

IRS Mounts Major Payroll Tax Audit Initiative of 6,000 Companies

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The Internal Revenue Service (IRS) has quietly unveiled its most significant audit initiative in decades—an initiative the IRS confirmed last week with little fanfare even though its expansive scope will target the federal tax returns of 6,000 companies. In the next few months, the IRS will commence the first wave in its audit initiative—audits intended to “study” compliance in the areas of payroll taxes, independent contractor (IC) status, fringe benefits, and executive compensation. The primary audit goals include (i) reducing the tax gap by increasing tax compliance and payroll tax collections and (ii) reducing the number of “misclassified” ICs. A likely secondary objective, and one urged by the Government Accountability Office (GAO), is to ensure benefits coverage and “labor protections” traditionally associated with employee status.

Most companies have never been subjected to a payroll or targeted tax audit even though payroll taxes account for more than 70% of federal tax revenues and are now a Tier 1 audit issue. Those companies that have are typically surprised at the scope, far-ranging issues, and unique procedural nuances associated with these audits. The unusual issues targeted in payroll tax audits have their origin in the IRS National Office’s unique organizational structure, which gives the Tax Exempt and Governmental Entities (TEGE) Division of the IRS interpretative and tax controversy jurisdiction over these issues.

The IRS has stated that these payroll tax audits are intended to impose as little burden as possible on businesses. However, the sheer number of companies targeted (6,000) and the methodology employed (taxpayer compliance audits) suggest precisely the opposite. This initiative comes on the heels of renewed congressional scrutiny of IC issues, and the GAO’s own report urging the IRS to focus its “efforts to probe the improper classification of workers” as ICs and—perhaps most ominous—to invoke its penalty authority to deter misclassification. The audits will incorporate methods imposed by the Taxpayer Compliance Measurement Program (TCMP) audits last conducted more than 20 years ago. Tax advisors with experience in fringe benefits, payroll tax, and/or TCMP audits will realize that, in fact, this will likely be a painful process requiring the allocation of scarce financial and administrative resources even if an audit seeking to “reduce the tax gap” ultimately reveals no employment tax adjustments are warranted.

What Issues Will the Audits Target?

The audits will focus on traditional payroll tax issues but with special emphasis on (1) worker classification/IC status, (2) executive compensation, (3) fringe benefits, and (4) payroll taxes. The first phase of the initiative will target 6,000 companies to determine the level of noncompliance. (Compare this to the 24 taxpayers the IRS initially targeted in its much-publicized executive compensation audits). The initiative will provide the IRS a foundation to further refine its targeted issues list. Such a refinement will

likely bring sweeping changes not only in audit techniques but also in the breadth, depth, and scope of future examinations.

The IRS indicates that it has already developed the infrastructure to conduct broader inquiries using existing experienced agents combined with some additional training from the IRS National Office in the areas of worker classification, fringe benefits, and payroll taxes. In its attempts to collect taxes and lay the foundation for closing the tax gaps, the audits will initially focus on the following four subject matters before expanding to other issues:

Worker Classification/Independent Contractors. The focus will include traditional IC relationships, exclusion of misclassified workers from benefits, and eligibility for certain IC relief provisions, as well as possible focus on three-party relationships, W-2 vendors, and staff leasing relationships.

Officers' Compensation. The IRS will apparently devote special attention to executive compensation such as loans, executive travel, nonqualified deferred compensation, retirement contracts, stock-based compensation, and golden parachutes (including whether the executives properly included the amounts in gross income). The first round of information document requests (IDRs) also reveals that the IRS will audit Section 409A compliance.

Fringe Benefits. The auditors will look at a number of executive fringe benefits associated with officer compensation such as aircraft, company cars, club dues, spousal travel, and housing. The fringe benefits aspects of the audit will also cast a wider net seeking to challenge more broad-based noncash fringe benefits such as expense reimbursement arrangements, gift cards, working condition fringes, club memberships, employer cafeterias, and athletic facilities.

Payroll Taxes. The audits will be structured as payroll tax audits of Forms 941 and will be influenced by an experienced corps of employment tax agents. Since payroll tax withholdings are a Tier 1 audit issue, the IDRs will focus on more traditional employment tax inquiries, including next-day deposit requirements, backup withholding, B Notices, and Form W-2/Form 1099 compliance.

How Should Companies Prepare?

To proactively address this IRS audit initiative, employers are advised to conduct their own compliance reviews—the method the IRS recommended in its much smaller executive compensation audits three years ago. Conducting a compliance review allows a company to evaluate the targeted audit issues on its own terms. It also assesses exposure and examines the eligibility criteria for the three separate relief provisions available for IC issues, fringe benefit issues, and payroll taxes. We concur with past IRS audit initiative statements that being proactive offers companies “a good opportunity . . . to make sure that the rules are being complied with themselves . . . as there are certainly opportunities to make fixes before the IRS comes in.” While conducting such a review, however, companies should keep in mind that protecting the privileged status of a compliance review is critically important. Every effort should be made to protect the privileged status of the compliance review and any other preparations to become “audit ready.”

The Morgan Lewis Difference

Morgan Lewis correctly anticipated the looming challenge posed by the IRS on these important issues. We proactively assembled a team of payroll tax and fringe benefit attorneys to assist our clients in addressing the precise issues being targeted in this far-reaching IRS audit initiative. In former leadership

roles within IRS National Office's TEGE Division, one or more of our team members were involved in most of the substantive guidance on the targeted topics, including developing the IRS training materials still used as the foundation for training IRS agents on fringe benefits and payroll tax issues, as well as in playing key roles developing and counseling auditors on the relatively little-known administrative relief provisions and other taxpayer tools that can make the audits less burdensome.

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