



## **The Basics of Payroll Tax Compliance**

Payroll compliance refers to the adherence to laws and regulations governing the payment of employees. These regulations can be at the local, state, or federal level and encompass various responsibilities that employers must fulfill. Some examples of these responsibilities include determining employee classification, providing employee benefits, calculating and deducting taxes such as social security and unemployment taxes, making periodic tax deposits, and managing deductions and withholdings on wages.

Maintaining payroll compliance is an ongoing process that applies to organizations regardless of their industry. Failure to comply with these regulations can expose the organization to legal action and costly penalties. Additionally, non-compliance may impact the organization's eligibility for tax credits, which can adversely affect its financial performance.

### **Importance of Payroll Compliance**

Ensuring payroll compliance should be a top priority for any organization, regardless of its size or industry. Compliance not only helps organizations avoid legal consequences, fines, and penalties, but it also upholds the fair treatment of employees. Payroll regulations ensure that employees receive fair compensation for their work and prevent organizations from imposing inhumane working conditions or long working hours. As such, payroll compliance is crucial for the well-being of employees.

Furthermore, payroll compliance is essential for attracting top talent. Organizations that disregard payroll laws may face difficulties in recruiting and retaining skilled employees. Complying with payroll regulations is a manifestation of good corporate governance and demonstrates the organization's commitment to treating employees fairly.

### **Basics of Payroll Tax Compliance**

All organizations, regardless of size or industry, are required to comply with federal and state laws when processing payroll. Payroll compliance is a continuous process that starts when an employee is hired and extends even after they leave the organization.

The specific compliance requirements may vary depending on the organization's size, location, and operational characteristics. If an organization operates in multiple jurisdictions, it must comply with the applicable laws in each of those regions. Additionally, some organizations may need to adhere to regulations outlined in union contracts to achieve full payroll statutory compliance.

Although compliance requirements differ, most non-federal payroll regulations cover issues such as overtime, minimum wage, reporting new employment, and taxes. However, there are also federal regulations that apply to all organizations operating in the United States.

### **Federal Income Tax**

Federal Income Tax is one of the taxes that employers need to withhold from their employees' paychecks to comply with payroll regulations. The amount of tax is determined by the IRS and can be calculated either as a percentage of the employee's wages or based on their wage bracket. The withholding also



depends on the exemptions specified by the employee on their W-4 Form. The withheld amount, ranging from 10% to 37%, is reported to both the employee and the IRS using the W-2 Form.

### **Employee Classification Rules**

Accurately classifying employees is crucial to ensure payroll compliance. Employers have different responsibilities depending on whether they hire independent contractors or employees. With employees, the employer has more control over their work, schedules, benefits, and reimbursements. This classification also impacts payroll compliance, as employers are required to withhold taxes and pay their share of taxes for employees. Independent contractors, on the other hand, are responsible for paying their own taxes.

### **FLSA**

The Fair Labor Standards Act (FLSA) is a vital federal regulation that governs minimum wage, overtime, recordkeeping, and child labor standards. Organizations must comply with these regulations, including providing minimum wages and paying overtime when necessary. If an organization hires workers under 18 years old, they must adhere to appropriate hours and age restrictions.

Overtime pay is an important requirement outlined in the FLSA. Generally, eligible employees receive additional pay for working more than 40 hours in a workweek. However, not all employees are automatically entitled to overtime pay. Employers must determine, based on the FLSA, which employees are exempt and which are non-exempt from overtime pay. Exempt employees typically include administrative, professional, and executive employees who meet specific criteria under the FLSA. Other exempt categories include employees of small newspapers, recreational businesses, seasonal amusement businesses, and farmworkers.

### **Fringe Benefits**

When offering fringe benefits to employees, employers need to ensure compliance with payroll regulations. The nature of benefits can vary between organizations, so employers must carefully evaluate applicable laws and regulations. Generally, all fringe benefits are taxable and should be included in the employee's wages unless stated otherwise by law. Examples of taxable benefits include reimbursements for moving expenses and mileage reimbursements. Employers are required to withhold taxes for these fringe benefits and report them using the Form W-2.

### **Federal Insurance Contributions Act (FICA) Taxes**

FICA Taxes, which encompass social security and Medicare taxes, are deducted from employees' wages. Employers are responsible for withholding these taxes and remitting them to the federal government. The frequency of tax deposits depends on the business, either monthly or semi-weekly. Additionally, employers must report FICA taxes to the IRS every quarter using Form 941.

### **Federal Unemployment Tax Act (FUTA)**

Under the Federal Unemployment Tax Act (FUTA), employers pay taxes to fund federal unemployment benefits. Unlike FICA taxes, FUTA taxes are solely paid by the employer. As of 2022, the tax rate under



FUTA is fixed at 6% and applies to the first \$7,000 of each employee's annual wages. Employers must pay FUTA taxes quarterly using Form 940.

### **Equal Pay Act (EPA)**

The implementation of the Equal Pay Act aimed to eliminate wage inequality by prohibiting employers from making discriminatory wage rate decisions. According to this act, employees must be paid equally if they are performing substantially similar work, regardless of their gender, race, or ethnicity. To comply with the Equal Pay Act, organizations must establish systematic wage rate factors and maintain proper documentation for all wage rate decisions.

### **State Regulations**

Alongside federal regulations, employers must also be aware of state regulations for payroll compliance. These requirements can vary from state to state, and organizations operating in multiple states must fulfill the payroll compliance requirements for each state individually. Generally, state laws require organizations to withhold income taxes for the state, report new hires, and adhere to minimum wage and overtime regulations.

### **How to comply with labor laws**

Complying with both federal and state labor laws can be challenging, as these laws can be complex and even a minor mistake can lead to expensive litigation and penalties for organizations. In addition to federal and state laws, there are also local laws and union contracts that contribute to the complexity of ensuring compliance.

To navigate the labyrinth of labor laws, it is crucial for the payroll team to continuously monitor US employment laws using appropriate tools. Employing an integrated time platform that supports out-of-the-box payroll compliance can greatly assist in overcoming these challenges.

### **Cost of failures**

Failure to enforce payroll compliance can result in costly litigation for organizations. In the fiscal year 2021 alone, the Department of Labor received 20,279 wage and hour settlement-related complaints, resulting in back wages totaling nearly \$234 million and affecting 193,349 employees. Given these risks, organizations should prioritize ensuring payroll compliance and invest time, effort, and resources into achieving it, as the cost of lawsuits far outweighs the cost of compliance.

### **Common compliance mistakes**

There are several common mistakes that employers make in terms of payroll compliance. By examining and understanding these mistakes, organizations can avoid repeating them. One common mistake is the misclassification of independent contractors and freelancers.

### **Freelancer misclassification**

Employers often hire freelancers and independent contractors to supplement their workforce, which can reduce payroll burdens as these workers are not entitled to employee benefits such as overtime pay. However, it is crucial to correctly classify these hires as contractors or freelancers, as there are distinct tax implications for each category. Misclassifying full-time employees as independent contractors to avoid tax



responsibilities is illegal and can result in expensive lawsuits. Employers may also be liable for additional taxes, penalties, and interest. To prevent unintentional misclassification, employers should ensure accuracy in paperwork when hiring new people and periodically reevaluate employee classifications.

### **Errors in Classifying Exempt and Non-exempt Employees**

One common mistake that organizations make is incorrectly classifying their employees as exempt or non-exempt. Some organizations mistakenly believe that salaried employees are automatically exempt from overtime pay under the Fair Labor Standards Act (FLSA). However, exempt employees are not eligible for overtime pay, while non-exempt employees must be paid for any overtime hours worked. To avoid these errors, organizations should perform three tests to determine the exemption eligibility of their employees, with salary being just one of those tests. Misclassifying an employee can result in lawsuits, audits, and the organization being responsible for back wages and penalties.

### **Failure to Report Taxes**

Payroll compliance also involves accurately reporting taxes to the government. Employers not only need to withhold the correct taxes from their employees' paychecks but also report those taxes correctly. It is not uncommon for employers to overlook or forget to file the necessary tax paperwork due to its complexity. Different forms, such as Form 940, Form 941, Form W-2, and Form 1099, need to be submitted, depending on the nature of the business. Failure to report taxes accurately can lead to stiff fines and penalties.

### **Missed Tax Deadlines**

Organizations often miss tax deadlines due to the complexity of filing processes. Each tax form has a different filing deadline and may be due at different intervals. For example, Form 941 is due quarterly, while Form 940 is due annually. Employers must not only submit these forms to the IRS but also to their employees in the case of Form W-2 and Form 1099. To ensure compliance, the payroll team must plan and strategize their processes for submitting all forms and taxes before the deadlines.

### **Inaccurate Overtime Calculations**

Errors in calculating overtime pay are common in payroll compliance. Organizations often fail to account for other types of compensation, such as commissions, stipends, and bonuses, when calculating overtime pay. Misclassifying non-exempt employees as exempt can also result in incorrect overtime calculations. Additionally, inaccurate hourly rates can be used when calculating overtime pay for employees on a salary or weekly pay basis. Inaccurate overtime pay can lead to significant back pay, fines, and legal action by employees.

### **Failure to Tax Employee Benefits**

Different employee benefits have varying tax implications. While some benefits, like commuter plans and health-savings accounts, do not require employers to withhold taxes, others do. Employers offering taxable benefits must withhold the correct amounts from employees' paychecks and report those amounts on the appropriate tax forms. It is crucial for employers to evaluate the tax regulations and obligations applicable to the benefits they offer to ensure payroll compliance.



### **Missed Paperwork and Reporting for New Hires**

Employers are responsible for ensuring the completion of all necessary paperwork when hiring new employees. This includes verifying employment eligibility with Form I-9 and reporting relevant information to the appropriate state department. Missing any required forms can lead to non-compliance.

### **Shoddy Recordkeeping**

Proper recordkeeping is essential for payroll compliance. Employers must maintain accurate payroll records for current and former employees. State laws often require organizations to keep records for employees who have left within the previous three years. Records should be well-organized and securely stored. Storing records on cloud-based systems can be beneficial for modern organizations.

### **Best Practices for Payroll Compliance**

To streamline payroll compliance processes and ensure long-term success, organizations can adopt several best practices:

- Create a payroll compliance checklist tailored to specific business needs and compliance requirements.
- Create a comprehensive payroll calendar to track deadlines for different tax forms and submission periods.
- Schedule periodic internal audits to ensure the accuracy of employee data and payroll information.
- Seek expert advice from accountants specializing in payroll compliance if resources are limited.
- Invest in a cloud platform to automate payroll processes, integrate with other essential tools, and streamline compliance efforts.

By following best practices, organizations can manage payroll compliance effectively and stay on top of updates to payroll laws, making the process less daunting over time.