THE SMALL BUSINESS GUIDE TO PAYROLL

What you need to know to properly classify, tax and pay your employees.

GenesisHR SOLUTIONS

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Introduction

As an employer, it's critical to know what you're responsible for in terms of paying your employees. Incorrectly processing your payroll is expensive—and could lead to financial and even legal trouble. In this guide, you'll learn what you're responsible for when it comes to properly classifying, taxing, and paying your employees.

Part 1: Choosing The Right Payroll Frequency

Are you paying your employees correctly? Many small business owners are not—and these errors can be very costly for a small business owner. Here are some tips for paying your employees at the correct frequency.

Employers may pay their employees on a weekly, biweekly, semimonthly, or monthly basis. The state in which the employer conducts business will usually establish the pay frequency for the employees, based on an employee's classification: exempt or nonexempt. Employers can choose to pay their employees more frequently but never less.

Approved Payroll Frequencies

- **Weekly**: 52 times per year.
- **Biweekly**: 26 times per year.
- **Semimonthly**: 24 times per year.
- **Monthly**: 12 times per year.

While salaried employees are commonly paid semimonthly or even monthly, you should think about your entire employee base and how it might change before you select a frequency. You might have all salaried employees today, but if you hire employees in the future who are paid hourly and are considered nonexempt, you might need to make a change.

Changing frequencies can be a major undertaking and very disruptive to your employees. While some states allow hourly employees to be paid semimonthly, it can be an administrative headache to calculate overtime, because overtime is based on hours per week, and pay periods won't have an even number of weeks. Using a semimonthly or monthly pay period might be good for cash flow and is permitted in some states, but you could be creating an awful lot of extra work and even risk penalties in certain states.

There are good business arguments for different pay frequencies, and the laws can vary quite a bit from state to state. If cash flow is not a concern and you plan to hire in multiple states, you might want to consider a weekly or biweekly pay frequency. Most employees prefer to be paid more frequently, as well—so you'll keep your employees happy and keep yourself out of trouble.

Part 2: Independent Contractors Vs. W-2 Employees

If you are wondering if you are paying your employees correctly, you're not alone. Classifying employees correctly is a critical issue, because it affects how much a business pays in taxes, the amount of withholdings from paychecks, and which tax documents need to be filed.

Incorrect classification can lead to large fines and penalties for failing to file the proper tax returns and paying employment taxes.

Whether an honest mistake or a deliberate choice by a business owner trying to save money, classifying employees incorrectly as 1099 contractors could cost a great deal. The IRS continues to invest in more agents to enforce the rules, and penalties are steep!

If you don't want to put your business at risk, take the time to determine how to best classify your employees using IRS guidelines. Here is an abbreviated version of considerations to help you determine the difference between an independent contractor and an employee.

Behavioral Control

- Are you directing the employee on how, when, or where to do their work?
- Are they using tools you provided?

- Are they working with other employees hired by you?
- Are they using your supplies or being told by you where to obtain supplies?
- Are they wearing your uniform or being told what to wear?

Financial Control

- Does your business pay the expenses of the work performed?
- Are you reimbursing the employee for any of their own funds used?
- Do you take all financial risk away from the employee performing the work?

Relationship Of The Parties

- Are you providing any benefits to this employee such as health insurance or paid time off?
- Is this employee lacking their own workers' compensation and liability insurance?

If you answer yes to these questions, you probably have a W-2 employee.

Still have questions about independent contractors vs. W-2 employees?

If you are still having trouble making a clear decision about how to classify your employees, you can ask the IRS. File form SS-8, and it will send back a Determination of Worker Status.

Part 3: Exempt Vs. Nonexempt Employees

One of the most common mistakes we see in the employment relationship (and one that can be quite costly) is misclassifying employees as exempt who should be nonexempt. Sound familiar to you?

Business owners get this one wrong fairly often. Sometimes it's an innocent mistake, but other times it's a deliberate decision made to avoid the potential costs of nonexempt employees; namely overtime wages.

Exempt vs. nonexempt is governed by the FLSA (Fair Labor Standards Act) and the U.S. Department of Labor. Detailed information can be found here to answer many questions. Depending on the job functions of your employees, some of them could be excluded from the statute. The vast majority of employees in the U.S. are governed by FLSA, and it's critical that you classify these employees correctly.

Why do you need to follow FLSA regulations?

We have seen companies get this wrong and face enormous penalties. Consider how large a penalty could be if you had a number of employees classified as exempt, who should have been paid overtime, over the course of a few years. You would owe back wages (at time-and-a-half) to the employees, and the penalties and interest on the taxes you should have paid could be enough to sink your company.

Understanding Nonexempt Vs. Exempt

Here are the basics on the differences between the two classifications and how to determine whether your employees should be considered exempt or nonexempt.

Nonexempt: A nonexempt employee needs to be paid at least minimum wage and must be paid overtime (1.5 times regular rate) for all hours above 40 in a workweek. Most U.S. workers fall into this class unless they meet certain requirements to make them exempt.

Exempt: An exempt employee is not protected by FLSA and employers are not required to pay overtime wages for any work above 40 hours per week. (The term "exempt" literally means exempted from FLSA.)

Exempt employees need to meet the following criteria:

- They must be paid at least $23,600 per year ($455 per week). They must be paid on a salary basis.
- They must perform duties that are considered exempt.

There are three main categories of exempt duties:

- Executive
- Professional
- Administrative

In May 2016, the U.S. Department of Labor (DOL) approved a final rule to modify the white collar exemptions provided by the FLSA. The rule will go into effect on December 1, 2016. The white collar exemptions are minimum wage and overtime exception rules for executive, administrative, professional, outside sales, and computer employees.

The rule focuses on updating the salary and compensation levels needed for Executive, Administrative, and Professional workers to be exempt. Specifically, it does the following:

- Sets the standard salary level at the 40th percentile of earnings of full-time salaried workers in the lowest-wage Census Region, currently the South ($913 per week; $47,476 annually for a full-year worker).
- Sets the total annual compensation requirement for highly compensated employees (HCE) subject to a minimal duties test to the annual equivalent of the 90th percentile of full-time salaried workers nationally ($134,004).
- Establishes a mechanism for automatically updating the salary and compensation levels every three years to maintain the levels at the above percentiles and to ensure that they continue to provide useful and effective tests for exemption.

Additionally, the rule amends the salary basis test to allow employers to use nondiscretionary bonuses and incentive payments (including commissions) to satisfy up to 10% of the new standard salary level.

This is an area many businesses get wrong and pay a steep penalty for. By taking the time to determine the correct status of your employees, you will save yourself valuable time, money, and headaches. You can learn more about correctly classifying your employees in our guide Hourly or salaried, exempt or nonexempt: Are you correctly classifying your employees?

Part 4: Remote Workers & Payroll Taxes

Are you withholding taxes correctly for your remote workers?

More and more frequently, employers are allowing their employees to work from home a few days a week. But what if an employee lives in a different state than the employer's usual place of business? Employers may have to deal with the complex challenges of allocating wages among these several states and not even realize it.

Generally, employers are required to withhold state income tax based on where the work is performed. This could also apply to employees who travel between different satellite offices. Although this sounds simple, there are different rules depending upon the state:

- You need to make sure your organization is registered with the Department of Revenue.
- You must collect and remit state income tax withholding for all states in which work is performed.

Additionally, there are major differences in how some states treat the taxation of certain benefits. Most states follow federal tax treatment; listed below are a few exceptions to this rule:

- **California**: Employee contributions to a Health Savings Account (HSA) are considered taxable. Any employer contributions to an

HSA are considered income for state reporting purposes.

- **New Jersey:** Employee contributions to an HSA are considered taxable. Health insurance premiums paid through payroll deductions must be made on an after-tax basis.
- **Pennsylvania:** 401(k) deferrals are included as income.

These differences make it extremely difficult for payroll systems to accurately allocate wages among these states.

Another challenge is when an employee lives in a taxing state that is higher than the state in which they work. When this occurs, the employer is expected to treat the work state as the “primary” taxing state and, if registered in the employee’s resident state, withhold the difference in tax as a “secondary” state withholding tax.

Finally, withholding income tax from nonresidents requires close attention to detail. Generally, the state in which the employee performs work is the primary taxing state. However, some states have reciprocal agreements with surrounding jurisdictions. If you have an employee who resides in a state that has a reciprocal agreement with the state in which they are employed, you should withhold state income tax based on where they reside rather than where the work is performed.

As you can see, it can get quite confusing. If you’re in doubt, seek the advice of a tax expert.

Part 5: Managing Per Diem Employees The Right Way

In industries that require work to be done 24/7 or at any moment (like health care), per diem employees can be, and often are, the answer. Literally meaning “daily,” per diem employees work on an as-needed basis, often work less than full-time employees, work with a flexible schedule, and do not receive benefits. The clear advantage of having such employees is the ability to call on one to cover for a temporarily absent employee. A hospital, for instance, will take advantage of these “daily” workers, resulting in an adequately staffed building at all times, even if a high number of employees are out. Per diem employees make up the reserve tank.

But per diem employees can be a double-edged sword.

In most cases, per diem employees’ increased flexibility is a pro for both them and the employer, and they show up when needed. Per diem arrangements typically work out fine. However, when the employee becomes unresponsive and/or is unreliable, what do you do? You probably already have a fairly straightforward plan of action in mind—you get rid of the problematic per diem employee.

But it is how you do it that matters. If you just “get rid of” the problematic per diem employee without following several easy, but critical, guidelines, the former per diem employee may file a claim for unemployment—and win.

Consider the scenario of a per diem nurse who regularly cancels or changes her shifts at the last possible minute. This becomes a major scheduling disruption and frustrates both you and her fellow employees, who are forced to cover for her when she's out, as she often is.

What Not To Do

The easiest—and most obvious—seems to be to simply stop scheduling her. Since per diem employees work only when needed and only when scheduled, this would fix the problem, right? Not quite. She can file an unemployment claim and the state would most likely side with her, because you have no proof to counter her claim. After all is done, your unemployment tax rate will rise. So, what do you do?

What To Do

There are three principles that can help you manage per diem employees to minimize unemployment liability in the long term.

1. Treat per diem employees as if they were regular employees. They should receive annual reviews and be subject to the disciplinary process, like any other employee. This way, you will have a history of their performance you can use if necessary.

2. Document. Documentation is one of your biggest tools in minimizing unemployment liability with per diem employees. If and when he or she files a claim for unemployment, you will be prepared and have something to show to the state. Document any last-minute shift cancellations or changes and keep a calendar of shifts offered to the per diem employee that he or she refused. Additionally, require that per diem employees put their resignation in writing and have written proof of status change requests when regular employees become per diem employees.

3. Have a policy in place that reflects your expectations regarding per diem employees. State that it is a voluntary termination if they do not pick up any shifts for a certain period of time (60-90 days generally works). If the nurse in the example decides to stop working her shifts and files a claim for unemployment, the burden of proof will rest on her side, and, as long as she doesn't have any compelling reasons for voluntarily quitting, will likely lose the case.

Having the foresight in these kinds of situations is the biggest deciding factor of the outcome. It is, of course, best to apply these principles sooner rather than later, before a problem reveals itself. But it is never too late to begin now and be insured for the future.

Part 6: Detecting & Preventing Payroll Fraud

Payroll fraud is a serious issue, and business owners should have a system for detecting and preventing it. The most common form of payroll fraud is when an employee gains access to funds they are not entitled to. For salary employees, this could mean adding fake employees to the payroll and collecting their wages. Hourly employees may also commit payroll fraud by altering the hours they work or by clocking in or out of work at inappropriate times.

Detecting Payroll Fraud

Luckily, payroll fraud is fairly uncommon, but it is still important for businesses to understand the best methods of detecting it. Leaders should look for signs that their employees are living above their means or if more than one employee has the same address. Payroll audits and payroll system checks are also a great way to find anomalies with payroll.

Preventing Payroll Fraud

The best way to ensure that employees are not tempted to commit payroll fraud is to make sure they are fully aware of the consequences they face. They should understand that along with workplace consequences, there are also legal consequences of payroll fraud. Also, it's probably in the best interest of the business to have an outside party or a staff member—not involved in the payroll department—perform regular audits on the entire system.

Payroll fraud is an issue that companies of all sizes face, which is why it's important to have a detection and prevention plan in place to protect your business from major losses.

Part 7: Understanding Wage Garnishments

A wage garnishment or wage attachment is an order issued by a court or a government agency that directs an employer to deduct a certain amount of money from an employee's paycheck and send it to a government agency or creditor.

Types Of Garnishments & Withholding Orders

- **Federal tax levy:** The "exempt" amount is based on pay period, marital status, and number of exemptions claimed. Example: For an employee claiming single with one exemption on a biweekly payroll, all but $390.38 would be withheld and remitted to the IRS until the levy is paid in full or released.
- **State tax levy and garnishments:** Most states have their own laws regulating wage garnishments. If the state wage garnishment law is different from the federal law, the law that results in the lowest amount garnished should be applied. For example, if it is part of

your state's law that only 15% of your disposable income can be garnished, that law would be applied instead of the federal law.

- **Student loans:** The Higher Education Act authorizes the Department of Education agencies to garnish up to 10% of disposable earnings to repay defaulted federal student loans.
- **Other withholding and garnishment orders:** 25% of your disposable earnings.
- **Child support:** The garnishment law allows up to 50% of a worker's disposable earnings to be garnished if the worker is supporting another spouse or child or up to 60% if the worker is not. An additional 5% may be garnished for support payments more than 12 weeks in arrears.

Wage Limit Garnishments

Federal and state law places limits on how much of your wages may be garnished. For most types, federal law limits wage garnishments to the lesser of 25% of your disposable earnings (wages left after deductions required by law) or the amount by which your weekly disposable earnings exceed 30 times the federal hourly minimum wages.

Wage Garnishment Examples

- If your disposable income is $217.00 per week, then a creditor would not be able to get a wage garnishment against you. $7.25 (federal minimum wage) times 30 hours equals $217.50 disposable pay.
- If disposable earnings are more than $217.50 but less than $290.00 ($7.25 times 40 hours), the amount above $217.50 can be

garnished.

Are there exceptions to the law?

Court orders in Chapter 13 bankruptcy cases are not subject to wage garnishment limits. If the bankruptcy court sends an income deduction order, employers must deduct the plan payment from the employee's paycheck, even if the deduction exceeds federal or state wage garnishment limits. Child support orders and federal tax levies are not subject to the wage limit.

Additional Resources

Processing payroll incorrectly is expensive and may lead to trouble. By learning about each of the responsibilities outlined in this guide, you'll have a better idea of how to properly classify, tax, and pay your employees.

For more information, check out Hourly or salaried, exempt or nonexempt: Are you correctly classifying your employees? and The Small Business Guide To Year-End.

If you'd like help getting individual answers to your questions about payroll, call us for a free consultation today!

Let's talk.