



Policy and Process: Withholding Tax Field Audit Procedure		Policy Number: AX XXX	
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Purpose

This is a procedure to instruct employees how to properly conduct Arizona withholding tax field audits. Consistency and structure is necessary to ensure the proper approaches and techniques are used in auditing withholding taxes and creating assessments. This will provide guidelines for existing, new or temporary employees to ensure these audits are conducted in both a confidential and efficient manner. Through the understanding of this procedure the affected parties will have an increased knowledge of the importance of the field audit in determining withholding tax compliance.

Scope

This procedure covers all employees working in the withholding tax audit unit.

Definitions and Abbreviations

- DOR – Department of Revenue

Policy

All DOR employees will be responsible for following the attached process. This will create a consistent, systematic approach to conducting withholding tax audits.

Process

THE AUDIT

The Department of Revenue's purpose in conducting withholding tax audits is to verify that the correct tax was withheld and remitted in a timely fashion to the Arizona Department of Revenue. As such, the employer is required to provide the auditor with records when requested to verify information on withholding tax returns submitted to Arizona.

Throughout the course of an audit, the employer is to receive fair, courteous and professional treatment from the auditor. The auditor should only request information that is relevant to the audit, and should give the employer a reasonable amount of time to supply that information. Therefore, withholding tax audits should not include a year where the statute of limitations will be expiring within four months from the date of the appointment letter.



In addition, the auditor should not close a case as disagreed because the statute of limitations is expiring and the employer is still gathering information for review. Instead, when possible, the auditor should obtain a waiver to extend the statute of limitations.

PRE-AUDIT ANALYSIS

Prior to the mailing of the appointment letter, the auditor should complete a thorough analysis of the employer in order to identify potential audit issues. The easiest and most comprehensive manner in which this can be accomplished is through analysis of the various information available to the auditor on TAS, The New Withholding Data base in Mega and DES.

The auditor should also verify whether there is an open corporation tax or flow through entity examination currently in progress. If an open case exists, the auditor should then contact that auditor and inquire as to the scope of the withholding tax review. The withholding tax or business tax case should then be either transferred to one office or should be worked in unison with the other audit team, as deemed appropriate by management staff. In either event, the withholding tax and business tax cases should be worked in conjunction with one another to reduce the burden on the business and as much as possible reduce or eliminate the need for taxpayers to respond to multiple requests to provide the same records.

In summary, during the pre-audit analysis the auditor should try to:

- Determine how the business operates
- Identify which business functions are carried on in Arizona
- Establish the type of business operations carried on outside Arizona
- Ascertain total number of workers employed within and outside Arizona

Sources of information and available tools include:

- Various Tax data obtained from TAS and DES
- Withholding Tax Employer Profile Data Sheet
- The *General Questionnaire*
- The *Withholding Tax Audit Interview Questions*
- The *Records Requirement List*
- Allocation factors on the Arizona corporate tax return and federal tax return
- Internet research



- Closed case files
- Current open audits
- LexisNexis Accurint

AUDIT APPOINTMENT

The initial request for information is conducted through either an appointment letter or telephone call. In most cases, this letter will be a form letter accompanied by a records request indicating the information needed to be reviewed at the audit. This letter should be drafted to suit each employer based on the pre-audit analysis. For example, if the employer is a non-filer, the appointment letter or phone contact should also include a questionnaire asking for an explanation.

The appointment letter or confirmation letter usually includes a date specifying when and where the audit will be taking place and should be sent to the taxpayer at least ten days prior to the start of the audit. Proper scheduling of audits will afford the employer a reasonable time to assemble the required accounting records and should aid in reducing a request for postponement of the start of the audit.

The appointment letter should always contain two enclosures. The first is a blank power of attorney, which will enable the employer to appoint a representative to discuss the case.

The second is Publication 007, *Your Rights as a Business Taxpayer in the Audit Process*, which clarifies some important questions that the employer may have. Publication 007 is especially vital due to the information contained within that describes what the taxpayer should expect during the course of a field audit in addition to the mechanics of the appeals process.

1. **SCHEDULING THE AUDIT** - Auditors are encouraged to arrange their schedules with the employer, or the representative, in such a manner as to spend a sufficient number of consecutive days at the audit site to complete the audit without having to make return visits. Most opening interviews can be conducted via conference call and required audit documents can be sent electronically or by mail. Additional information clarifying an issue or substantiating expenses can be sent through the mail, if necessary.

The auditor should always confirm the appointment by telephone prior to the field visitor or phone conference. This will give the auditor the opportunity of asking questions concerning the type of business, and also affords a more thorough discussion with the taxpayer concerning the records that will be



required for the audit.

The auditor should schedule the audit at the employer's place of business.

2. **POSTPONEMENTS** - If the employer requests a delay, a reasonable period, generally thirty days from the originally proposed starting date, should be allowed. Postponements for more than thirty days should be requested by the employer in writing, setting forth the reasons and advising of a date when the records will be available for review. (**Note:** When the employer requests a postponement for any length of time, the auditor may need to request the employer to extend the statute of limitations.)
3. **NO RESPONSE** - If the auditor does not receive a response from the employer or representative within the first three weeks after the appointment letter is mailed, the auditor should attempt to verify by telephone that the employer is still in business. The auditor should then send a "Second Request" for information by certified mail with a "return receipt requested" to the employer's last known address.

If there is still no response from the employer, a visit may be necessary to the last known address to see if the employer is still in business. If the auditor visits the business location and has contact with the employer, a decision will then have to be made as to whether a withholding tax field audit should be conducted. As a result of the site visit, the auditor may decide to discontinue the audit based on discussions with the employer as well as through personal observations.

The auditor should also search the TAS computer system and check DES and the internet to see if the employer is listed at any additional addresses, and then contact them by phone if possible.

If the employer or the representative notifies the auditor that the employer is no longer in business, the auditor should request verification. If the employer is in fact out of business, the auditor should then make a determination if they should continue the audit based on the pre-audit analysis.

If the audit seems worthy, the auditor should complete the audit even if the company is out of business. Here, the auditor should utilize all available information in order to create an accurate assessment and should identify all responsible individuals. If the auditor determines that the employer is out of business, and the audit does not seem worthy, the auditor should then close the



case without audit.

OPENING INTERVIEW

It is important that the auditor conduct a thorough opening interview. Some of the questions that should be asked are as follows:

- What the business does and how does it operate?
- Location and types of various business activities conducted both within and without Arizona.
- How the business withholds on nonresident employees working in Arizona.
- How the business withholds on residents working outside Arizona.
- What is the in-house payroll procedure, how is withholding accounted for, who is in charge of this, what are the checks and balances, etc.

In short, an understanding of how the business operates is vital to the audit process. In addition, the questions asked at the opening interview should be modified based on the business under audit.

RESPONSIBLE PERSONS

It is imperative that all auditors identify and record in their field audit report all of the individuals responsible for reporting and remitting the income taxes withheld. As a result, this will ensure that the DOR, if necessary, will be able to issue responsible person assessments on the appropriate individuals.

It is essential that all auditors also identify and record in their field audit report the reasons for either assessing or not assessing responsible persons. A responsible person assessment is on an individual, and is created in addition to the assessment issued to the entity under examination. Therefore, it is vital that a detailed explanation is documented by the auditor as to the rationality applied in determining the identity of the responsible persons. This is especially crucial during the appeals process, and is extremely useful during review of informal protest materials received from individuals identified by the auditor as responsible persons.

If the employer is uncooperative or cannot be located, the auditor should use other means in an attempt to identify the responsible persons of the business.

Responsible person assessments should only be issued on unpaid cases (agreed or disagreed) where there is a reasonable indication that collection of the tax liability is



questionable as indicated by financial factors, or if the business is to be (or has been) sold or dissolved.

Some of the financial indicators to consider include, but are not limited to, the following:

- Filing and payment record;
- Cash flow problems;
- Pending lawsuits;
- Bankruptcy or restructuring proceedings;
- Any other condition(s) which may jeopardize the payment of withholding taxes due.

BOOKS AND RECORDS

It is important that the employer and/or the representative are fully aware of the information that will be required for the audit. The term "books and records" has different meanings to various people. Therefore, the auditor should always be as specific as possible when requesting books and records that will be reviewed. Also, the employer should be alerted that additional records may be requested during the course of the audit based on the direction that the audit takes.

General requests for information can be found in standard appointment letters to the employer. However, auditors should remember to adjust their requests for information based on specific records needed for each individual audit due to the type of industry in which the employer operates and the results of the auditor's pre-audit analysis.

The best means in which the auditor may accomplish this initial request for information is to first complete a thorough pre-audit analysis. Then, the auditor should have a conversation with the taxpayer/representative. This will allow the auditor to be more forward in his/her request for records, and will help point the audit in the appropriate direction.

Some of the Arizona State and Federal documents that will normally be requested and reviewed in each audit include the following forms:

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|------|---|
| A-4 | <i>Arizona Withholding Percentage Election</i> |
| A-4V | <i>Voluntary Withholding Request for Arizona Resident Employed Outside of Arizona</i> |
| A-4P | <i>Annuitant's Request for Voluntary Arizona Income Tax Withholding</i> |



<i>A1-QRT</i>	<i>Arizona Quarterly Withholding Tax Return</i>
<i>A1-WP</i>	<i>Withholding Deposit Coupons</i>
<i>A1-APR</i>	<i>Arizona Annual Payment Withholding Tax Return</i>
<i>A1-C</i>	<i>Arizona Charitable Withholding Statement</i>
<i>A1-E</i>	<i>Employer's Election to Not Withhold Arizona Taxes in December</i>
<i>A1-QTC</i>	<i>Quarterly Payment of Reduced Withholding for Tax Credits</i>
<i>A1-R</i>	<i>Arizona Withholding Reconciliation Tax Return</i>
<i>A1-T</i>	<i>Withholding Transmittal of Wage and Tax Statements</i>
<i>A-4C</i>	<i>Request for Reduced Withholding to Designate for Tax Credits</i>
<i>WEC</i>	<i>Withholding Exemption Certificate with Instructions</i>
<i>WECI</i>	<i>Withholding Exemption Certificate, Native Americans with Instructions</i>
<i>WECM</i>	<i>Withholding Exemption Certificate for Military Spouses</i>
<i>941</i>	<i>Federal Quarterly Reconciliation of Tax Withheld</i>
<i>940</i>	<i>Federal Reporting of Unemployment Tax</i>
<i>W-2</i>	<i>AZ and Federal Employee Wage and Tax Statement</i>
<i>W-3</i>	<i>Transmittal of Wage and Tax Statements</i>
<i>W-4</i>	<i>Federal Employee's Withholding Allowance Certificates</i>
<i>1096</i>	<i>Annual Summary and Transmittal of U.S. Information Returns (includes 1099-MISC summary)</i>
<i>1120, 1120S</i>	<i>Federal Corporation and S Corporation Tax Return</i>
<i>120, 120 S</i>	<i>Arizona Corporate Income Tax Returns</i>
<i>1065</i>	<i>Federal Partnership Tax Return</i>
<i>165</i>	<i>Arizona Partnership Tax Return</i>
<i>Schedule K-1</i>	<i>Arizona Resident share of partnership income</i>
<i>1040 Schedule C</i>	<i>Sole Proprietor Tax Schedule</i>



In addition, when appropriate, the auditor should also request and review the general ledger, cash disbursements journal, payroll register, Certificate of Incorporation, and job contracts with subcontractors.

It is possible that the employer's records may be maintained in computerized form. In these situations, the auditor may still request paper records be supplied, if the request is not burdensome. If the employer maintains electronic payroll records the auditor should do what he/she can to utilize these records and limit the burden on the taxpayer of supplying paper information.

AUDIT GOALS AND ISSUES

As in any audit, the main goal is to verify that the amounts reported and remitted on the tax returns are correct. Specifically, the main goals of the auditor during a withholding tax audit are to ensure that the employer is:

1. Computing and remitting the proper amount of withholding tax due,
2. Following proper filing requirements, and,
3. Correctly classifying the proper individuals as employees.

Whenever feasible, the withholding tax audit period should be brought up to and include the last quarter filed by the employer.

The auditor should also be aware that there may be additional affiliated entities for which payroll should be reviewed. This issue may be important when attempting to reconcile Federal taxable wages on the W-2's to the business tax returns (941, 1065, 1120, AZ 120, AZ 120S, 1065, etc...). Based on this analysis, the auditor may then choose to review additional employers in order to conduct a complete withholding tax audit of the original entity under examination.

In order to satisfy each of the audit goals as described above it is the auditor's responsibility to use various audit techniques and procedures during the course of the audit. In addition to completing the pre-audit analysis as described previously in these guidelines, the most prevalent and productive methods that should be utilized to document that the employer has accounted for the proper amount of wages and to determine that a sufficient amount of tax has been withheld and submitted to Arizona include the verification of wages, and a review of the W-2's, payroll register, general ledger and cash disbursements journal.



The third goal of ensuring that the employer has properly classified all independent contractors involves a review of form 1099's, and is discussed in the next section. Then, if after a review of all the requested records the auditor determines that an assessment will be issued, the auditor should produce a draft assessment for the taxpayer's review.

Verifying Wages and Taxes Paid - In every audit, the auditor should compare the amount of wages reported on the employer's wage and tax statement to the employer's corporate, partnership or sole proprietor tax returns. Wages to employees may be reported and are commonly found in some or all of the following areas of the employer's tax return:

- Compensation of Officers
- Salaries and wages
- Cost of goods sold
- Subcontract expense
- Consulting expense
- Management Fees
- Other Expenses

If the wages on the tax return do not agree with the Arizona wages reported on the W-2's the auditor should always identify the reason and reconcile the difference. Some typical explanations include: *accrual basis, fiscal year, deferred compensation, or missing wage and tax statements.*

- **Accrual Basis** - May arise when a taxpayer accounts for an expense on the tax return that was not actually paid. For example, if a calendar year taxpayer has a monthly payroll that ends 1/15 of the following tax year, this means that the employees were not actually paid for the period 12/15 through 12/31. Since these workers were not paid until 1/15 of the following year, none of the wages earned from 12/15 through 12/31 will show on the employee W-2's. However, the calendar year accrual taxpayer will account for that salary expense and will include it on their general ledger and tax return for the amount of wages from 12/15 through 12/31.
- **Fiscal Year** - Usually occurs when an employer uses a fiscal year on the tax return because it coincides with their general ledger accounting. Since the W-2's are submitted on a calendar year basis, the wages and compensation on the tax return will not reconcile with the total wages on the W-2's. In these instances, the auditor should reconcile the tax return to the general ledger. Then, the general ledger wage amounts should be calculated over the



calendar year and should reconcile to the total wages on the W-2's.

- ***Deferred Compensation*** - Items such as accumulated sick leave and vacation leave, or stock option plans may be included in wages and compensation on the tax return and not included on the employee W-2's. If material, the auditor should explore these areas and verify that the compensation paid should not have been included as federal taxable wages on the employee W-2's.
- ***Missing Wage and Tax Statements*** - The auditor should be aware of the existence of subsidiaries or other divisions of the entity that are accounted for under another employer identification number. Also, W-2's may not have been provided because they are simply in another box or are located at another site, such as storage in a warehouse facility. Here, a quick reconciliation from the tax return to Federal Form W-3 should identify any potential issues.

If the tax return wages are greater than the wage statement returns, and the employer cannot account for the difference, it may be possible that there were wages paid for which there were no withholdings. For example, year-end bonuses with no withholdings may be the cause for the two numbers not reconciling.

In some cases the auditor may be examining an employer with workers located in other states in addition to employing workers in Arizona. Here, reconciling the tax return wage amounts to the Arizona wage amounts may not be possible. In these cases, the auditor should instead reconcile the general ledger Arizona wages and compensation paid to the Arizona W-2 amounts. In addition, W-2 summary sheets may not be available or total Arizona wages may be difficult to calculate. In these instances, the auditor may use the A1-QRT, A1-APR, or A1-R to obtain total Arizona wage figures.

Other documents that should be reviewed for the purpose of reconciling Arizona state wages and taxes include the employer's state corporate or partnership returns, and Federal Forms 940 and 941.

- (1) **AZ Form A1-QRT and A1-WP** - The auditor should review these forms during the course of the audit to ensure that the employer has submitted all A1-WP and A1-QRT payments to the Department. All A1-WP amounts should then be reconciled to Department records and to the employer's A1-QRT quarterly tax returns. If the employer has not retained these forms and there is no record of the employer submitting withholding taxes to Arizona, the auditor should review the employer's canceled checks and then search the Tax Department records using the bank information that should be printed on the canceled check.



Form A1-QRT also requires the employer to enter the number employees who worked during or received pay for the quarter.

(2) **AZ Corporation (120), S Corporation (120-S) and Partnership (1065)**

Returns - When these returns are submitted, the employer is sometimes required to compute a Business Allocation Percentage based on three factors. This three factor calculation is included in the attachments to the tax return and one of the three factors is for Arizona payroll amounts of "wages and other compensation of employees except general executive officers." Although officer salaries are not included in this amount, this figure may present the auditor with an indication that there was additional Arizona payroll that the employer has not been reporting. The employer is not required to complete the three factor method when 100% of the employer's income is derived from Arizona sources, which indicates that 100% of the employer's Federal wages is from Arizona employment.

(3) **Federal Forms 940 and 941** - These figures will more likely reconcile to the total W-2 wages issued by the employer because these forms represent Federal wage figures for a calendar year period. The total number of employees nationwide can also be found on line 1 of the quarterly 941 returns.

Reviewing W-2's - When the employees and their gross Federal wages have been identified, the auditor should review all of the W-2's to ensure that a sufficient amount of Arizona taxes have been withheld from the employee's wages. This should enable the auditor to identify individuals that had no Arizona State taxes withheld as well as those individuals that had an under-withholding of Arizona state taxes during the period under audit.

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1. **Resident Employees** – Arizona state withholding tax should be withheld on 100% of the wages paid to Arizona resident employees working only in Arizona. For Arizona resident employees working outside Arizona, Arizona withholding tax may not be required.
 2. **Nonresident Employees** – for discussion of withholding on nonresident employees, please refer to Section III of these guidelines.

Corporate Apartments - Auditors should always inquire with the employer as to the existence of corporate apartments. If the business owns or rents a corporate apartment



in Arizona, the auditor should determine who uses the apartment, as well as when and for what it is used. Not only could this line of questioning lead to potential withholding tax issues, the answers to these questions might lead to residency and/or wage allocation issues for individuals.

Payroll Register - A review of the employer's payroll register is another method that the auditor should utilize in order to identify those individuals that had no Arizona taxes withheld as well as individuals that had an under-withholding of Arizona taxes during the period under audit. Although an analysis of the W-2's or A1-R may show sufficient withholdings for all workers, a review of the payroll register may reveal that certain salary payments made to individuals during the course of the audit period may have included low withholdings or show no withholdings. A complete payroll register will provide a list of all workers for every payroll period, and will include salary and withholding information. The auditor should evaluate these entries for materiality, and should scrutinize the last several payroll periods for balloon payments and/or bonuses. For example, if an auditor discovers a salary payment at the end of a calendar or fiscal year with a large amount of withholdings, it may be possible that there were salaries paid during the year with little or no withholdings for which there should have been normal withholdings. In these instances, the auditor should assess any tax, interest and penalties that are applicable for the periods in which there should have been withholdings.

It should be noted that although a payroll company may be generating and creating the employer's withholding and payroll register information, the auditor must still conduct the audit and follow procedures in the same fashion. The employer under audit informs the payroll company of employee withholding exemptions and is still responsible for withholding and submitting the required taxes to Arizona. Therefore, it is up to the auditor, not the payroll company, to verify that the correct amount of tax has been withheld and submitted.

General Ledger - In conjunction with the payroll register, the auditor should also examine the general ledger "Loans and Exchanges" or similar accounts. This account will indicate a possible reclassification of officer or shareholder loans into payroll. For example, if according to the payroll register the officer or shareholder received little or no salary during the course of the fiscal year, and then received a substantial salary payment at the end of the year, it is possible that journal entries in the "**Loans and Exchanges**" account were in fact wages. Therefore, there should have been withholdings on the salary amounts in the "Loans and Exchanges" account, so the employer is liable for any tax, interest and penalties that are applicable. If the employer insists that these payments were loans, the employer must provide the



auditor with a loan agreement showing the payment due date and the interest rate of the loan.

In addition, a review of the employer's Arizona withholding tax returns should be completed. These records and amounts should be compared to the corporation's general ledger and the Department's records for accuracy, and any discrepancies should be explained. This will verify that all Arizona taxes withheld were paid to Arizona. Moreover, if the employer does not supply the auditor with these requested documents, the auditor must request the canceled checks to ensure that these amounts were paid.

Cash Disbursements Journal – For smaller and midsize entities, the auditor should review all payments made from the employer's cash disbursements journal. It is here that the auditor would possibly identify unreported cash payments for wages paid to employees.

This could include employees that are "paid off the books," additional compensation and/or fringe benefits for employees that received a W-2 for services, as well as any costs for the owner's personal expenses.

For questionable payments, the auditor should inquire with the business or representative as to the reason for the expenses, where they were categorized on the tax return, and request the appropriate invoices and documentation for the expenses. Then, the auditor can add as wages any amounts for which the business cannot document a reason for the expense.

Employer Credit for Taxes Paid by Employee - If the employer is unable to supply valid documentation for an amount of under-withholding, the additional tax required to be withheld should be assessed against the employer. In addition, interest and any applicable penalties should be assessed to the present date. If, however, the employer can obtain documentation proving that the employee has filed a Arizona income tax return and paid the additional tax due to Arizona, the employer will be relieved of the tax only, but will still be liable for interest plus any penalties that may also apply.

For example, due to the nature of withholding tax field audits, an auditor may find that former workers may be difficult to locate, or that a large firm may find requesting records for each employee a substantial burden. Therefore, the auditor may agree to search Department records for a sample of the employees in order to



reduce the employer's responsibility of providing information, and may use the findings in order to make a projection.

Example 1: An employer that has recently stopped conducting business cannot locate the twenty individuals that had been working there during the tax years under audit. The total tax under-withheld is equal to \$50,000 for these twenty employees. The auditor and representative agree that the auditor will search the Department records for only one of the tax years under audit and disclose the percentage of tax due for that tax year. As a result, the auditor discovers that four of the twenty employees did not file tax returns for a total of \$5,000 in tax under-withheld. Therefore, per the agreement, the auditor assesses tax, penalty and interest based on ten percent of the total tax liability for each year under audit.

Example 2: An employer operates a factory that averages 500 employees each year. However, many workers leave and are hired each year. The auditor and the employer agree to a sampling of twenty-five employees for only one of the tax years under audit. The total tax under-withheld is equal to \$80,000 for these twenty-five employees. The auditor and representative also agree that the auditor will review Department records in order to determine if these individuals filed tax returns with Arizona. As a result, the auditor finds that ten of the twenty-five employees did not file tax returns for a total of \$40,000 in tax under withheld. Therefore, per the agreement, the auditor assesses tax, penalty and interest based on fifty percent of the total tax liability for each year under audit.

The auditor may also apply findings based on the sampling techniques of Department records whether or not there is a final audit agreement. Accordingly, auditors may also employ this procedure and use their findings where the employer has been uncooperative, or a disagreement exists on the discussion of the auditor's conclusion.

It is important to note that, when using the Department's records as described in the above examples, due to the confidentiality provisions of the Tax Law, the auditor is not permitted to disclose, specifically, which workers did or did not file a tax return with Arizona.

These methods should be used for unusual circumstances encountered during the course of a withholding tax field audit, especially where a substantial burden would be placed on the employer to provide the requested information.

Computing Audit Tax Due - When it has been determined that there will be an assessment issued and the employer has completed the required process as described above, the auditor must compute the tax due and issue the draft assessment to the



employer. Here, the most preferable method to accomplish the calculation is to use the exemptions claimed on the Federal W-4 (or AZ A-4 if applicable) that were supplied by the employer during the audit for each worker in question. This would be especially favorable where there are only a few employees to consider.

If the employer does not provide the auditor with any of the requested W-4 and/or A-4 certificates, the auditor should consider all of the workers as one employee and compute the tax due based on a single filing status with zero exemptions (or the applicable default rate). This will be most common in situations where the auditor has reclassified independent contractors to employee status.

The actual calculation of tax due should be performed through the use of the Tax Department's WERC computer application. This application is available to all auditors, contains all of the pertinent tax rates and is an accurate means of identifying the correct tax due on the audit. It also provides the auditor with an important source of work papers and is an efficient and effective use of the auditor's time.

In addition, the auditor should remember that, as mentioned above in the discussion of the audit process, credit should be given for the tax paid for all individuals that filed tax returns with Arizona. Therefore, if all of the individuals in question filed tax returns with Arizona, the employer will be responsible for only the interest and applicable penalties due through April 15 of the following tax year. Also, as mentioned above in the discussion of the verification process, interest will continue to accumulate on the interest from April 15th to the current date.

HIGH WAGE EARNERS WITH LOW OR NO ARIZONA STATE WITHHOLDING AND ARIZONA STATE NEXUS

There are two classes of high wage earners: high wage earners who have a connection to Arizona on the payroll records (such as an Arizona work location or Arizona home address), and those who do not have a connection to Arizona on the payroll records.

If the auditor can run a comparison of Department resources, using reported return information, e-file W-2 information, and A1-R W-2 information, then the auditor can determine if employees, especially high wage earners, have amounts withheld that seem to be very low compared with their wages. The auditor should examine these anomalies in trying to create leads for audits. Employees with lower wages with under withholding will also appear on these comparisons. Depending on the number of exceptions on each report the audit team can examine all the exceptions. The



exceptions can be stratified with the largest exceptions examined in detail and the rest of the exceptions can be examined based on sampling. This approach is most useful when a small number of exceptions account for a large percentage of the under withholding. If there is a large number of exceptions and none of the exceptions deviate much from the mean a test sample could be done for all the exceptions. A discussion with the taxpayer should take place as to the audit plan to be used.

It should be pointed out, if the taxpayer requests a detailed audit or if the employer and auditor cannot agree on a test sample approach, a detailed audit should be done.

It should also be noted that there could be valid explanations as to why there is under withholding. For example, if an employee moved or transferred into Arizona during the last month of the year, this may be a valid reason for the indicated under withholding.

HIGH WAGE EARNERS WITH NO ARIZONA STATE WITHHOLDING AND NO ARIZONA STATE NEXUS

As noted above there are two types of high wage earners. The second type, those who have no connection to Arizona on the company payroll records, require a very different audit approach from the high wage earners who are connected to Arizona. The audit of the non-connected high wage earners must be conducted in a reasonable manner taking into account how the business operates.

The following are suggestions for the manner in which this issue should be developed during the audit. These are just suggested procedures and they should be modified based on the facts and circumstances of each case. Suggestions for developing this issue during the pre-audit phase are located in the recommended procedures in the Pre-Audit Analysis section of these guidelines.

A thorough opening interview is also very important in the development of this issue. The auditor should consider asking some or all of the following questions at the opening conference:

- How does the business operate?
- What business functions are carried on both within Arizona and outside of Arizona?
- If corporate headquarters are located out of Arizona, are any divisions headquartered in Arizona?
- Do any other subsidiaries or affiliated entities conduct business in Arizona?



- Locations and functions of various business segments/operations
- How often do employees travel to Arizona?
- Where do the employees stay while working in Arizona?
- Are there corporate apartments in Arizona? If yes, who stays there? Obtain log?

Audit procedures audits with High wage earners with no Arizona connections) -A report indicating these wage earners should be shown to the taxpayer. The taxpayer should be told this is a list of the highest paid employees who do not have an Arizona home address, an Arizona work location, or, Arizona wages. These are people who do not have a Arizona withholding requirement. The taxpayer should also be told that as part of our audit we verify the accuracy of their payroll system. In most cases the taxpayer should be asked to provide a list of the titles and work locations for the employees. The taxpayer should also be asked if any of these employees perform services in Arizona. If, based on the auditor's conversations with the taxpayer and the auditor's knowledge of how the business operates, it does not seem reasonable that these high wage earners work in Arizona, the examination of this issue should not continue.

Please note that any report representing these high wage earners should not be provided to the taxpayer unless presented for discussion purposes only. However, if the employer is uncooperative and will not provide information regarding this audit issue, prior to issuing an estimated assessment, the M a n a g e r should call and write executives of the firm under audit (in addition to the representative) to inform them information has not been provided as requested. Under no circumstances should the employer be presented with a potentially substantial assessment prior to the review of the information. If attempts at obtaining information regarding this issue fail, the audit team should then contact Field Audit Management prior to issuing an assessment regarding the high wage earner issue.

If based on all available information the auditor believes high paid employees may be coming into Arizona to perform services, a small test sample should be selected and the taxpayer should be asked to provide documentation to show the employee's travel activities for a few months during the year. If possible, the sample employees should be selected based on information obtained through the auditor's pre-audit analysis and/or opening conference.

Documentation to be reviewed may include, but is not limited to, travel vouchers, expense accounts, calendars, airplane travel logs, credit card statements and/or corporate card accounts. Towards that end, an attempt should be made by the auditor to refine the request for information by asking the business their method of accounting for employee travel reimbursement.



If it is found based on the test sample that high wage earners are coming into Arizona to perform services and the time spent in Arizona is more than 60 days, a discussion needs to take place with the taxpayer as to what will be the next step, such as projection of the error percentage found in the test sample, the selection of a larger test sample, or a detailed examination (if requested by the employer).

The preferable method is to audit a sample. While the taxpayer should be offered the option of a detailed audit, this should only be conducted when the taxpayer requests it, or if the auditor and taxpayer cannot arrive at an agreement as to a test sample method and the taxpayer appears to have significant non-compliance problems.

If the employee works for less than 60 days in Arizona and their primary work location is outside of Arizona, the employee may not be subject to withholding.

An employee who works 60 or fewer days in Arizona, but receives compensation related to services performed in Arizona in prior years (such as stock options or deferred compensation) may be subject to withholding.

In some instances a decision may be made to create individual audit cases on the high wage earner. If this decision is made the case should be created as soon as possible and the auditor should not wait until the withholding tax case is closed.

RECLASSIFICATION OF INDEPENDENT CONTRACTORS

Employers decide whether to classify workers as independent contractors or employees. While both types of workers may provide similar services, employees do so under direct control of the employer. Conversely, independent contractors, organized as sole proprietorships, partnerships or corporations, provide services without the employer's direct control.

As a result, during the audit process the auditor should review 1099's issued by the entity. The auditor should then evaluate if workers receiving 1099's are properly classified as independent contractors because employers have economic incentives to misclassify. When employers classify employees as independent contractors, employers can reduce their tax liabilities by avoiding social security, unemployment and withholding taxes, as well as reducing their health insurance costs and avoiding contributing to tax qualified retirement plans. Other reasons for not treating workers as employees include costs associated with minimum wage laws, worker's compensation insurance and collective bargaining. As a result, workers misclassified as independent contractors incorrectly deduct business expenses not allowable to employees.



In order to properly evaluate the independent contractor issue the auditor should follow the same criteria that IRS examiners utilize for reclassifying workers. According to IRS Publication 15-A, *Employer's Supplemental Tax Guide*, this guidance includes the common-law rules which revolve around the degree of, or right of control an employer has over workers.

Common-Law Rules - To determine whether an individual is an employee or an independent contractor under the common law, the relationship of the worker and the business must be examined. All evidence of control and independence must be considered. In any employee-independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered.

Facts that provide evidence of the degree of control and independence fall into three categories: **Behavioral control, Financial Control, and the Type of Relationship** of the parties as shown below.

1. **Behavioral Control** - Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of
 - *Instructions the business gives the worker.* An employee is generally subject to the business's instructions about when, where, and how to work. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved.
 - *Training the business gives the worker.* An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.
2. **Financial Control** - Facts that show whether the business has a right to control the business aspects of the worker's job include:
 - *The extent to which the worker has unreimbursed business expenses.* Independent contractors are more likely to have unreimbursed expenses than employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services they perform for their business.
 - *The extent of the worker's investment.* An independent contractor often has a significant investment in the facilities he or she uses in



performing services for someone else. However, a significant investment is not required.

- *The extent to which the worker makes services available to the relevant market.*
- *How the business pays the worker.* An employee is generally paid by the hour, week or month. An independent contractor is usually paid by the job. However, it is common in some professions, such as law, to pay independent contractors hourly.
- *The extent to which the worker can realize a profit or incur a loss.* An independent contractor can make a profit or loss.

3. **Type of Relationship** - Facts that show the parties' type of relationship include:

- *Written contracts describing the relationship the parties intended to create.*
- *Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.*
- *The permanency of the relationship.* If you engage a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that your intent was to create an employer-employee relationship.
- *The extent to which services performed by the worker are a key aspect of the regular business of the company.* If a worker provides services that are a key aspect of your regular business activity, it is more likely that you will have the right to direct and control his or her activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

In determining the proper classification, the above factors can be extremely subjective. The auditor should keep in mind that each factor may or may not apply, and if a factor does apply its degree of importance can vary from occupation to occupation and with the related facts and circumstances.

Therefore, the auditor should weigh *all* of the above factors that apply to the employer under audit in order to determine the status of a worker or group of workers within a company. Here, the auditor may request the job contracts between the employer and



worker in order to clarify many of the common-law rules. Furthermore, in situations where the auditor may need additional guidance beyond the common-law rules on a particular industry or type of worker, the auditor should conduct detailed research in order to achieve an informed decision.

One extremely valuable source of information is the IRS training materials on this subject, *INDEPENDENT CONTRACTOR OR EMPLOYEE?* These materials can be found on the IRS internet website at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Independent-Contractor-Self-Employed-or-Employee>.

Another helpful source of research is *Tax Management Portfolio No. 391 - Employee V. Independent Contractor*. This manual, published by The Bureau of National Affairs, Inc., lists numerous occupations and provides a detailed analysis of who is an employee for Federal employment tax purposes, and emphasizes the difference between "employee" and "independent contractor." In addition, each analysis cites a corresponding Revenue Ruling, court case or regulation section.

In addition, although the auditor may simply inquire as to the nature of the common-law rules within a specific company, the easiest fashion in which to elicit a thorough response is to supply the employer with a blank IRS Form SS-8 for completion (see Appendix A). A properly completed IRS Form SS-8, *Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, will enable the auditor to review each of the common-law rules in detail and to make a more informed decision. ***However, it should be clear to the auditor that no decision to reclassify workers should be based on only one or two factors.***

Corporate Officers - According to Section 3121(d)(1) of the Internal Revenue Code, the term employee also means any officer of a corporation. Generally, all amounts shown on Federal Form 1099-Misc as paid to a corporate officer should usually be reclassified to wages. However, an officer who performs no services or only minor services, and neither receives nor is entitled to receive any pay, is not considered an employee. A ***director of a corporation*** is not an employee with respect to services performed as a director.

Industry Examples - The following examples, also found in IRS Pub 15-A, may help the auditor properly classify workers.

- **Building and Construction Industry**



Example 1. Jerry Jones has an agreement with Wilma White to supervise the remodeling of her house. She did not advance funds to help him carry on the work. She makes direct payments to the suppliers for all necessary materials. She carries liability and workers' compensation insurance covering Jerry and others he engaged to assist him. She pays them an hourly rate, and exercises almost constant supervision over the work. Jerry is not free to transfer his assistants to other jobs. He may not work on other jobs while working for Wilma. He assumes no responsibility to complete the work and will incur no contractual liability if he fails to do so. He and his assistants perform personal services for hourly wages. Jerry Jones and his assistants are employees of Wilma White.

Example 2. Milton Manning, an experienced tile setter, orally agreed with a corporation to perform full-time services at construction sites. He uses his own tools and performs services in the order designated by the corporation and according to its specifications. The corporation supplies all materials, makes frequent inspections of his work, pays him on a piecework basis, and carries workers' compensation insurance on him. He does not have a place of business or hold himself out to perform similar services for others. Either party can end the services at any time. Milton Manning is an employee of the corporation.

Example 3. Wallace Black agreed with the Sawdust Company to supply the construction labor for a group of houses. The company agreed to pay all construction costs. However, he supplies all the tools and equipment. He performs personal service as a carpenter and mechanic for an hourly wage. He also acts as superintendent and foreman, and engages other individuals to assist him. The company has the right to select, approve, or discharge any helper. A company representative makes frequent inspections of the construction site. When a house is finished, Wallace is paid a certain percentage of its costs. He is not responsible for faults, defects of construction, or wasteful operation. At the end of each week, he presents the company with a statement of the amount he has spent, including the payroll. The company gives him a check for that amount from which he pays the assistants, although he is not personally liable for their wages. Wallace Black and his assistants are employees of the Sawdust Company.

Example 4. Bill Plum contracted with Elm Corporation to complete the roofing on a housing complex. A signed contract established a flat amount for the services rendered by Bill Blum. Bill is a licensed roofer and carries workers' compensation and liability insurance under the business name, Plum Roofing. He hires his own roofers who are treated as employees for Federal employment tax purposes. If there is a problem with the roofing work, Plum Roofing is



responsible for paying for any repairs. Bill Plum, doing business as Plum Roofing, is an independent contractor.

Example 5. Vera Elm, an electrician, submitted a job estimate to a housing complex for electrical work at \$16 per hour for 400 hours. She is to receive \$1,280 every 2 weeks for the next 10 weeks. This is not considered payment by the hour. Even if she works more or less than 400 hours to complete the work, Vera Elm will receive \$6,400. She also performs additional electrical installations under contracts with other companies, which she obtained through advertisements. Vera is an independent contractor.

- **Trucking Industry**

Example. Rose Trucking contracts to deliver material for Forest, Inc. at \$140 per ton. Rose trucking is not paid for any articles that are not delivered. At times, Jan Rose, who operates as Rose Trucking, may also lease another truck and engage a driver to complete the contract. All operating expenses, including insurance coverage, are paid by Jan Rose. All equipment is owned or rented by Jan and she is responsible for all maintenance. None of the drivers are provided by Forest Inc. Jan Rose, operating as Rose Trucking, is an independent contractor.

- **Computer Industry**

Example. Steve Smith, a computer programmer, is laid off when Megabyte Inc. downsizes. Megabyte agrees to pay Steve a flat amount to complete a one-time project to create a certain product. It is not clear how long it will take to complete the project, and Steve is not guaranteed any minimum payment for the hours spent on the program.

Megabyte provides Steve with no instructions beyond the specifications for the product itself. Steve and Megabyte have a written contract, which provides that Steve is considered to be an independent contractor, is required to pay Federal and state taxes and receives no benefits from Megabyte. Megabyte will file a Form 1099-Misc. Steve does the work on a new high-end computer which costs him \$7,000. Steve works at home and is not expected or allowed to attend meetings of the software development group. Steve is an independent contractor.

- **Automobile Industry**

Example 1. Donna Lee is a salesperson employed on a full-time basis by Bob Blue, an auto dealer. She works six days a week and is on duty in Bob's showroom on certain assigned days and times. She appraises trade-ins, but her appraisals are



subject to the sales manager's approval. Lists of prospective customers belong to the dealer. She has to develop leads and report results to the sales manager. Because of her experience, she requires only minimal assistance in closing and financing sales and in other phases of her work. She is paid a commission and is eligible for prizes and bonuses offered by Bob. Bob also pays the cost of health insurance and group-term life insurance for Donna. Donna is an employee of Bob Blue.

Example 2. Sam Sparks performs auto repair services in the repair department of an auto sales company. He works regular hours and is paid on a percentage basis. He has no investment in the repair department. The sales company supplies all facilities, repair parts and supplies; issues instructions on the amounts to be charged, parts to be used, and the time for completion of each job; and checks all estimates and repair orders. Sam is an employee of the sales company.

Example 3. An auto sales agency furnishes space for Helen Smith to perform auto repair services. She provides her own tools, equipment, and supplies. She seeks out business from insurance adjusters and other individuals and does all the body and paint work that comes to the agency. She hires and discharges her own helpers, determines her own and her helpers' working hours, quotes prices for repair work, makes all necessary adjustments, assumes all losses from uncollectible accounts, and receives, as compensation for her services, a large percentage of the gross collections from the auto repair shop. Helen is an independent contractor and the helpers are her employees.

- **Attorney**

Example. Donna Yuma is a sole practitioner who rents office space and pays for the following items: telephone, computer, on-line legal research linkup, fax machine, and photocopier. Donna buys office supplies and pays bar dues and membership dues for three other professional organizations. Donna has a part-time receptionist who also does the bookkeeping. She pays the receptionist, withholds and pays Federal and state employment taxes, and files a Form W-2 each year. For the past two years, Donna has had only three clients, corporations with which there have been longstanding relationships. Donna charges the corporations an hourly rate for her services, sending monthly bills detailing the work performed for the prior month. The bills include charges for long distance calls, on-line research time, fax charges, photocopies, mailing costs, and travel costs for which the corporations have agreed to reimburse. Donna is an independent contractor.



- **Taxicab Driver**

Example. Tom Spruce rents a cab from Taft Cab Co. for \$150 per day. He pays the costs of maintaining and operating the cab. Tom Spruce keeps all fares he receives from customers. Although he receives the benefit of Taft's two-way radio communication equipment, dispatcher, and advertising, these items benefit both Taft and Tom Spruce. Tom Spruce is an independent contractor.

Safe Harbor Section 530 Provisions - In the Revenue Act of 1978, Congress addressed a controversy that had existed since the late 1960's between taxpayers and the IRS as to whether certain individuals treated as independent contractors should be reclassified as employees. Refer to TSB-A-94(4)I for an Advisory Opinion on Section 530 of the Revenue Act of 1978.

Section 530(a) provides that, in general, if, for purposes of employment taxes, the taxpayer did not treat an individual as an employee for any period, and, in the periods after December 31, 1978, all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to such individual for such period are filed on a basis consistent with the taxpayer's treatment of such individual as not being an employee, then, for purposes of applying such taxes for such period with respect to the taxpayer, the individual shall be deemed not to be an employee unless the taxpayer had no *reasonable basis* for not treating such individual as an employee. Section 530(a) also provides that satisfaction of the requirement of a "*reasonable basis*" for not treating an individual as an employee for a period can be met if the taxpayer's treatment of such an individual for such a period was in reasonable reliance of any of the following:

- Judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer;
- A past IRS audit of the taxpayer in which there was no assessment attributed to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to a position held by this individual; (Note: A taxpayer may not rely on a prior audit if the current working relationship between the taxpayer and their workers is significantly different from their working relationship at the time of the audit.), or;
- Long-standing recognized practice of a significant segment of the industry in which such individual was engaged.

The above Section 530 relief only applies to the issue of the employer-employee relationship. It does not apply to payments for services which the employer erroneously treated as excludable from the definition of wages or employment. In



addition, even if the taxpayer has met the safe harbor rules, Section 530 relief is not available for years in which the appropriate forms 1099 have not been timely filed.

Section 530 Relief is a federally granted relief of certain employment tax liabilities. As such, this relief can only be granted at the Federal level and not directly by Arizona State. We are in a position, *after Federal intervention*, to honor the Federal grant of relief and do so similarly for Arizona State purposes. However, if during the conduct of the field audit we determine that there are factors that perhaps were not provided the IRS in the petition for relief which would otherwise disqualify the Section 530 Relief finding, then we are not obligated to conform to this relief for Arizona State purposes.

The Arizona State Tax Law does not provide a specific structure by which employers may make direct application to Arizona for relief under Section 530. Relief should be sought first at the Federal level. Audit staff is not obliged to consider the relevancy of Section 530 applications. However, the auditor should be aware of this Federal initiative, should take its provisions into consideration when evaluating the circumstances of each individual case, and be reasonable, fair and practical when determining whether there is a liability in evaluating independent contractor issues.

Instances may occur during the conduct of field audits in which, due to the State's lack of authority to directly grant Section 530 relief, taxpayers may choose to seek to initiate relief from the Internal Revenue Service. In cases such as this, the auditor may suspend audit activity pending the results of the IRS determination and thereafter render an audit determination. If the auditor chooses this course, the auditor should be cognizant of statutes and procure any required waivers.

IRS Classification Settlement Program (CSP) Offers - The IRS initiated this experimental program in order to resolve Employee vs. Independent Contractor cases. The CSP was initially implemented for a two year trial basis for all cases open as of March 5, 1996 in either Examination or Appeals and for all examinations commenced between March 5, 1996 and March 5, 1998. The CSP has since been extended indefinitely.

The CSP was established by the IRS due to several external criticisms, such as the lack of consistency in the application of the common-law rules. In addition, the IRS felt that the time and expenditure spent on these audits were not worth the outcome because the cases were usually settled on appeal in exchange for prospective treatment. Therefore, the CSP was created in order to: reduce the cost and time of resolving reclassification issues for all parties involved; encourage prospective treatment of reclassified workers as employees; approximate the appeals results; and



to promote voluntary reclassification of independent contractors.

The CSP provides only five possible outcomes for any examination where independent contractor status is reviewed:

1. If an IRS examiner determines that a business has NOT misclassified a worker as an independent contractor, no reclassification issue exists and a CSP offer is not necessary and should not be made.
2. If an IRS examiner determines that misclassified workers are employees, but Federal forms 1099 were NOT timely filed, the taxpayer is not eligible for a CSP offer.
3. If an IRS examiner determines that a business has misclassified a worker as an independent contractor, and forms 1099 were timely filed, the examiner must then determine whether the business is entitled to relief from retroactive and prospective liability for employment taxes under Section 530 of the Revenue Act of 1978, as described in the previous section of these guidelines. If the IRS examiner determines that the employer has NOT met the requirements of Section 530, a CSP offer will be made.

The CSP offer provides that the taxpayer begins to prospectively treat the workers correctly, as employees, and agrees to a deficiency assessment equal to 100 percent for only the latest year under examination. Prospective treatment means that the taxpayer agrees to begin treating the worker as an employee effective the first day of the quarter following the agreement date (For example: the CSP agreement is signed by the taxpayer and approved by the IRS on March 15, 1996. The quarter ends March 31, 1996. Therefore, the taxpayer should begin treating the workers as employees on April 1, 1996.).

4. If the business has misclassified the worker, forms 1099 were timely filed, and the business has met the requirements of Section 530, no assessment should be made, nor should an examiner request any changes in the employer's treatment of the workers for employment tax purposes. However, a CSP offer for prospective treatment will be made to the taxpayer because some taxpayers may prefer to treat workers as employees. This is purely at the option of the taxpayer, and the taxpayer may begin treating the workers as employees currently or at the beginning of the next year.
5. This situation occurs when the business has misclassified the worker, the business has timely filed forms 1099, and the examiner cannot conclusively



determine whether or not the business clearly meets the requirements of Section 530. The CSP offer in these circumstances includes prospective compliance and agreement to a deficiency assessment equal to 25 percent of the latest audit year deficiency. As with the 100 percent CSP assessment described in number 3 above, the taxpayer should begin treating the worker as an employee effective the first day of the quarter following the agreement date.

The auditor should be aware of this Federal initiative, as a taxpayer under an Arizona State withholding tax field audit may have accepted a CSP offer from the IRS. As with Section 530 relief, it is also important to note that while Arizona State does not have authority to enter into a CSP agreement with a taxpayer, the auditor may take such an agreement into consideration when evaluating the circumstances of each individual case. Again, Arizona State auditors should, as always, be reasonable, fair and practical when determining whether there is a liability during the conduct of cases involving independent contractor issues.

OTHER AUDIT ISSUES

Offshoot Cases - The withholding tax audit is unique in that it exposes the auditor to a wide range of issues not encountered in other types of audits. Auditors have a wide variety of information available to them on the computer system that may be useful prior to and during the audit, as well as the ability to request audits on C-Corporations, S-Corporations, Partnerships and individual tax returns if there appears to be audit potential.

For example, a review of W-2, A-4, 140 or other information reviewed on audit might raise questions regarding possible residency or wage allocation issues for personal income tax audits. In these instances, the auditor should be aware of questionable information on the W-2's, such as Arizona addresses for individuals filing as non-residents. Or, the auditor might be conducting the audit at the Arizona place of business in the presence of an officer or shareholder who shows on their W-2 an address that does not make sense, such as Florida. In each of these instances, the auditor should first ask pertinent questions or request the appropriate information in an attempt to resolve the relevant issues for the individual in doubt. Then, only after the auditor is confident that a valid audit issue exists should the auditor consider requesting an audit on these individuals.

Also, in conjunction with a review of 1099's for the reclassification of independent contractors, the auditor should review 1099's for compliance purposes. A test check of the 1099's issued to individuals should be made to insure that both residents and nonresidents are filing personal income tax returns and reporting the 1099 income to



Arizona. If an individual is not reporting 1099 income earned in Arizona on their individual tax return, the auditor should consider requesting an audit.

The auditor should also review the overall tax returns of the Corporation, S-Corporation or Partnership under audit. Issues such as distributions to shareholders of Corporations, AAA account for S-Corporations, guaranteed payments to partners of a Partnership, or business allocation issues for any of these entities could uncover other potential audit issues. In addition, issues that affect other taxes may be discovered, such as sales tax or corporation tax. Therefore, when appropriate, the auditor should either request a case for audit or refer the case to the appropriate Audit Division staff.

Furthermore, in certain withholding tax audit cases, it may be important that the auditor review the expenses taken on the employer's tax return, including "Other Deductions." This may disclose additional compensation paid to employees that may not be included on the W-2's. This may also cause the disallowance of S-Corporation, Partnership or Sole Proprietor expenses that will flow through to the individual shareholder or partner tax returns. Therefore, although the substantiation of expenses may only affect an S-Corporation's, Partnership's or Sole Proprietor's income, which is not a withholding tax issue, the examination of certain expenses is important to the overall purpose of a withholding tax audit.

Expenses - When examining the employer's Corporation or Partnership tax returns, the auditor should mainly identify those expenses that will affect the employer's withholding tax returns. However, the auditor may also review expenses for substantiation that will either affect the income of an entity, or an individual's personal income tax return. This decision should be based on materiality and should be relevant to a particular audit issue. If questioned, the auditor should always explain his reason for requesting substantiation. The auditor should also explain that although it is a withholding tax audit, the auditor may examine any issue that appears questionable on the employer's Corporation or Partnership tax return.

The auditor should also evaluate expenses that may be deemed as constructive dividends. A constructive dividend usually occurs where certain business expenses have been claimed on the tax return, but in fact these expenses were for the personal use of an individual, officer, or shareholder of the entity. For example, if an officer or shareholder purchases or leases a car, pays the mortgage on his house, or goes on vacation, and takes the expense on the employer's tax return, these expenses will be considered as personal expenses. This audit change will have a dual effect. The auditor will disallow the expense on the Corporation tax return (lead for corporate audit), and the auditor will also increase the income on the individual's personal income tax (lead for income audit) .



After the auditor has identified a potential constructive dividend issue from the tax return, the auditor should review that expense account in the general ledger. This may enable the auditor to obtain some detail as to the exact nature of the expense and, as a result, determine if the constructive dividend issue still exists. Then, the auditor should ask relevant questions of the employer or representative, and request and review the receipts for these expenses in order to determine if these expenses were in fact constructive dividends. Here, if the records available for review are voluminous, the auditor may use a sample of a few months in order to achieve an accurate determination. Other records that may be helpful include employee expense accounts and/or travel vouchers.

These same expenses might also display an indication as to a permanent place of abode within Arizona. In addition to the above, rent expense, telephone expense or garage expense might signify that a corporate apartment exists for the use of an officer, shareholder or partner. In these instances, the auditor should always question the employer as to who is using the apartment, as well as how often, so the auditor can make an informed decision as to whether or not to pursue a residency audit.

And, finally, certain expenses might also include hidden wages for which there were no withholdings. For example, expenses such as promotion fees, sales commissions or bonuses should warrant further examination.

Fringe Benefits - The employer generally must include fringe benefits in an employee's gross income. These benefits may also be taxable and subject to Arizona personal income tax withholding. Fringe benefits may include, but are not limited to, employer provided cars, flights on private aircraft, free or discounted commercial flights, vacations, discounts on property or services, memberships in country clubs or other social clubs, and tickets to entertainment or sporting events. In general, the amount that must be included is the amount by which the fair market value of the benefit is more than the sum of what the employee paid for it plus any amount the law excludes.

Although normally excluded from wages, the below noted fringe benefits are not excluded from highly compensated employees unless the benefit is available to employees on a nondiscriminatory basis.

- No-additional-cost services: services provided to employees at no additional cost to the employer.
- Qualified employee discounts
- Meals provided at an employer operated eating facility
- Reduced tuition for education provided by educational organizations to its



employees

Please refer to IRS Publication 15-B, *Employer's Tax Guide to Fringe Benefits*, for additional information regarding fringe benefits.

Successor/Transferee Liability - In instances where it is possible that there is a new business, which is in substance the old business with a new name and identification number, the auditor may be able to proceed against this new employer for the prior employer's liability. If the case meets the materiality threshold, and there appears to be a connection between the new entity and the employer under examination, it is recommended that the auditor pursue the new entity for the defunct employer's liability.

There is case law that allows for the assessment of the second or "successor" entity if the second corporation is considered the mere continuation of the old business:

Today's Child Learning Center, Inc. v US, DPa Mar 6, 1998:

A newly formed corporation was found liable for the employment tax liabilities of another corporation because it was found to be the successor in interest and alter ego of that corporation. Among other factors, the officers and shareholders were virtually identical and control of the corporations remained in the same hands. The successor corporation was in the same business, providing the same services at the same location. In addition, the original corporation's assets, such as good will, employees, furniture, equipment and premises were used and assumed by the new corporation.

References

N/A

Attachments

N/A

Exceptions

N/A