

# **POP QUIZ!:: IRS TO START WIDESPREAD EMPLOYMENT TAX EXAMINATIONS IN FEBURARY 2010**

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The Internal Revenue Service is striving to improve employment tax compliance and is putting its new and improved resources behind the effort. Starting in February 2010, as part of its National Research Program, the IRS will randomly select 6,000 taxpayers for intensive employment tax examinations over the next 3 years. Those selected will include a wide range of large, medium and small for profit businesses and tax exempt entities.

The purpose of the audits is to identify problem areas and reduce the “Tax Gap” attributable to unreported employment tax, currently estimated to be \$54 billion, of which \$15 billion represents FICA and unemployment taxes.

In addition to reviewing an employer’s withholdings and remittance of income taxes and Social Security and Medicare contributions, Revenue Agents will concentrate on five (5) areas:

**1. Worker Classification** – The examinations will review a taxpayer’s independent contractors to determine if those individuals should be classified as employees and, as a result, be subject to income tax withholding and employment tax. If the IRS finds that the workers are misclassified, such a determination may have an impact on the employer’s state tax and unemployment insurance obligations, as well as expose the employer to claims for unpaid wages and overtime.

**2. Fringe Benefits** - The IRS will be reviewing fringe benefits provided to employees to determine whether such benefits are in fact non-taxable (such as employee discounts and continuing education expenses), or should be included as compensation and subject to withholding and employment taxes. An example of a commonly misclassified fringe benefit is the use of a company vehicle for commuting to and from work.

**3. Officers’ Compensation** – Officer/shareholder compensation has frequently been an issue in corporate audits. Shareholders of S corporations who attempt to avoid employment taxes by receiving all of their income as distributions, rather than reasonable employee compensation, will face significant tax deficiencies and penalties. In determining whether compensation paid to a shareholder is reasonable, the IRS will consider all benefits and funds advanced to the shareholder, the shareholder’s duties and responsibilities and the standards in the industry.

**4. Employee Expense Reimbursement Plans** – To avoid being treated as compensation, and therefore subject to withholding and employment tax,

reimbursed expenses must be paid pursuant to an “accountable plan.” The employer must demonstrate that the reimbursed expenses are reasonable, business-related, properly accounted for and reimbursed in a timely manner.

**5. Non-filers** – The IRS will also continue its efforts to identify employers that are not filing their quarterly and annual employment tax returns, as well as any required information returns. In addition to the tax due, non-filers will face significant penalties and possible referral for criminal investigation.

There is nothing an employer can do to avoid being randomly selected, but employers can and should take this opportunity to review their internal policies and take any necessary steps to minimize their exposure.

If you wish to discuss the IRS employment tax examinations or have your current practices reviewed for potential exposure, please contact **Caroline D. Ciruolo (410-547-7852 or [cciraolo@rosenbergmartin.com](mailto:cciraolo@rosenbergmartin.com))** or any attorney in our tax group:

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