
Now that W-2 season is over, what should payroll tax departments focus on?

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In brief

The first quarter of the year is generally a very busy time for payroll tax departments. For 2013, the challenges with the Fiscal Cliff legislative changes created additional work for many payroll departments requiring Forms W-2c (corrected wage and tax statement) to any employees impacted by the retroactive changes to the tax free limit for commuter transit benefits.

So, now that April 15th has passed, what should payroll tax departments focus on?

Well, now is an ideal time to ensure that there are policies and procedures in place to minimize W-2cs next year. Clearly, W-2cs required due to legislative changes instituted after W-2s have been issued can't be avoided, but now is a great time to analyze the W-2cs produced for 2012, and determine any preventative changes that can be made to assist with the accuracy for 2013 W-2 reporting.

Also important is to make sure that amended returns are filed with the various agencies to reflect the wages and taxes reported on the Forms W-2c. If you are using a tax service provider, remember you may have to provide updated employee wage information to ensure that amendments are appropriately filed.

We discuss below some of the common causes of Forms W-2c, along with potential solutions and considerations.

In detail

Employees taxed in incorrect state

One of the most common causes of Forms W-2c is employees being taxed in the incorrect state. This is likely to be caused by one of the following:

- Incorrect work or resident address data is held by the Human Resources (HR) Department

- Tax setup in payroll system does not accurately reflect address information
- Reciprocal agreements have not been taken into account

Consider implementing some or all of the following to reduce such errors:

- Engage with HR and employees to outline the importance of correct work

location / home address information, and the impact inaccurate data will ultimately have on the employee

- Regularly produce and review change reports, i.e. change in work location, change in home address, to ensure tax information is updated promptly

- Consider undertaking an audit of employee tax setup to assess if all employees are being taxed correctly
- Evaluate if procedures are in place to collect applicable state Forms W-4 to show that reciprocity applies, and that employees are made aware of the requirements
- Document and distribute a policy and procedures with regard to corrections to state tax withholdings
- Consider educating employees with regard to withholding tax requirements - employees may not understand incremental withholding, reciprocity agreements, supplemental withholding, additional states' withholding, etc.
- Encourage employees to review their check stubs on a regular basis to facilitate accurate withholding

Don't forget that the employer is liable for withholding tax in the correct state, and therefore, could be subjected to penalties and interest if there is a failure to withhold.

Wage overpayments

Wage overpayments always cause issues for employers at the end of the tax year. The timing of employee repayments of wages is imperative in determining whether a Form W-2c is required, and what boxes on the Form W-2 should be amended.

IRS guidelines indicate that wage repayments received in the same calendar year of the overpayment can be offset against taxable wages in that same year. This means that taxable wages (Boxes 1, 3 and 5), income taxes withheld (Box 2) and social security and Medicare taxes (Boxes 4 and 6) can be adjusted on the W-2 and a

Form 941-X (if applicable) can be submitted to reclaim the amounts from the IRS.

However, where a repayment is received in a calendar year following the year of the overpayment, the IRS does not allow the employer to adjust income tax wages or withholding. The wages paid in error in the prior year remain taxable to the employee for that year. This is because the employee received and had use of those funds during that year.

Upon receipt of a wage repayment for a prior year, employers are entitled to file Form 941-X to recover social security and Medicare taxes. A Form W-2c should also be issued to the employee to correct Boxes 3, 4, 5 and 6. The IRS does not allow employers to correct Box 1 wages for the amount paid in error.

This means that the employee is not entitled to file an amended return (Form 1040X) to recover the income tax on these wages. Instead, the employee is entitled to a deduction (or credit in some cases) for the repaid wages on his or her income tax return for the year of repayment.

This can be confusing for some employees, so consider training HR on these requirements. Employees should be encouraged to repay amounts before the end of the tax year so that they can immediately receive refund of income taxes withheld. Otherwise, they will have to wait until filing their tax return for the year in which they made the repayment, which could be several months.

Finally, think about what is causing the overpayments. Is there a process within payroll that can be improved to reduce the volume of employee overpayments, is there a system issue, are there other departments which should be involved in a solution?

Additional year end related wages

As a result of year-end adjustments and Forms W-2c, the employer may agree to reimburse certain expenses, such as tax preparation fees, for some of its employees.

Remember that such reimbursements will be considered taxable to the employee. The employer may consider grossing up the amount paid to ensure that the employee does not suffer additional tax on the reimbursement.

In addition, the employer may agree to pay specified taxes on behalf of an employee, for example, social security or Medicare taxes that were under withheld due to a payroll error.

In such cases, the amounts are again considered taxable income to the employee, and, therefore, should be included in the employee's income in the year the amount was paid by the employer.

Third party sick pay

Generally, a third party whom the employer uses to make payments of sick pay to its employees will be responsible for withholding federal income tax (if applicable), employee social security and employee Medicare taxes from the taxable portion of the payments. The third party is also liable for the employer share of the social security and Medicare taxes, and the federal unemployment tax, unless the third party transfers this liability to the employer.

A good example of this would be the State of New Jersey Department of Labor and Workforce (NJ DOL), which makes disability payments to individuals under the state disability plan. The NJ DOL is responsible for determining the amount of the payments subject to tax (based on the level of employer and employee contributions to the plan), and

withholding and depositing applicable employee taxes.

However, the NJ DOL also provides each employer with a regular statement detailing the disability payments made to its employees, thereby, passing the liability to pay and file employer taxes to the employer. This also means that the employer is responsible for including the taxable wages on the employee's Form W-2. In some cases, this information is identified after the close of the year, and therefore, Forms W-2c are required.

In addition, Box 13 (Third party sick pay) should be checked, and reporting is required on Form W-2 in Box 12 (Code J) for any sick pay that was paid by a third party and was not includable in income.

In many cases, employers are unaware of this requirement, specifically for New Jersey. Employers should consider implementing procedures to facilitate third party sick pay is captured in the payroll system on a timely basis, to ensure tax deposits are made timely and to avoid year-end adjustments.

Non cash fringe benefits

The inclusion of non cash fringe benefits in taxable income can sometimes cause last minute adjustments at year end, as a lot of employers choose to treat the value of taxable non cash benefits as paid annually, under the special accounting rule provided by the IRS.

In addition, this rule allows employers to treat the value of taxable non cash fringe benefits provided during the last two months of the calendar year as being paid in the following calendar year. For example, the cost of a car service provided to an employee in December 2012 could be included in 2013 taxable income under the special accounting rule. This allows employers sufficient time to gather

data, and could assist in avoiding that year end rush.

Note that although the special accounting rule is optional and does not have to be applied to all non cash benefits, if it is used for a specified fringe benefit, the same treatment must be applied for all employees who receive that benefit.

In addition, impacted employees must be notified of the period in which the special accounting rule was used (generally either with their Form W-2 or on their last paycheck of the year).

The completeness of fringe benefit reporting can also be a concern for employers. It is now more common for employment tax audits to involve the accounts payable department in investigations. In this way, authorities can begin to identify all payment types made to employees and executives (e.g. expense reimbursements, unsubstantiated company credit card payments, spousal travel, club memberships, loans to employees), and then confirm whether appropriate amounts are included in taxable income.

Therefore, payroll tax departments should consider being proactive in this regard. A good place to start may be to review the organization's fringe benefit policy, but it may also be useful to meet with other departments to identify all possible benefits provided to employees. Once a complete list of employee benefits is available, the payroll department can make sure there are procedures in place at year end to facilitate that all such benefits are appropriately captured on Forms W-2.

Reconciliation to final paycheck

One idea that can dramatically reduce the number of queries payroll tax departments receive at year end is to invest some time teaching employees how to reconcile their final paycheck to their Form W-2.

This education should be tailored to your organization, but typical reconciling items could include:

- Imputed income items not shown on paycheck, for example:
 - Taxable Group Term Life Insurance (Box 12, Code C)
 - Taxable relocation expenses
 - Stock option exercises / RSU vestings
 - Taxable expense reimbursements.
- Pre tax deductions, such as:
 - 401(k), or other qualified pension, contributions (but would be taxable for FICA)
 - Contributions under a Section 125 Cafeteria Plan to medical, dental and vision plans
 - Commuter transit benefits and/or car parking within the monthly tax free limit
 - Contributions to a Flexible Spending Account (FSA), Health Savings Account (HSA), etc.
 - Deferrals under a non qualified deferred compensation plan (but would be taxable for FICA).
- State specific differences, for example:
 - For California purposes, contributions to HSAs are considered taxable wages
 - For New Jersey purposes, contributions to health plans via a Section 125 Cafeteria Plan cannot be made pre tax
 - For Pennsylvania purposes, 401(k), or other qualified

pension, contributions are included in taxable wages.

This gross to taxable type calculation can also help to identify any wage type setup errors, or additional concerns. A good process would be to complete such reconciliation on a quarterly or monthly basis.

Also consider providing a "cheat sheet" to employees as to the amounts reported in each Box of the Form W-2, specific to your organization.

The takeaway

PwC's Employment Tax Practice is experienced in assisting employers in

developing company policy and implementing formalized payroll audit procedures to facilitate compliance with employment tax legislation and also to generate efficiencies within payroll tax departments.

The team also consists of payroll systems specialists who can review and assist with the implementation of automated procedures.

Possible areas where we could provide support are:

- Drafting employee communications

- Preparing policies and procedures that work for your team
- Working with third party payroll providers to increase efficiencies
- Reviewing wage type setup to facilitate correct taxability (including for states and locals) and correct mapping to Form W-2
- Assisting with payroll tax reconciliations
- Reviewing completeness of fringe benefits, and improve appropriate reporting

Let's talk

If you have any questions or would like to discuss further, please contact one of the following individuals:

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