PUBLICATION

IRS Will Audit 6,000 Companies – Make Sure Your Employment Taxes Are In Order

November 23, 2009

An employment tax audit may be in your very near future. In an interview given to Bloomberg by John Tuzynski, IRS Chief of Employment Tax Operations, on September 18, 2009, Tuzynski said that the IRS will spend three years auditing 6,000 companies beginning in February 2010. The companies will be selected at random and will include large and small companies. They will be selected from across many different industries. This marks the first comprehensive examination of employment tax issues by the IRS since 1984.

The scope of the audits will include many employment issues, but will pay particular attention to how employers classify individuals as independent contractors, as well as executive compensation and taxable fringe benefits. According to Tuzynski, most audits will be conducted in person, but information may be obtained from other sources as well.

Main Audit Issues

Worker Classification: Though the IRS is clearly intending to address all aspects of a company's employment and employment tax practices, it seems that the IRS has placed a heightened focus on worker classification – that is, whether a worker is properly classified as an employee or an independent contractor. Generally, the IRS favors classifying a worker as an employee and will only permit independent contractor classifications in clear circumstances. According to a report by the Government Accountability Office released in August, only 3% of determinations submitted to the IRS showed workers to be true independent contractors, and in 2008 the IRS assessed over $64 million in taxes and penalties for worker misclassification. Improper classification, as viewed by the government, cheats the government out of employment tax revenue and the worker out of labor protection.

With these statistics and policy considerations in mind, the IRS considers there to be wide-spread, substantial cases of misclassification that could result in increased revenues for the government and greater protections and benefits for workers, all of which will ultimately cost employers more money in the form of higher tax liabilities, reporting requirements and increased benefit expenses. Reclassification of a significant number of workers could also dramatically increase claims for prior benefit plan coverage which should have been provided, result in enforcement assistance from the U.S. Department of Labor, and could ultimately result in a retirement plan's disqualification from tax-qualified status.

Executive Compensation: In addition to worker classification, executive compensation will be another focus of these anticipated audits. This will likely arise in two contexts: 1) reasonable salaries for officers of Subchapter S corporations; and 2) deferred compensation. The reasonable salary issue pertains mostly to closely-held, often family-owned, businesses. This is due to a tax planning opportunity that allows business owners who are also employees of the business to pay themselves a reasonable salary, while recognizing the remainder as a dividend. This opportunity saves the business owner additional employment tax liabilities. However, the business owner must take care to ensure that the salary is reasonable for the business. If it is too low, the IRS could assess additional employment tax and penalties.

Nonqualified deferred compensation[1] has been on the Service's radar for the past few years, and the IRS is already conducting audits to ensure companies are compliant. This type of deferred compensation is governed in part by Section 409A and its accompanying Treasury Regulations. Section 409A addresses all forms of nonqualified deferred compensation including employment agreements, stock option plans, equity incentive programs, severance arrangements and bonus programs. If these plans are neither exempt from those rules nor compliant, the executive or other individual will be subject to significantly higher federal income taxes on the compensation. Note that the deferred compensation audits may relate even to persons who are not considered to be employees, as the rules dealing with the taxation of deferred compensation relate to all service providers in any capacity. For example, the deferred compensation audits may cover directors, consultants, mid-level management, or any other service provider.

Taxable Fringe Benefits: The third focus in these audits, as stated by Tuzynski, will be taxable fringe benefits. These issues often arise with the personal use of company-owned vehicles, aircraft or vacation homes. The IRS will be looking to ensure that employees who utilize these benefits are assessed appropriate taxes for their use.

Action Steps

Given the potential liability for the taxes, interest and penalties, as well as increased reporting requirements, that could result from these audits, companies should immediately address their employment tax record keeping and other compliance requirements. Without limiting the type of action steps to be considered, a business (in consultation with its attorneys and accountants) should consider the following:

1) Where independent contractors have been used, review the facts surrounding the workers' relationship with the company to determine that the workers truly are independent contractors under the facts and circumstances test used by the IRS;

2) If not already done so, review all nonqualified deferred compensation arrangements to determine whether the arrangements are either Section 409A exempt or compliant;

3) For Subchapter S corporations, review salaries of the employee-shareholders to determine whether the salaries are reasonable; and

4) Ensure that the value of taxable fringe benefits that employees utilize have been properly included in their income and that appropriate withholding/remittances have been made.

When problems are corrected prior to an audit and self-reported, the penalties assessed are often less severe than they would have been if the IRS discovers the problems upon audit.

Should you have any questions or wish to discuss any aspects of these impending audits, please an attorney in the Firm's Tax Department.

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[1] Generally, deferred compensation from other than certain tax-qualified profit-sharing, pension or other similar plans, or from other arrangements which are deferred payments relating to services but are exempt through statute or regulations from the requirements of Internal Revenue Code Section 409A.