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Are You Ready for an Employment Tax Audit?

Starting this month, the Internal Revenue Service ("IRS") is commencing a National Research Project to collect information on employment tax compliance issues. But, don't let the name fool you. The IRS plans to audit 6,000 employers over a 3-year period. Each year, 2,000 employers will be chosen for examination. The employers will be randomly selected from every geographic region of the country and business category, including tax-exempt entities. This is in addition to the IRS's routine employment tax audits, totaling 60,000 annually.

The IRS believes this study is necessary because business practices regarding employment tax issues have changed significantly over the past 25 years. The last IRS study of employment tax compliance was in 1984. There are two main goals for the study: (1) to secure statistically valid information for computing the employment tax gap, and (2) to develop audit selection formulas so the IRS can focus on the most noncompliant employment tax areas.

Approximately 200 to 300 specially trained agents will perform these audits. The audits will be comprehensive in nature, including line-by-line reviews of employment tax returns and information returns. The auditors will focus on traditional payroll issues but with special emphasis on five areas – (1) worker classification, (2) fringe benefits, (3) officer compensation, (4) employee expense reimbursement plans, and (5) non-filers. The IRS has already selected the first group of 2,000 taxpayers who will soon receive notices that their 2008 years are to be examined. Any issues identified will also be reviewed in prior and subsequent tax years.

In light of this IRS initiative, organizations should conduct a review of their worker classification procedures, reporting of fringe benefits and other employee tax compliance requirements such as expense reimbursement plans. In addition, employers might review compliance with Section 530 of the Revenue Act of 1978, a safe-harbor provision that prevents the IRS from changing a taxpayer's employment classification of workers where the taxpayer

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has a reasonable basis for its position and meets certain prerequisites.

Tax-exempt organizations will account for approximately 1,500 of the 6,000 entities investigated in this project. In addition to the above preparatory actions, tax-exempt organizations should ensure they have the proper documentation to establish that compensation paid to their executives and other "disqualified persons" was reasonable. Without such documentation, disqualified persons and corporate officials risk imposition of excise taxes for payment of excess compensation. Further, such organizations should confirm that all remuneration provided to a disqualified person is documented as compensation or the disqualified person and the corporate officials risk imposition of excise taxes for an "automatic excess benefit transaction." Any such documentation must exist prior to any audit.

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