New IRS Employment Tax Initiative: What Does It Mean for Nonprofits?

Be sure you're adhering to the law when it comes to paying employment taxes.

By Jessica R. Lubar

The IRS has just begun a three-year project focusing on employment tax compliance issues. As part of this project (known as the National Research Program, or NRP), the IRS will conduct employment tax audits of at least 6,000 employers, including nonprofit organizations.

What Auditors Will Be Scrutinizing

Although nonprofits may be exempt from income tax, they're not exempt from employment taxes, such as FICA and income tax withholding requirements. If you fail to comply with the employment tax rules, the IRS could charge you interest and penalties on underreported amounts. And under excess benefit rules, the IRS may penalize both your management team and the employee who receives excess benefits.

IRS examiners will focus on three employment tax areas:

I. Compensation

The IRS can impose excise taxes if it decides that "insiders" (executive officers, board members, or anyone else with major influence in the organization) of a 501(c)(3) or 501(c)(4) are receiving excessive compensation. These excise taxes can be up to 200% of the excess compensation.

These rules are referred to as the intermediate sanctions rules because they let the IRS provide penalties that are less severe than revoking an organization's tax-exempt status. The IRS has recently begun vigorously enforcing these rules, more so than at any time in the past.

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II. Fringe Benefits

Many nonprofits overlook the area of fringe benefits. It often comes as a surprise to them that some of the "perks" they provide should be included in an employee's income as taxable compensation, even if no cash is paid.

Perks may be either taxable or tax-free. If you incorrectly treat a fringe benefit as tax-free, the IRS will respond as if you didn't report the full amount of compensation paid. Such an error can have major consequences. The IRS could consider the value of that perk as an excess benefit in addition to imposing employment-tax-related penalties. Excess benefits may result in penalties not only to the recipient but to your organization's managers and board members as well. Even if the value of a perk is relatively small, if you provide it to many people, interest and penalties could be large.

In the past, the IRS has found nonprofits failing to report a variety of taxable perks. These fringe benefits have included holiday gifts, the use of a car, the use of an apartment, educational expenses, relocation expenses, and the personal components of business travel.

The IRS will also review employment reimbursements. Whenever you reimburse expenses, you must do so in accordance with a written reimbursement plan. The plan must require employees to account for their expenses and to pay back any excess payments received.

Any reimbursements that aren't paid in accordance with such a plan are treated as additional compensation, just like taxable perks.

In past audits, the IRS has identified the following reimbursements that sometimes fall through the cracks: expense reimbursements outside organizational policies, spouse travel expenses, nonaccountable expense allowances, and reimbursement for club memberships.

III. Worker Classification

The IRS wants to be sure you aren't improperly classifying work-

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Nonprofit World • Volume 28, Number 2 March/April 2010.
Published by the Society for Nonprofit Organizations
5820 Canton Center Road, Suite 165, Canton, Michigan 48187
734-451-3582 • www.snpo.org

ers as independent contractors (rather than employees). While you're not responsible for employment taxes for independent contractors, you do need to pay such taxes for payments made to employees.

The IRS considers workers to be "employees" if conditions such as the following exist: (1) The organization has control over how and where the workers perform their jobs. (2) The organization sets the hours the workers must work and pays them by the hour, week, or month. (3) The workers and the person who hired them have a continuing relationship, implying that an employee-employer relationship exists.

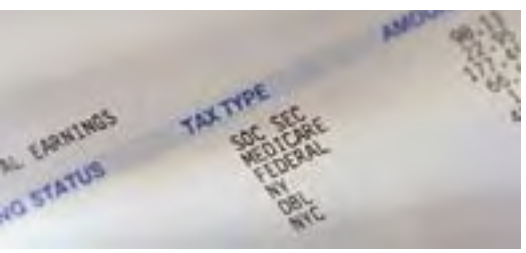
Because classifying workers can be tricky, Congress has provided relief from liability in certain cases, so you may not be subject to penalties or need to reclassify your workers. To be entitled to this relief, you must meet three requirements:

1. The Substantive Consistency Requirement: You can't ever have treated the worker as an employee for federal tax purposes. The worker must always have been identified as an independent contractor.

2. The Reporting Consistency Requirement: You must have filed all required federal-tax paperwork as if the worker were an independent contractor.

3. The Reasonable Basis Requirement: You must have had a reasonable basis for not treating the worker as an employee. A reasonable basis exists if it's supported by judicial precedent, IRS rulings, a past IRS audit, or a long-standing practice of a significant segment of your industry.

It's critical that you review your relationship with your independent contractors to be sure you've classified them correctly. At the very least, be sure you satisfy the



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requirements for relief so that, if the IRS finds that you've misclassified workers, you can avoid harsh penalties.

Other Issues

IRS examiners will also be looking at whether an organization is filing the required tax returns and whether it has performed "backup withholding" on payments to independent contractors, if necessary. Backup withholding (withholding 30% from payments to independent contractors) is required if the independent contractors don't provide their taxpayer identification numbers. Any Form 1099 that is submitted without a taxpayer identification number should have had backup withholding done on the payment.

The IRS is also concerned with loans made by a nonprofit to organizational insiders. Such loans could be considered excess benefits subject to penalties.

What Can Nonprofits Do?

It's clear that the IRS will be focusing on employment taxes for some time, not only as part of this new initiative but in all its nonprofit audits. Here are steps for you to take now:

1. Review your relationships with workers.

- Are independent contractors classified correctly? Are any corrections necessary?
- If a worker is being treated as an independent contractor, is the documentation consistent?

2. Review your fringe benefits.

- Have you accounted for all benefits and perks?
- Review your benefit plans to ensure that they exclude people that you, as the plan sponsor, classify as independent contractors (so that any retroactive reclassification of such people as "employees" won't result in unintended plan coverage).
- Be sure you have a written reimbursement plan.

3. Examine any loans your organization has made.

- Have you loaned money to any of your organization's insiders (those who have a substantial influence on your organization's operations, such as board members and managers)? Are these loans properly documented and consistent with the excess benefit rules?
- Have you made any loans to any of your employees? Look especially at employment-related below-market-loan rules.

4. Be sure Form 1099s include payees' tax identification numbers. If they don't, ensure that backup withholding was performed.

5. Confirm that compensation and benefits are reasonable.

- Can you document that any taxable fringe benefits that weren't included in income were provided as compensation?
- If any portion of compensation, including taxable fringe benefits, would be an excess benefit, determine what steps are necessary to correct the excess benefit. ■

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RESOURCES FROM *NONPROFIT WORLD*
(available at www.snpo.org/members)

- **IRS Clarifies Intermediate Sanctions Law** (Vol. 19, No. 3)
- **How to Be Sure Compensation Is Reasonable** (Vol. 17, No. 1)
- **Employee or Independent Contractor? Don't Let the IRS Reclassify Your Workers** (Vol. 10, No. 4)
- **Retirement Plan Changes** (Vol. 26, No. 6)
- **New Regs Unravel Intermediate Sanctions Snares** (Vol. 19, No. 4)