

# IRS Focuses on Employment Tax Issues during Tax-Exempt Organization Audits

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With tax filing season well underway, organizations of all sizes are beginning to identify areas of potential noncompliance and, for nonprofits, a common culprit is employment tax issues.

The IRS has emphasized employment tax compliance during its tax-exempt audits for many years. As we've noted in multiple prior Nonprofit Standard blog posts (see ["IRS Issues 2017 Work Plan for Tax Exempt Organizations"](#) and ["UBI Issues: Is Your Organization at Risk?"](#)), the IRS has officially stated that this employment tax focus will continue into 2017. In the IRS' Tax Exempt and Government Entities FY 2017 Work Plan, which details its priorities and mission for the coming year, the IRS disclosed that more than 25 percent of closed audits had a "primary issue" related to employment tax. At the end of June 2016, 1,323 audits involved primarily employment tax issues, out of a total 4,984 closed examinations. Further, the IRS continues to include employment tax issues within its list of high-risk areas of noncompliance.

The IRS states in its 2017 Work Plan that, "Employment Tax includes unreported compensation, tips, accountable plans, worker reclassifications and noncompliance with FICA, FUTA and backup withholding requirements." While this definition covers a wide range of areas, our experience with IRS employment tax audits and associated information document requests (IDRs) indicates that likely issues for review may include, but are not limited to, the following:

- Expense reimbursements and accountable plan compliance;

- Fringe benefits (e.g., relocation/moving, automobiles, group term life, cell phone reimbursement, prizes/awards, spousal travel and education benefits);
- Independent contractor classification and income reporting;
- Supplemental pay reporting and processes, including timing of wage inclusion for various tax and wage types (including retirement pay and incentives);
- Form W-9 process, Form 1099 TIN matching procedures and backup withholding compliance;
- Forms W-2c and 941-X processes;
- International cross-border employment tax issues; and
- General compliance procedures for employment tax filing obligations.

The IRS appears to be trying to streamline its processes for audit target identification, focusing on increasing efficiency as it works with fewer resources. As such, the agency has implemented a "data-driven case selection process," and is seeking new ways to identify data that can indicate patterns of noncompliance. Other 2017 IRS priorities include working to develop an employment tax knowledge database (the "Employment Tax K-Net") to track and disseminate what is learned during audits, and to use it to further train employees in this area. It is likely that with enhanced training, IRS examiners will more readily identify more complex potential employment tax issues for review rather than merely focusing on the "low hanging fruit."

**Failure to comply with employment tax reporting obligations can result in the imposition of significant tax, penalties and interest.**

Based upon the IRS' continued focus on employment tax issues, it is imperative that tax exempt entities review their policies and processes and invest in initiatives and resources to ensure compliance. Organizations should also document all policies and processes so that they may readily demonstrate upon audit that IRS compliance protocols are followed. Being proactive and completing an internal employment tax process review or even a "mock audit" may help to identify issues and result in the early implementation of corrections before the IRS is involved. Failure to comply with employment tax reporting obligations can result in the imposition of significant tax, penalties and interest. Additional wage inclusion due to employment tax noncompliance could also trigger further questions from the IRS pertaining to inurement or private benefits.

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