



The Biweekly
Payroll
Compliance
Publication
Of The
American
Payroll
Association

PAYROLL CURRENTLY

Volume 16

Issue # 9

May 2, 2008

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Restaurant That Charged Wait Staff for Glass Breakage Violated the FLSA, Lost Tip Credit

Gravitas, a restaurant, required its wait staff to contribute one dollar per shift to a glass-breakage fund to offset the cost of the expensive stemware used by the restaurant for serving wine. The wait staff sued the restaurant, saying that the breakage deduction violated the minimum wage provisions of the Fair Labor Standards Act (FLSA). The restaurant argued that the stemware was a “facility” provided to employees that could be used as an offset against the minimum wage due. The court sided with the wait staff and awarded back wages, liquidated damages, and attorney fees [*Chisolm v. Gravitas Restaurant Ltd.*, No. H-07-475, 2008 U.S. Dist. LEXIS 28254 (SD Tex., 3-25-08)].

Under the FLSA (29 USC §203(m)), an employer may count the reasonable cost of furnishing an employee with board, lodging, or “other facilities” toward meeting the minimum hourly wage requirement. The court explained that a “facility” must be in the nature of board or lodging and must primarily benefit the employee, rather than the employer.

Here, Gravitas provided expensive stemware to stimulate the sale of expensive bottles of wine, which benefited the

restaurant by giving it increased revenue and cachet. Because the breakage fee was not a facility furnished for the benefit of the wait staff, it could not be used as a credit against the minimum wage, and its deduction reduced the wages of the wait staff below the required minimum.

An employer that violates the minimum wage provisions of the FLSA is liable for the full amount of the minimum wage, along with an equal amount in liquidated damages (29 USC §216(b)). Because Gravitas used the FLSA’s “tip credit” to pay its wait staff only \$2.13 per hour (see *The Payroll Source*®, p. 2-36), the court required the restaurant to pay the difference (\$3.02 of the \$5.15 per hour minimum wage in effect at the time) for all hours worked by the wait staff while the breakage fee was in effect.

The court awarded the wait staff liquidated damages equal to the back pay due, saying that Gravitas did not show a good faith belief that the breakage fee could be imposed as an “other facility” under §203(m). Moreover, there was no indication that Gravitas relied on legal advice or that the breakage fee was a common practice in the industry. ■

IRS Issues Final Regulations on Employer Comparable Contributions to HSAs

The IRS has issued final regulations on employer comparable contributions to Health Savings Accounts (HSAs) in cases where an employee has not established an HSA by December 31st, or where an employer accelerates

contributions for the calendar year for employees who have incurred qualified medical expenses [73 F.R. 20794, 4-17-08; <http://edocket.access.gpo.gov/2008/pdf/E8-8214.pdf>]. The final regulations adopt the provisions of earlier proposed

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Q. Our company operates a nursing home. The dinner hour is the busiest time of day for the facility, and management would like to hire students from the local high school to help. The students hired would be under age 16, would work after school (no more than three hours for five days a week) and would work no later than 7 p.m. Would these work hours satisfy child labor restrictions? What jobs would be open or closed to these students?

A. The hours to be worked by the students you hire would satisfy the limits set by guidance under the Fair Labor Standards Act (FLSA) for hours worked by 14- and 15-year-olds (see *The Payroll Source*®, p. 2-61).

What they can do. Minors age 14 and 15 can work in a variety of food service jobs, including waiting on tables, bussing tables, dispensing food from a steam table or chafing dish, washing dishes, and preparing salads and other food. They can clean cooking equipment, and can filter, transport, and dispose of cooking oil or grease as long as the temperature of the equipment surfaces and the oil or grease is not greater than 100 degrees Fahrenheit.

What they cannot do. Cooking is prohibited for 14- and 15-year-olds except for cooking with gas or electric grills (where the cooking does not involve an open flame) and except cooking with deep fat fryers that are equipped with and utilize automatic devices that lower and raise baskets into and out of the oil or grease. Minors age 14 and 15 also may not perform baking activities (even the act of removing a pie or a loaf of bread from an oven) or operate “Neico” broilers, pressurized fryers, or rotisseries. And the operation or tending of most power-driven machinery is off limits to 14- and 15-year-olds.

Additional information about youth employment in the healthcare industry is available in a Department of Labor fact sheet at www.dol.gov/esa/regs/compliance/whd/whdfs52.pdf.

Note: When both the FLSA and state law apply, employers must comply with the more restrictive federal or state law (i.e., the law providing the greater protection to the minor). See *APA’s Guide to State Payroll Laws*, Table 1.4, Child Labor Work Hour Restrictions, for state law provisions (www.americanpayroll.org/publication/).

regulations (see *PAYROLL CURRENTLY*, Issue No. 14, Vol. 15) without substantive revision.

Background

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Pub. L. No. 108-173) added Section 223 to the Internal Revenue Code (IRC) to permit eligible individuals to establish HSAs for taxable years beginning after December 31, 2003. It also added Section 4980G, which imposes an excise tax on an employer that fails to make comparable contributions to the HSAs of its employees for a calendar year. *Note:* The excise tax is equal to 35% of the total amount contributed by the employer to the HSAs of its employees during that calendar year.

An employer is not required to contribute to the HSAs of its employees. However, in general, if an employer makes contributions to any employee’s HSA, then the employer must make comparable contributions to the HSAs of all comparable participating employees. Comparable participating employees are eligible individuals who have the same category of High Deductible Health Plan (HDHP) coverage – i.e., self-only or family coverage.

Employee has not established an HSA by December 31

The regulations provide a means for employers to comply with the comparability requirements with respect to (1) employees who have not established an HSA by December 31, or (2) employees who may have established an HSA but not notified the employer of that fact.

The regulations provide that, in order to comply with the comparability rules for a calendar year with respect to such employees, the employer must comply with a notice requirement and a contribution requirement.

Notice requirement. By January 15 of the following calendar year, the employer must provide all such employees written notice that each eligible employee who, by the last day of February, both establishes an HSA and notifies the

employer that he or she has established it, will receive a comparable contribution to the HSA.

If an eligible employee then establishes an HSA and notifies the employer by the end of February, the employer must contribute to the HSA by April 15 comparable amounts (taking into account each month that the employee was a comparable participating employee) plus reasonable interest.

The notice may be delivered electronically. The regulations provide sample language that employers may use as a basis in preparing their own notices.

Acceleration of employer contributions. For any calendar year, an employer may accelerate part or all of its contributions for the entire year to the HSAs of employees who have incurred during the year qualified medical expenses exceeding the employer’s HSA contributions at that time.

If an employer accelerates contributions for this reason, (1) these contributions must be available on an equal and uniform basis to all eligible employees throughout the calendar year, and (2) the employer must establish reasonable uniform methods and requirements for accelerating contributions and determining medical expenses.

An employer is not required to contribute reasonable interest on either accelerated or nonaccelerated HSA contributions, unless regulation §54.4980G-4 Q&A 6 (where an employee has not established an HSA at the time the employer funds its employees’ HSAs) or 12 (where an employer makes additional HSA contributions to correct non-comparable contributions) applies.

Effective date

The regulations apply to employer contributions made for calendar years beginning on or after January 1, 2009. However, employers may rely on the final regulations beginning on or after April 17, 2008. ■

IRS Issues Guidance on Income Tax Withholding on Wages Paid to Employees Working Outside the U.S.

The IRS has released a legal memorandum offering guidance on income tax withholding on remuneration paid to employees working outside the U.S. [ILM 200814010, 12-12-07 (released 4-4-08)]. The memorandum was prepared in response to a request, later withdrawn, for a private letter ruling.

Background

The scenario addressed in the IRS memorandum is as follows: A U.S. partnership employs a number of U.S. citizens and U.S. resident aliens in a foreign country. Some of these expatriate employees qualify for the IRC §911 foreign earned income and housing exclusion.

The employer requested two rulings:

- Whether remuneration paid to expatriate employees satisfies the requirement for exemption from U.S. wage withholding under IRC §3401(a)(8)(A)(ii) that the employer is required by the law of a foreign country to withhold income tax on it. The employer proposes an “approach” intended to replicate a tax withholding system for expatriate employees in a foreign country where payroll deductions from wages are prohibited.

- Whether the exemption from U.S. wage withholding under IRC §§3401(a)(8)(A)(i) or (ii) can apply to remuneration for services paid to an individual who is a resident alien and not a U.S. citizen.

IRC §3401(a)(8)(A) exceptions to income tax withholding

IRC §3402(a) generally provides that every employer making a payment of wages must withhold federal income tax determined in accordance with tables or computational procedures prescribed by the Secretary of the Treasury. For purposes of federal income tax withholding, “wages” is defined as all remuneration for services performed by an employer for

an employer, with certain exceptions.

Section 3401(a)(8)(A) provides an exception for services (i) performed by a citizen of the United States if, at the time of the payment, it is reasonable to believe that the remuneration will be excluded from gross income under §911; or (ii) performed in a foreign country (or U.S. possession) “by such a citizen” if, at the time of the payment, the employer is required by the law of the foreign country (or U.S. possession) to withhold income tax on it.

IRS interpretation #1. In the scenario under review, the foreign country does not require income tax withholding on the wages of the expatriate employees. Therefore, that remuneration does not qualify for exemption from U.S. wage withholding under §3401(a)(8)(A)(ii), whether or not the employer implements its proposed “approach.”

IRS interpretation #2. The exception in §3401(a)(8)(A)(ii) directly references the exception in §3401(a)(8)(A)(i), limiting the scope of its applicability to U.S. citizens with the language “by such a citizen.” Nothing in the statute suggests that either of the exceptions applies to anyone other than U.S. citizens. Therefore, neither exception can apply to an employee “who is an alien individual.”

A similar conclusion was reached in Revenue Ruling 92-106, which said that amounts paid as remuneration for services to an employee who is a U.S. citizen are wages to the extent that they exceed the amount of the exclusion the employee is entitled to under §911 (and are not subject to withholding under the laws of a foreign country). In the case of wages paid to a U.S. resident alien, however, no exemption from income tax is available for the amount of the §911 exclusion to which the employee is entitled. ■

TIGTA Issues Report Critical of IRS Efforts to Address Employment-Related and Tax Fraud Identity Theft

In a recently issued report, the Treasury Inspector General for Tax Administration (TIGTA) presents the results of a review of the effectiveness of IRS actions:

- in assisting taxpayers victimized by identity theft and their current and future compliance issues; and
- in pursuing action against individuals responsible for employment-related and tax fraud identity theft [TIGTA Audit Rpt. 2008-40-086, 3-25-08; www.treas.gov/tigta/auditreports/2008reports/200840086fr.pdf].

In conducting its review, TIGTA interviewed IRS personnel and studied IRS documentation – from the Identity Theft Program Office, the Automated Substitute for Return, Automated Underreporter, and Withholding Compliance functions, and the Criminal Investigation Division – to learn how the Service processes identity theft cases, researched the Federal Trade Commission and Social Security Administration websites, and reviewed FTC and SSA documentation.

Background

The Federal Trade Commission (FTC) is the primary federal agency responsible for receiving identity theft complaints and maintains the Identity Theft Clearinghouse. According to the FTC, 56,125 (22%) of all reported identity theft complaints in calendar year 2007 resulted from either

the filing of a fraudulent tax return or the misuse of someone’s identity to obtain employment. During calendar years 2002-2007, the number of fraudulent tax returns filed as a result of identity theft increased 579%, and the number of complaints resulting from employment-related identity theft more than doubled.

In 2005, the IRS established the Identity Theft Program Office. The Office is responsible for assessing IRS processes to identify internal areas susceptible to identity theft, as well as for implementing an IRS Enterprise Identity Theft Strategy with three components:

- **Prevention.** The IRS Criminal Investigation Division (CID), Refund Crimes Unit, works to identify fraudulent tax returns filed by criminals using another person’s tax information in order to steal a tax refund.

- **Outreach.** The IRS alerts the public about possible identity theft scams through news articles and has revised its most widely used tax documents to include identity theft information.

- **Victim assistance.** The IRS has revised internal procedures and worked with the SSA to reduce the time needed to resolve “scrambled” social security numbers (SSNs). When two tax returns are filed under the same SSN and

the IRS cannot determine the true owner of the SSN, the “scrambled” SSN is sent to the SSA for verification. In the interim months (the process previously took up to two years), the affected taxpayers would not be entitled to credits and/or refunds related to their SSN. The IRS is also updating its processes and notices to provide help to taxpayers whose names and SSNs have been used by an identity thief for employment purposes.

Results of review

Tax fraud identity theft is rarely prosecuted. The IRS Enterprise Identity Theft Strategy for prevention does not include pursuing individuals using another person’s identity, unless their case directly relates to tax fraud. Employment-related fraud cases worked by the CID address employment tax issues but do not address the illegal use of SSNs for employment.

The actual crime of identity theft is investigated by the CID only if it was committed in conjunction with other criminal offenses that have a large tax effect. According to the *Internal Revenue Manual*, an identity theft violation is not intended to stand alone, but it “must have a direct link to the substantive tax or the related conspiracy violation that is the focus of the criminal investigation.” Rarely would it occur that an “identity theft is charged without a companion substantive tax or related conspiracy violation.”

For tax year 2005, the total number of prosecution recommendations made in conjunction with identity theft was 45, or 1.6% of the total number of prosecution recommendations made by the CID. For tax year 2006, the total number of prosecution recommendations made in conjunction with identity theft was 55, or 2.0% of the total number of prosecution recommendations made.

According to the IRS, the CID received only 625 fraud referrals from various IRS functions or outside parties (e.g., the Department of Justice, taxpayers) in fiscal year 2005 and 603 referrals in fiscal year 2006. However, because there is no unique coding for identity theft referrals, there is no way to determine if any of these fraud referral cases were related to identity theft.

More needs to be done to address employment-related identity theft. The use of another person’s SSN to obtain employment is often done in conjunction with a name different from SSA records. This is known as an SSN-name mismatch. In these instances, the IRS and the SSA do not associate the income and benefits with the lawful taxpayer.

While SSN-name mismatches are a significant problem for the IRS and SSA, the more serious problem develops for a lawful taxpayer when both the person’s name and SSN are used by someone else to gain employment. No action is taken to stop someone from continuing to commit employment-related identity theft using another person’s SSN and name. The IRS does not actively try to identify or stop an individual from committing identity theft. Moreover, the IRS does not notify the employer of the problem of an employee using someone else’s identity.

Because the IRS and the SSA will assume that information on Forms W-2 is accurate, the earnings resulting from the identity theft will be attributed to the lawful taxpayers for determining both social security benefits and tax liabilities. The IRS generally does not pursue the taxes that may be due on income earned using a stolen identity.

For example, wages earned by an individual using

another person’s identity would not be reported on the lawful taxpayer’s tax return. Because the name and SSN on the Form W-2 match IRS records, the IRS would assume the unreported wages belonged to the taxpayer. As a result, the Automated Underreporter (AUR) function would send a notice to the taxpayer for the underreporting of income. If the taxpayer provides adequate documentation to prove identity theft, the IRS will remove the income and tax liability from the taxpayer’s account and close the case.

For tax years 2003 and 2004, more than 27,000 lawful taxpayers had to resolve problems with the AUR function as a result of employment-related identity theft. For tax year 2004, approximately \$550 million in wages was reported for identity theft victims contacted by the AUR function. TIGTA estimates that approximately \$268 million (49%) of these total wages resulted from identity theft.

According to IRS management, the Service is unable to do more to stop continued use of someone’s identity in employment-related identity theft cases for the following reasons:

- Notifying an employer that an employee is using another person’s identity is not permissible because it would be an unlawful disclosure of tax information.
- The IRS does not have sufficient enforcement resources to address most of these cases.
- The responsibility for employment-related identity theft cases is not within the jurisdiction of the IRS. Further, due to disclosure rules, the IRS has concerns about sharing information on these cases with other agencies.
- It would not be worthwhile to pursue employment-related identity theft cases for unreported tax liabilities because the taxes owed on most of these cases are not significant.
- The FTC Identity Theft Clearinghouse is not reliable; therefore, the IRS CID does not use the FTC database to evaluate whether additional actions are needed to address complaints of tax-related identity theft.

TIGTA replies that in tax fraud and employment-related identity theft cases, the IRS is usually the first agency to become aware of the problem and has the information needed to address the identity theft. If the IRS takes no additional action to stop further use of another person’s identity, then there is no deterrent to keep the problem from spreading.

The report also disputes several of the IRS claims, insisting that coordination among agencies with jurisdiction over use of another person’s identity for employment is important to ensure that federal records related to income earned by a taxpayer are correct and to ensure appropriate law enforcement. Federal law (42 USC §408) allows the SSA to pursue criminal penalties for an individual who fraudulently obtains, uses, or represents an SSN to be theirs. And there are a number of exceptions in the IRC that allow disclosure of taxpayer information in order to investigate illegal activity. If the IRS believes these exceptions are not adequate for the purposes of combating identity theft, then IRS management should seek a legislative remedy. Finally, TIGTA says that it is not clear how IRS management concluded that the data in the FTC Identity Theft Clearinghouse was unreliable because the IRS has not received or evaluated it. TIGTA’s own limited review indicated that the data “appeared to be reported accurately,” but the report said further investigation and evaluation were needed.

☞ **RECOMMENDATION 1** – TIGTA said the IRS should develop and implement a strategy to address employment-related and tax fraud identity theft. This should include coordinating with other federal agencies such as the FTC and the SSA to evaluate and investigate identity theft allegations related to tax administration.

The IRS responded by saying that it did not plan to more actively try to identify or stop individuals from committing employment-related identity theft and notify employers of their employees using someone else's identity. The Service insisted that IRC §6103 broadly restricts the IRS from sharing taxpayer information with third parties.

The IRS also said that the CID had evaluated FTC Identity Theft Clearinghouse data and concluded that it generally did not provide enough details or personal information to support the initiation of an investigation and that it had not been verified or authenticated by the FTC. Therefore, the CID would continue to rely on alternative data sources. TIGTA pointed out, in rebuttal, that the Identity Theft Clearinghouse "is the sole national repository of consumer identity theft complaints" and reiterated its view that it should be an important source of data for the CID.

The IRS has improved outreach efforts and documentation standards. To date, the IRS Identity Theft Program Office has been responsible for:

- Revising widely used documents, such as the Form 1040 instruction booklet and *Your Federal Income Tax* (Publication 17) to include information on identity theft.
- Creating and maintaining an identity theft webpage on irs.gov that provides taxpayers with updated information regarding identity theft issues and links to other federal agencies (e.g., SSA, FTC) that may be of assistance to victims of identity theft.
- Creating the DVD *Identity Theft: Outsmarting the Crooks* and the publication *Identity Theft: Prevention and Victim Assistance* that provide valuable information to taxpayers concerning identity theft issues.
- Issuing public service announcements stating that the IRS does not communicate with taxpayers via e-mail in an effort to reduce the number of identity thefts resulting from "phishing."
- Partnering with TIGTA's Office of Investigation to create the "Phishing In-Box" – an e-mail address to which taxpayers can send suspicious e-mails they believe may be part of a "phishing" scam.
- Giving numerous identity theft presentations to the tax preparer community at various events.

In addition, in June 2007, the IRS issued a memorandum to its employees establishing a consistent agency-wide standard when requesting written documentation from taxpayers to resolve their identity theft cases. Specifically, these new documentation requirements consist of two parts:

- *Authentication of identity* – a copy of a valid U.S. federal or state government issued form of identification (e.g., driver's license, state identification card, social security card, passport, etc.).
- *Evidence of identity theft* – a copy of a police report or an Identity Theft Affidavit filed with the FTC.

Efforts are still needed to reduce burden on identity theft victims. TIGTA reports that some identity theft victims are unnecessarily contacted multiple times. For example, for tax years 2003 and 2004, 1,274 identity theft victims were

unnecessarily contacted multiple times by the AUR function. In each of these cases, taxpayers were contacted even though identity theft closing codes were already posted on the AUR system for a prior year underreporting issue. Individual case screens on the AUR system do not currently show prior year closing codes. TIGTA estimates that for tax year 2004, the IRS was unable to assess over \$440,000 as a result of working these unproductive cases and not working other more productive cases.

In addition, TIGTA identified 55 tax year 2003 identity theft cases closed by the AUR function in which taxpayers were subsequently contacted by the Withholding Compliance function for underwithholding issues in tax year 2004. The Withholding Compliance function case creation criteria do not include prior year AUR function identity theft closing codes.

☞ **RECOMMENDATION 2** – TIGTA said the IRS should update individual case screens on the AUR system to display prior year closing codes, and should revise the Withholding Compliance function case selection criteria to include special handling of identity theft victims.

The IRS responded by saying that in January 2008, it implemented a universal identity theft indicator, which is placed on a taxpayer's account when the taxpayer self-identifies as an identity theft victim and provides the proper documentation to verify his or her identity.

The IRS said it will develop business rules for various programs, to apply unique treatments to cases when the universal identity theft indicator is present. TIGTA pointed out, however, that the Service has not set specific action dates for implementing these new rules.

The IRS also said it is developing a five-year strategy, but TIGTA noted that there is no mention of when this strategy will be implemented or how its success will be measured.

More information is needed to determine the impact of identity theft on tax administration. The IRS currently lacks the comprehensive data needed to determine the impact that identity theft has on tax administration, according to TIGTA. Only the AUR function is able to identify taxpayer cases closed as identity theft. But AUR function personnel use identity theft closing codes only on cases that result in no change in the tax liability because they do not have a choice of closing codes that allow for multiple issue case closures involving identity theft. This means that none of the multiple issue cases reviewed by the AUR function (e.g., almost 4.5 million in tax year 2005) would be coded as identity theft if there was a tax assessment made on one of the underreported issues.

☞ **RECOMMENDATION 3** – TIGTA said the IRS should establish closing codes for multiple issue cases on the AUR system that will allow for individual underreporting issues to be closed as identity theft.

The IRS responded that its new universal identity theft indicator (implemented in January 2008) supersedes the need for the AUR program to develop a new system to report multiple closing codes. The new indicator, which will be used as a factor in the selection and prioritization of AUR function cases in future years, will permit the Service to centrally track incidents of identity theft, protect revenue threatened by identity fraud, and reduce taxpayer burden related to identity theft. TIGTA agreed that if the new indicator operates as intended, it should be sufficient. ■

May Is Direct Deposit and Direct Payment Month

May 2008 has been designated as Direct Deposit and Direct Payment Month. This is an ideal time for payroll professionals to promote direct deposit as a secure and reliable way for employees to receive their paychecks.

According to NACHA – The Electronic Payments Association, employers and employees benefit from direct deposit in a variety of ways:

- The account reconciliation process is simplified. Your account statement will have a single dollar amount for the total amount of the direct deposit transactions versus individual check amounts to reconcile.
- Direct deposit eliminates manual check preparation, which can reduce administrative costs.
 - You'll have fewer checks to print and store.
 - Payments never get lost or stolen.
 - Fraud is reduced because there is less potential for counterfeit checks, stolen checks or signature plates, altered amounts, and forged signatures.
 - No signatures are required, so there is no need for facsimile signature security.
 - It costs more to process a paper check.
 - Direct deposit requires less manual handling than a check, which reduces the potential for errors.

- Problems are very rare. The chance of having a problem with a check is much greater than with direct deposit.

- Businesses can save anywhere from \$0.50 to \$1.25 per payment by using direct deposit instead of checks.

- Productivity is increased because employees spend less time away from work cashing or depositing payroll checks.

Suggestions for effective promotions are available at www.electronicpayments.org/businesses/bs.marketing-resources.promotion.php. APA's *The Guide to Successful Direct Deposit* also offers tips for marketing direct deposit to your employees. In addition, the book explains how to implement and administer a direct deposit program and discusses the federal and state regulations on direct deposit. Order the recently published 2008 edition by visiting www.americanpayroll.org/publication or calling APA's Membership Services at 210-224-6406.

Note: New this year is <http://payitgreen.org>, a website that explains how setting up direct deposit benefits the environment. A Green Calculator lets you discover your financial paper footprint and calculate how much you can reduce your environmental impact by switching to electronic payments. ■

Tile Installer Was an Independent Contractor

Uriah Jones was hired by DBMA Corp. as a tile installer on a condominium renovation in 2003 and was paid \$8,360. DBMA reported Jones's earnings to the IRS on Form 1099-MISC. Jones did not include the earnings from DBMA on his 2003 income tax return, and the IRS assessed a deficiency of \$2,274 for unpaid self-employment tax. The question for the Tax Court was whether Jones was an employee or an independent contractor of DBMA.

The court applied the common law test and determined that Jones was an independent contractor. The factors the court considered included the following: (1) the degree of control exercised by DBMA over the details of Jones's work; (2) which party invested in the work facilities used by Jones; (3) Jones's opportunity for profit or loss; (4) whether DBMA could discharge Jones; (5) whether the work performed by Jones was an integral part of DBMA's business; (6) the permanency of the relationship between the parties; and (7) the relationship the parties believed they were creating.

All of the factors but one (the fifth) indicated that Jones was an independent contractor. Although DBMA exercised some control over the hours Jones worked, Jones nevertheless

exercised a degree of control consistent with independent contractor status. He was free to complete his work with the means and methods of his choice, and he used his home workshop to complete work after advising DBMA on the best way to complete the project.

Jones supplied his own tools and all supplies other than tile. DBMA paid Jones a fixed price for his work, so if Jones underestimated the cost of supplies or the time to complete the job he risked losing money. DBMA did not discharge Jones; the company waited until after Jones completed the tile project to tell him that he would not be used on other projects. The relationship between Jones and DBMA ended when the job for which he was hired was over; the fact that Jones worked for three other companies as an employee in 2003 did not mean that he was also an employee of DBMA. DBMA treated all of its workers as independent contractors, and although Jones claimed that he had always worked for other companies as an employee, he never submitted a Form W-4 to DBMA, as he had to other employers [*Jones v. Commissioner*, T.C. Memo 2007-249, No. 18719-05 (8-27-07)]. ■

Supreme Court Refuses to Hear Case Involving Constitutionality of Taxing Damages for Nonphysical Personal Injuries

The U.S. Supreme Court has refused to hear the appeal of a dispute involving the constitutionality of IRC §104(a)(2), which excludes an award of damages (other than punitive damages) from gross income only if it is received "on account of personal physical injuries or physical sickness." For purposes of this exclusion, a provision added in 1996 explains that "emotional distress shall not be treated as a physical injury or physical sickness" [*Murphy v. IRS*, No. 07-802 (U.S. Sup. Ct., 4-21-08)].

Background

Marrita Murphy paid taxes on an award of \$70,000 for emotional distress and injury to her reputation because of the misconduct of her former employer, the New York Air National Guard. The NYANG had "blacklisted" her and provided unfavorable references to potential employers after she complained to state authorities about environmental hazards on a NYANG airbase.

A psychologist testified that Murphy had suffered

“physical manifestations of stress,” including teeth grinding, anxiety attacks, shortness of breath, and dizziness; Murphy testified that she could not concentrate, stopped talking to friends, and no longer enjoyed “anything in life.”

IRC §§104(a)(2) and 61

The U.S. Court of Appeals for the District of Columbia said that Murphy was compensated only for mental pain and anguish and for injury to her professional reputation. At best, her physical injuries may have been considered as evidence of the severity of her emotional distress, but “her physical injuries themselves were not the reason for the award.” Therefore, said the court, §104(a)(2) did not permit Murphy to exclude her award from gross income.

The §104(a)(2) exclusion from gross income was narrowed by Congress in 1996 explicitly to provide that “emotional distress shall not be treated as physical injury or physical sickness.” In other words, an award on account of emotional distress is *not excluded* from gross income. “For the 1996 amendment of §104(a) to make sense,” said the court, “gross income in §61 must include an award for nonphysical damages such as Murphy received.”

Congress’s power to tax

To be permitted under the Constitution, a direct tax – laid

on the general ownership of property – must be apportioned by population. For example, taxes on real or personal property are direct taxes. An indirect tax – generally referred to as an excise tax – must be uniform throughout the U.S. Examples of excise taxes include taxes on activities, uses, and privileges incidental to the ownership of property such as sales, gifts, and particular business transactions.

Here, Murphy’s award was not a tax on the ownership of property. She surrendered some part of her mental health and reputation in return for monetary damages, and was taxed only after she received a compensatory award. In other words, the tax was assessed on a transaction.

Murphy was vindicating her rights using the legal system; and legal rights are a privilege taxable by excise, said the court. Finally, the court noted that the tax on an award of damages for a nonphysical personal injury operates with “the same force and effect” throughout the U.S. and therefore satisfies the requirement of uniformity.

Note: The court had previously ruled that §104(a)(2) was unconstitutional and ordered a refund of taxes paid on the \$70,000 award, but reversed itself on reconsideration (see [PAYROLL CURRENTLY, Issue No. 16, Vol. 15](#)). ■

Employee Awarded Almost \$500,000 in Liquidated Damages for FMLA Violations

A U.S. District Court in Connecticut has awarded an employee \$496,344 in liquidated damages under the Family and Medical Leave Act (FMLA) after she was awarded a similar amount in compensatory damages under the Connecticut Family and Medical Leave Act (CFMLA) [*Persky v. Cendant Corp.*, No. 3:99CV2273 (EBB), 2008 U.S. Dist. LEXIS 11870 (D Conn., 2-15-08)].

Background

Kim Persky was Vice President and General Manager of Sidewalk, a joint venture between Cendant Corp. and Microsoft Corp. In November 1998, Persky notified her supervisor that she would be going on maternity leave in January 1999. Cendant hired Jonathan Yee to serve as Persky’s “placeholder” during her leave.

In February 1999, Microsoft exercised an option to purchase the entire Sidewalk operation and laid off nearly 300 Sidewalk employees. Under a transition agreement, a transition team that included Yee was retained through the end of 1999.

Persky was told to apply for other management positions within the company, but she was not explicitly offered a specific replacement position. In July 1999, Cendant told Persky that her failure to accept any of these positions was being interpreted as voluntary resignation from the company.

Persky filed a complaint with the Connecticut Department of Labor (CDOL) charging Cendant with violations of the CFMLA (Conn. Gen. Stat. §31-51kk et seq.) and was awarded \$496,344, which represented compensation for: wages she would have earned had she worked at Cendant until the end of 1999; severance pay; the value of lost stock options; performance and stay bonuses paid to Yee during the transition; and interest. Cendant paid the award after it was affirmed by the Connecticut Supreme Court. Then, because the CFMLA does not provide for liquidated damages, Persky sued in federal court under the FMLA.

Analysis

The court said that Cendant’s violation of the CFMLA also established a violation of the FMLA. Accordingly, Persky was entitled to liquidated damages equal to those she received from the CDOL – \$496,344.

The court explained that under the FMLA, an employer “shall be liable” for liquidated damages for interfering with an employee’s substantive rights under the Act (29 USC §2617(a)(1)(A)) and an award of liquidated damages equal to the employee’s damages is the norm. A court can decline to award liquidated damages only where the employer can show that it violated the FMLA in good faith and had objectively reasonable grounds for believing that its act or omission was not a violation of the FMLA.

Here, Cendant understood that its obligation under the FMLA was to restore Persky to her original or an equivalent position unless her employment would otherwise have been terminated during her maternity leave. And even if Cendant honestly believed that Persky’s employment would have been terminated during her maternity leave, that belief was unreasonable.

Cendant’s general counsel and human resources department failed to adequately investigate whether Persky’s position had, in fact, been terminated. Cendant did not review the transition agreement to determine what functions the transition team would be performing for Microsoft, but if it had, it would have found that they were substantially similar to those provided by the company for Sidewalk before the sale. No one questioned Yee about the duties he performed as Persky’s “placeholder.”

Even if it was true, as Cendant claimed, that Yee’s functions were to wind down the Sidewalk business, the company did not ascertain whether Persky could perform those functions. When Persky protested that Yee was temporarily performing her duties, Cendant did not check out

her claims, but dismissed them as “posturing.” The transition agreement did not address Persky’s position, but it specifically called for Yee – Persky’s temporary replacement – to be on the transition team through the end of 1999.

Finally, the court rejected Cendant’s plea that the award of nearly a half-million dollars in liquidated damages was impermissibly punitive. The FMLA contemplates the doubling of an award of damages no matter how large the award may

be. Moreover, liquidated damages are based on economic damages. Persky was a highly paid executive with nearly 15 years of experience. She had overall responsibility for the Sidewalk operation, handled a budget of \$30 million, and oversaw a sales staff of 300 employees that included the senior vice president of sales and the vice president of operations. ■



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Alabama

Reporting new hires electronically now required. Effective 5-1-08, employers with five or more employees are required to report all newly hired, rehired, and recalled workers to the Department of Industrial Relations (DIR) electronically. Instructions on this process may be found at <http://dir.alabama.gov/nh>. Employers with questions concerning electronic new hire reporting should send an e-mail to newhire@dir.alabama.gov or call 334-353-0408 for further clarification [DIR, News Release, 4-21-08].

Iowa

Form W-2 recordkeeping period extended. Effective 4-30-08, employers must keep copies of Forms W-2, *Wage and Tax Statement*, for four years (previously three years) from the end of the year for which the W-2 applies [701 Iowa Adm. Code 46.3].

Nebraska

Minimum withholding rate decreased. Effective 4-16-08, employers with 25 or more employees must withhold state income tax for each employee at a rate of at least 1½% (previously 3%) of gross wages minus tax qualified deductions, unless the employee provides satisfactory evidence to the employer that a lesser state withholding amount is justified in the employee’s particular circumstances [L.B. 1004, L. 2008].

Nevada

Minimum wage and daily overtime rates increased. There are two minimum wage tiers in Nevada. The lower tier may be paid to employees to whom qualifying health benefits have been made available by the employer. The higher tier must be paid to all other employees. Effective 7-1-08, the lower minimum wage will increase to \$5.85 an hour from \$5.30 an hour, and the higher minimum wage will increase to \$6.85 an hour from \$6.33 an hour (this updates *The Payroll Source*®, p. 2-66). These rates are adjusted annually based on the rate of inflation.

Eligible nonexempt employees who are paid a base rate of one and one-half times the applicable state minimum wage or less an hour are entitled to overtime if they work more than eight hours in any workday. Effective 7-1-08, daily overtime must be paid if an employee is paid less than \$10.275 an hour (\$6.85 x 1.5) or \$8.775 (\$5.85 x 1.5) if the employer provides health benefits [Office of the Labor Commissioner, State of Nevada Minimum Wage and Daily Overtime 2008 Annual Bulletins, 4-1-08].

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PAYROLL CURRENTLY NEWSLETTER

Payroll Currently (ISSN 1065-6529) is published biweekly by the American Payroll Institute Inc., in cooperation with The American Payroll Association, 30 East 33rd Street, 5th Floor, New York, NY 10016-5386; Tel: 212-686-2030; Fax: 212-686-4080. Payroll Currently is designed to provide authoritative information in regard to the subject matter covered. It is provided with the understanding that the publisher is not engaged in rendering legal, accounting or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought. © Copyright 2008 American Payroll Association. All rights reserved. Printed in the USA.