Employment tax audits: Identifying pitfalls and increasing compliance

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In brief

Any business facing an employment tax examination is likely to be subject to scrutiny on certain key areas. The IRS historically has focused on and continues to emphasize fringe benefits, worker classification, travel expense reimbursements, and executive compensation. Additionally, international payroll is a new area of emphasis for the IRS in its examinations and could affect businesses with even a small number of foreign inbound or US outbound employees.

IRS employment tax agents look into all of these issues regularly and have developed broad information document requests to identify potential gaps in compliance. The evolution of the IRS's Questionable Employment Tax Practices Program to share information with at least 37 state agencies heightens the importance for businesses to ensure they are currently compliant.

To achieve increased certainty, employers should review existing policies and procedures, even before an examination, to ensure they are appropriately identifying potential missteps and improving processes in these areas in order to minimize tax and penalty exposure. This article highlights a few of the key areas commonly examined by employment tax specialists and ways for businesses to proactively increase their compliance in these areas.

In detail

Travel expenses

Accountable plans

A common area of emphasis in employment tax examinations is business expense reimbursements. IRS employment tax specialists are taking a close look at company practices around travel expense reimbursement arrangements to determine whether the accountable plan requirements are satisfied. Employers should be aware of the general rules that permit the exclusion of gross income by employees as well as the fact patterns that may trigger income inclusion for employees and withholding, depositing, and reporting obligations for employers.

Business expense reimbursements made by employers to employees are excluded from wages only if they are paid under an accountable plan. To qualify as an accountable plan, the following three requirements must be met:

- There must be a business connection to the expenditure;
- There must be adequate accounting (substantiation) of the time, place, and purpose of the expenses by the recipient within a reasonable period of time; and
- Excess reimbursements or advances must be returned within a reasonable period of time.

With respect to the first requirement, the employee's expenses have a business connection if incurred in connection with his or her performance of services as an employee. These are non-personal expenses that, without employer reimbursement, would have been deductible by the employee on his or her individual federal income tax return as a business expense.

Under the second requirement, an employee must substantiate his or her business expenses within a reasonable period of time. To provide adequate accounting, an employee must submit evidence to the employer of the amount of the expense, the date, time, and place the expense was incurred, and the business purpose for the expense. Documentary evidence substantiating these expenses generally may include bills, receipts, or similar items to support the claimed expenses, but there are certain exceptions depending upon the facts that also may eliminate the need for receipts or bills.

Under the third requirement, amounts paid or advanced by the employer that exceed the amounts spent by the employee must be returned to the employer within a reasonable amount of time. Certain safe harbor methods are available to determine whether this requirement was satisfied. Advances paid for business expenses in excess of the amount actually incurred and substantiated by the employee, which are not required to be returned to the employer, are wages subject to federal income tax withholding, social security and Medicare (FICA) taxes, and federal unemployment (FUTA) taxes.

The benefit of an accountable reimbursement arrangement is that properly documented business expenses are excluded from the employee's gross income, exempt from federal income tax withholding and FICA, and are not reported on Form W-2, *Wage and Tax Statement*. If an allowance or reimbursement arrangement does not meet all three requirements listed above, it is defined as a 'nonaccountable plan.' In general, payments made under a nonaccountable plan are taxable wages subject to federal income tax withholding, FICA taxes, and FUTA taxes when paid or when constructively received by the employee.

To the extent that there is a systematic failure of an accountable plan, such as clear evidence that employees are not providing substantiation of expenses or receiving advances without returning excess reimbursements, the IRS may assert that *all* expense reimbursements are paid under a nonaccountable plan and therefore constitute taxable wages.

Tax home

Travel expenses reimbursed by an employer through an accountable plan are not excludable from an employee's gross income unless the employee was temporarily traveling 'away from home.' For companies that have a number of transient employees traveling and incurring related business expenses, this analysis can be challenging. IRS agents will closely examine the facts and circumstances to determine whether the associated travel expenses should have been included in employees' wages. In particular, agents may identify key employees or groups of employees and scrutinize their performance of services to assess whether the individuals were traveling away from home.

An employee's 'home' is the individual's principal place of business. If the employee has no regular or principal place of business, the home is the location where the individual maintains certain personal and business connections. In particular, the IRS will consider: (1) the total time spent by the employee at each location, (2) the degree of business activity at each location, and (3) the business income derived from each location.

The determination of employees' tax home is also critical because transportation expenses, such as commuting expenses, generally are wages subject to federal income tax withholding, FICA tax, and FUTA tax as personal expenses. Commuting expenses are those incurred when an individual travels between his or her private residence and tax home.

Employers with a transitory workforce will find this factual analysis particularly challenging, but it is important to monitor employee assignments and periodically assess whether any employee's tax home has shifted. As noted above, business expenses are excludable only while the employee is *temporarily* traveling away from home. The general rule is that employment is temporary for these purposes if the employee travels away from home to a single location on an assignment that is realistically expected to last (and in fact does last) for one year or less.

If the assignment at any point is expected to have an indefinite duration, or it is determined that it will last longer than one year, the employee's tax home shifts to the location of the assignment and travel expenses are not excludible from gross income. Accordingly, it is crucial for businesses to document the employee's assignments, maintain current employee-level data, address long-term work assignments at the outset of the project and re-evaluate the arrangement as it progresses to

ensure the correct tax treatment of reimbursements for related travel expenses.

Per diem

A per diem allowance provides an alternative to some of the stringent accountable plan requirements. A per diem allowance is a payment made to employees for lodging, meals, or incidental expenses incurred while traveling. This allowance is paid in lieu of a reimbursement of actual travel expenses. By offering a per diem allowance to employees who incur business-related travel expenses, documentary evidence such as receipts are not required to be submitted to the employer.

There is a published federal per diem rate for combined meal and lodging costs, by geographic area, as well as a per diem rate for meals alone. Either rate may be used to reimburse employee travel expenses. To be excluded, the per diem allowance must be equal to or less than the applicable federal per diem rate. To the extent that the allowance exceeds the federal rate, the excess (if not returned to the employer) constitutes wages subject to withholding, depositing, and reporting requirements.

While an employee does not have to provide receipts, invoices, or bills to substantiate the actual amount of the business expense incurred, it is important to note that the date, location, and business purpose of the expenses incurred with the per diem allowance still must be documented. For example, employees may complete an expense report that notes the business purpose of expenses paid with the per diem allowance in addition to where and when the expense was incurred.

For companies that have large numbers of employees who receive a per diem allowance, valid documentation can become a significant issue on an employment tax examination. IRS agents may challenge whether the per diem allowance was properly excluded from employees' gross income if expense reports were not submitted or if employees were not traveling away from their tax home. Therefore, employers should review their policies and procedures for per diem allowances to ensure that the amount remitted is less than the published federal per diem rate and expense reports are required and are reviewed for the proper information.

Key takeaways for travel expenses

In summary, the IRS could assert that an employee's reimbursed travel expenses are includible in his or her taxable income if they find that the accountable plan rules were not met, the employee was not temporarily traveling away from his or her tax home, or the per diem allowances were not properly documented or were in excess of the published federal per diem rate.

To the extent that there is wide-scale failure to treat business expense reimbursements as taxable income where these requirements are not satisfied, such as recipients not temporarily traveling away from their tax home, the tax exposure could be significant. Moreover, policies and procedures to gather documentation are critical to ensure that the accountable plan rules and substantiation requirements for per diem allowances are satisfied.

Depending on the facts, there also could be penalty exposure for the failure to furnish and file correct information returns, failure to timely deposit employment taxes, failure to file or failure to pay the amount of tax reported on Form 941, *Employer's Quarterly Federal Tax Return*, or for accuracy-related penalties.

Worker classification

The classification of service providers as employees or independent contractors continues to be a key area of emphasis in employment tax examinations. The correct classification of a worker is a topic of renewed emphasis during routine internal compliance reviews not only because of the potential tax and penalty exposure that may result from misclassification, but now because of the excise taxes imposed by the Patient Protection and Affordable Care Act on 'large' employers that fail to provide healthcare coverage to full-time employees.

Whether a worker is properly classified for tax purposes as an independent contractor or an employee is a complex question. There is no statutory bright-line test. Instead, the applicable common law standard requires an examination of the facts and circumstances surrounding the relationship between a service recipient and a service provider. Following the common law standard, the employment tax regulations provide that an employer-employee relationship exists when the employer for whom the services are performed has the right to direct and control the worker who performs the services. This control refers not only to the result to be accomplished by the services provided, but also as to the details and means by which that result is accomplished.
The IRS currently uses a framework of three general categories of evidence to assess the facts and circumstances and determine whether an individual is an employee or an independent contractor. The three categories of evidence are: (1) behavioral control, (2) financial control, and (3) the relationship of the parties.

Behavioral Control focuses on facts that illustrate whether there is a right to direct or control how the worker

performs the specific task for which he or she is engaged, such as instructions, training, and evaluation system.

Financial Control focuses on facts that illustrate whether there is a right to direct or control how the business aspects of the worker's activities are conducted, such as significant investment in equipment or materials, unreimbursed expenses, services available to the relevant market, method of payment, or opportunity for profit or loss.

Relationship of the Parties focuses on facts that illustrate how the parties perceive their relationship, such as the intent of the parties expressed in contracts, employee benefits, discharge /termination, and regular business activity.

Businesses may perform an evaluation of their current pool of independent contractors to identify potential misclassification and determine what remedial actions are advisable. For example, businesses may update the terms of their relationship with independent contractors to strengthen the classification. Before making a change, businesses should consider whether safe harbor relief under section 530 of the Revenue Act of 1978 may allow them to continue to classify a group of workers as independent contractors.

When reclassification is the best option, certain IRS settlement programs, such as the Voluntary Classification Settlement Program, may provide attractive alternatives to businesses to mitigate exposure. If the IRS identifies misclassified workers, the employer could face an assessment for employment taxes and related penalties and, starting in 2015, may face additional excise taxes imposed as a result of the Affordable Care Act. There are other significant indirect consequences beyond payroll tax liability, such as employee benefit plan participation, for worker misclassification.

International

The IRS has reorganized its organizational structure in an effort to manage international aspects of compliance more effectively. One result is that international payroll tax issues have gained further attention. IRS employment tax specialists have received training and are pursuing more aggressive audit plans in this area. The scope of these audits often includes a thorough review of payroll practices related to the treatment of wages paid to both inbound and outbound employees.

For non-resident aliens (NRAs) performing services in the US, as well as US persons performing services outside the US, there are a series of significant considerations to be addressed when assessing an employer's withholding and reporting obligations.

As to the employee, specific facts including the employee's citizenship, residency, Visa status, treaty position, location of services performed, and personal elections may drive the employer's responsibilities. Initially, an employer must determine whether the employee is a US citizen, a US resident, or an NRA for US tax purposes. Like US citizens, resident aliens generally are taxed on their worldwide income, while NRAs are taxed only on their US-source income absent an exception.

Facts about the employing entity (and entity in control of the payment of wages, if different) also are important. For example, FICA taxes often apply to wages paid by US employers, but not to foreign employers, that employ US citizens or residents abroad.

It also is important to remember that FICA, FUTA, and federal income tax withholding rules are not the same and often result in different treatment of the same wage item.

The IRS may propose an adjustment for FICA, FUTA, and federal income taxes if it determines that an employee's US taxable wages were improperly calculated and reported. Therefore, it is essential for employers to gather the necessary information in order to assess their responsibilities with regard to the payments and to identify potential exceptions that may apply to reduce or eliminate withholding of federal income tax, FICA, or FUTA.

The IRS also has increased enforcement efforts directed at information reporting and withholding on US-source FDAP (fixed, determinable, annual, periodical) income. In general, a withholding agent that makes a payment of US-source FDAP income, such as a payment for personal services, to an NRA who is a non-employee has an obligation to withhold taxes, deposit the amounts withheld to the IRS, and report those payments on Forms 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, and 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*. Businesses should assess whether they make reportable payments to NRA non-employees and received valid documentation in connection with those payments, such as Form W-8-BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding*, or Form 8233, *Exemption from Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual*.

The takeaway

Preparedness and prevention are critical tools in navigating complicated employment tax issues. A proactive approach to the potential

issues raised in employment tax audits will identify key areas to address through updated policies and procedures as well as mitigate tax and penalty exposure. Taxpayers should assess whether there are any gaps in payroll processes and the gathering of appropriate documentation in the areas of travel expense reimbursements, worker classification, and international payroll, given the likelihood of these issues being raised in the context of an employment tax audit. Additionally, it is important for taxpayers to be aware that these more commonly raised issues may not be the only items addressed by the IRS upon examination, and thus other employment tax issues may need to be considered ahead of an examination.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC Private Company Services representative, or one of the subject matter professionals listed below:

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