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Employment Issues & the IRS: Why All Employers Should Review Employee-Related Plans and Practices Now!

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The Internal Revenue Service has recently announced plans to conduct payroll tax audits of approximately 6,000 companies and increase its focus on compliance issues relating to section 409A of the Internal Revenue Code of 1986 ("Code"). To be ready for such audits, employers should review worker classifications, fringe benefit polices, executive compensation arrangements and Code-qualified employee benefit plans now. This will allow companies to make the necessary corrections and mitigate possible penalties and fees that might be assessed in an IRS audit. Critical areas to focus on are: payroll tax practices, section 409A plans and employment arrangements, and Code-qualified 401(k) and defined benefit plans.

Payroll Tax Practices

In September 2009, the IRS announced that it intends to audit 6,000 companies over the next three years with a focus on payroll tax practices, fringe benefits and executive compensation. The IRS will use this information as part of its National Research Program to determine general compliance issues within these areas. The goal is to increase compliance in the payroll tax area, thereby increasing overall tax collections. Companies should conduct a thorough review of their current payroll tax practices in advance of these audits. In particular, the IRS will focus on worker classification and fringe benefit policies. Fringe benefits include items such as transportation benefits, education assistance, and employee discounts. Fringe benefits that do not meet the applicable rules and documentation requirements can result in income to an employee as well as employment tax obligations on the employer. Executive and non-executive fringe benefit policies and expense reimbursement procedures should be reviewed for any discrepancies that may have monetary implications to the employee or employer in a tax audit.

Also, companies should assess whether those individuals or third-party relationships currently classified as "independent contractors" actually qualify as such. These classifications will directly impact tax withholding and benefits issues and are determined by a wide variety of facts and circumstances. Improper worker classifications can ultimately impact federal and state tax liabilities (including unemployment tax liability), health and welfare benefits obligations, Code-qualified benefit plan participation and funding, and IRS penalty exposure. Companies may be able to mitigate certain risks and penalties by proactively assessing whether all current worker classifications are correct. In general, an employment tax and benefits review is essential as the IRS begins this large scale audit and ultimately uses the information it gathers to focus on particular types of employers and issues.

Section 409A

Code section 409A was enacted in 2004 as a broad-based statutory reform of nonqualified deferred compensation. Deferred compensation is compensation earned in one taxable year, which is or may be payable in a later taxable year. Violation of these complex rules (whether operational or documentary) can result in severe penalties to the recipient of such deferred compensation. The amount connected to the violation will be subject to immediate taxation, a 20% additional tax and an interest payment at 1% above the underpayment rate. While IRS Notice 2008-113 provides a corrections program for certain operational failures, all section 409A applicable plans and arrangements were required to be in documentary compliance by December 31, 2008. However, based on IRS Notice 2008-115, there may be an opportunity to amend non-compliant documents by December 31, 2009 for benefits that will vest in 2010 or later, without causing adverse tax consequences to employees.

Now that section 409A is fully in effect, the IRS will likely focus on related plans and arrangements as part of an audit. We understand that the IRS is currently formulating 409A audit guidelines for years 2006-2008. Employers should review all deferred compensation plans for documentary compliance, as well as review all deferral and/or subsequent deferral elections, potential payment accelerations, and any stock-related awards subject to 409A. These internal reviews may allow a company to proactively correct any problems before an IRS audit, as well as providing assurance to executives or other employees that they should not be subject to 409A penalties and that any current operational errors have been remedied.

Qualified Plan Corrections

A preemptive internal review of all qualified plans may permit employers to correct errors and pay smaller penalties than if these errors are discovered during an IRS audit. In addition, such a proactive approach to plan corrections may be looked at favorably by the IRS if there is an audit at a later date and errors are discovered. The Employee Plans Compliance Resolution System ("EPCRS") allows employers to correct qualified plan errors while preserving the tax benefits of the plan. The Self-Correction Program ("SCP") and Voluntary Correction Program ("VCP") are available to employers for plan errors found before an IRS audit has commenced. The SCP is available for operational failures only, and may not even require the employer to notify the IRS of the plan error or pay any penalty. While the VCP requires plan sponsors to submit the error and proposed correction to the IRS, any potential fees are specified within the program and are much less than a penalty would be for a plan error found during an IRS audit. Plan sponsors should review qualified plans now in order to protect the tax-qualified status of the plan and pay reduced fees for errors that would cost much more if found during an audit.

Conclusion

With increased pressure on the IRS to collect amounts that have previously fallen between the cracks and the focus on executive compensation by Congress, the Treasury Department, the Securities and Exchange Commission and the press, the IRS is more likely to focus on employee-related issues within company tax audits. A current review of all employee-related plans and practices will increase the likelihood of employers finding most, if not all, discrepancies, thereby reducing the company's potential exposure in an IRS audit. Employers should review all employee plans and arrangements now to ensure that the company is in compliance with all laws and regulations. By doing so, a company will be able to better defend its taxation positions in the event of an IRS audit.

If you have any questions about the content of this advisory, please contact the Pillsbury attorney with whom you regularly work or any of the members of the Executive Compensation & Benefits group.

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