

## DETAILED IRS EMPLOYMENT COMPLIANCE AUDITS ANNOUNCED

The IRS has developed a **National Research Program (NRP)** on employment taxes. The goal is to collect substantial data that will assist the IRS with improving its examination techniques and close the gap between what is actually paid in employment tax and what should be paid. This is the first study on employment taxes in 25 years.

These detailed employment tax examinations of employers of various sizes were scheduled to begin in late February. Selected employers will be receiving IRS letters stating either they are subject to a "compliance research examination" or a "3859-B" examination. The bulk of the examinations will be conducted by the IRS Small Business/Self-Employment Division.

Under this NRP project, the IRS will randomly select and examine 2,000 employers in each of the next three years. The audits will likely begin with a review of IRS Forms 941, although the auditor may look at any line on an employment tax return. The examinations will focus primarily upon the following areas:

- Worker classification (employee vs. independent contractor);
- Fringe benefits;
- Reasonableness of executive compensation;
- Backup withholding; and
- Form 1099 reporting.

We recommend employers review the law and related regulations and evaluate their procedures and practices to ensure they are in compliance. Presented below is a brief overview of the above identified employment tax areas.

### EMPLOYEE VS. INDEPENDENT CONTRACTOR

In general, for income tax purposes, any worker receiving compensation for services is either an employee or an independent contractor. The IRS has a history of aggressively seeking to re-classify as "employees" those individuals who employers have attempted to classify as "independent contractors."

#### How does the IRS determine who is an employee?

In an examination, the IRS will consider all the facts and circumstances. Generally, an employer/employee relationship exists when the service recipient has the right to discharge at will, provides tools and a place to work, or provides training and supervision of the work.

#### If an employer issues a 1099-MISC to the person performing a service, doesn't that prove the worker is an independent contractor?

No. The IRS does not consider the type of document issued (W-2 or 1099-MISC) when determining who is an employee. Similarly, a worker's title or position, how payments are made or measured, and whether the worker is full or part-time, or has been hired to fill a temporary versus permanent position, are not determinative of his proper status.

#### What forms should I have on file for employees?

Each employee should have signed W-4 and I-9 forms on file, as well as completed employee benefit program participation forms.

#### What forms should I have on file for independent contractors?

Each independent contractor should have furnished to the employer a completed Form W-9 with his address and 9-digit taxpayer identification number (TIN). We recommend this form be filled out prior to the date the service is provided.

### FRINGE BENEFITS

Fringe benefits include a wide array of payments made by employers to, or on behalf of, their employees that are partially or totally tax-free. In addition, many fringe benefits are excludable from federal income tax withholding (FITW), social security and Medicare tax (FICA) and federal unemployment tax (FUTA). Some common examples are "no-additional cost services," "qualified employee discount programs," certain types of transportation assistance, and various types of "working condition fringe benefits" (such as on-site cafeterias for employees).

Many of these benefits cannot disproportionately benefit different classes of workers both as to eligibility to participate and benefits offered. The IRS enforces this through nondiscrimination testing with specific benchmarks that apply to the employer's "highly compensated employees."

#### Who is a highly compensated employee?

Generally speaking, an employee who either owns at least 5% of the employer in the current or previous year, or whose compensation is more than \$110,000 in the preceding year is considered a highly compensated employee.

#### What fringe benefit plans require information returns to be filed?

In many cases, no special information returns are required to be filed with the IRS with regard to an employee's receipt of employer-paid fringe benefits. For the most part, whenever special information returns are required, such obligation is satisfied by appropriate coding of the employee's Form W-2.

### EXECUTIVE COMPENSATION

The Internal Revenue Manual urges examiners to consider multiple factors to test if compensation is "unreasonable," including: nature of duties, experience, background, knowledge of business, size of business, individual's contribution to profit-making, time devoted to business, economic conditions generally and locally, character and amount of responsibility, time of year compensation is determined, the amounts' comparability to payments by similarly-sized businesses in same area to equally qualified employees for similar services, and whether any portion of the payments represent whole or partial payment for a business or acquisition of assets.

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## What are the consequences if the IRS determines compensation is “unreasonable (i.e., excessive)?

The portion determined to be excessive can be regarded as a non-deductible dividend to the employee if the employee is also a stockholder in the employer. For this reason, closely held businesses should carefully document through corporate minutes which of these factors were considered in determining base salary and bonuses for its executives.

## Would the IRS be concerned about “unreasonable” compensation which is paid to stockholder-employees of S-corporations?

Generally, no. But, the IRS is, however, interested in determining if the salaries being paid to stockholder-employees are less than what a “reasonable” salary would be for such an executive. The IRS’ interest in this regard is due to the fact that S-Corporation net earnings (after salaries and other tax deductible expenses) are not subject to Social Security and Medicare employment taxes. Therefore, small or no salaries to stockholder-employees is seen by the IRS as a way to circumvent or unfairly reduce these types of employment taxes.

## BACKUP WITHHOLDING

Backup withholding represents federal income tax that must be withheld by the payor of a “reportable” payment.

### What is a “reportable” payment?

“Reportable” payments generally include payments of interest, dividends, royalties, rents, commissions, and other compensation paid to non-employees.

### When is backup withholding required?

Backup withholding is required in the following circumstances:

- A payee either does not furnish his taxpayer identification number (TIN) to the payor or furnishes an “obviously incorrect number.” Examples of the latter would be a number with alphabetic letters or fewer than 9 digits.
- The IRS or a broker notifies the payor that the TIN is incorrect.
- The IRS has notified the payor of payee underreporting with respect to interest and dividends.
- The payee has failed to make the exemption certificate (Form W-9) with respect to interest and dividends.

### How much does the payor withhold and how does the payor remit the amount withheld?

The payor is required to withhold 28% of the “reportable” payment. Withheld amounts are reported on IRS Form 945 which must generally be filed with the IRS on or before January 31 of the year following the making of the payment.

## FORM 1099 REPORTING

An IRS Form 1099 is an information return filed with the IRS. It reports calendar year payments to recipients of most types of fixed and determinable income. In most cases, payors must also furnish copies of the Form 1099 to recipients of the payments on or before January 31 of the year following the year in which the payments were made. Copy A of each of the Forms 1099, accompanied by transmittal IRS Form 1096, must generally be filed with the IRS on or before February 28 each year. If filing electronically, these forms can be filed by March 31.

### Who should receive a Form 1099?

A payee who receives payments during the calendar year for broker & barter transactions (1099-B); dividends and distributions (1099-DIV); interest (1099-INT); and miscellaneous income such as rents, royalties, prizes and awards not for services, payments for services performed in a trade or business by people who are not treated as its employees (i.e., independent contractors, corporate directors) (1099-MISC). There are 16 types of 1099 Forms, each with at least one specific purpose and annual reporting amount requirement. General and specific instructions for each type of Form 1099 can be obtained at [www.irs.gov](http://www.irs.gov).

### What are the penalties for not issuing required Forms 1099?

There are generally two categories for penalties related to 1099s.

- A penalty of up to \$50 per 1099 can be assessed for failure to file correct information by the due date. If the IRS determines that the failure to file by the due date resulted from intentional disregard of IRS rules, the penalty increases to \$100 per 1099.
- A penalty of up to \$50 per 1099 can be assessed for failure to furnish correct payee statements to each payee. Again, if the IRS determines that the failure to furnish the payee statements by the due date resulted from intentional disregard of the IRS rules, the penalty increases to \$100 per 1099.

### What choices does a payor have if a payee will not provide to the payor the payee’s correct TIN?

The payor should present the payee with a Form W-9 and written notice that 28% will be withheld for backup withholding or the payor will consider ceasing payments to the payee until a TIN is provided. In any event, no payments should be made until a Form W-9 is completed and returned to the payor with the payee’s address and 9-digit TIN.

*If you receive an IRS “compliance research examination” or a “3859-B” examination letter, we encourage you to contact a UHY Advisors’ tax professional to assist you in preparing for the examination. We are also available to represent you during the examination.*

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