

EMPLOYMENT AND TAX LAW E-ALERT
MARCH 2010

CALLING IT "RESEARCH," IRS BEGINS MASSIVE
EMPLOYMENT TAX AUDITS

Using its most experienced auditors, the Internal Revenue Service has launched a national "research project" to randomly audit thousands of for profit and not-for-profit businesses throughout the United States. Its goal is to determine the extent of the employment "tax gap" (the amount the government is losing from businesses not complying with payroll and employment tax requirements) and to compile data it will use to formulate payroll and employment tax audit selection criteria in the future.

The IRS will continue this project for three years and will audit 2,000 employers each year, including 500 tax-exempt entities and 110 government entities. Those selected in 2010 will be notified in March that their 2008 taxes will be audited. The audits will be exceedingly comprehensive, but will focus especially on the following areas the IRS believes will bear the most fruit:

1. **Worker Misclassification.** The distinction between "employee" and "non employee" workers is one of the most elusive and complex ones in the tax Code (and the distinction is not identical for state and federal purposes). When the IRS researched this area in 1984, it estimated that 34 million employees were misclassified as independent contractors, resulting in a tax gap of \$1.6 billion. When considering whether a worker is misclassified, the IRS reviews the employer's ability to direct and control the worker's business and tasks. Employers should note that Congress has afforded them "Section 530 Relief" from tax liability for misclassification if they can establish they have consistently applied independent contractor status to all those in substantially similar positions, they have filed all tax returns required, and they have a reasonable basis for their determination, such as judicial or IRS precedent or industry practice.
2. **Treating Taxable Fringe Benefits as Nontaxable.** The value of most fringe benefits is taxable to employees. The IRS believes that the value of many of these benefits is not being included in employees' taxable income, and will review items such as company cars, moving expenses, club memberships, educational expenses, and employee discounts for compliance.
3. **Failure to Comply with Employee Expense Reimbursement Plan Requirements.** The IRS enforces "Accountable Plan" rules that require employers to show that reimbursed expenses are connected to their business; to obtain from employees adequate documentation for every reimbursed expense; and to ensure that employees pay back any excess advances or expense reimbursement payments they have received. Absent an Accountable Plan, reimbursed expenses must be treated as wages and are subject to payroll taxes.
4. **Insufficient Wages Paid to Executives Who Also Receive Dividends.** The IRS will look at whether closely held business owner-employees are receiving wages in the form of dividends to avoid personal income taxes.

In auditing not-for-profits, in addition to investigating worker misclassification, fringe benefits, and expense reimbursements, the IRS will look into whether officers and board members are benefiting excessively from insider transactions with the organization. If so, the IRS will require repayment and an excise tax of up to 200% of the excess benefit may also be imposed. Not-for-profits should also be prepared to justify loans to board members, officers, and employees and establish that executive compensation is reasonable.

It is clear that both the IRS and Massachusetts Department of Revenue will be devoting increasing audit resources to employment tax compliance. Davis Malm's tax and employment attorneys regularly assist their clients with reviewing current practices to ensure compliance, and where advised, with making appropriate applications for amnesty. We also can help clients in preparing for their interview, in those cases where a client has been selected for audit.

MASSACHUSETTS ANNOUNCES EMPLOYMENT TAX AMNESTY PROGRAM

Like the IRS, the tax authority for the Commonwealth of Massachusetts has also focused recently on employment-related taxes. Pursuant to new legislation, the Massachusetts Department of Revenue has announced a two-month tax amnesty program, which provides relief for taxpayers who failed properly to withhold income taxes from employees. (The program also provides relief for certain other taxes.) Generally, all penalties will be waived if the taxpayer voluntarily comes forward during the amnesty period (beginning April 1, 2010 and ending June 1, 2010) and pays all taxes and interest in full. The Department will be sending a "Tax Amnesty Notice" to eligible taxpayers.

In applying for amnesty, taxpayers may find it particularly helpful to be represented by an attorney, rather than their tax preparer. With the protection of the attorney-client privilege, client and counsel can frankly discuss whether the taxpayer is, in fact, liable for any back taxes, how any such delinquencies should be disclosed, and the relative costs and advantages of doing so during the narrow amnesty window. Where tax liability is uncertain, as it often is, counsel can approach the Department on the client's behalf, on an "anonymous" basis, to secure a good faith settlement before the client has to disclose its identity or potential tax liability.

Governor Patrick's recently proposed budget will provide increased funding for Departmental auditors for the fiscal year beginning July 1, 2010. We can expect that a fair share of this additional funding will be devoted to auditing employment tax delinquencies. The amnesty program is designed as a strong incentive for taxpayers to come voluntarily into compliance prior to this step-up in enforcement.

CONTACT

If you have concerns about your current payroll and employment tax policies or have questions about this client alert, please contact [Avi M. Lev](#) or a member of our [Employment Practice](#).

This article is provided as a courtesy and may not be relied upon as legal advice, or to avoid taxes and penalties. Distribution to promote, market, or recommend any arrangement or investment to avoid or evade taxes, including penalties, is expressly forbidden. Any communication with the author as to its contents, does not, of itself, create a lawyer-client relationship. Under the ethical rules applicable to lawyers in some jurisdictions, this may be considered advertising.

IRS Circular 230 Notice: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication is not intended or written to be used, and cannot be used by any taxpayer, for the purpose of avoiding U.S. tax penalties.