



irs audits employment tax compliance by nonprofits

MSK Client Alert

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As part of a national research project that began in 2010, the IRS is now in the process of examining various organizations with a focus on whether these entities are complying with the laws governing employment tax reporting and withholding. Both for-profit and tax-exempt entities are being examined by the IRS as part of this project. The IRS' decision to include tax-exempt nonprofits in the "pool" of entities that may be examined may result in these nonprofits having to face some challenging issues.

In the national research project, the IRS is randomly selecting several thousand entities for audit. The examinations will cover specific areas of the tax law where the IRS perceives abuses have been taking place. These areas include worker classification, fringe benefits, officer compensation, and reimbursement of employee expenses.

This means, for example, that a nonprofit that may have improperly classified workers as independent contractors (instead of as employees) could face significant tax bills if it is audited and these errors are discovered. Tax-exempt entities that have classified workers as independent contractors should conduct a thorough 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 any examination less stressful and time-consuming and reduce the potential tax exposure.

In addition to the worker classification issue, examinations will focus on compensation and fringe benefits that are provided by nonprofits to their employees, especially officers. The IRS will determine if entities are properly valuing the fringe benefits provided and whether they are including (and properly accounting for) these benefits when reporting the compensation being

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paid to their employees. If a fringe benefit is taxable, it is generally treated as additional salary or wages. This means that income taxes and employment taxes (such as Social Security (FICA)) must be withheld and remitted to the government based on the value of the fringe benefit. Failure to do so could subject the employer to liability for the amount that it should have withheld, plus penalties and interest.

An additional complication for nonprofits that fail to properly include fringe benefits in compensation, or that incorrectly value these benefits, is possible exposure to the intermediate sanction rules in Internal Revenue Code Section 4958. These rules, which generally apply to entities classified as public charities, prohibit excessive compensation and other benefits from being paid by a public charity to certain "disqualified persons." If these rules are violated, significant penalties may be assessed on both the disqualified person who received the excessive benefits and on the charity's managers who participated in awarding the excessive benefits.

Although there are many types of fringe benefits that the IRS is examining, one example is the car allowance. The Internal Revenue Code contains very specific rules on how to value, and account for, the benefit of an employer-provided car. As a result, it is important for employees who use an employer-provided vehicle to maintain logs that track personal and business use. If an employee fails to maintain accurate records, the IRS may seek to include the full value of the vehicle's use in the employee's income. This will have employment tax consequences to the nonprofit (because the employee may be viewed as having received additional salary/wages for which no withholding was taken) and may also result in a violation of the intermediate sanction rules if the employee's compensation (including fringe benefits) exceeds what is reasonable under the circumstances. This same analysis (and potential consequences) will apply to other fringe benefits, such as reimbursement for educational expenses, childcare assistance payments, cafeteria plans, and employee discounts.

If a nonprofit is selected for examination by the IRS, the IRS may seek to scrutinize a substantial number of records. As a result, it is essential to ensure that privileged records, such as records that are cloaked with the attorney-client privilege, are protected from disclosure to the IRS. Additionally, the entity 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 well-defined 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.

If you have any questions, please contact the author or any member of the MSK Charitable Sector Practice.