



heads up to employers - new irs audit program will focus on employment taxes

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by Jeffrey D. Davine

attorneys

Jeffrey D. Davine

practice areas

transactional tax

Employers should be aware that the Internal Revenue Service has recently begun a program that will target 6,000 US companies at random over the next three years for comprehensive employment tax examinations.

The program is called the "Employment Tax National Research Project." Although the title sounds innocuous enough, the effect on those businesses that are selected to "participate" is likely to be significant.

Approximately 200 to 300 specially trained IRS examiners will conduct these audits. Employers who are unlucky enough to lose the IRS audit "lottery" and be selected for examination can expect a "comprehensive" (aka, time-consuming and potentially expensive) examination of their employment tax records and returns. The process of selecting businesses for examination will be determined based on statistical sampling and not necessarily because of incorrectly filed returns.

These audits will be similar to the ones conducted in the past with respect to income tax issues (known as "Taxpayer Compliance Measurement Program" audits). This means it is likely that there will be little regard by the IRS concerning the intrusiveness of the examination or the degree of disruption that the examination may cause to the employer. It is expected that most of the audits will be conducted in person.

The stated goals of the Project are as follows: (i) secure statistically valid information for computing the "employment tax gap" (which is the difference between the amount of taxes collected and the amount of taxes actually owed-estimated to be more than \$200 billion annually) and (ii) determine compliance characteristics so that the IRS can focus on the most noncompliant



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The plan is for the examinations to focus on returns filed for calendar years 2007 and 2008. The IRS may, however, expand the scope of the examinations to include earlier and later years if merited.

Although the IRS will be able to examine any line on an employer's employment tax returns during the audit, the IRS has indicated that the examinations will focus on the following issues: (i) worker classification (i.e., employee vs. independent contractor); (ii) fringe benefits; (iii) executive compensation; and (iv) expense reimbursements.

This means, for example, that employers who may have improperly classified workers as independent contractors and who are examined could face potentially staggering tax bills. Employers who have classified workers as independent contractors would be well advised to conduct a review of their records, policies, and procedures concerning worker classification (as well as the other areas that will be focused on by the IRS) to ensure that, if questioned, they can support their decisions. Having complete and accurate records, as well as sound policies and procedures, should help make the examination less stressful and time-consuming and reduce the potential exposure.

As is true with respect to most examinations, a substantial number of records may be scrutinized by the IRS. As a result, it is extremely important to ensure that privileged records, such as records that are cloaked with the attorney-client privilege, are protected from disclosure. Additionally, an employer should designate one person who will interact with the IRS examiner. This person can be someone "in-house" who is experienced with IRS examinations or outside counsel. Having a clear chain of command will help reduce the chances of any misunderstandings with the IRS and also reduce the chances of inconsistent information and statements being provided to the IRS. The person who is designated to communicate with the IRS examiner should insist that all requests for information from the IRS be in writing. In addition to leaving no question as to what is needed, this will prevent multiple requests by the IRS for the same information.