



Mastering Payroll Compliance

10 Missteps to Avoid

Executive Summary

Businesses pay government agencies millions of dollars each year in labor and tax compliance penalties. And, in this economy agencies are more vigilant than ever about enforcing regulations. To help avoid fines, it can pay to be aware of common payroll pitfalls.

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Who needs an EIN?

You need a EIN if you:

- have employees;
- operate a business as a corporation or partnership;
- file an employment, excise, or alcohol, tobacco and firearms tax return;
- withhold taxes on income, other than wages, paid to a non-resident alien;
- have a Keogh plan; or
- are involved with certain organizations such as farmers' cooperatives, estates, or trusts.

You can apply for a EIN online, by phone, by fax, or by mail. See www.irs.gov for details.

Apply early enough to have the assigned number when you need to file a return or make a payment. If you apply by mail, it may take four to five weeks to receive your EIN.

Misstep 1: Tax Agency Requirements

Each business must have an assigned identification (ID) number. Employers without valid ID numbers should touch base with federal, state, and local agencies because sending returns or payments without an ID can result in delays in posting account information — and penalties to follow.

A federal tax ID number, or federal employer identification number (EIN), is like a social security number for a business. The IRS uses the EIN to identify a business, and the ID must be included on all tax filings. Also, banks typically require a EIN to open a business bank account. Other companies with which an employer does business may ask for an ID number to pay submitted invoices.

For information about obtaining a federal employer identification number or to apply for a number online, go to:

<http://www.irs.gov/businesses/small/article/0,,id=98350,00.html>.

States require a unique identification number for the same reasons. For information about obtaining and registering for a state tax agency ID, browse <http://www.irs.gov/businesses/small/article/0,,id=99021,00.html>.

Misstep 2: Social Security

In the United States, “social security” refers to the federal Old Age Survivors and Disability Insurance (OASDI) Act. Insuring all workers and their families against universal risks, OASDI spreads the costs and benefits of insurance protection among the entire workforce. Responsibility for paying the social security tax is split fifty-fifty between the employer and employee.

In 2010, the social security tax rate was 12.4 percent, so the employer and the employee each paid 6.2 percent. For 2011 only, the employee share will be reduced to 4.2 percent because of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

Employers must be sure to include accurate and complete employee names and social security numbers on Forms W-2, otherwise, the IRS or Social Security Administration may reject tax return information associated with W-2 wages. Assessment of penalties is also possible

Misstep 3: Garnishments and Child Support

Wage garnishment takes the form of a court order requiring an employer to withhold an employee's earnings for the payment of a debt. Title III of the Consumer Credit Protection Act prohibits an employer from discharging employees because their earnings have been subject to garnishment for any one debt, regardless of the number of levies made or proceedings brought to collect it.

Employers must always include the employee case number with garnishment payments. This simple component of conscientious recordkeeping makes the posting process much more efficient for the garnishing agency and may save the employer from the possibility of delinquency notices.

Employers must also be mindful of federal and state new-hire requirements. New-hire reporting is the process by which an employer reports information about newly hired employees to a designated state agency shortly after the date of hire. New-hire reports are matched against child support records at the state and national levels to locate parents who owe child support monies. This

is especially helpful for interstate cases (in which one parent lives in a different state from the child), which are often the most difficult cases for states to resolve. With new hire-reporting, state child support enforcement agencies can issue income-withholding orders, the most effective means of collecting child support in a timely fashion.

Misstep 4: Third-Party Sick Pay

Even though an employee on long-term disability is receiving salary payments from a third-party insurance provider, employers still must fulfill tax-filing requirements on the employee's wages. This responsibility can catch an employer unaware.

The third party must report disability payments on Form W-2 for employees paid sick pay if the third party either:

- is paid an insurance premium and is not reimbursed on a cost-plus-fee basis; or
- is designated as the employer for sick payments based upon an agreement; or
- fails to:
 - withhold the employee's share of social security and Medicare taxes and deposit them when due;
 - notify the employer of the disability payments made and taxes withheld so the employer can file proper returns (i.e., in time to file Form 941 tax returns quarterly with the IRS); and
 - provide the employer with information about sick payments made by January 15 of the following year to enable the employer to prepare employee W-2s showing sick pay amounts.

More information about sick pay can be found in IRS Publication 15-A, *Employer's Supplemental Tax Guide*.

Misstep 5: Fringe Benefits

In general, taxable fringe benefits are reported when received by the employee and are included in employee wages in the year they are received. Employers must identify and report fringe benefits correctly although they are easily disregarded as incidental events. The IRS looks closely at how employers interpret this type of compensation.

The following are common fringe benefits. Some may not be taxable, are taxable above certain thresholds, or are taxable under specific circumstances. See IRS Publication 15-B (2011), *Employer's Tax Guide to Fringe Benefits* for details.

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|---|---------------------------------------|
| • Health savings accounts and cafeteria plans | • Incentive stock options |
| • Dependent care expenses | • Interest-free or bargain-rate loans |
| • Company-provided car | • Meals and lodging |
| • De minimis items | • Medical and dental coverage |
| • Education assistance | • No-additional-cost services |
| • Employee discounts for property or services | • Outplacement services |
| • Employee stock purchase plans | • Employer-provided retirement plans |
| • Free parking | • Stock bonuses or bargain purchases |
| • Group-term life insurance | • Transit passes |
| | • Working-condition benefits |

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Misstep 6: Employee vs. 1099 Contractor

Proper classification of a worker as an independent contractor may save a company money and benefits, such as pension, group health, and workers' compensation insurance, as well as social security and unemployment insurance taxes.

In most cases, the only tax form employers need to complete is a Form 1099-MISC at the end of the tax year for workers classified as independent contractors. Classifying workers as employees, on the other hand, requires the company to withhold federal, state, and local income taxes; pay half of the tax mandated under the Federal Insurance Contributions Act (FICA) for social security and Medicare; pay the full tax required under the Federal Unemployment Tax Act (FUTA) and any state unemployment insurance tax laws; pay for workers' compensation; file a number of returns during the course of the year with the various tax authorities; and provide W-2s by January 31. The employee may also have rights to any employee benefits offered, such as health insurance, vacations, holidays, or retirement plans.

It is important for small businesses to understand the employee versus independent contractor distinction. Correctly classifying workers before they perform services can save a business confusion, hassles, and possible fines down the road. The hiring company has the burden of proving that it had no control over the work or the worker when the worker was classified as an independent contractor.

For more details about classifying employees, see the following: <http://www.irs.gov/businesses/small/article/0,,id=99921,00.html>.

If you have questions about how to classify a worker, ask your financial consultant or attorney.

Misstep 7: Exempt vs. Non-Exempt

Employees with exempt status are exempt from some of the provisions of the federal wage and hour law, Fair Labor Standards Act (FLSA). These employees may also be exempt from similar state wage and hour laws. Examples of exempt employees under FLSA include the white collar exemptions: executives, professionals, certain computer professionals, and outside salesperson. An administrative exemption is also available as defined under the FLSA. Exempt employees must generally be paid on a salary basis, which is not subject to reduction based on the quality or quantity of work performed.

The FLSA requires employers to pay non-exempt employees the minimum hourly wage rate and a premium rate for overtime work. Implementing regulations for the FLSA define working time for purposes of compensation.

Disclosure of a single classification issue can often trigger a full wage and hours audit that can lead to an unplanned financial burden. Employers must be careful not to stretch the rules of classification.

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Misstep 8: Overtime Rules

An employer who requires or permits a non-exempt employee to work overtime is required to compensate the employee with the appropriate premium pay for such overtime work. Employees covered by the Fair Labor Standards Act must receive overtime pay for hours worked in excess of 40 in a work week of at least one and one-half times their regular rate of pay. The FLSA does not require overtime pay for work on Saturdays, Sundays, holidays, or regular days of rest, unless overtime hours are worked on such days. State laws may vary.

Premium pay for working weekends or nights is a matter of agreement between the employer and the employee (or the employee's representative). The FLSA does not require premium pay including double-time for weekend or night work.

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Misstep 9: Group Term Life

Group-term life (GTL) insurance plans are usually offered by employers to employees. The cost of the first \$50,000 of group-term life insurance premiums is tax-free to employees and deductible for employers who bear the premium expense. The cost of any additional term coverage will generally show in box 12 with a code "C" on an employee's Form W-2 and be included in boxes 1, 3 and 5 as taxable wages.

Employers should not waste valuable time at year-end dealing with last-minute GTL computations. The best strategy is to calculate and withhold the employee portion of a GTL benefit throughout the year rather than waiting until the calendar deadline.

Misstep 10: Tax Deposits

Penalties can add up when the IRS finds missed payments in the look-back period. The solution could not be simpler: pay your tax liability on time!

Conclusion

Employers owe it to themselves — to say nothing of their obligation to their employees — to be well-versed in tax, employment, and benefits guidelines. At the same time, complying with state and federal statutes is the first step in avoiding costly penalties. A squeaky-clean record with tax agencies reinforces a company's reputation.

About Paychex

Paychex, Inc. is a leading provider of payroll, human resource, and benefits outsourcing solutions for small- to medium-sized businesses. The company offers comprehensive payroll services, including payroll processing, payroll tax administration, and employee pay services such as direct deposit. Human resource services include 401(k) plan recordkeeping, section 125 plans, a professional employer organization, time and attendance solutions, and other administrative services for business. A variety of business insurance products, including group health and workers' compensation, are made available through Paychex Insurance Agency, Inc. Founded in 1971, and with headquarters in Rochester, New York, the company has more than 100 offices in the U.S. serving approximately 500,000 payroll clients. For more information about Paychex products and services, visit www.paychex.com.

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