



Policy and Process: Withholding Tax Audit Manual		Policy Number: AX XXX	
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## Purpose

This is a procedure to explain to auditors the proper way to approach and complete a withholding tax audit. Consistency and structure is necessary to ensure the proper handling of taxpayers' documents and records in the withholding tax audit area. This will provide guidelines for existing, new or temporary employees to ensure 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 audit procedures necessary for a successful withholding tax audit.

## Scope

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

## Definitions and Abbreviations

- DOR – Department of Revenue
- WERC -- Withholding Examination Report Creator
- WEC – Withholding Exemption Certificate
- WEIC – Withholding Exemption Certificate for Indians
- FEIN – Federal Employer Identification Number
- ARS – Arizona Revised Statute
- TAS – Tax Accounting System
- DES – Department of Economic Security
- A1-R – Arizona Annual Withholding Tax Reconciliation Return
- A1-QRT – Arizona Quarterly Withholding Tax Return
- EFT – Electronic Funds Transfer
- 941 -- Federal Quarterly Withholding Tax Return
- A.A.C -- Arizona Administrative Code
- W-2 – Wage and Tax Statement
- W-2C – Corrected Wage and Tax Statement

## Policy

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

## Process

Arizona Withholding Tax Audits



A. Prior to contacting Taxpayer

1. After receiving the Withholding audit assignment search for all FEIN numbers that belong to Taxpayer on the TAS system. The Excel withholding tax audit template will provide downloads of license data and reporting history from the TAS system.

(Reported history is unavailable at this time, auditor needs to manually sum up the quarterly reported on TAS.)

2. If necessary, review the TAS System for inactive/cancelled withholding license data. The TAS System Screen displays the amount and postmark date of withholding tax payments. It also displays quarterly return (A1-QRT) data. This includes A1-QRT payments for prior periods and any prior period delinquent A1-QRT's.

3. An employee's W-2 shows the total Arizona tax withheld from pay during the tax year. The employer is directly liable to report the Arizona tax withheld to the Department. The sum total of all Arizona tax withheld on all W-2s (Plus 1099-R's) is the amount owed by the employer for Arizona withholding tax. WTR 99-2 requires employers to include copies of 1099-Rs that contain Arizona tax withheld to be filed with the A1-R. Basic requirements for employers to calculate and report Arizona withholding tax are contained in ARS§ 43-401, ARS§ 43-412, ARS§ 43-414, ARS§ 43-415 and ARS§ 43-435. If a W-2C (amended W-2) was properly issued by the employer, the auditor will use the W-2C to determine the employer's Arizona tax withholding liability.

4. Refer to the instructions for Form A1-QRT for the latest payment due date information. Specific due date information is also contained in section E below.

5. The sum of Arizona tax withheld reported on quarterly returns is reconciled on the A1-R annual return. To perform a withholding audit it is of paramount importance to summarize the Arizona tax withheld on all W-2's, W-2C's and 1099-R's. The withholding tax audit template within Excel, (Withholding Examination Report Creator or WERC), compares the A1-R Arizona tax withheld amount to match the Arizona tax withheld issued on W-2's and W-2C's. Additional audit work papers may be required in some cases to indicate the amount and due date of periodic payments of Arizona withholding tax. Any material difference is due or credited to the employer as part of a withholding tax audit. Applicable penalties and interest will also apply to any difference.

6. Non-filers and zero filing: If the employer is not filing withholding tax or appears to be underreporting, perform comparisons with other available information. The cause of any material inconsistencies can be identified during the field audit. Check DES unemployment tax data in the DES inquiry system. DOR issues an "Inquiry Guide" to help navigate the screens within the DES "Tax Employer Accounting System". The Employer Base Information Inquiry "EBIT" screen displays basic name address and account number information for the employer. The Labor Statistics Inquiry "BLSI" screen displays both total wages and taxable wages for



Arizona unemployment tax purposes by quarter for each employer. The Wage Inquiry by Employer "WAGA" screen displays wages by employer number and by employee social security number for that employer. The total wage data should roughly approximate Arizona wages reported on the A1-R Arizona payroll amount. In some cases DES makes audit determinations that personnel providing services are actually employees not independent contractors for prior periods. Certain pretax or deferred compensation items could also cause a difference between the amount of income subject to withholding tax and unemployment tax. The DES data is only useful in obtaining general information about an employer prior to a field audit. All actual audit determinations will be made by field audit review of the employer's payroll records.

7. Review any prior withholding tax audits, audit lead reports or other available information to determine potential problem areas. Request that copies of any recent IRS withholding tax audits be provided on the day of field work.

#### B. Mailing the Intent to Audit Letter

1. Advise Taxpayer that you have been assigned to perform a field audit review of Arizona withholding tax. Confirm that the payroll records required for the withholding tax audit are at the same location as the field audit records. If Taxpayer specifies a location separate from the audit location for the withholding tax audit, confirm that location in writing. If the location is out of state and not in the vicinity of the audit location write an audit lead for a separate audit trip only if a preliminary review indicates an audit is needed. Otherwise write a report to close the withholding tax audit. Explain the purpose of all of the forms that will be sent with the Intent to Audit Letter. Discuss confidentiality issues and the purpose of Form 285 with Taxpayer.

2. If your research indicates taxpayer is a non-filer or zero filer raise these issues during the initial phone call. It could be that Taxpayer is reporting withholding under another license or considers all personnel that provide services to be independent contractors or employees that qualify as legally exempt from withholding requirements under *ARS* § 43-403.

#### C. Mailing the Audit Appointment Letter

1. When you receive the Audit Assignment Approval Form from the Withholding Audit Manager, call the Taxpayer and set the audit appointment date(s).

2. Inform the Taxpayer that Federal Forms 941, 943, W-2 and W-3's will be required for review. Inform Taxpayer about missing returns A1-QRT or A1-R's at this time. Request that Taxpayer gather information or documentation to establish reporting and payment of missing returns. Ask taxpayer about prior IRS withholding tax audits. If any, request that copies of Form 4668/4669 or a revenue agent's report be available on the field audit appointment day. Also request a copy of Taxpayer's protest of the IRS withholding tax audit.

3. The auditor should schedule field review of the payroll records, withholding tax returns and related documents. Any specific questions regarding confidentiality should be referred to the DOR disclosure officer.



D. Field Audit Work

1. Explain purpose of audit to Taxpayer. Review nature of business enterprise and nature of personnel considered exempt from withholding tax per *ARS*§ 43-403. The status of personnel considered independent contractors is outside the scope of withholding tax audits for prior years or quarters within the current calendar year. If a Taxpayer has any questions about the status of personnel providing services suggest he contact the IRS and the unemployment tax section of the Arizona Department of Economic Security. Additional information is contained in *WTR* 93-3.
2. If Taxpayer is a sole proprietorship, request copy of Schedule C filed with Federal Form 1040. The reported wage expense amount should reconcile to amounts shown in the payroll records.
3. If Taxpayer consistently files limit the review of withholding tax to the most recent closed calendar year. If differences or errors are noted expand the audit to include all quarterly withholding tax returns filed within a 4 year statute of limitation. If Arizona income tax was withheld by a non-filer for periods more than 4 years ago consult your Manager.
4. Review any prior withholding tax audits, audit lead reports or other available information to determine potential problem areas.
5. If Taxpayer is a corporation request copy of Federal Form 1120. The reported wage expense amount should reconcile to amounts shown in the payroll records.
6. If Taxpayer is a qualifying subchapter S corporation, request copy of Federal Form 1120S. The reported wage expense amount should reconcile to amounts shown in the payroll records.
7. If payroll is a factor used in the apportionment ratio calculation of a multi-state corporation doing business in Arizona, then withholding must be reported to Arizona.
8. If Taxpayer is a partnership request a copy of Form 1065. The reported wage expense amount should reconcile to amounts shown in the payroll records.
9. The employer should include copies of any (*WEC*) Arizona Withholding Exemption Certificates with his quarterly returns. The certification is completed by employees who anticipate no Arizona income tax liability for the taxable year based on eligibility of a tax credit allowance for income taxes paid to the state of domicile or residency. The employee must be a resident of California, Indiana, Oregon or Virginia. Refer to *ARS*§ 43-1096 and *WTR* 92-3. If an employee is a Native American and meets the criteria listed on the *WECI* Form, no Arizona withholding tax is required. The Native American must complete the form.
10. Review the payroll system and records for the most recently completed calendar year. Prepare list of Arizona income tax withheld by employee manually or by



magnetic download. If the employer files a magnetic disc of W-2 data with his A1-R you already have this data back at the office. *(We are still waiting on IT and Audit IT to make those available to the withholding unit.)*

11. Determine if there are any employees temporarily assigned to work in Arizona. Confirm compliance with allowed statutory exceptions to required withholding. For example, an employer doing business in several states may temporarily bring nonresident employees into Arizona for up to 60 days during the calendar year and be exempt from Arizona withholding requirements on those employees. ARS§ 43-403.A.5.b.

12. Determine if there are any retired employees receiving their pension or annuity payment directly from the employer. The retiree can elect Arizona tax withholding. Any Arizona tax withheld would appear on a 1099R. This amount is combined with Arizona income tax withheld on W-2's and reported on the A1-QRT and A1-R. Copies of the 1099R's that contain Arizona tax withheld are required to be filed with the A1-R per WTR 99-2.

13. If there are major compliance problems then additional documentation will be needed to support the audit results. In cases where a W-2 contained amount for Arizona tax withheld, and the employer did not file returns or filed zero returns to Arizona an audit for that calendar year is definitely required. Significant information will be required to document and support the withholding tax audit conclusions. The documentation and data collected will depend on the records available.

14. Money or other forms of payment taken by a sole proprietor or partner in a partnership should be accounted for in a draw account. A sole proprietor must have an EIN if wages are paid to one or more employees. The IRS considers a spouse to be an employee in a sole proprietorship if working for the other spouse. **If a married couple works together they are considered to be a partnership by the IRS and each would receive a Form 1065, Schedule K-1. Refer to IRS Publication 541 for specific information.**

15. Partners are generally not considered employees. A partner's income is reported as a distribution on Form 1065, Schedule K-1.

16. Remember that a single member LLC reports using a Form 1040 Schedule C only if the single member is an individual. A single member who is an individual can also file as a corporation if Form 8832 is submitted to the IRS. If the single member is a corporation, the LLC income is reported on Form 1120 or 1120s. Multiple member LLC's generally file as a partnership using Form 1065. However, a multiple member LLC can also file as a corporation if Form 8832 is submitted to the IRS.

17. Corporate officers are considered employees if they receive compensation for services rendered. The amount paid should generally be commensurate with the officers' duties. Refer to IRS Publication 535 for more information. A loan to a corporate officer by the corporation should include the general characteristics of a loan. There is generally a promissory note or contract with a stated period of repayment to evidence the loan.



18. Schedule the Arizona tax withheld from all W-2's that were issued. Copy some or all W-2's to support the audit conclusions. Copy Federal *Form 941* and any breakdowns by state for a multi-state employer. Federal income tax withholding on Form 941 for Arizona employees would help support the audit conclusions.

19. Obtain copies of W-4's on employees who have filed as exempt or large numbers of exemptions. (i.e. where gross wages are over \$15,000 and there is no federal/state withholding. Provide copies of these W-4's to individual income tax audit through your Manager. The fact that these W-4's are referred to individual income tax audit is confidential (*ARS 42-2001.2(a)vii*) and not disclosed to the employer under audit. No mention of the referral is to be made in the audit notes, audit work papers or audit exhibits.

20. Comparisons of Arizona tax withheld reported on employee AZ140's to employer Arizona tax withheld data for that employee is currently outside the scope of employer withholding tax audits performed by field auditors.

#### E. Payment Due Date Determination

##### **Annual basis withholding:**

If the combined amount of Arizona tax withheld for the preceding 4 calendar quarters is \$800 or less the employer may pay and file on an annual basis using the *A1-APR* return. The income tax withheld for a particular quarter may exceed \$200. The return is due on February 28 of the following year. To qualify for annual filing a 4 quarter reporting history must first be established. At least 3 of the 4 quarterly returns must have been filed timely. All subsequent annual filings of the *A1-APR* must be timely.

##### **Quarterly basis withholding:**

The sum of the Arizona tax withheld reported for the 4 immediately preceding calendar quarters divided by 4 is equal to or less than \$1,500. The quarterly returns & payments (*A1-QRT*) are due on or before April 30, July 31, October 31 and January 31.

If Arizona tax withheld exceeds an average of \$1,500 per quarter based upon the previous four quarters, the federal payment rules apply. The federal law requires a look back period of one year. The look back period is the amount of federal tax withheld reported on federal Forms 941 for the period July 1 through June 30. For example, the Federal look back period for calendar year 2004 is July 1, 2002 through June 30, 2003.

##### **Monthly:**

If the federal withholding tax due for the July 1 through June 30 period was \$50,000 or less then the employer qualifies for monthly payments. The monthly payment is due on the 15<sup>th</sup> day of the following month. If an employer fails to make a timely monthly payment because prior to that reporting period it reported on a quarterly basis instead of a monthly basis, the department shall notify the employer that it is out of compliance. The department shall not assess a penalty (*ARS 42-1125*)



against the employer for failing to make a timely monthly payment if the employer had filed and remitted all taxes due on a quarterly basis and brings all filings and payments in current compliance within 30 days after being notified by the department. ARS 43-401(D).

**Semi-weekly:**

If the Federal withholding tax due for the July 1 through June 30 period exceeds \$50,000 then semi-weekly payments are required. If the pay day falls on Wednesday, Thursday or Friday then the payment is due on the following Wednesday. If the pay day falls on Saturday, Sunday, Monday or Tuesday the payment is due on the following Friday. Federal and Arizona bank holidays that occur on a weekday extend the due date.

**Next day rule:**

Any time federal tax withheld accumulates to an amount exceeding \$100,000 then a next banking day payment of the entire sum is required. The Arizona withholding tax is due the same day as the federal deposit even though the accumulated Arizona tax withheld amount is less. If an Arizona employer subject to monthly payments is subject to next day federal deposits during a quarter, all Arizona tax withholding payments for the remainder of the quarter are done under the semi-weekly payment schedule, unless additional next day payments are due.

Employers on a semi-weekly schedule do not fall under the next banking day payment rule when more than \$100,000 is accumulated from 2 separate payment periods. For example, a Tuesday payday accumulates \$95,000 of Federal tax which is due the following Friday. On Wednesday of the same week another \$10,000 is accumulated. Because the Saturday through Tuesday pay day period is separate from the Wednesday through Friday pay period only \$95,000 was actually accumulated.

If an employer on a semi-weekly schedule accumulates more than \$100,000 in the same pay period then the entire amount is due next day. For example, by Monday of a Saturday through Tuesday period \$105,000 of federal tax withheld has accumulated. The \$105,000 payment is now due on Tuesday, not Friday. The \$105,000 due on Tuesday is not changed by the fact that another \$30,000 has accumulated on Tuesday. The employer under a semi-weekly payment schedule reports the remaining \$30,000 on Friday, the normal payment date for a Saturday through Tuesday semi-weekly period.

**Electronic Filing:**

Employers with an average quarterly Arizona withholding tax liability of \$20,000 or more for the prior year are required to use EFT. A.A.C. R15-10-302(C)1. The failure to pay by electronic funds penalty of 5% in ARS 42-1125(O) and the late payment penalty in ARS 42-1125 (D) are applicable to an EFT not deposited to the DOR account on or before the due date. A.A.C. R15-10-307(C).

F. Audit Write Up

1. The primary audit objective is to confirm that the employer correctly reported the total of all Arizona tax withheld on W-2s, W-2C's and 1099R's to the Department. Additionally, the timeliness of Arizona tax withheld reporting and payment during the audit period is determined.



2. ARS 42-1125-A imposes a 4 and 1/2% penalty based on the amount required to be shown on the return for each month or fraction of a month between the due date of the return and the date on which it is filed. This penalty cannot exceed 25%. The penalty can be abated if Taxpayer shows reasonable cause for his failure to file. The Excel withholding tax audit program allows for interest only calculations if this penalty is abated.

3. ARS 42-1125.D imposes a 1/2% penalty for each month that a taxpayer fails to pay the amount shown on a return. This penalty cannot exceed 10%. If a taxpayer is liable for penalties under both subsection A and D of this section then the combined penalties cannot exceed 25%.

4. ARS 42-1125.K imposes a one time civil penalty of \$100 per month or any portion of a month up to a total of \$500.00 on any information return required by Title 43 that is either late or does not contain all information required.

5. ARS 42-1125.H. If the amount, whether determined by the department or the taxpayer, required to be withheld by the employer pursuant to title 43, chapter 4 is not paid to the department on or before the date prescribed for its remittance, the department may add a penalty of twenty-five per cent of the amount required to be withheld and paid, unless it is shown that the failure is due to reasonable cause and not due to wilful neglect.

6. Determine if any referrals should be made to individual income tax audit regarding specific employees. Determine if any referrals should be made to individual income tax audit or corporate tax audit on over reported Arizona wage expense on income tax returns.

7. Complete the audit work papers that link into the Withholding Excel system. Complete the withholding tax audit notes in Word. Prepare the tentative withholding tax audit work papers within the Withholding Excel system. The tentative audit must be approved and reviewed by the Manager prior to release to taxpayer. Discuss tentative audit results with taxpayer. Advise taxpayer about audit protest process.

## References

N/A

## Attachments

N/A

## Exceptions

N/A