

IRS Releases Updated Employment Tax Examination and Appeals Rights Publication

The Internal Revenue Service ("IRS") has issued an update to Publication 5146 (Employment Tax Returns: Examinations and Appeal Rights) which outlines the procedures used to conduct employment tax examinations and employers' rights and responsibilities during and after the examination process. Employment tax examinations typically include a review of an employer's withholding and deposit practices related to income taxes, Social Security and Medicare taxes, and, to the extent applicable, tax obligations under the Federal Unemployment Tax Act and Railroad Retirement Tax Act. Such exams will also consider the proper reporting of these taxes. In recent years the IRS has continued to increase its focus on employment tax audits for all employers.

According to the Publication, employment tax audits generally arise in one of two ways:

1. IRS's computer selection programs. These programs select employers for audit based on errors on information returns employers file with the IRS (e.g. Forms W-2 or 1099), information from past examinations, or other selection criteria identified by the IRS as being risk areas.
2. Results from IRS compliance programs. These programs may involve review of information obtained from mailings to employers regarding targeted areas of employment tax issues. These programs may also be based on reliable information received from sources like news media and other public records.

Once selected for examination, the IRS will seek to determine whether an employer correctly performed its withholding obligation and whether the employer timely deposited and reported withheld amounts. This portion of the exam can include a review of proper reporting on Forms W-2, Forms 1099-MISC, Forms 941, Forms 945, etc. During the examination process, the IRS can contact third-parties to verify the information reported by an employer. For example, the examiner may reach out to an employer's payroll providers, independent contractors and/or financial institutions to verify the accuracy of positions taken on employment tax returns.

Because of the significant financial impact an employment tax

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audit can have, it is advisable to review current tax practices in areas the IRS has identified as high risk for noncompliance. In addition, employers should shore up any gaps in internal controls to decrease the opportunities for errors to occur. Depending on the size and complexity of the employer's compensation programs, it may be desirable to consult with tax counsel throughout the examination process.

There are a number of relief provisions that may be available if an IRS examination determines an employer owes employment taxes. Most notably, the relief available in worker misclassification cases. If certain criteria are met, an employer may be able to avoid any liability or be subject to only a fraction of the amount of additional employment taxes owed for workers the IRS determines were misclassified as independent contractors rather than employees. However, if employers disagree with the IRS's determination and/ or relief provisions are unavailable, Publication 5146 indicates that employers may be able to reach a compromise or resolution through the IRS's appeals procedures or through judicial review and provides a brief outline of each process.

We have represented a number of clients that have been audited and we are aware of several other employers currently under audit. These experiences give us a unique understanding of the relevant issues and the process that is involved in employment tax audits. In addition, one of our partners serves on the Advisory Committee on Tax Exempt and Government Entities which advises the IRS leadership on policy and procedural improvements in several areas, including employment taxes.

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