Beginning this fall the Internal Revenue Service (IRS) is initiating a tax compliance project using its National Research Program (NRP). The project will include employment tax audits of thousands of businesses randomly selected over the next three years. The NRP started in 2000 to measure the “tax gap” between taxes voluntarily reported and paid by businesses and the amounts the IRS has determined are actually due.

The NRP is focusing on four areas that the IRS feels are improperly reported by employers and businesses:

1. Worker Classification (employee vs. independent contractor status)
2. Taxable Fringe Benefits
3. Officers’ compensation
4. Reimbursed expenses

**Worker Classification:**

It is important to determine the proper classification for employees and independent contractors. Be very careful when paying individuals as independent contractors. With more than 60 percent of taxes coming through the employer tax system, it is incumbent on employers to properly classify their employees. Your HR personnel can “test” your companies Independent Contractors to determine if they meet the IRS guideline for Independent Contractor status. Misclassifications can be costly. If you find a classification error, rectify it immediately.

If the IRS reclassifies a worker as an employee, the employer becomes liable for employer taxes such as Social Security, Medicare and Unemployment taxes as well as a portion of the employee’s taxes that should have been withheld. Additionally the employer will be liable for penalties and interest for failure to (a) pay these taxes, and (b) file payroll tax returns. Businesses may have their retirement plan retroactively disqualified which could cause all vested accrued benefits to become fully taxable for all employees enrolled in the plan. They may have to include reclassified employees in all company sponsored benefits.

**Taxable Fringe Benefits:**

The fair market value of any fringe benefit received by an employee is includible in the employee’s taxable wages and on their year-end W-2 unless the benefit is specifically excludable by law.

Examples of some taxable fringe benefits include: personal use of company vehicles, personal flights on an employer provided aircraft, employer provided housing, employer provided memberships in social or country clubs, and employee legal services paid for by an employer. This list is not meant to be all inclusive; it is a representation of the types of fringe benefits that are taxable compensation to employees.

As a general rule taxes associated with the value of these fringe benefits must be deducted from regular cash wages before the end of the calendar year.

**Officer’s Compensation:**

Services provided by owners of a corporation are Wages. Because S-Corporation profits are not subject to social security taxes, the IRS requires owners to be paid a “reasonable compensation” for services rendered. The IRS is carefully looking at S-Corporations that do not pay an employee/owner reasonable compensation. Reasonable compensation is defined as “what a similar individual would be paid to handle all the ownership duties and responsibilities.”

**Reimbursed Expenses:**

Expense reimbursements or allowances can be deductible by the business and not taxable income to the employee if they are paid under an accountable plan. To qualify as an accountable plan, the reimbursement or allowance arrangement should meet three requirements:

1. There must be a business connection—payments must be for deductible business expenses paid or incurred by
employees in connection with performing services for their employer.

2. Employees must substantiate their expenses in a timely manner—this means submitting a written expense statement to their employer showing business nature and amount of the expense.

3. Employees must be required to return excess payments—at least quarterly an employer must give an employee a statement that shows payments in excess of substantiated expenses and request additional substantiation or the employee must return the unsubstantiated amounts within 120 days of the statement date.

All or nothing—if the arrangement meets all three of these requirements, all amounts paid under the arrangement are treated as paid under an accountable plan and are included in the employee's taxable income as wages or other compensation.

The Best Defense:
The best way to be prepared for such an audit is to make sure documents are “audit ready.” You should have available the prior four years' records, and they can be provided on electronic media if desired. Basic employment tax records available for the IRS review should include:

- Federal business employer identification number (FEIN);
- Amounts and dates of all wage, annuity, and pension payments;
- Amounts of tips reported to you by your employees, if applicable;
- Record of allocated tips, if applicable;
- The fair market value of in-kind wages paid;
- Names, addresses, Social Security numbers and occupations of all employees;
- Employee copies of W-2's that were returned as undeliverable;
- Dates of employment for each employee;
- Periods for which employees were paid while absent due to illness or injury, and the amount of weekly rate of payments you or third-party payers made to them;
- Copies of employee tax withholding allowance certificates (W-4);
- Copies of employees' Earned Income Credit Advance Payment Certificates (Form W-5);
- Dates and amounts of tax deposits, including acknowledgment numbers for EFTPS deposits;
- Copies of returns filed;
- Records of fringe benefits and expense reimbursements provided to employees, including substantiation.

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