Controlling employment tax costs in a declining economy

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The heart of the matter

As unemployment rises, so do the costs of coping with it. The latest data tells us the US economy lost 539,000 jobs in April, as the national unemployment rate climbed to 8.9 percent, the highest it has been since 1983. It is predicted to reach 10 percent by year end.

Many states are suffering from even higher unemployment rates. With the economy in mind, employers are enforcing a variety of payroll saving strategies, such as cutting benefits, 401(k) matches, and healthcare contributions. As unemployment rates increase, there are both immediate and delayed consequences. Administration costs for unemployment claims increase for employers, and state unemployment insurance taxes rise, as well. At the same time, states that declare insolvency due to the depletion of their trust funds are finding it necessary to borrow money from the federal government or through bond issuances.

This borrowing results in solvency surcharges and additional assessments on unemployment insurance tax rates to cover the repayment of principal and interest. Further, as employers go out of business, expenses will grow for existing employers because states will need to allocate these costs to the remaining tax pool.

Therefore, for the next five years or longer, employers can expect unemployment insurance tax rates and related expenses to rise. Also, if the states can't repay federal loans, employers can anticipate incurring that cost as well, in the form of increased Federal Unemployment Tax Act ("FUTA") rates. If a state defaults in its payment of a federal loan, the state unemployment tax credit available to employers in that state will be reduced, thereby increasing the FUTA rate for affected employers.

Several states—California, Indiana, Michigan, New York and Ohio, to name a few—currently have outstanding loans with the federal government; the list of states that may soon join their ranks is growing.

Insolvent trust funds are just part of the problem. States are in financial crisis across the board, and as a result are focusing on new sources of income. On the employment-tax front, this includes an increased concentration on nonresident wage withholding audits.

Considering the gloomy economic outlook, it may appear that there is little an employer can do to control rising costs. But employers can be proactive and implement measures to lessen the impact and mitigate costs.

An in-depth discussion

An employer's focus in controlling employment tax costs falls to the payroll department, starting with its concentration on the compliance function.

Through processing regular payroll, the department oversees what is often the largest expense category in a company: compensation. The department is responsible for (a) computing taxes on a federal, state, and local level; (b) filing returns on a monthly, quarterly, and annual basis; and (c) depositing money with federal, state, and local agencies, often on a daily basis.

An additional responsibility includes processing fringe-benefit payments. The department must track taxable versus non-taxable amounts for purposes of capturing the correct information for Form W-2 reporting. The payroll department also must analyze special payments, characterized as supplemental wages (e.g., bonuses, stock options, taxable moving expenses, severance, etc.), from the perspective of state taxability and sourcing.

The compliance function not only involves processing, filing, and remitting taxes, but also the oversight of policies and procedures to (a) maintain data integrity for liability and tax calculations and, (b) preserve the confidentiality of employee pay information. This is an arduous process that can be further complicated when companies change in significant ways, such as acquiring or divesting business operations or reorganizing due to economic challenges.

Often, the process of controlling employment tax costs appears to be a luxury that payroll departments can defer to a period of downtime. In reality, controlling these expenses becomes most important in times of crisis.

Payroll departments generally occupy one of two areas in a company structure: (1) human resource/shared services department or (2) tax department. Depending on the location, stakeholders may have different goals and objectives in managing the payroll process, but to control employment costs the approach should be similar.

To control employment tax costs, stakeholders should focus on three primary areas:

- Compliance
- The impact of employment tax costs that are outside an employer's control but are significant enough to affect operations.
- The impact operations have on employment tax costs, requiring expenses within an employer's control to be under constant consideration.

In controlling costs, the compliance function must be properly managed to account for accurate reporting and timely remittance practices.

In cases involving employers that have not properly withheld and remitted tax dollars to states in which employees perform services (even if they are present in a nonresident state for only a day or two), an employer could be responsible for the tax that should have been withheld, plus interest and penalties.

New York and Minnesota are leading this charge with respect to nonresident employee withholding, while California is focusing on a payer's responsibility to withhold from nonresident independent contractors. In these cases, the cost of noncompliance could become the company's liability.

In addition, management must be mindful of any business activities that would require establishing payroll accounts in new jurisdictions, as well as new legislation that would impact reporting requirements, such as State Unemployment Tax Act ("SUTA") dumping laws, Section 409A, and single member limited liability company regulations.

Vigilance in the compliance process reduces unnecessary assessments, interest and penalty payments, and the need for resources to resolve such issues.

The second area of focus in controlling costs involves an understanding of the impact employment tax costs have

on operations. We have already discussed the imminent increase in costs, which all employers will bear because of the down economy. It is important to share this information internally, so that decision-makers understand what is on the horizon. That way, they can better predict how those costs will affect budgets and forecasts in the short- and long-term.

The final area of focus for controlling costs involves management's diligence in being proactive and seeking opportunities in the employment tax arena.

- Employers can apply a number of measures to mitigate costs in a down economy, including the following:
- Review past transactions to identify overpaid employment taxes and determine whether refund opportunities may be still be available.
- Manage future acquisitions and reorganizations.
- Consider a Supplemental Unemployment Benefit Plan to reduce Federal Insurance Contributions Act ("FICA") and FUTA taxes on severance payments.
- Streamline payroll structure to reduce the administrative costs of processing payroll returns and deposits.
- Evaluate or develop procedures to reduce areas of exposure.
- Review third-party payroll contracts for cost savings through bundled services or upgrades, or consider alternative vendors for competitive pricing.
- Manage state unemployment tax costs with cost-control measures.
- Review voluntary contributions and joint account analysis opportunities in a timely manner.
- Protest all penalty notices.

What this means for business

Companies can set themselves apart from competitors by refraining from reactive behavior and seeking opportunities in the employment tax arena. Mitigating employment tax costs can help employers recover significantly from the effects of a down economy.

Employers must consider their own circumstances and take advantage of all opportunities. Opportunities include:

- A company that has grown via acquisitions or reorganized in the recent past should review those transactions to identify any overpaid employment taxes and to determine what refund opportunities may be available.
- A company in a position to acquire a new business or organization should include its payroll department in the due diligence process. The department should initially focus on (a) identifying areas of exposure at the target, (b) ascertaining that all returns have been filed and taxes paid and, (c) assessing whether any penalty rates could be assigned in the future. The department also should consider whether successor saving opportunities are available; determine whether it must notify governmental agencies of the transaction or obtain new account numbers; and ensure that correct tax rates are assigned. These measures can eliminate SUTA dumping exposure and unexpected tax assessments.
- A company planning a layoff or plant closure that would involve severance payments should consider implementing a Supplemental Unemployment Benefit Plan ("SUB Plan") to reduce FICA and FUTA taxes on payments to severed employees. SUB plans can be simple or complex. However, in their most basic form, they must tie to the state unemployment benefit program and be approved by that state agency. SUB plans provide involuntarily terminated employees with a supplement to state unemployment benefits via periodic payments or wage continuation, and as such are not subject to FICA tax. Moreover, while these payments are still subject to federal, state, and local income tax withholding, the rates are generally much lower than the supplemental withholding on lump-sum payments; consequently, employees have a greater amount of take-home pay at a time when they need the extra financial support.
- If an employment tax structure involves many employing entities (i.e., numerous Federal Employment Insurance Numbers or FEINs), a company should consider streamlining its payroll structure to reduce the administrative cost of processing payroll returns and deposits. To achieve a more simplified payroll structure, employers can choose a common pay agent or an employee management company.

  The common pay agent election is an administrative technique to reduce a company's compliance burden. One or more "electing employers" designates another entity as the common pay agent. The agent withholds, deposits, and reports federal employment taxes on behalf of employers under its FEIN (Forms 941 & W-2). While the election does not reduce overall employment tax liability, it can significantly decrease the cost of processing payroll returns and deposits.

  An employee management company ("EMC") is a restructuring technique that helps taxpayers consolidate their payroll tax function into as few legal entities as possible. The EMC provides employee management, benefit, and payroll services to the company, and assumes all employment tax filing responsibilities (federal, state and local employment taxes) reported under its FEIN. An EMC simplifies the payroll structure and significantly decreases the cost of processing payroll.
- If a company offers a complex compensation program, it should evaluate payroll procedures to reduce areas of exposure and prevent an employee's tax from becoming the employer's liability. Key procedures are those that pertain to (a) multi-state withholding and reporting compliance, (b) noncash benefits and, (c) employee versus independent contractor classifications.

Companies should pay particular attention to business expense reimbursements as they relate to the accountable

plan rules. If there are areas of exposure, a voluntary disclosure agreement can reduce potential liability. A number of states are offering amnesty programs during 2009.

- Companies that contract with a third-party payroll vendor should review contracts for cost-saving measures—for example, replacing paychecks with direct-deposit and debit cards, or upgrading contracts for more services at the same price. Older contracts priced on a la carte services may be renegotiated. Other options to consider include eliminating under- utilized services and pricing other vendors.
- If a company has experienced or anticipates a layoff, it can control state unemployment tax costs by dedicating resources to manage the unemployment claims process. Whether claims are outsourced to a third-party vendor or administered internally, companies need to be responsive in providing good records to protest claims and to reconcile documented terminations with state reports. Vigilance in this area is vital, as benefit charges affect a state unemployment rate for at least three years. Misallocated charges are more likely to occur in a recession, when state employees are processing large volumes of claims. If misallocations are not caught by the taxpayer, they will unnecessarily increase an employer's cost.
- When a company receives its annual state unemployment insurance tax rate notices, it should dedicate resources to review voluntary contributions and joint account opportunities in a timely manner. If this service is provided by a third-party vendor, its assumptions should be verified, as they utilize historic data to project the future. Often, companies have a better understanding of their future employment tax position, and this knowledge can change the outcome of a vendor's analysis. The same is true of a joint account analysis.
- If a company receives a federal, state, or local penalty notice, it should be proactive and respond in a timely manner. Steps include researching all issues and negotiating or appealing assessments, especially penalty charges. A company should not automatically pay without first understanding the facts at issue.

Many employers feel powerless in the face of rising employment tax costs in this economy. Companies can take a number of steps to lessen the impact of rising unemployment claims and employment tax costs. Proactively seeking opportunities within each situation can help control costs and realize savings—which, in turn, better positions a company to endure the recession and recover more quickly when the market reverses direction.

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