



Tax Update

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Preparing Your Business for More Invasive Employment Tax Audits Under the Employment Tax National Research Project

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Introduction

The Internal Revenue Service (IRS) has begun the first comprehensive employment tax study in 25 years, the Employment Tax National Research Project, with a stated goal of closing the "Tax Gap."

The difference between the amount of tax owed and the amount of tax collected is commonly referred to as the "Tax Gap." During this time of economic recession, the federal budget and our growing national deficit have become focal points for discontent from both the left and the right.

Reigning in spending and increasing taxes have been touted as solutions to the dilemma, but both of these strategies carry significant political consequences for our elected officials. Reducing the tax gap, on the other hand, has the same effect on the federal budget as a tax increase or spending reduction without any of the painful political side effects.

Therefore, it comes as no surprise that the IRS is conducting this study, since more than 60% of federal revenues come from the employment tax system.

The Employment Tax National Research Project (NRP)

In November 2009, the IRS published, in "Headliner Volume 280," its intention to conduct the NRP over a three-year period. The audits began in February 2010 and will continue in 2011 and 2012, covering 2,000 taxpayers per year for a total of 6,000 employment tax audits under the program.

In Headliner 280, the IRS stated that the NRP has two stated goals: (1) to secure statistically valid information for computing the employment tax gap, and (2) to determine compliance characteristics so the IRS can focus on the employment tax areas in which there is the greatest noncompliance. It is anticipated that under the NRP, the IRS will conduct examinations that will be "comprehensive in scope," and all records pertaining to employment tax returns and issues will be subject to review during these examinations.

The audits will not be confined to any particular segment of taxpayers. Large businesses, small businesses, tax-exempt organizations, and governmental entities will all be targeted. In fact, the IRS has indicated that the program will include 1500 tax-exempt organizations, or 500 audits per year.

Although there are only a total of 6,000 audits being conducted under the Employment Tax National Research Program, taxpayers may not rest easy if they are not one of the lucky 6,000 to be selected. The strategy of the IRS is not to conduct these audits on a one-time basis. The information obtained in the audits will be used to identify recurring patterns of noncompliance in order to adjust the IRS's resources for use in future examinations. In other words, all businesses need to review their employment tax framework in order to identify and correct potential noncompliance issues.

What Will Be Examined in the NRP Audits?

The NRP will focus on several subject areas, including:

Worker Classification: The question of whether a worker is an employee or an independent contractor keeps rearing its head. In the NRP audit, the IRS will look more closely to determine whether an employer qualifies for relief from employment taxes under the safe harbor provisions of Section 530 of the Revenue Act of 1978. Pennsylvania is the latest in a growing list of states that has made it a criminal offense to misclassify workers in the construction industry.

A Department of Labor study in 2000 found that between 10 and 30% of firms audited in nine states misclassified at least a portion of their employees.

Executive Compensation: This includes non-salary compensation, like loans, travel, deferred comp, stock-based compensation and more.

Fringe Benefits: Several items may fall into this category, including: the use of company aircraft or cars, club dues and housing, among other perks. The audits may even include benefits like gift cards, employer cafeterias and athletic facilities.

Payroll Taxes: The agents will examine Forms 941, Employer's Quarterly Federal Tax Return. As part of this, they will look at backup withholding, next-day deposit requirements and Form 1099/W-2 compliance, among other issues.

What To Expect

Taxpayers will be informed by a letter or a telephone call if they have been selected for an employment tax audit. The letter, often referred to as the "confirmation letter," may or may not contain a request for information from the IRS. The next step is for the agents who will be conducting the fieldwork to meet with the taxpayer before the audit begins.

Requests for information by the IRS should be made in writing by use of Form 4564, the Information Document Request. Taxpayers need not provide more information than what is specifically requested by the IRS.

Audit issues that cannot be resolved during the examination and which are not part of a closing agreement may be appealed to an IRS Appeals Office. Open audit issues that cannot be resolved through the Appeals Office may be litigated in the courts.

What Can Schneider Downs Do For You?

The experienced professionals at Schneider Downs have extensive experience dealing with the issues that the IRS will be examining during the NRP audits. However, we will be able to assist you most effectively if you contact us **before** you are selected for an NRP audit.

In the area of worker classification, Schneider Downs can perform a comprehensive review of all employment relationships and identify any areas of noncompliance in advance of any adverse actions by the IRS. Misclassification of employees has a far-reaching effect on employers through Social Security and Medicare taxes, unemployment taxes and overtime compensation.

Schneider Downs can also review employee benefit plans that may be the subject of an NRP audit, and identify any noncompliance with ERISA and state laws.

Fringe benefit plans can be reviewed for any noncompliance including:

- Identifying all fringe benefits
- Confirming that the taxpayer properly reported, withheld and deposited the payroll taxes associated with the identified fringe benefits in a timely manner
- Identifying and implementing statutory fringe benefit rules
- Identifying and implementing the special valuation rules that apply to the fringes

Schneider Downs will conduct a review on all of the fringe benefits that the IRS has targeted in past audits, including:

- Employer-provided automobiles
- De minimis fringe awards such as gift cards
- Discounted property or services
- Education assistance offered as (1) educational assistance plans, (2) working condition fringes and (3) scholarships
- Meal reimbursements and travel per diem plans (these may become a separately targeted issue by the IRS and will be the subject of a separate upcoming article)
- Corporate credit cards (often associated with the travel expense reimbursement and per diem issues)
- Dependent care assistance programs

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- Adoption assistance
 - Leave banks
 - Moving expenses
 - Fitness memberships
 - Life insurance over \$50,000 in coverage
 - Qualified transportation fringe benefits (mass transit, van pools and employer-provided parking)
 - Qualified retirement planning
 - Listed property such as personal computers for home use
 - Severance payments, outplacement counseling and SUB (Supplemental Unemployment Benefits) Payments
 - Vacation awards, including free travel, vacation homes and cash-out provisions

Once you have received a confirmation letter or phone call notifying you that you have been selected for an audit, the scope of services we will be able to provide will be limited by time constraints. However, we can still help organize a properly functioning internal team to manage the examination and supervise the flow of information between you and the IRS examiners. We can review all information before it is turned over to the IRS, and ensure that all information released to the IRS is complete, organized and focused.

Conclusion

The 6,000 audits to be conducted under the NRP are only the beginning of an increased focus on compliance with employment tax issues by the IRS. This is an issue that affects all businesses, large and small, public and private, for-profit and non-profit.

Businesses that are unprepared for these audits are likely to face considerable costs. In addition to any penalties imposed by the IRS, increased costs in administrative and financial resources will be incurred during the audit, as well as legal fees to challenge any contested findings in the audit.

Schneider Downs can alleviate those costs by providing a comprehensive review of the issues that may arise in an employment tax audit and suggest the implementation of policies that will pass IRS scrutiny. Schneider Downs can also organize the information and resources necessary to allow your business to navigate quickly and cost-effectively through an NRP employment tax audit.

If you have any questions, please contact your Schneider Downs representative at 412-261-3644.

This brochure describes certain services of Schneider Downs & Co., Inc. that may be available depending upon the client's particular needs. The specific terms of an engagement letter will govern in determining the services actually to be rendered by Schneider Downs to a particular client.

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