

IRS Small Business Audits

In February, 2010, the Internal Revenue Service (IRS) began its long anticipated National Research Program (NRP) audits for employment taxes. The NRP will randomly audit approximately 2,000 employers per year for the next three years. Because the audits are random, any employer, whether for profit or nonprofit, big or small, could be selected. The purpose of the NRP audits is to provide the IRS with a statistical sample of overall employment tax compliance.

If you are a small business employer, the NRP audits are a good reminder for you to undertake an internal review now, so that you can bring your business into compliance in advance, and be prepared in the event that you are audited.

In addition to determining levels of compliance, the NRP audit data is used by the Treasury Department to determine the “tax gap,” which represents the difference between taxes that are owed and taxes that were not fully paid because of taxpayers’ underreporting, underpayment and non-filing. The Treasury Department estimates that the tax gap for employment taxes is approximately \$59 billion per year, consisting of underreported FICA taxes (\$14 billion), unemployment taxes (\$1 billion), self-employment taxes (\$39 billion) and underpaid taxes (\$5 billion).

The IRS has identified several issues on which the employment tax NRP audits will be focused:

Worker classification: Businesses generally determine whether a worker is an employee or independent contractor by applying common law rules. These rules state that if the employer has a right to control the manner and means by which the worker performs services, as well as the result, the worker is an employee. If this standard is not met, the worker is generally treated as an independent contractor.

Although this may seem evident, worker classification determinations are actually very fact-intensive and difficult to make. In the NRP audits, there is significant focus, not only in the tax arena but also under laws such as wage and hour, on the proper classification of workers.

Fringe benefits: The IRS audits will focus on whether taxable and nontaxable fringe benefits are being properly reported, and whether all rules required to receive a nontaxable fringe benefit are being followed. Common fringe benefits include: accident and health benefits, educational assistance, employee discounts, employer provided lodging and meals, moving expenses, transportation benefits and working condition fringes.

Reimbursed expenses. Reimbursed expenses may be either taxable as wages or nontaxable. In order for expenses to be treated as nontaxable, they must be made under an “accountable plan.” An “accountable plan” requires:

- a business connection;
- reasonable expenses;
- a reasonable accounting for the expenses; and
- reimbursement for any excess payments.

In the audit, the IRS will examine whether proper accountable plans have been established and whether employees are compliant.

Compensation of owner employees. The last area of particular scrutiny in the NRP audits is the reasonableness of officer or owner compensation when such persons receive both wages and dividends or other profit distributions. This issue is most likely to arise for closely held or small one-person corporations.

Reasonableness of officer compensation that should be treated as wages versus dividends is also a fact-specific test that is difficult to gauge.

As an owner/operator of a small business, you should not ignore the fact that you may be subject to a NRP audit, which will be intensive and time consuming. If deficiencies are discovered in any of the areas mentioned above, you will be liable for whatever penalties are assessed. If you can conduct an internal audit in these areas now, you may identify and correct specific items so that you become compliant, in the event that your business is audited.