

# Labor and Employment 2018 Symposium

## Payroll Problems You Do Not Want (But May Have)

### Dorsey Speakers

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# ahead of the curve

Workplace law trends for today and beyond.  
Come up to speed to stay ahead.

## Payroll Problems You Do Not Want (But May Have)

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## Overview

- Nonqualified plans and employment taxes
- Correcting payroll taxes
- Bonuses – Sign-on bonuses
- Bonuses and flat rate taxes
- Bonuses and timing of deductions
- Fringe benefits and taxes
- Payroll penalties (Form W-2, Form 1095-C)
- Payroll tax audits
- Tax Cuts and Jobs Act payroll impact
- Employment Related Settlements
- Benefit plans and payroll codes



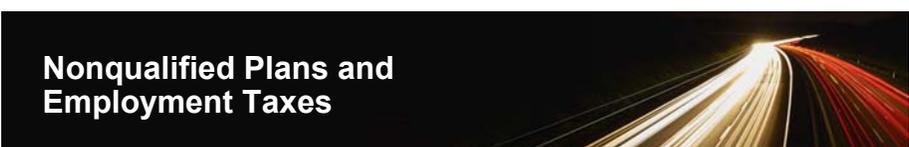


## Why Payroll Matters...

- **Payroll systems and payroll taxes are often taken for granted because there is system in place for collecting income and employment taxes**
  - Payroll systems are only as good as information provided and employer practices
  - Possibility of additional tax revenue has encouraged additional federal and state review of payroll practices to collect revenue



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## Nonqualified Plans and Employment Taxes

- **Section 3121(v)(2) provides special rule for when nonqualified deferred compensation is subject to employment taxes**
  - In general, nonqualified deferred compensation must be taken into account as wages for employment tax purposes as of later of:
    - (i) date on which services creating right to amount are performed, or
    - (ii) date on which right to amount is no longer subject to substantial risk of forfeiture
  - 26 C.F.R. § 31.3121(v)(2)-1(a)(2)
  - Whether substantial risk of forfeiture exists is determined under section 83
    - 26 C.F.R. § 31.3121(v)(2)-1(e)(3)



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## Nonqualified Plans and Employment Taxes

- **Section 3121(v)(2) (continued)**
  - Special rule allows delay until when amount is reasonably ascertainable under nonaccount balance plan
  - Nonaccount balance plan
    - Nonaccount balance plans are plans that are not account balance plans (for example, defined benefit plans)
    - 26 C.F.R. § 31.3121(v)(2)-1(c)(2)(i)
  - Reasonably ascertainable
    - Amount considered reasonably ascertainable on first date “benefit payments attributable to the amount deferred are known, and the only actuarial or other assumptions regarding future events or circumstances needed to determine the amount deferred are interest and mortality”
    - 26 C.F.R. § 31.3121(v)(2)-1(e)(4)(i)(B)
  - Although inclusion may be delayed under special rule, employer may include it earlier
    - 26 C.F.R. § 31.3121(v)(2)-1(e)(4)(ii)



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## Nonqualified Plans and Employment Taxes

- **In general, section 3121(v)(2) means that employment taxes are often due before income taxes on nonqualified deferred compensation**
  - This leads to errors in proper timing of employment taxes
  - Examples
    - Employer contributes (or credits) \$10,000 to account balance nonqualified plan that is fully vested to be paid upon termination – employment taxes due at time contribution is made
    - Employer contributes (or credits) \$5,000 to account balance nonqualified plan that vests after three years to be paid upon termination – employment taxes due at time contribution vests
- **Special rule allows employment taxes to be paid later in same year**
  - However, then present value as of date employment taxes is to be used (includes earnings or reasonable rate of interest)
  - 26 C.F.R. § 31.3121(v)(2)-1(e)(5)



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## Correcting Payroll Tax Errors

- **Payroll tax errors may result in:**
  - Underpaid and underwithheld taxes
  - Overpaid and overwithheld taxes
  - Changes in amounts reported on Forms 940, 941, and W-2
- **When error is discovered after return is filed, employer should amend and correct its return**
- **Forms most employers use to correct:**
  - Use Form 941-X to correct errors on previously filed Form 941
  - There is no “X” series form for Form 940; use Form 940 for applicable year
  - Use Form W-2c unless Form W-2 has not yet been filed
- **Revenue Ruling 2009-39 provides helpful examples**



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## Correcting Payroll Tax Errors

- **Correct errors resulting in underpaid FICA taxes using interest-free adjustment process**
  - 26 C.F.R. § 31.6205-1
  - No interest or penalties are charged on underpayments of FICA taxes
  - Report additional amount due on adjusted return (e.g., Form 941-X) and pay amount due on date adjusted return is filed
    - Must be filed by due date for filing employment tax return for return period in which error was discovered
    - Error is discovered when employer has sufficient knowledge of error to be able to correct it
  - May use to correct FICA tax errors on current and prior year returns
    - Employer must collect amount of under collection by deducting amount from remuneration of employee
  - May not use interest-free adjustment process
    - If failure to report relates to issue raised in examination or if employer knowingly underreported its employment tax liability
    - After receipt of notice and demand for payment or Notice of Determination of Worker Classification



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## Correcting Payroll Tax Errors

- **Correct errors resulting in overpaid FICA taxes using refund claim processes**
  - 26 C.F.R. § 31.6413(a)-2 and § 31.6402(a)-2
  - **Use interest-free adjustment process or file refund claim**
    - Interest-free adjustment process
      - Only available if 90 or more days remaining before expiration of statute of limitations
      - Beneficial if underpaid taxes in same period
    - Refund claim may seek interest
  - **Statute of limitations**
    - 26 U.S.C. § 6511; generally 3 years from time return was filed or 2 years from time tax was paid, whichever is later
    - 26 U.S.C. § 6513; returns filed or taxes paid for calendar year before April 15 of succeeding calendar year are deemed filed or paid on April 15 of such succeeding calendar year



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## Correcting Payroll Tax Errors

- **Correct errors resulting in overpaid FICA taxes using refund claim processes (continued)**
  - **Employee reimbursement or consent required**
    - Employer must repay or reimburse employee for amount of overpaid employee FICA tax or obtain employee's consent to claim
    - For employee FICA tax overcollected in prior years, employer must obtain employee's written statement
    - Revenue Procedure 2017-28 provides consent guidelines
  - **Correct amounts reported on Form W-2c (or Form W-2 if not yet filed)**
    - Correct Social Security and Medicare wages and tax withheld (Boxes 3 through 6)



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## Correcting Payroll Tax Errors

- **Correcting underpaid income tax or additional Medicare tax**
  - 26 C.F.R. § 31.6205-1
  - Use interest-free adjustment process if error is ascertained *within same calendar year* that wages to employee were paid
    - Exceptions
      - Underpayment is attributable to administrative error
      - Section 3509 applies due to misclassification
      - Adjustment is result of IRS examinations
    - Employer must collect amount of under collection on or before last day of calendar year by deducting amount from remuneration of employee



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## Correcting Payroll Tax Errors

- **Correcting underpaid income tax or additional Medicare tax (continued)**
  - If error is not ascertained within same calendar year, interest-free adjustment process does not apply
    - Matter for settlement between employee and employer
    - Employer can be liable for underwithheld income tax or additional Medicare tax
    - Employer may use Form 4670, *Request for Relief of Payment of Certain Withholding Taxes*, and Form 4669, *Statement of Payments Received*, to request relief from paying income tax or additional Medicare tax to IRS where employee has paid
    - If underpaid income tax is paid to IRS in later year, *do not* adjust income tax withholding amount in Box 2 of Form W-2c



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## Bonuses – Sign-On Bonuses

- **Sign-on bonuses**
  - Taxable when paid (even if physician or employee does not start until later year)
    - Physician or employee receives sign-on bonus in connection with establishing employer-employee relationship
    - Revenue Ruling 2004-109
  - Because taxable when paid, there should be withholding from sign-on bonus when paid
  - Reported on Form W-2
- **Sign-on loans**
  - Taxable when (and if) forgiven
  - Because taxable when forgiven, there should be withholding from other compensation being paid when forgiven
  - Reported on Form W-2



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## Bonuses – Sign-On Bonuses

- **Sign-on loans and loan requirements**
- **Loan requirements**
  - Loan must be repaid (loan does not need to be included in income when made because of expectation of repayment)
  - Loan documents must include legally binding promissory note executed with legal obligation for repayment or performance of services
  - Loan must bear reasonable rate of interest (exception if loan is \$10,000 or less)
    - If no interest charged or below market rate charged, difference will be viewed as compensation and amount included in income in year employer fails to charge interest on loan
    - Exception to interest requirement if employer loans to employee do not exceed \$10,000 and one of principal purposes is not tax avoidance
      - 26 U.S.C. § 7872(c)(3); 26 U.S.C. § 7872(f)(10)



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## Bonuses – Sign-On Bonuses

- **Sign-on loans and loan requirements (continued)**
  - Code and temporary regulations provide limited exception for certain employee relocation loans that are used to purchase new principal residence provided certain conditions are met
  - 26 U.S.C. § 7872(f)(11)
- **If loan is subsequently forgiven by employer, loan and interest on loan is included at time it is forgiven**
  - In essence, this means employer must impute income to physician and withhold income and employment taxes on imputed income from other compensation
  - This can lead to payroll complexity depending on frequency of loan forgiveness discussed more under payroll aspects discussion



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## Bonuses and Flat Rate Taxation

- **Bonuses are considered “supplemental wages”**
- **Supplemental wages up to \$1 million**
  - An employer can opt to apply 22% flat rate of withholding instead of using aggregate procedure, which aggregates supplemental wages with regular wages and applies tables
    - When choosing between aggregate procedure and optional flat rate procedure, employer can treat employees differently
  - **Conditions to use flat rate withholding**
    - 26 C.F.R. § 31.3402(g)
    - Employer has withheld income tax from employee’s regular wages during same calendar year or prior calendar year in which supplemental wages are paid
    - Supplemental wages are separated from regular wages (either paid on separate check or listed on separate line on same check as regular wages)
    - If supplemental wages exceed \$1 million, then higher rate is applied to amount exceeding \$1 million



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## Bonuses and Flat Rate Taxation

- **Supplemental wages in excess of \$1 million**
  - Mandatory flat rate of withholding at top marginal income tax rate, i.e., 37% for 2018
  - Highest marginal rate only applies to amount above \$1 million
- **Employees may provide new Form W-4 to employer to achieve specific rate of withholding on bonuses**
  - Employee cannot restrict employer's application of Form W-4 to one payment
  - If employee submitted request for additional withholding on Form W-4 immediately prior to payment of bonus, employer is permitted but not required to apply Form W-4 withholding elections to bonus payment
  - After Form W-4 becomes effective, it remains in effect and applies to all other wage payments, including regular wage payments, until replaced by another valid Form W-4
  - IRS Information Letter 2012-0063



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## Bonuses and Timing of Deductions

- **Cash method employers deduct in taxable year in which bonuses are paid**
- **Accrual method employers deduct in taxable year in which “all-events” test is satisfied**
  - “All-events” test is satisfied when:
    - All events have occurred that establish fact of liability
    - Amount of liability can be determined with reasonable accuracy
    - Economic performance has occurred for liability
    - 26 C.F.R. § 1.461-1(a)(2)(i)
  - All-events test looks only to whether actual legal right or obligation exists as of close of taxable year, not whether it is probable that particular legal right or obligation will occur at some point in future
  - Case law and IRS rulings provide guidance on when all-events test is satisfied with respect to bonuses approved in one year and paid in subsequent year



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## Bonuses and Timing of Deductions

- **Relevant case law**

- Resolution of board of directors approving bonuses can fix liability for purposes of all-events test
- Taxpayer permitted to deduct bonuses in year of board resolution even though bonuses were not actually paid until later year
- Critical that resolution fixed obligation to pay bonuses and employees knew amounts they would receive
- See, e.g., *Willoughby Camera Stores, Inc. v. Commissioner*, 125 F.2d 607 (2d Cir. 1942); *Champion Spark Plug Co. v. Commissioner*, 30 T.C. 295, 298 (1958); *Produce Reporter Co. v. Commissioner*, 18 T.C. 69 (1952)



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## Bonuses and Timing of Deductions

- **Revenue Ruling 2011-29**

- **Accrual method employer pays bonuses to employees**
  - Under bonus program, bonuses are paid to employees for services performed during taxable year
  - Amount of bonuses payable to employees as group is determined either (1) through formula that is fixed prior to year-end, or (2) through other corporate action such as resolution before year-end
  - Bonuses are paid after end of taxable year and employee must be employed on date bonuses are paid
  - Any bonus amount allocable to employee who is not employed on payment date is reallocated to other eligible employees
- Code section 461 requirements satisfied even though employer does not know identity of any particular recipient and amount payable to that recipient until after end of taxable year



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## Bonuses and Timing of Deductions

- **IRS Field Attorney Advice 20134301F (Sept. 18, 2013)**
  - All-events test not met if employer retains right to modify or eliminate bonuses
  - Bonuses paid under plan that reserved employer's right to unilaterally modify or eliminate bonuses at any time prior to payment do not meet all-events test any earlier than date bonuses are paid
  - All-events test may be met absent legal liability if some other event fixes liability, but plans and approval of plans were not events fixing liability where taxpayer explicitly disavowed any obligation to pay bonuses under plan terms
- **One additional requirement for accrual method employers**
  - Bonuses also must be paid within 2-1/2 months after end of year to avoid being nonqualified deferred compensation under Section 409A



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## Fringe Benefits and Taxes

- **A de minimis fringe benefit is benefit provided by employer of property or services with value so small that accounting for them is unreasonable or administratively impracticable**
  - Value of benefit is determined by frequency provided to each individual or, if this is not practical, to workforce as whole
  - See section 132(e)
- **Examples**
  - Personal use of photocopier (with restrictions)
  - Group meals
  - Occasional theater or sporting event tickets
  - Coffee, donuts, or soft drinks
  - Flowers or fruit for special occasions
  - Local telephone calls
  - Traditional holiday or birthday gifts with low fair market value
  - 26 C.F.R. § 1.132-6(e)(1)
- **Cash and gift cards are never de minimis**



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## Fringe Benefits and Taxes

- **Regulations under Code provide that cash and cash equivalents are never excludable as fringe benefit**
  - “[A] cash equivalent fringe benefit (such as a fringe benefit provided to an employee through the use of a gift certificate or charge or credit card) is generally not excludable”
  - 26 C.F.R. § 1.132-6(c)
- **Value of gift card does not matter**
  - IRS has indicated that gift cards of \$25 or less are to be treated as compensation
  - ABA Tax Section’s Employee Benefits Committee, JCEB Meeting with Internal Revenue Service, Q&A 2 (May 6, 2011)
- **Regulations allow employers to provide employees traditional holiday gifts**
  - An example is turkey (or ham) at holiday
  - 26 C.F.R. § 1.132-6(e)(1)



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## Fringe Benefits and Taxes

- **Gifts are form of compensation**
  - Exclusion from compensation for gifts does not include “any amount transferred by or for an employer to, or for the benefit of, an employee”
  - Section 102(c)(1)
  - However, de minimis fringe benefit rules allow limited birthday and holiday gifts of property



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## Fringe Benefits and Taxes

- **Prizes are form of compensation**
  - Except as provided under sections 74 and 117, “gross income includes amounts received as prizes and awards”
  - Section 74(a)
- **Exceptions**
  - Qualified scholarships (section 117)
  - Length of service and safety awards (section 274(j))
  - De minimis fringe benefits (section 132)
    - Priv. Ltr. Rul. 2010-05-014 (Feb. 5, 2010); see also Priv. Ltr. Rul. 2011-35-022 (May 20, 2011) (revoking Priv. Ltr. Rul. 2010-05-014 based on variations in distribution)
  - Certain awards that employee transfers to governmental entity or charitable organization
- **Prizes are compensation if from employer’s vendors**
  - ABA Tax Section’s Employee Benefits Committee, JCEB Meeting with Internal Revenue Service, Q&A 2 (May 6, 2011)



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## Payroll Penalties

- **Form W-2 and Form 1095-C**
- **Significant reporting penalties under sections 6721 and 6722**
  - Failure to provide timely form with correct information
    - \$250 to employee and additional \$250 to IRS per form
    - \$500 to employee and additional \$500 to IRS per form if intentional disregard
  - Deadline generally January 31 for employee and March 31 (electronic filers) for IRS
    - Limited opportunity for extensions
    - IRS extended Form 1095-C deadline this year on own accord



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## Payroll Penalties

- **Form W-3 and Form 1094-C signed under penalties of perjury, which has its own significant penalties and potentially could result in imprisonment (very rare)**



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## Payroll Tax Audits

- **IRS selects returns to examine in one of two ways:**
  - IRS computer programs with selection criteria identified by IRS as being risk areas
  - Information from compliance projects suggests return may have incorrect amounts
- **How audits are conducted**
  - Correspondence audits are conducted entirely by mail
  - Field audits are conducted in person
  - IRS makes final determination of when, where, and how audit will take place
- **What happens during payroll tax audit**
  - Examiner will request information and verify compliance with information reporting requirements
  - IRS may contact third parties regarding case
  - IRS may request extension of statute of limitations



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## Payroll Tax Audits

- **Fast track settlement is available in payroll tax audits**
  - Involves independent mediator from IRS Office of Appeals
  - Completely optional
  - May expedite resolution of case
  - No fee required
  - Available to most taxpayers and for most issues
  - No requirement to accept any resolution; if issues remain unresolved, appeal rights are still available
- **Special procedures available in payroll tax audits if additional tax is owed**
  - Request relief from paying income tax withholding and additional Medicare tax where employee or payee have reported income
  - Interest-free adjustments
- **Appeal within IRS or federal courts**



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## Payroll Tax Audits

- **Common payroll tax audit issues**
  - Worker classification
  - Tip income
  - Fringe benefits
  - Expense reimbursement plans
  - Nonqualified deferred compensation
  - Travel and commuting expense reimbursements
  - Stock-based compensation
  - Trust fund recovery penalty



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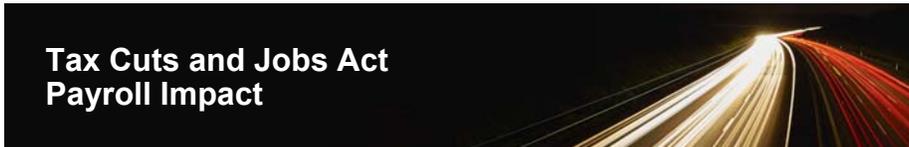


## Payroll Tax Audits

- **Special procedures for worker classification issues**
  - Section 530 relief
  - Classification Settlement Program (CSP) may be available if section 530 relief is not available
  - Section 3509 reduced rates
  - Issuance of Notice of Determination of Worker Classification
    - Interest-free adjustment is not available once issued
    - Appeal to U.S. Tax Court or, after paying tax, initiate refund suit after paying tax in U.S. District Court or U.S. Court of Federal Claims
- **Trust fund recovery penalty under section 6672**
  - Assessed against responsible persons
    - Include individuals, another corporation, payroll service provider, or professional employer organization who were responsible for paying trust fund taxes to IRS but willfully did not do so
  - Amount of penalty is 100% of amount of unpaid trust fund taxes



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## Tax Cuts and Jobs Act Payroll Impact

- **Fringe benefit and welfare changes**
  - Mass transit (Act § 13304; Code § 274(a)(4) and § 274(l))
    - Effective 2018 onward
    - Employers cannot deduct; employees do not need to include
  - Bicycle transit (bicycle commuting) (Act § 11047; Code § 132(f)(8))
    - Effective 2018-2025
    - Employers can deduct; employees need to include and cannot deduct
  - Unreimbursed expenses (Act § 11045; Code § 67)
    - Effective 2018-2025
  - Moving expenses (Act § 11048; Code § 132(g) and § 217)
    - Effective 2018-2025
    - Employers can deduct; employees need to include and cannot deduct
  - Achievement awards (Act § 13310; Code § 274(j)(3))
    - Effective 2018 onward
    - Now codified (before regulations); potentially more enforcement
    - Employers may deduct; employees may exclude if limited to tangible personal property



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## Tax Cuts and Jobs Act Payroll Impact

- **Fringe benefit and welfare changes (continued)**

- **Entertainment expenses (Act § 13304; Code § 274(a)(1))**
  - Effective 2018
  - Employers generally may not deduct expenses for:
    - Entertainment, amusement, recreation
    - Membership dues for clubs organized for business, pleasure, or any other social purpose
    - Facility or portion of facility used for above
    - Exception if employer includes value of expense in employee's income
  - Employers may continue to deduct
    - 50% of food and beverage expenses associated with their trade or business
    - 50% of expenses related to on-premises food and beverages that meets *de minimis* fringe benefit requirements or is for employer convenience
- **Unreimbursed trade or business expenses (Act § 11045; Code § 67)**
  - Effective 2018-2025
  - Employees can no longer take itemized deduction for unreimbursed trade or business expenses



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## Employment Related Settlements

- **Generally, most settlement payments in employment lawsuits are taxable income to plaintiffs**

- Examples: Payments for back pay, front pay, severance, emotional distress damages, interest awards, and punitive/liquidated damages

- **Exceptions**

- Payments intended to compensate for damages “on account of personal physical injuries or physical sickness”
  - 26 U.S.C. § 104(a)(2)
- Payments for mental anguish if they do not exceed actual medical expenses attributable to emotional distress
  - 26 U.S.C. § 61, 26 U.S.C. § 104(a)(2)



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## Employment Related Settlements

- **Settlement payment imposes reporting (and potentially withholding) obligations on employer**
  - Form W-2 for wage payments
  - Form 1099-MISC as “other income” for non-wages
- **Back pay, front pay, severance**
  - Treated as “wages” for purposes of FICA, FUTA, and income tax withholding and must be reported on Form W-2
- **Critical for settlement agreement to make express allocation between wages and non-wages**
  - When settlement agreement makes express allocation, it is generally binding for tax purposes, as long as agreement is entered into by parties in adversarial context, at arm’s length, and in good faith
    - See, e.g., *Bagley v. Commissioner*, 105 T.C. 396, 406 (1995), *aff’d* 121 F.3d 393 (8th Cir. 1997)
  - Without allocation, IRS may classify entire settlement as wages



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## Employment Related Settlements

- **Settlement agreement should make specific allocation of attorneys’ fees**
  - If specific allocation, attorneys’ fees generally taxable to employee and reported by employer on Form 1099-MISC
  - If no specific allocation, attorneys’ fees treated as wages if settlement recovery characterized as wages



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## Employment Related Settlements

- **Employer risks and liabilities for failing to properly treat all or any portion of settlement payment as wages**
  - Liability for FICA and income tax that should have been deducted and withheld
  - Penalties
    - Failure to pay
      - 26 U.S.C. § 6651(a)(2) and (3)
    - Failure to deposit
      - 26 U.S.C. § 6656(a)
    - Negligence or fraud
      - 26 U.S.C. § 6662 or § 6663
  - Interest on any amounts owed
- **Employer risks additional liability, penalties, and interest if employer improperly treated employee as nonemployee**
  - 26 U.S.C. § 3509



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## Employment Related Settlements

- **Impact of Tax Cuts and Jobs Act on settlements**
  - **Sexual harassment settlements**
    - New section 162(q): No deduction “under this chapter” for (1) “any settlement or payment related to sexual harassment or sexual abuse”, or (2) “attorney’s fees related to such a settlement of payment” IF such settlement or payment is subject to a nondisclosure agreement”
    - Applies to payments made on or after December 22, 2017



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## Employment Related Settlements

- **Impact of Tax Cuts and Jobs Act on settlements (continued)**
  - **Sexual harassment settlements**
    - **Broad and undefined language creates significant uncertainties**
      - Central terms left undefined
      - Scope of deduction limitation unclear
      - Unintended consequences to claimant
      - Commentators predict future technical corrections bill would address this provision

## Benefit Plans and Payroll Codes

- **Payroll systems have specific payroll codes for each benefit**
  - **Most benefit deductions reflect fixed dollar amount each period (health, dental, vision, life, long-term disability, etc.)**
    - **For example, \$200 per payroll period for health insurance**
  - **Most benefit deductions do not change during year (exception if employee experiences life event, such as marriage or birth of child, or change in hours)**
  - **However, tax-qualified retirement plans and nonqualified retirement plans are usually deductions based on percent of compensation**

## Benefit Plans and Payroll Codes

- **Payroll codes control taxation of benefits**
- **Tax-qualified retirement plans (401(k) plans, money purchase plans, etc.) and 403(b) plans**
  - Plan documents define compensation
  - Payroll codes should match plan documents, but need to be verified
  - Because elective contributions are generally percent of compensation, if compensation is not defined in same manner under payroll system and plan, this can lead to errors
- **Nonqualified retirement plans**
  - Like tax-qualified retirement plans, contributions to nonqualified plans are also generally percent of compensation
  - Failure here can lead to errors and violations of section 409A or other applicable provisions



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## Benefit Plans and Additional Issues

- **Imputed income**
  - **Group term life insurance**
    - If certain conditions are met, employer may exclude value of group term life insurance of up to \$50,000 from employee's income; above to be included in employee's income
      - See 26 U.S.C. § 79
    - Value is determined under table based on age
      - See 26 C.F.R. § 1.79-3
  - **Domestic partner benefits (generally, health and dental benefits)**
    - If domestic partner is not tax dependent, then value of domestic partner coverage should be imputed as income to employee
  - **Non-tax dependent children and grandchildren (generally, health and dental benefits)**
    - If not tax dependent, value of coverage should be imputed as income to employee



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## Wrap Up

- Questions?



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