

IRS to Audit 6,000 Companies to Test Employment Tax Compliance

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The Internal Revenue Service (IRS) has announced that beginning in February 2010 it will commence detailed employment tax examinations of 6,000 U.S. companies. These examinations will provide statistical data for the IRS' first National Research Program (NRP) study of employment tax compliance since 1984. One stated objective for this audit initiative is to provide updated estimates for the extent to which the so-called "tax gap" is derived from employment tax compliance issues. Although the initiative is not specifically limited to these areas, the IRS has indicated that these audits will focus on five primary employment tax issues: worker classification, fringe benefits, reimbursed expenses, officer compensation and non-filers.

Which Companies Will Be Targeted?

The IRS has indicated that it will select 2,000 companies per year over the next three years to be audited as part of this NRP initiative. The audit initiative will target a broad cross-section of businesses of varying size and legal form, including tax-exempt employers. The IRS has remarked that there is very little that companies can do to avoid being targeted under this audit initiative, because the companies will be selected at random.

Once selected, companies should anticipate that the employment tax audits will be extremely detailed, and will very likely cover issues beyond the five specified areas of focus.

Who Will Conduct the Audits?

The IRS has indicated that these audits will be conducted by approximately 200 to 300 of its most experienced agents. These agents will undergo further specialized training in connection with their role in this employment tax audit initiative. These audits will very likely involve a line-by-line review of the company's employment tax returns (IRS Form 941, "Employer's Quarterly Tax Return"). The agents are also likely to review related documents, such as the employer's income tax returns (IRS Forms 1120, 1065, 990, etc.), as well as any information returns filed (IRS Forms W-2, 1099, etc.)

What Tax Returns Will Be Subject to the Audits?

The IRS has indicated that the NRP audits will likely focus on employment tax returns for the calendar years 2007 and 2008. Of course, the IRS is not limited in its ability to expand the scope of the audit either backwards or forwards into other open employment tax years, or into other categories of tax.

What Steps Can We Take to Prepare?

Although there is nothing that a company can do to avoid being targeted under this audit, there are certain measures that companies can take in response to the dramatic shift in the way the IRS will be policing employment tax compliance:

The tax and payroll departments should review the company's current payroll practices, with a specific focus on the five areas identified by the NRP initiative, as well as any other known areas of weakness.

Companies should also review the condition of their three most recent years'

employment tax returns, as well as all supporting documents and records. In most cases, the company's third-party payroll administrator can assist with this process. In the event that the company is selected for examination, good IRS examination management practices should be followed, including these steps:

Designate a clear "chain of command" for responding to audit notices and other IRS communications.

Retain expert outside advisors early in the process.

Maintain control over the IRS audit by requesting additional time to respond to information document requests, or tailoring the scope of information requested, where appropriate.

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