TOP 10 PAYROLL MISTAKES WE SEE COMPANIES MAKE

The Internal Revenue Service ("IRS") has focused its attention on closing the tax gap and one way it hopes to do so is by collecting under-withheld employment taxes. As part of the Employment Tax Research Project it launched in 2010, the IRS is reviewing the payroll practices of 6,000 employers in four main areas:

- Worker Misclassification
- Fringe Benefits
- Executive Compensation
- Payroll Taxes

Once the research project is complete, the IRS will identify areas in which compliance errors routinely occur and focus audits on those issues. Companies not selected as part of the research project should examine their payroll practices and make any necessary corrections before the IRS investigates.

In our experience, these are the most common payroll mistakes we've seen companies make:

1. **Classification of Employees as Independent Contractors**
   Workers are generally classified as either employees or independent contractors. Getting this classification right is important, as how compensation is reported to the IRS depends on this classification (i.e., Form W-2 vs. Form 1099). Whether the individual is entitled to benefits (such as medical insurance coverage, retirement plan benefits and grants of equity compensation) can hinge on status as an employee. Whether a person is subject to federal income tax and employment tax withholding is also contingent on status.

2. **Failure to Subject Vendor Payments to Backup Withholding**
   If a company issues a payment to a vendor without first obtaining a Form W-9, the vendor should be subject to mandatory backup withholding at a 28 percent rate. Even when it is later determined that a vendor is not subject to backup withholding (for example, a corporation), if the company did not obtain a Form W-9 prior to issuing payment, there may still be an issue: On audit, the IRS has pursued the collection of a failure to deposit penalty on the amount that should have been withheld.

3. **Not Including the Fair Market Value of Gift Cards, Prizes and Awards in Employees' Income**
   For federal income tax purposes, most prizes and awards are considered taxable fringe benefits subject to federal income and employment tax withholding. Gift cards are the equivalent of cash and should always be included in taxable wages. Certain items can be excluded from wages if they are de minimis in nature. However, cash equivalents are never de minimis.

4. **Failure to Issue Form 1099s**
   A Form 1099 must generally be issued to vendors, including independent contractors, who provide more than $600 in services. Some entities, such as corporations, are not required to be issued a Form 1099. If a company fails to timely furnish a Form 1099, it can be subject to penalties.

5. **Failing to Timely Deposit Withheld Taxes**
   Generally, a company is required to deposit taxes on a monthly or semiweekly basis. When taxes reach certain amounts, they must be deposited the next business day. If a company does not deposit these taxes in a timely manner, the company may be subject to late deposit penalties and interest. Penalty rates range from 2 percent to 15 percent, depending on the timing of the deposit.

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6. **Failure to Deposit Withholding Taxes on Vested Restricted Stock and Exercise of Stock Options**
   When an individual exercises stock options, employment taxes should be deposited within one day of the settlement date. The settlement date should not be more than three days after the date of exercise. However, when an employee is granted restricted stock, he or she generally recognizes income upon vesting. Income and employment taxes are required to be withheld on the fair market value of the shares less any amount the employee paid for such shares on that date. The income and employment taxes may be required to be deposited the next business day.
7. **Incorrectly Excluding Expense Reimbursements from Reportable Wages**
   Whether expense reimbursements can be excluded from an employee's wages depends on whether he or she is reimbursed pursuant to an accountable plan. An accountable plan is generally one under which expenses are only reimbursed if there is a business connection to the expenditure, there is an adequate accounting of the expenditure and any excess reimbursements are returned to the employer. If expenses are reimbursed under a policy or plan that does not meet these requirements, they must be included in taxable wages.
8. **Failure to Include Nonqualified Deferred Compensation in Executives' Incomes**
   If nonqualified deferred compensation plans have not been amended to comply with Internal Revenue Code section 409A or have provisions that do not comply with 409A, the executives could have an income recognition event prior to the payment of the deferred amounts and could be subject to an excise tax.
9. **Not Including the Appropriate Value of Taxable Fringe Benefits in Employees' Income**
   Taxable fringe benefits can also include spousal travel, company-provided automobiles, country club dues and housing benefits. How a company values these fringe benefits for purposes of income and employment tax reporting and withholding can be a complicated issue. For example, there are three valuation methods for calculating the value of personal use of company provided vehicles. Is your company calculating this correctly?
10. **Excluding Travel and Commuting Expense Reimbursements in Employees' Income**
    Most of the time, travel and commuting expenses are not taxable income to an employee. However, if a short-term assignment extends beyond a year, or if an employee travels to a permanent work site not located in the same area as his permanent residence, those company provided travel and commuting benefits may need to be included in the employee's income.

This list, while not comprehensive, should provide your company with a starting point to identify areas for improvement. Conducting a compliance review, while there is still time to address errors, is critical in avoiding negotiations on penalties and interest with the IRS.

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