

AN ALERT FROM THE BDO COMPENSATION &amp; BENEFITS TAX PRACTICE

# BDO KNOWS: COMPENSATION & BENEFITS



## ► SUBJECT

### IRS BEGINS PAYROLL TAX AND EXEC COMP AUDIT INITIATIVE OF 6,000 COMPANIES

## ► SUMMARY

In February 2010, the Internal Revenue Service began its first Employment Tax National Research Project (“NRP”) in 25 years. The Service asserts that business practices regarding employment tax issues may have changed significantly since the last IRS employment tax study in the 1980s, necessitating this study. Examinations comprising the study will be conducted to collect data that will allow the Service to understand the compliance characteristics of employment tax filers.

As noted in a recent IRS press release, the impetus for the NRP tax audit program originated from a report to Congress by the Treasury Inspector General for Tax Administration, which indicated that payroll tax noncompliance is a serious drain on the United States Treasury.

Although the Service has characterized the project as a “research study,” it is believed the project’s ultimate goal is revenue collection. Because payroll taxes account for approximately one third of all tax revenues collected within the federal tax system, the Service believes the audits will quickly generate much needed revenue. The agency suspects that employers may be underpaying payroll taxes by approximately \$14 billion annually. It is also expected that states will follow the IRS lead and begin their own audits.

The results will also allow the Service to gauge more accurately the extent to which businesses properly comply with employment tax law and related reporting requirements. When completed, this information will help the Service select and audit future employment tax returns with the greatest compliance risk.

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The Service will randomly select 2,000 taxpayers each year for the next three years. The examinations will be comprehensive in scope. An employer may be informed by letter or by phone that it has been selected for an audit. In addition to information developed on audit, IRS examination techniques will include internal sources of information, interviews, and publicly available employer policies obtained from various sources, including the Internet.

The main goals of the NRP are to:

- Secure statistically valid information for determining the size of the employment tax gap;
- Determine compliance characteristics so the Service can focus on the most noncompliant employment tax areas; and
- Establish a strategy that will enable it to identify and audit future employment tax returns deemed to have the greatest compliance risk

The NRP focus is as follows:

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

**Officers' Compensation.** The Service will 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 indicate that the Service 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, Employer's Quarterly Federal Tax Return, and will be influenced by an experienced group of employment tax agents. Because 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, and Form W-2/Form 1099 compliance.

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## ▶ NEXT STEPS

### What should employers do right now?

Companies should consider the following as best practices as well as being ready in case they receive a letter from the Service:

- Conduct a self-review of company employment tax procedures and practices to ensure compliance and take the opportunity to fix any incorrect or impermissible methods;
- Prepare an internal team that will coordinate the organization's participation during the examination with the Service; and
- Be ready to provide the Service with information it will request pertaining to employment tax records.