Tax & Employee Benefits Alert

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Employment Tax Audits Have Begun

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Employment Tax Audits

In February 2010, the Internal Revenue Service ("IRS") began employment tax audits of approximately 6,000 U.S. companies. The IRS will audit 2,000 companies each year for the next three years to provide statistical data for the National Research Program study of employment tax compliance, which the IRS has not done since 1984. The 2,000 companies selected each year will be at random and will include businesses ranging in size from large to small as well as tax-exempt employers. The audits will be conducted by 200 to 300 of the IRS's most experienced agents, and although the audits will likely focus on employment taxes for calendar years 2007 and 2008, the IRS may audit any open tax years.

What Areas Will the IRS Focus On?

The IRS has indicated that it may focus on the following areas:

- **Worker Classification**. The focus will be on the classification of workers as "independent contractors," including the exclusion of misclassified workers from certain benefits.

- **Fringe Benefits**. The focus will be on executive fringe benefits, including aircraft usage, company cars, club dues, spousal travel and housing. The audit may also review certain broad-based noncash fringe benefits such as working condition fringes, club memberships and employer cafeterias.

- **Reimbursed Expenses**. The focus will be on expense reimbursement plans and whether such plans are properly classified as "accountable plans," which disallows the reimbursement of certain qualified business expenses from being treated as compensation.

- **Officer Compensation**. The IRS has indicated that it will devote significant attention to executive compensation. This may include reviewing executive loans, stock-based compensation arrangements, retirement arrangements and golden parachute payments (i.e., if executives properly included such golden parachute payments in income), and nonqualified deferred compensation arrangements. *Notably the IRS has developed an extensive and time-consuming questionnaire that audited companies will need to complete regarding Code Section 409A. The IRS's goal is to ferret out the level of compliance with this complicated and arcane Code Section which governs deferred compensation plans. We have attached a sample information document request ("IDR") the IRS has issued relating to Section 409A compliance at the end of this alert.*

- **Non-Filers**. The focus will be on companies that are subject to employment taxes but are not currently filing employment tax returns.

Be aware, however, that these employment tax audits are going to be extremely detailed and may go beyond the scope of the five areas described above.

Next Steps

Although you will not be able to avoid being targeted, you can take certain measures to reduce your exposure. Specifically, while focusing on the five areas specified above, your tax and payroll departments should review all current compensation arrangements and payroll practices and policies for employment tax compliance. In addition, you should not attempt to complete any IRS information requests without the assistance of a qualified tax professional with expertise in this area.

If you have any questions in general or are under audit, please contact Debra Koenig, Lecia Johnson, Sven Skillrud or other member of the Godfrey & Kahn Tax & Employee Benefits Team at 414-273-3500.

Sample Section 409A Information Document Request

One area that the IRS has already indicated it will be focusing on is Section 409A, which governs nonqualified deferred compensation arrangements. Further information regarding Section 409A and its requirements can be found in our prior updates at: http://www.gklaw.com/practice.cfm?action=news&practice_id=26.

Specifically, the IDRs that the IRS has issued thus far require the company under audit to identify detailed payment information and take potential positions regarding certain information, including:

- Identifying any plan or arrangement providing for a legally binding right to compensation in one year that is paid in a subsequent year and is not subject to Section 409A; the basis for such position; and if the basis is the short-term deferral exclusion, the specific terms of the plan or arrangement, including describing any substantial risk of forfeiture;

- Describing the terms of any deferral elections and the relevant election deadlines;

- Describing the terms of any subsequent deferral elections (*i.e.*, changes to initial deferral elections), including the original and rescheduled payment dates;

- Identifying any acceleration of payments made before the originally scheduled payment date, including elections made under any applicable transition relief and the deadlines for such elections and identifying the original and actual payment dates;

- If a public company, identifying the "specified employees" and the relevant periods the employees were considered as such; describing any payments of nonqualified deferred compensation made to specified employees during the applicable year due to a separation from service, and whether such payments were made six months after the date of separation from service;

- Describing any stock rights that could be subject to Section 409A;

- Determining any funding of deferred compensation occurred during an event that relates to a decline in the company's financial condition; and

- Identifying any Section 409A violations and whether the company utilized a Section 409A corrections program.

As a reminder, a violation of Section 409A can accelerate the participant's inclusion of all income deferred under the arrangement which would results in a 20% penalty tax for the participant over and above the income tax owed, as well as interest on such amounts if the tax is not paid in the proper tax year, and additional tax reporting and withholding obligations for the company. Furthermore, these consequences may apply not only to the offending plan or arrangement, but also to similar plans or arrangements subject to Section 409A to which the participant is a party, even if those arrangements comply with Section 409A.

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