consisting of legal counsel and qualified tax professionals, early in the process.
- Maintain control over the IRS audit process by requesting additional time to respond to information document requests, or tailoring the scope of information requested, where appropriate.
- Consider application of Section 530 of the Revenue Act of 1978. Section 530 can, in certain circumstances, relieve businesses of employment tax liabilities resulting from worker reclassification.

The Bottom Line

While not all companies will be targeted under this study, the IRS is sending a clear message that employment tax compliance is at the center of their radar. Based on statements made by IRS representatives and, more importantly, recent IRS activity, the IRS is strongly committed to reducing the tax gap. The data obtained from the study and related examinations will be utilized to maximize the effectiveness of IRS employment tax audits and will undoubtedly increase tax revenues.

It is imperative that attorneys and law firms are ready and able to assist clients targeted by the IRS as well as defend such examinations to its own practices. In the event you or your clients are contacted by the IRS and informed that an audit will commence or that an adjustment is being made, the guidance of a seasoned tax professional is invaluable.

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