

What companies should know about rising employment tax risks

In 2021¹, the United States' Internal Revenue Service (IRS) closed 46,204 federal-level employment tax examinations² (i.e., audits). That's around 183 examinations for every business day of that year³, generating a shade over \$1.3 billion in additional tax assessed. Consider how many similar examinations also occur each year at both US state level and in other countries, and the quantum of examinations occurring may be far more significant than some businesses may think.

In fact, it may not be the number of employment tax examinations that the IRS closed that is of most interest; study the rate of growth of these examinations and a bigger picture emerges. Take the COVID-19-impacted tax year out of the equation and one can see that the number of examinations grew from an average of around 15,000 in 2018 to more than 46,000 in 2021 – an increase of more than 200%.

If employment tax audits were to occur solely in the domestic context, that would be one thing; the truth is, however, an employment tax audit in one location can quickly trigger broader, deeper examination of other issues by another revenue authority.

Converging trends

Today, there are five (if not more) converging trends that are, in aggregate, adding up to a higher incidence of employment tax controversy:

- ▶ Companies everywhere realize that the wage and benefits packages offered to employees must play a more important role than ever in the attraction and retention of talent. Digitalization, COVID-19, the cost-of-living crisis and an increased focus on the Environmental, Social and Governance (ESG) agenda are having a revolutionary effect on both the type of benefits companies can offer, how they administer them and the speed at which they are implemented. All of this may represent the genesis of new and unexpected employment tax risks.
- ▶ Employers now work with a greater number of third-party service providers, across a range of different employment tax activities, including payroll, mobility, contingent workers and third-party benefits platforms. This has led to an increased reliance and dependency on these outsourced providers, which in turn means that a company may not have one dedicated resource who is clear on the process and policies related to each activity, let alone having a level of responsibility for the employment tax compliance overlaying these processes.

¹ Source: 2021 IRS Data book: Table 18: Examination Coverage: Recommended Additional Tax, and Returns with Unagreed Additional Tax, After Examination, by Type and Size of Return, Fiscal Year 2021. Accessed on 29 August 2022.

² 29,946 were field-based and 16,240 were correspondence-based.

³ There were 252 business days in 2021.

- ▶ Digitalization is having a profound impact on tax administration and the ability of revenue authorities to supplement human judgment with machine-led insights and more when it comes to pinpointing potential compliance gaps.
- ▶ The world is experiencing fundamental shifts in where and how people work, and hybrid working is now commonplace globally, potentially creating new risks. Domestic and cross-border travel, historically a key source of employment tax risk, has restarted after the COVID-19 pandemic, with renewed emphasis around hybrid/remote worker arrangements.
- ▶ “Off payroll” working – whether providing services through a Personal Service Company (PSC) (or similar vehicle) or through self-employed individuals - has become an issue for revenue authorities as they look to tackle ‘lost revenue’. Many countries are now legislating to tackle off payroll working, in some cases making compliance of PSC workers the responsibility of the company that hires such workers. Similarly, revenue authorities are scrutinizing the use of contingent or “gig” workers. More widely, EU Member States have agreed a Directive⁴ (“DAC7”) under which platform operators must report the income of platform users.

Digitalization drives a new employment tax environment

Tax teams of mid-sized and large companies are often finding a new urgency to assess their employment tax risk exposure across their global footprint. This trend is not related to a sudden interest in understanding more about a country’s tax laws, but rather they may have received, often for the first time, tax authority examinations that either resulted or may end up resulting in actions (including civil or criminal penalties) far more punitive than they may have received in their headquarters location.

One key reason for this evolving shift is the digitalization and modernization of tax administration, where there is a clear phenomenon occurring wherein higher volume or more transactional taxes — starting, naturally with value-added taxes or goods and services taxes, but moving rapidly into employment taxes — are now required to be tracked and reported digitally and often on a real-time basis. With more mainstream use of data analytics by tax authorities — and that the very complexity, scale and geographic dispersion of employment tax obligations can sometimes be a source of risk itself — it is clear that the stage is set for a rapid and profound increase in employment tax disputes.

As an example, with the introduction of payroll e-filing in Ireland in 2017, payroll returns were subsequently required to be filed digitally with the Irish Revenue each month which has led to a rapid increase in examinations by the tax administration as data was being reviewed quickly. Similarly, companies in Brazil required to make similar submissions using Brazil’s SPED platform

⁴ See this EY Global Tax Alert for more information: https://www.ey.com/en_gl/tax-alerts/eu-adopts-tax-transparency-rules-for-digital-platforms-dac7

will have been aware of this for some time, with SPED believed to churn out more than 300,000 automatic infringement notices (across all tax types) each month.

Globally, companies are now experiencing growing expectations from tax authorities that they should have their full employment tax data at their fingertips at all times. This is leading companies to put in place far more rigor around data integrity generally, including performing a greater volume of line-by-line data reviews to ascertain whether items can go through payroll or instead need to be lodged with the authorities by an “off-payroll” submission, such as a Pay-As-You-Earn Settlement Agreement in the UK.

Table 1: Common employment tax audit triggers in the 10 largest jurisdictions by GDP

Country (listed in order of GDP size) ⁵	Common employment tax audit triggers
United States	<ul style="list-style-type: none"> ▶ Worker classification ▶ Fringe taxable benefits (cash/non-cash benefits) ▶ Timing of tax deposits including those related to equity payments to executives and other employees
Mainland China	<ul style="list-style-type: none"> ▶ Equity incentive income tax reporting ▶ Special tax inspections for live streamers, online influencers in e-commerce industry
Japan	<ul style="list-style-type: none"> ▶ While payments to non-residents tend to attract revenue authority review, employment tax issues do not usually trigger a tax audit in Japan and are reviewed as part of any wider corporate income tax audit.
Germany	<ul style="list-style-type: none"> ▶ Non-cash benefits ▶ Company cars ▶ Company events
United Kingdom	<ul style="list-style-type: none"> ▶ Off-payroll workers ▶ Specialist payroll irregularities ▶ Travel and expenses

⁵ According to World Bank data accessed on 30 August 2022.

- India
 - ▶ Challenges faced in claiming the Dependent Personal Services exemption
 - ▶ Tax Department denying foreign tax credit claims on procedural or other grounds
- France
 - ▶ Redundancy payments
 - ▶ Business expenses (salaries and social charges) paid to managers of French companies who perform functions in foreign companies
- Italy
 - ▶ Tax residency
 - ▶ Tax relief (requirements for the application of a relief on certain professional income lower than EUR65,000)
- Canada
 - ▶ Reg 102/105 (Withholding tax requirements for services rendered in Canada by foreign national/nonresidents)
- Korea
 - ▶ In general, employment taxes are reviewed as part of the periodic corporate tax audit, and it is rare for employment tax issues to be the sole trigger of a tax audit. There are, however, several common issues that are often reviewed during the course of a wider tax audit:
 - ▶ Retirement income/salary income classification for executives
 - ▶ Welfare expenses
 - ▶ Travel expenses and business vehicles

Connections within a tax authority across different types of tax (or even across different government departments) can now occur far more regularly because of digitalization – whether via the use of data analytics or something more sophisticated, such as machine learning or even artificial intelligence. Instances of this playing out in real life are becoming commonplace; as an example, companies operating in the UK should now expect their share plan submissions to be cross-checked by HM Revenue & Customs against their corporation tax return and any other relevant tax documentation. This level of sophistication of review would have been unheard of just a few years ago and it is representative of the new breadth of evolving scrutiny being driven by digitalization and use of advanced technology and data-driven auditing techniques.

Indeed, many revenue authorities have either moved (or are in the process of moving) from “all paper” to mandatory “paperless” environments. This move allows far better connectivity across different tax types within the tax authority and broader. While this connectivity is largely (but

not exclusively) limited to in-country sharing, the ongoing alignment between the continuous movement of people and the extensive information sharing between different national tax authorities suggest cross-border scrutiny will expand in the future. Likewise, highly transactional review of data including expense payments will become part of such reviews.

Adding to this equation is the fact that tax authorities everywhere, particularly during a period of economic weakness, will look for the opportunities to secure new revenue. Many areas within employment tax are commonly viewed as strong potential candidates for new or higher yield especially due to a combination of the sheer scale of how many employees a company may have, longevity over which an error may occur and ease of collection as they audit the company rather than the individual employees.

Understanding the different sources of employment tax risk

There are at least five categories of risk that can stem from the suboptimal management of employment taxes:

1. Business risks – may include a failure to coordinate or communicate between two or more departments who may share responsibility for hiring and paying workers, or a failure to understand that a benefit may become taxable as tax laws change and evolve
2. Tax technical / legislative risks – may include the lack of awareness or error around new or changing legislation or administrative practice which changes the tax treatment of compensation or similar other payroll related matters
3. Tax enforcement risks - often driven by technical savvy tax administrations who are under pressure to reduce the tax gap and find new sources of tax revenue
4. Contagion risk – occurs when a tax authority examination expands beyond the initial employment tax issue(s) being scrutinized and quickly spreads to other tax types, years or even geographies
5. Reputation risks – happens when a mistake by the company negatively impacts its corporate brand, with external customers or with the company's own employees

All four categories come down to one thing: the company's tax department is often responsible to address the issue in conjunction with other key stakeholders within the organization.

Business risks are typically numerous and broad in nature, spanning everything from the general (such as a failure to invest in the experienced professionals with relevant and extensive knowledge of employment taxes) to very specific matters (such as a weakness, failure or even complete absence of a data gathering protocol). Such risks can often center upon the failure to coordinate between different departments and functions within an organization which share the burden of responsibility for tasks such as periodically hiring (and therefore needing to classify and comply from a tax perspective) contingent workers. Is this the problem of Human Resources (HR), the legal department or the tax department? The answer lies in where the buck stops, with ultimate responsibility landing squarely at the feet of tax.

Business expenses and employee benefits provide many anecdotal examples of a tax technical employment tax risk, also highlighting the interaction between two or more types of employment tax risk, something that often foreshadows a tax dispute. Consider a company that may pay their employees to travel between one location and another within a country – albeit for a limited amount of time, as a major project is taken forward — but that has not instigated the necessary tracking controls and protocols around such payments. The company may, over time, find that these employees’ movements may become a taxable benefit as the project for which the employees were traveling becomes delayed and travel silently moves from being incidental and irregular and instead is viewed as a regular commuting activity, and therefore a taxable benefit. Consider that the issue may have been occurring for several hundred people and for several tax years, and the full quantum of the potential exposure quickly becomes apparent. This example, like many other employment tax risks, illustrates that such risks can often be the result of a combination of business risk and tax technical risk. Seldom do risks have but a single source.

Consider, too, a second, timely example involving business expenses. During the course of the COVID-19 pandemic, the majority of non-essential workers were limited to working from home for an extended period, and employers, always with one eye on employee retention (not to mention attraction) naturally offered their employees – often across multiple countries – new benefits to support their purchase of home office equipment such as standing desks, high quality chairs or the payment of home internet service.

The trouble is, not all countries treat the same items as either tax-free or taxable. Being in such a hurry, though, not every company may have checked the tax treatment of every item in every country, and many may now have to unpick the problem after the fact, refiling tax returns and dealing with new tax assessments as a result. Moreover, a small change in way the benefit was offered could have resulted in employee and employer costs saving.

In regard to tax enforcement risk, governments the world over have come to understand that employment taxes are an area that, due to their inherent complexity, scale, newness (i.e., as tax policy responds to changing ways of doing business) and as yet largely untapped potential as a tax revenue source, may yield more marginal revenue than other areas of tax. Tie that in with revenue authorities’ new digital capabilities, and it is soon clear why this third area of risk is fast evolving.

The risk of a dispute with a revenue authority should not be the only concern of companies, either. Inconvenient, time-consuming and costly as employment tax disputes are, their potential financial impacts can, in fact, be matched by the reputation risks faced by companies. These reputation risks, though, may not stem from media headlines read by millions of customers about the level of taxes a company is believed to pay. Instead, they may come from a different source – the company’s own personnel, who can not only feel let down and resentful toward the company but may actually have to pay additional tax costs many years down the road.

Contagion risk must always be considered with an employment tax risk framework. Employment taxes can often be the starting point of a dispute that began with one very specific issue but quickly broadened to incorporate others – or, indeed, multiple tax years. In some case, the impacts are deeper still – the presence of tax obligations of an individual taxpayer (often a short-term business traveler) may trigger a revenue authority to argue that a new permanent establishment may have been created.

A simple business trip or expenses payment, therefore, perhaps coupled with something seemingly innocuous like the signing of a contract or other legal agreement, can end up triggering the levying of corporate income tax. Consider, for example, that in Germany, wage tax and social security audits are conducted on a regular basis. Tax auditors there may file control notices if they believe an issue may have a linkage or knock-on effect with another tax type. Moreover, such linkages often only come to light many years after a first infraction occurred, meaning that the problem festers and compounds. In the best cases, that means more work for the tax function to unpick past errors. In the worst, it can mean a financial restatement.

The truth is that the potential sources of employment tax risk are almost endless – and indeed, even the auditing of a single employee’s personal tax returns can sometimes lead to a wider examination of the corporation. The companies that are most successful in mitigating these risks will be those that are not only proactive but also *innovative* in their thinking about what *could* occur and how to protect against it. Indeed, it is those companies who will typically not only do a better job of managing and mitigating risk, but who may also reap the benefits of being able to identify a greater number of new opportunities via their advantageous approach to employment tax management.

Final thoughts

Employment tax obligations are rather like waves hitting a beach; day and night they are always there, but sometimes several factors can converge at once, and the waves become rough and unpleasant.

Compounding the challenges, employment taxes flex and change with both business strategy and business operations, not to mention the business and economic environments. At some points in time, they may represent obligations around equity and compensation. At others, risks may stem from contingent workers bought in to help meet demand for a product or service. They can also include a host of different tax and social security obligations that may be managed operationally by third parties – but are still the ultimate responsibility of the company when the time comes to meet tax compliance obligations.

Couple all this with the fact that overall responsibility for employment taxes is seldom clear – and is often spread across an organization’s tax, payroll, finance and/or HR functions, not to mention those third parties – and it may be of little surprise that this area of tax is flush with new examination by revenue authorities everywhere.

What can – and should – a company do to best identify and then mitigate these risks? The answer and is being communicated loudly by revenue authorities around the world: companies need to enhance their tax governance, which should naturally include the adoption of a framework approach to employment tax risk management.

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Employment taxes are multi-faceted and complex. Please contact any of the below EY professionals to discuss this topic in more detail.

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EYG no. 009909-22Gbl