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COBRA Premium Discount Eligibility Extended to May 31

On April 15, President Barack Obama signed into law the Continuing Extension Act of 2010 (CEA; Pub. L. No. 111-157). The CEA retroactively extends the deadline for involuntary terminations qualifying for COBRA premium assistance for two months, from April 1, 2010, through May 31, 2010, and extends emergency unemployment insurance benefits as well.

The CEA also includes extended COBRA election procedures for individuals who were involuntarily terminated

from April 1-14, 2010, and new notice requirements for plan administrators. Specifically, the CEA provides that for such individuals there is an extended 60-day election period if they have not chosen COBRA continuation coverage. The CEA also provides that plans that are subject to COBRA continuation provisions must send such individuals notice of the extended election period as part of their COBRA coverage notification, within 60 days after their termination. ■

Forms W-2, W-3, and W-3c Reissued to Reflect HIRE Act Changes

The IRS has revised and reissued Forms W-2, *Wage and Tax Statement*, W-3, *Transmittal of Wage and Tax Statements*, and W-3c, *Transmittal of Corrected Wage and Tax Statements*, as well as the instructions for the forms, to reflect changes necessitated by the Hiring Incentives to Restore Employment (HIRE) Act (see **PAYROLL CURRENTLY**, Issue No. 4, Vol. 18). The revised forms and instructions can be found on APA's website at www.americanpayroll.org/members/Forms-Pubs/#not.

Form W-2

While the format of the 2010 Form W-2 remains unchanged, the instructions for employees on the back of Copy 2 contain a reference to new Box 12, Code CC, which is where employers will report the employee's wages and tips that are exempt from the employer portion of social security tax in 2010 under the HIRE Act.

The updated instructions for Form W-2 make clear that employers must report all of the wages and tips paid to a qualified employee for which the employer claimed the HIRE Act social security tax exemption in Box 12 with Code CC. This includes wages and tips paid to the employee from April 1 - December 31, 2010, for which the social security tax exemption was claimed, plus wages and tips paid to the employee from March 19-31, 2010, for which the employer claimed a social security tax credit in the second quarter. The

amount reported in Box 12 with Code CC may not exceed \$106,800, the social security wage base maximum for 2010.

Form W-3

Form W-3 has been changed by creating Boxes 12a and 12b to replace the previous Box 12—Deferred compensation.

- *Box 12a—Deferred compensation* is used to report the total of all amounts reported on Forms W-2 in Box 12 with Codes D-H, S, Y, AA, and BB. This total was previously reported in Box 12 of Form W-3.

- *Box 12b—HIRE exempt wages and tips* is used to report the total of all amounts reported on Forms W-2 in Box 12 with Code CC.

Form W-3c

Form W-3c has been changed by creating Boxes 12a and 12b to replace the previous Box 12a-d—(Coded items).

- *Box 12a—Deferred compensation* is used to report the total of all amounts reported on Forms W-2c in Box 12 with Codes D-H, S, Y, AA, and BB as "Previously reported" and "Correct information." This total was previously reported in Box 12 of Form W-3c.

- *Box 12b—HIRE exempt wages and tips* is used to report the total of all amounts reported on Forms W-2c in Box 12 with Code CC as "Previously reported" and "Correct information." ■

Cell Phones Would Be 'De-Listed' Under Bill Passed by House

On April 14, the House passed H.R. 4994, the Taxpayer Assistance Act of 2010. One provision of this bill would remove cell phones and similar telecommunications equipment from items defined as "listed property" under IRC §280F(d)(4) for tax years beginning after December 31, 2009. While this would make it much easier for employers to deduct the cost of providing cell phones to their employees, it may not help employees as much.

An employee's gross income does not include a working condition fringe benefit, which is defined as any property or services provided to the employee (e.g., a cell phone) to the extent that, if the employee paid for such property or services,

the amount paid could be deducted by the employee as a business deduction. However, personal use of an employer-provided cell phone is a personal expense, and §262(a) says no business deduction is allowed for personal, living, or family expenses, unless another section of the IRC provides otherwise.

This bill also includes the same information return penalty increases that appear in H.R. 4213 (as passed by the Senate) and H.R. 4849 (as passed by the House) discussed in **PAYROLL CURRENTLY**, Issue No. 4, Vol. 18 ("COBRA Premium Assistance Deadline Expires Before Extension Can Be Enacted"). ■

IRS Offers Guidance on the Tax Treatment of Health Care Benefits for Children Under Age 27

The IRS has issued guidance on the tax treatment of health coverage for children up to age 27 under the Patient Protection and Affordable Care Act (Pub. L. No. 111-148) and the Health Care and Education Reconciliation Act of 2010 (Pub. L. No. 111-152) – the Acts – signed into law on March 23 and 30, 2010, respectively (see **PAYROLL CURRENTLY**, Issue No. 4, Vol. 18).

IRS Notice 2010-38 [released 4-27-10; www.irs.gov/pub/irs-drop/n-10-38.pdf] provides guidance on the Acts' amendment of IRC §105(b), effective March 30, 2010, to extend the general exclusion from gross income for reimbursements for medical care under an employer-provided accident or health plan to any employee's child who has not attained age 27 as of the end of the taxable year.

Note: The Acts make parallel amendments, also effective March 30, 2010, to §401(h) for retiree health accounts in pension plans, §501(c)(9) for voluntary employees'

beneficiary associations (VEBAs), and to §162(l) for deductions by self-employed individuals for medical care insurance. The Acts also added §2714 to the Public Health Service Act. This new section, however, does not parallel amended §§105(b), 401(h), 501(c)(9), and 162(l). It requires insurers to extend coverage to adult children under 26 and is effective for the first plan year beginning on or after September 23, 2010.

IRC §§105 and 106

Medical care reimbursements. IRC §105(b) generally excludes from an employee's gross income employer-provided reimbursements made directly or indirectly to the employee for the medical care of the employee, employee's spouse, or employee's dependents. Under the Acts, the exclusion from gross income under §105(b) applies with respect to an employee's child (within the meaning of §152(f)(1)) who has not attained age 27 as of the end of the

taxable year, including a child of the employee who is not the employee's dependent within the meaning of §152(a). Thus, the age limit, residency, support, and other tests described in §152(c) do not apply with respect to such a child for purposes of the income exclusion under §105(b).

Accident or health coverage. Section 106 excludes from an employee's gross income coverage under an employer-provided accident or health plan. Prior to the Acts, the exclusion under §106 paralleled the exclusion for reimbursements under §105(b). There is no indication that Congress intended to provide a broader exclusion in §105(b) than in §106. Accordingly, the IRS intends to amend the regulations under §106, retroactively to March 30, 2010, to provide that coverage for an employee's child under age 27 is excluded from gross income.

New rule. Thus, on and after March 30, 2010, both coverage under an employer-provided accident or health plan and amounts paid or reimbursed under such a plan for medical care expenses of an employee, an employee's spouse, an employee's dependents, or an employee's child who has not attained age 27 as of the end of the employee's taxable year are excluded from the employee's gross income.

Examples

• **Example 1.** Employer X provides health care coverage for its employees and their spouses and dependents and for any employee's child (as defined in §152(f)(1)) who has not attained age 26. For 2010, Employer X provides coverage to Employee A and to A's son C. C will attain age 26 on November 15, 2010. During 2010, C is not a full-time student. C has never worked for Employer X. C is not a dependent of A because prior to the close of the 2010 taxable year C had attained age 19 (and was also not a student who had not attained age 24).

(IRS analysis) C is a child of A within the meaning of §152(f)(1). Accordingly, and because C will not attain age 27 during 2010, the health care coverage and reimbursements provided to him under the terms of Employer X's plan are excludible from A's gross income under §§106 and 105(b) for the period on and after March 30, 2010, through November 15, 2010 (when C attains age 26 and loses coverage under the terms of the plan).

• **Example 2.** Employer Y provides health care coverage for its employees and their spouses and dependents and for any employee's child (as defined in §152(f)(1)) who has not attained age 27 as of the end of the taxable year. For 2010, Employer Y provides health care coverage to Employee E and to E's son G. G will not attain age 27 until 2011. During 2010, G earns \$50,000 per year and does not live with E. G has never worked for Employer Y. G is not eligible for health care coverage from his own employer. G is not a dependent of E because G does not live with E and E does not provide more than half of his support.

(IRS analysis) G is a child of E within the meaning of §152(f)(1). Accordingly, and because G will not attain age 27 during 2010, the health care coverage and reimbursements for G under Employer Y's plan are excluded from E's gross income under §§106 and 105(b) for the period on and after March 30, 2010, through the end of 2010.

• **Example 3.** Same facts as Example 2, except that G's employer offers health care coverage, but G has decided not to participate in his employer's plan.

(IRS analysis) G is a child of E within the meaning of

§152(f)(1). Accordingly, and because G will not attain age 27 during 2010, the health care coverage and reimbursements for G under Employer Y's plan are excluded from E's gross income under §§106 and 105(b) for the period on and after March 30, 2010, through the end of 2010.

• **Example 4.** Same facts as Example 3, except that G is married to H, and neither G nor H is a dependent of E. G and H have decided not to participate in the health care coverage offered by G's employer, and Employer Y provides health care coverage to G and H.

(IRS analysis) G is a child of E within the meaning of §152(f)(1). Accordingly, and because G will not attain age 27 during 2010, the health care coverage and reimbursements for G under Employer Y's plan are excluded from E's gross income under §§106 and 105(b) for the period on and after March 30, 2010, through the end of 2010. The fair market value of the coverage for H is included in E's gross income for 2010.

• **Example 5.** Employer Z provides health care coverage for its employees and their spouses and dependents. Effective May 1, 2010, Employer Z amends the health plan to provide coverage for any employee's child (as defined in §152(f)(1)) who has not attained age 26. Employer Z provides coverage to Employee F and to F's son K for 2010. K will attain age 22 in 2010. During 2010, F provides more than one-half of K's support. K lives with F and graduates from college on May 15, 2010, and thereafter is not a student. K has never worked for Employer Z. Prior to K's graduation from college, K is a dependent of F. Following graduation from college, K is no longer a dependent of F.

(IRS analysis) For 2010, the health care coverage and reimbursements provided to K under the terms of Employer Z's plan are excludible from F's gross income under §§106 and 105(b). For the period through May 15, 2010, the reimbursements and coverage are excludible because K was a dependent of F. For the period on and after March 30, 2010, the coverage is excludible because K is a child of F within the meaning of §152(f)(1) and because K will not attain age 27 during 2010. (Thus, for the period from March 30 through May 15, 2010, there are two bases for the exclusion.)

Cafeteria plans, health flexible spending arrangements (FSAs), and health reimbursement arrangements (HRAs)

IRC §125 allows employees to elect between cash and certain qualified benefits, including accident or health plans (described in §106) and health FSAs (described in §105(b)). The exclusion of coverage and reimbursements from an employee's gross income under §§106 and 105(b) for an employee's child who has not attained age 27 as of the end of the employee's taxable year carries forward automatically to the definition of qualified benefits for §125 cafeteria plans, including health FSAs.

A cafeteria plan may permit an employee to revoke an election during a period of coverage and to make a new election only in limited circumstances, such as a change in status event. The IRS intends to amend the regulations under §1.125-4, effective retroactively to March 30, 2010, to include change in status events affecting nondependent children under age 27, including becoming newly eligible for coverage or eligible for coverage beyond the date on which the child otherwise would have lost coverage.

An HRA is an arrangement that is paid for solely by an employer (and not through a cafeteria plan) that reimburses

an employee for medical care expenses up to a maximum dollar amount for a coverage period. The same rules that apply to an employee's child under age 27 for purposes of §§106 and 105(b) apply to an HRA.

Cafeteria plan transition rule. Cafeteria plans may need to be amended to include employees' children who have not attained age 27 as of the end of the taxable year. Notwithstanding the general rule that cafeteria plan amendments may be effective only prospectively, as of March 30, 2010, employers may permit employees to immediately make pre-tax salary reduction contributions for accident or health benefits under a cafeteria plan (including a health FSA) for children under age 27, even if the cafeteria plan has not yet been amended to cover these individuals.

A retroactive amendment to a cafeteria plan to cover children under age 27 must be made no later than December 31, 2010, and must be effective retroactively to the first date in 2010 when employees are permitted to make pre-tax salary reduction contributions to cover children under age 27 (but in no event before March 30, 2010).

FICA, FUTA, and income tax withholding

Coverage and reimbursements under an employer-provided accident and health plan for employees generally and their dependents (or a class or classes of employees and their dependents) are excluded from wages for Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) tax purposes. For these purposes, a child of the employee is a dependent, and no age limit, residency, support, or other test applies. Thus, coverage and reimbursements under a plan for employees and their dependents that are provided for an employee's child under age 27 are not wages for FICA or FUTA purposes. Such coverage and reimbursements are also exempt from income tax withholding.

Effective date

The changes to §§105(b), 106, 501(c)(9), 401(h), and 162(l) were effective on March 30, 2010. Taxpayers may rely on Notice 2010-38 pending the issuance of amended regulations. ■

Employer Pays Penalty When CPA Doesn't Timely File or Deposit Taxes

The U.S. Tax Court has ruled that an employer was not protected from employment tax penalties for failure to timely deposit or pay its employment taxes and file its employment tax returns, even though it had relied on a certified public accountant to perform these tasks [*McNair Eye Center, Inc. v. Commissioner*, TC Memo 2010-81, No. 1862-08L, 4-19-10].

CPA failed to file or pay on time for employer

McNair Eye Center, Inc. hired a CPA to be the company's administrator, bookkeeper, and accountant in 2004. The CPA's duties included filing the company's Form 941, *Employer's Quarterly Federal Tax Return*, and depositing and paying the payroll taxes that were owed. However, after the CPA was no longer employed by McNair, the company's owner discovered that the Forms 941 for the first three quarters of 2005 had not been filed until February 3, 2006. (The fourth quarter Form 941 was filed on time.) The company also failed to pay all of the tax reported on its Forms 941 for all four quarters of 2005, and did not timely make all its required federal payroll tax deposits.

At trial, the company's owner stated that he "never paid any attention" to whether the CPA actually paid the company's employment taxes, and that he never discussed it with the CPA. He also acknowledged that the company had a history of payroll tax noncompliance in two earlier years. The IRS assessed penalties against the employer under IRC

§6651(a)(2) for failure to pay tax and under §6656 for failure to make required tax deposits. Penalties were also assessed for the first three quarters of 2005 under §6651(a)(1) for failure to file Forms 941 on time.

Reliance on CPA was not reasonable cause

The employer argued that it had reasonable cause for the noncompliance because it had relied on its accountant to timely file, pay, and deposit its employment taxes. But the Tax Court ruled that there was no reasonable cause for the failure to timely file, relying on the U.S. Supreme Court's ruling in *U.S. v. Boyle* (1985) 469 U.S. 241, where the Court said that the "failure to timely file is not excused by a taxpayer's reliance on an agent, and such reliance is not reasonable cause for late filing." The court also determined that the company did not show reasonable cause for failing to make timely tax deposits.

Finally, the court rejected the owner's testimony that one of the reasons it didn't pay its employment taxes for 2005 was the "financial difficulties" it was having. The court said there was no clear evidence of the company's financial circumstances and that the company did not show "that it exercised ordinary business care and prudence but nevertheless was unable to pay its taxes or would have suffered undue hardship if it had paid the taxes when due." Therefore, it upheld the failure to pay penalty. ■

Merger and Acquisition Reporting Form Revised

Schedule D (Form 941), *Report of Discrepancies Caused by Acquisitions, Statutory Mergers, or Consolidations*, and its instructions were revised in April 2010. The only changes to the form itself involve replacing references to Form 941c, which is no longer in use, with Form 941-X. In addition to this change, the revised instructions include a change in the address for submitting Schedule D on paper. The new address is:

IRS Philadelphia Campus

P.O. Box 63241

Mail Stop N849

Philadelphia, PA 19114-8241

Please make sure that you do not send Forms 941 to this same address. Paper copies of Schedule D and Form 941 must be filed separately at the addresses shown in their respective instructions.

The revised instructions also clarify the language

describing when Schedule D should be filed. If the business is continuing to operate, Schedule D should be filed no later than the due date of Form 941 for the first quarter of the year after the calendar year of the transaction. If the business is not

continuing to operate, Schedule D should be filed when the business's final Form 941 is filed.

The revised form and instructions are available at www.americanpayroll.org/members/Forms-Pubs/#not. ■

Many Smaller Employers Will Have to Use EFTPS for Payroll Tax Deposits

The Treasury Department has announced that, as part of a three-pronged initiative to reduce the amount of paper transactions it handles, most employers that now are allowed to use paper Federal Tax Deposit Coupons and checks to make payroll tax deposits will have to make those deposits electronically through the Electronic Federal Tax Payment System (EFTPS) beginning in 2011. The primary exemption will be for employers that have \$2,500 or less in quarterly payroll tax liability and that pay their liability when filing their employment tax returns (e.g., Forms 941 or 944) [TG-644, 4-19-10; www.ustreas.gov/press/releases/tg644.htm].

Currently, employers are required to use EFTPS at the beginning of the second calendar year after their total federal tax deposits (e.g., payroll, income, excise, etc.) exceed \$200,000 in a calendar year. Once they meet the threshold, they must use EFTPS even if their total tax deposits dip below \$200,000 in a future year.

Move to mandatory electronic benefit payments

As part of its effort to provide safe and secure payments, reduce its environmental impact, and save money, Treasury will also require individuals receiving Social Security, Supplemental Security Income, Veterans, Railroad Retirement, and Office of Personnel Management benefits to receive their payments electronically. Individuals will be able to receive payments through direct deposit into a bank account or Treasury's Direct Express debit card. The requirement will apply to new enrollees beginning on March 1, 2011, and to current check recipients beginning on

March 1, 2013.

No more paper savings bonds through payroll

Finally, Treasury will eliminate the option to purchase paper savings bonds through payroll deductions for federal employees on September 30, 2010, and for the private sector by January 1, 2011. Individuals will still be able to buy paper savings bonds at financial institutions. Those who purchase savings bonds through payroll deductions will be encouraged to continue their purchases through Treasury Direct, a web-based system that allows individuals to buy and hold electronic savings bonds.

Security measures increased for e-payments

In conjunction with these electronic initiatives, Treasury is strengthening protections for individuals who receive direct deposit. Proposed rules from Treasury and other federal agencies that issue payments will:

- ensure that exempt federal benefit payments are protected from garnishment after they are directly deposited into accounts;
- reaffirm a longstanding policy that federal benefits must be directly deposited into an account in the name of the recipient and not into a third party's account, which will prevent entities such as payday lenders from establishing a master account to receive payments on behalf of multiple beneficiaries; and
- permit the direct deposit of benefit payments into master accounts established by organizations such as nursing homes, as long as certain consumer protections are provided for their residents. ■

FLSA Anti-Retaliation Provision Did Not Protect Prospective Employee

Natalie Dellinger worked for CACI, Inc. as an administrative assistant on various government contracts requiring security clearance.

First lawsuit. In July 2009, she filed a claim against CACI for violations of the minimum wage and overtime provisions of the Fair Labor Standards Act (FLSA). At the same time, she applied to Science Applications International Corp. (SAIC) for an administrative assistant position that required an individual with security clearance. SAIC offered Dellinger the position on August 21.

The offer was contingent, however, on submission of a document known as Standard Form (SF) 86, which is used for national security positions. It contains a variety of background questions, including a request for the applicant to list any non-criminal court actions to which he/she has been or is currently a party. Dellinger listed that she had filed a lawsuit against her former employer alleging FLSA violations.

Second lawsuit. On August 24, 2009, Dellinger hand-delivered the SF 86 to SAIC, which subsequently withdrew its offer of employment. Dellinger then sued SAIC, alleging that the failure to employ her was retaliatory action for the filing of her FLSA action against CACI.

Plain meaning of the statute

A U.S. District Court dismissed Dellinger's lawsuit against

SAIC, citing the plain meaning of 29 USC §215(a)(3), which provides that "(a) it shall be unlawful for any person ... (3) to discharge or in any other manner discriminate against any employee because such employee has filed any complaint or instituted or caused to be instituted any proceeding under or related to this chapter..."

For an individual to be "employed" by an "employer," said the court, the individual must be "suffered or permitted" to work. Here, however, Dellinger was never "permitted" to work for SAIC. In fact, her main allegation is that the offer of employment was withdrawn.

Two other courts that have addressed the issue have found that a job applicant should not be considered an "employee" for purposes of the anti-retaliation provision. Both cases rest on the plain language of the statute and both were unwilling to read the term "employee" to mean an individual who was *never* employed by the employer being sued.

Finally, said the court, Congress could have determined that the FLSA's anti-retaliation provision should apply to "any person" rather than "any employee." However, Congress did not make that policy determination, "and this court will not do so" [*Dellinger v. Science Applications International Corp.*, No. 1:10cv25, 2010 U.S. Dist. LEXIS 32861 (ED Va., 4-2-10)]. ■

DOL Announces Employee Classification Recordkeeping Proposal

Included in the U.S. Department of Labor's (DOL) recently released semiannual regulatory agenda is a proposal to update recordkeeping regulations under the Fair Labor Standards Act (FLSA) [75 F.R. 21823, 4-26-10; <http://edocket.access.gpo.gov/2010/pdf/2010-8938.pdf>]. The DOL estimates that it will issue proposed regulations in August 2010 updating FLSA recordkeeping requirements to foster more openness and transparency in demonstrating employers' compliance with applicable requirements to their workers and to assist in enforcement.

In a related Fact Sheet [Spring 2010 Regulatory Agenda Fact Sheet: Amendments to the FLSA Recordkeeping Regulations; www.dol.gov/regulations/factsheets/whd-fs-flsa-recordkeeping.htm], the DOL's Wage and Hour Division (WHD) explains that it is considering a proposal requiring covered employers to notify workers of their rights under the FLSA and to provide information regarding hours worked and wage computation.

In addition, any employers that seek to exclude workers from the FLSA's coverage (i.e., treat them as exempt employees) would be required to:

- perform a classification analysis,
- disclose that analysis to the worker, and
- retain that analysis to give to WHD enforcement personnel who might request it.

The proposal will also address burdens of proof where employers fail to comply with records and notice requirements.

Domestic employees and industrial homeworkers.

The WHD also intends to propose modernizing certain recordkeeping requirements for live-in domestic employees and persons considered industrial homeworkers under the FLSA. WHD is considering allowing alternative (i.e., automated or electronic) methods to take the place of mandatory paper records that are currently required in most instances for employees who work under such arrangements, while still requiring an accurate record of hours worked.

Employee Misclassification Prevention Act introduced

On April 22, Secretary of Labor Hilda L. Solis

issued a statement "applauding" the introduction of the Employee Misclassification Prevention Act in the House of Representatives (H.R. 5107) and the Senate (S. 3254). "I look forward to working with the Congress to address the important issue of misclassification of workers."

The Act would amend the FLSA to require employers to keep records with respect to nonemployees who perform labor or services for remuneration in the same way that they are currently required to keep records with respect to employees.

The Act would also require employers (within six months of enactment) to provide a notice to both employees and nonemployees – upon employment or commencement of labor or services, respectively, or upon changing an individual's status:

- informing the individual of his/her status as an employee or nonemployee;
- directing the individual to a DOL website (to be established within six months of enactment) for further information;
- providing the address and phone number of the local DOL office;
- including for each individual classified as a nonemployee the following statement: "Your rights to wage, hour, and other protections depend on your proper classification as an employee or nonemployee. If you have any questions or concerns about how you have been classified or suspect that you may have been misclassified, contact the [DOL]."; and
- including such other information as the Secretary of Labor may provide.

An individual would be presumed to be an employee if the required records were not kept and the required notice was not given.

Penalties are established as follows: up to \$1,100 for each misclassified individual, or up to \$5,000 for each misclassified individual in the case of an employer that repeatedly or willfully violates the Act. ■

Company President Was Personally Responsible for Unpaid Payroll Taxes

In 1998, David Frohnapple and Michael Shields purchased The Boling Group, a furniture manufacturing business. Shields was the executive vice president who oversaw the company's engineering and manufacturing processes. Frohnapple was the president in charge of the entire company, including its financial operations, sales, marketing, human resources, and general management.

Between 1999 and 2001, several persons worked for Boling as chief financial officer or controller, a position directly responsible for the company's finances, including its accounting and payroll functions. Jules Dizon held these positions in 1999 and 2000. Phyllis Younts was controller from September 2000 until Frohnapple fired her in March 2001.

Boling was in financial trouble when Frohnapple and Shields purchased it and continued to lose money until it filed

for bankruptcy in 2001. From April 1, 2000, until June 30, 2001, Boling failed to pay over to the U.S. the employment taxes it withheld from the wages of company employees. In 2006, the IRS assessed a penalty under IRC §6672 of more than \$515,000 against Frohnapple personally for the employment taxes that were required to be withheld from employees' wages but that were not paid when due. A U.S. District Court upheld the IRS assessment against Frohnapple because his failure to pay employment taxes in violation of IRC §6672 was willful [*Frohnapple v. U.S.*, No. 1:08CV387, 210 U.S. Dist. LEXIS 21114 (MD N.C., 3-8-10)].

☞ **WHAT THE LAW SAYS** – Under IRC §6672, in addition to whatever other penalties are assessed for the failure to withhold and deposit employment taxes, a person who is required to collect and pay over such taxes due but who "willfully" fails to do so is liable for an additional penalty equal

to the total amount due (this is known as the “Trust Fund Recovery Penalty” or the “100% penalty”). For purposes of §6672, a “responsible person” includes a company officer or an employee who is responsible for withholding and paying the company’s taxes; responsible persons generally are those who have the final word as to what bills should or should not be paid. For the 100% penalty to be applied, the responsible person must have acted willfully in not withholding and paying over trust fund (withheld income and employment) taxes. Paying other creditors rather than depositing payroll taxes is a willful failure to pay, even though the payments are made to keep the business from failing (see *The Payroll Source*®, p. 8-25).

Here, Frohnapple acknowledged that he was a responsible person under §6672, so the question for the court was whether he willfully failed to collect, account for, or remit payroll taxes during the period in question.

Willfulness

The court explained that willfulness can be shown by either a person’s actual knowledge of nonpayment or reckless disregard for whether payments are being made.

Here, Frohnapple first became aware that Boling had not paid its employment taxes when Dizon left the company in August 2000. Once he became aware of the situation,

Frohnapple “had an absolute duty to use all corporate funds to satisfy the currently accruing tax liability, as well as the outstanding tax liability,” said the court. Instead, with company bank deposits in excess of \$1.7 million, Frohnapple paid employee salaries, including his own, and also paid other creditors. None of the funds were used to pay payroll taxes. Accordingly, Frohnapple was liable for the unpaid taxes from August 2000 until June 30, 2001.

Frohnapple could not escape liability for the unpaid taxes by claiming that he relied on Younts to deal with the unpaid employment taxes. By the time Younts was hired, Frohnapple was already aware of the company’s payroll tax problems. He thus had a duty to exercise even greater oversight over the finance department to ensure that payroll taxes were being paid, and his failure to supervise Younts amounted to careless disregard of the situation, the court concluded.

Finally, Frohnapple was also liable for the taxes that went unpaid from April 2000 until Dizon’s departure in August 2000. Before he found out about the outstanding tax liabilities, Frohnapple was aware of the company’s ongoing financial problems and had made numerous personal loans to the company to meet the payroll and pay creditors. And outside accountants had advised him that Dizon’s financial statements were inaccurate. ■

WHD Issues Fact Sheet on Unpaid Internships Under the FLSA

The U.S. Department of Labor’s Wage and Hour Division (WHD) has issued a Fact Sheet to help determine whether interns must be paid the minimum wage and overtime under the Fair Labor Standards Act (FLSA) for the services they provide to “for-profit” private sector employers [WHD Fact Sheet No. 71, April 2010; www.dol.gov/whd/regs/compliance/whdfs71.htm].

‘Suffered or permitted to work’

The FLSA defines the term “employ” as to “suffer or permit to work.” Covered nonexempt individuals who are “suffered or permitted” to work must be compensated under the law for the services they perform for an employer. Internships in the for-profit private sector will most often be viewed as employment, unless the test relating to trainees is met. Note that the exclusion is quite narrow because the FLSA’s definition of “employ” is very broad.

Exception: training

Under some circumstances, individuals who participate in “for-profit” private sector internships or training programs may do so without compensation. The U.S. Supreme Court has held that the term “suffer or permit to work” does not make a person whose work serves only his or her own interest an employee of another who provides aid or instruction. This may apply to interns who receive training for their own educational benefit in some cases. The determination of whether an internship or training program may be excluded from the definition of employment depends on all the facts and circumstances.

Six criteria must be applied when making this determination (see *The Payroll Source*®, p. 2-62). If all of the criteria are met, an employment relationship does not exist under the FLSA, and the Act’s minimum wage and overtime provisions do not apply to the intern.

- The internship, even though it includes actual operation of the facilities of the employer, is similar to training that would be given in an educational environment;

- The internship experience is for the benefit of the intern;
- The intern does not displace regular employees, but works under close supervision of existing staff;
- The employer that provides the training derives no immediate advantage from the activities of the intern, and on occasion its operations may actually be impeded;
- The intern is not necessarily entitled to a job at the conclusion of the internship; and
- The employer and the intern understand that the intern is not entitled to wages for the time spent in the internship.

Educational environment

In general, the more an internship program is structured around a classroom or academic experience as opposed to the employer’s actual operations, the more likely the internship will be viewed as an extension of the individual’s educational experience (this often occurs when a college or university exercises oversight over the internship program and provides educational credit). The more the internship provides the individual with skills that can be used in multiple employment settings, as opposed to skills particular to one employer’s operation, the more likely the intern would be viewed as receiving training. Under these circumstances, the intern does not perform the routine work of the business on a regular and recurring basis, and the business does not depend on the work of the intern.

Primary beneficiary of the activity

On the other hand, if interns are engaged in the operations of the employer or are performing productive work (e.g., filing, other clerical work, or assisting customers), then the fact that they may be receiving some benefits in the form of a new skill or improved work habits will not exclude them from the FLSA’s minimum wage and overtime requirements because the employer benefits from their work.

Displacement

If an employer uses interns as substitutes for regular

workers or to augment its existing workforce during specific time periods, these interns should be paid at least the minimum wage and overtime compensation for hours worked over 40 in a workweek. If the employer would have hired additional employees or required existing staff to work additional hours had the interns not performed the work, then the interns will be viewed as employees and entitled to compensation under the FLSA.

Supervision

Conversely, if the employer is providing job shadowing opportunities that allow an intern to learn certain functions under the close and constant supervision of regular employees, but the intern performs no or minimal work, then the activity is

more likely to be viewed as a bona fide education experience. On the other hand, if the intern receives the same level of supervision as the employer's regular workforce, this would suggest an employment relationship, rather than training.

Job entitlement

The internship should be of a fixed duration that is established before it begins. Further, unpaid internships generally should not be used by the employer as a trial period for individuals seeking employment at the conclusion of the internship period. If an intern is placed with the employer for a trial period with the expectation that he or she will then be hired on a permanent basis, that individual generally would be considered an employee under the FLSA. ■

IRS Letter Discusses Employment Tax Overwithholding

Responding to an inquiry from a member of the U.S. House of Representatives, the IRS Office of the Chief Counsel has written a letter explaining the process to correct employment tax overwithholding errors after the close of the tax year in which an employer paid wages to an employee [INFO 2010-0010, released 3-26-10; www.irs.gov/pub/irs-wd/10-0010.pdf].

The letter says that whether an employer can correct employment tax overwithholding errors after the close of the tax year in which the payment of wages occurred depends on when the employer discovered the error and on whether it is an overcollection of FICA (social security and Medicare) taxes or income tax withholding.

Form 941-X

Generally, if an employer overcollects employment tax from an employee and discovers the error within the IRC §6511 period of limitations on credit or refund, the employer may correct the error by either making an interest-free adjustment (§6413) or by filing a claim for refund (§6402) before the period of limitations on credit or refund expires. Employers make the correction using Form 941-X, *Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund*. Form 941-X is a dual purpose form used both for making interest-free adjustments and claims for refund to correct employment tax errors.

Interest-free adjustment process. An employer can correct an overwithholding error using the interest-free adjustment process. The employer must first repay or reimburse the employee for the overcollected amount. An interest-free adjustment for an overcollection of income tax withholding can only be made if the employer discovers the error and repays or reimburses the employee within the same

calendar year as the payment of the wages.

However, an employer can correct an overpayment of income tax withholding due to an administrative error even if the employer did not discover the error until after the employer filed the return and did not repay the employee within the calendar year. An administrative error involves the inaccurate reporting of the amount withheld.

When making a correction using the interest-free adjustment process, the employer must file Form 941-X before the 90th day before the period of limitations on credit or refund expires.

Claim for refund process. An employer can also correct an overwithholding error using the claim for refund process. The employer must first repay or reimburse the employee for the overcollected amount or obtain the employee's consent to the filing of a refund claim. However, an employer can only claim a refund of overpaid income tax withholding if the employer did not actually withhold the amount from the employee.

Forms W-2 and W-2c

Form 941-X requires the employer to certify that it has filed or will file the required Form W-2, *Wage and Tax Statement*, or Form W-2c, *Corrected Wage and Tax Statement*. Employers must furnish employees with Form W-2 showing, among other information, the total amount of wages and amount deducted and withheld as tax. Employers must also furnish employees with a corrected statement, that is, Form W-2c, for a prior calendar year to show the corrected amount of wages if the amount shown on a previously furnished Form W-2 was incorrect. ■

Accountants Were Paid on a Salary Basis Despite Deductions From Salary and Bonuses

An accounting services firm did not violate the Fair Labor Standards Act's (FLSA) salary basis test despite a practice of making deductions from various components of its exempt employees' compensation. Therefore, the employees did not lose their FLSA-exempt status and were not entitled to overtime pay [*Bell v. Callaway Partners, LLC*, No. 1:06-CV-1993-CC, 2010 U.S. Dist. LEXIS 36564 (ND Ga., 2-5-10)].

Salary and bonus subject to takeaways

Callaway Partners, LLC, was an accounting services firm retained in 2003 to reconstruct the books and finances of HealthSouth Corporation, an Alabama healthcare provider accused of fraud by misstating its finances. Accountants working on Callaway's HealthSouth project were paid a weekly salary and additional bonus compensation.

Salary payments. Callaway paid the accountants working on the HealthSouth project a predetermined salary of between \$1,600 and \$2,000 per week. The firm notified the accountants that their weekly salary would be paid in full, except for:

- Days not worked for personal reasons, unpaid vacation, or illness (which could be offset by days of personal time off (PTO) earned);
- Unpaid disciplinary suspensions imposed for infractions of workplace conduct rules;
- Initial or terminal weeks of employment, when salary could be prorated for time actually worked in the first and last week of employment; and
- Weeks where the project was shut down completely and no work was performed (e.g., Thanksgiving or Christmas week).

Bonus payments. Callaway also paid bonuses to the HealthSouth project accountants for billable hours worked in excess of 40 hours in a week. In 2005, Callaway extended the bonus plan to accountants who worked fewer than five regularly scheduled days but averaged more than eight billable hours of work per day during the days worked.

Callaway computed the hourly rate for an accountant's bonus by dividing the accountant's salary by 40 so that, for example, an accountant paid a weekly salary of \$1,600 could earn a bonus of \$40 an hour ($\$1,600 \div 40$). When an accountant generated less than 40 billable hours in a workweek, Callaway carried the deficit forward and deducted it from future weeks' bonus calculations, so that an accountant producing 35 billable hours in Week 1 and 60 billable hours in Week 2 would receive a bonus based on 15 billable hours (20 bonus hours in Week 2 – 5 hours deficit from Week 1).

☞ **THE SALARY BASIS TEST** – In addition to meeting job duties tests to qualify for one of the FLSA's white collar exemptions, an employee must be paid at least \$455 per week on a "salary basis." An employee is paid on a salary basis if the employee regularly receives each pay period a predetermined amount that is all or part of the employee's compensation, which amount is "not subject to reduction because of variations in the quality or quantity of the work performed" (29 C.F.R. §541.602).

Here, the accountants acknowledged that they satisfied the duties tests for exemption from the FLSA's overtime pay requirements, so the only question for the court was whether

Callaway's pay practices violated the salary basis test.

Salary deductions did not violate the salary basis test

Department of Labor (DOL) regulations (29 C.F.R. §541.602(b)(1)) provide that deductions from the "predetermined amount" of salary may be made when an exempt employee is absent from work on one or more full days for personal reasons other than sickness or disability. Callaway's policy for making deductions from salary tracked these regulations, said the court. With the exception of allowed deductions for full-day absences during the normal workweek, Callaway did not reduce the accountants' salaries due to variations in the quality or quantity of work performed. The accountants routinely received their full pro-rata salary even when they missed partial days of work.

The court also found that it was understood that the normal workweek was Monday through Friday. The accountants knew that their weekly salaries would be reduced by one-fifth (not one-seventh) for each full day they missed for personal reasons. They were not subject to salary reduction for not working on weekends, and they were never required to use PTO or sick time when not working on a weekend. The fact that the accountants were encouraged, or occasionally required, to work on weekends did not mean that the company's workweek was undefined. Accordingly, Callaway could make full-day salary deductions in accordance with its policy for full days missed on Monday through Friday.

Bonus deductions did not violate the salary basis test

The court rejected the accountants' argument that Callaway's straight-time hourly bonuses made them "de facto" hourly employees because the firm's computation of an accountant's bonus based on an hourly rate of one-fortieth of his or her salary is expressly allowed by DOL regulations (29 C.F.R. §541.604(a)), which provide that "the exemption is not lost if an exempt employee ... receives additional compensation based on hours worked for work beyond the normal workweek. Such additional compensation may be paid on any basis (e.g., ... straight time hourly amount ... or any other basis)...."

The court rejected the accountants' claim that employers can only make lawful deductions from discretionary bonuses and fringe benefits, not from bonuses based on hours worked. DOL regulations only restrict deductions from salary – they do not prohibit deductions from additional compensation provided to exempt employees, regardless of the form of that additional compensation. ■

IRS Advises Airline on Employment Tax Treatment of NRA Flight Attendants

The IRS has released a Technical Advice Memorandum on the employment taxes applicable to wages paid by a U.S. air carrier to nonresident alien (NRA) flight attendants [TAM 201014051, release date 4-9-10; www.irs.gov/pub/irs-wd/1014051.pdf].

Work is performed in U.S. and abroad

A U.S. airline employs NRA individuals as flight attendants to perform services on flights originating from or terminating at a single U.S. airport. The NRA flight attendants perform services as employees within and outside the U.S. in connection with such flights. Each pay period, less than 50% of the services performed by each NRA flight attendant

is performed in the U.S.; also, less than 50% of the pay received by the NRA flight attendants in each payroll period is attributable to services performed in the U.S.

Gross income and income tax withholding

Wage withholding under IRC §3402 applies to remuneration paid by the certified U.S. air carrier to a NRA flight attendant for services performed within the U.S., provided the business visitor exception under §§861(a)(3) and 864(b)(1) does not apply.

Business visitor exception. The "business visitor exception" provides that compensation received by a NRA individual for personal services performed in the U.S. is not

income from U.S. sources if:

- the services are performed by a NRA who is present in the U.S. 90 days or less during the taxable year;
- such compensation does not exceed \$3,000; and
- the compensation is for services performed for an office or place of business maintained in a foreign country by a U.S. corporation.

Apportioning remuneration. U.S. source gross income and wages for services performed in the U.S. by the NRA flight attendants should be determined by multiplying the total compensation paid to a NRA flight attendant by the percentage of time the individual worked in the U.S. during the period to which the compensation relates. The calculation of time worked inside and outside the U.S. should take into account all time the NRA flight attendant is required to report for duty, including pre-flight, post-flight, and training time.

Remuneration subject to income tax withholding. Here, because the NRA flight attendants perform services for a foreign office of a domestic corporation, if a NRA flight attendant is present in the U.S. less than 90 days and has earned less than \$3,000 of income for services performed in the U.S. for the taxable year, then all of the income earned by the NRA flight attendant in the taxable year is treated as from sources outside the U.S. under §861(a)(3), and as income not effectively connected with the conduct of a U.S. trade or business under §864(b)(1), and is not subject to any U.S. income tax withholding. In all other cases, the portion of the NRA flight attendant's salary apportioned to income from U.S. sources is subject to income tax withholding, even if it is less than the amount apportioned to foreign sources.

Amounts excluded from U.S. gross income can be FICA wages

Services performed by a NRA flight attendant under a contract of service entered into outside the U.S. are included in the definition of "employment" under IRC §3121(b) if the services are performed on or in connection with an American aircraft and if the flight touches a U.S. port. Employment under this definition includes services performed both inside and outside the U.S. – substantially all the services performed by the NRA flight attendants here.

Remuneration for the services included in the definition of employment is wages subject to FICA tax whether or not it is income from U.S. sources. However, remuneration paid to a NRA flight attendant who is a resident of a foreign country and who is based in that same foreign country is not subject to FICA tax where there is a totalization agreement between the U.S. and that country, provided the employer has obtained a certificate of coverage from the foreign country stating that the services of the NRA flight attendant are covered under its social security system.

FUTA mirrors FICA

The statutory and regulatory provisions relating to wages and employment for FUTA tax purposes are similar to the FICA provisions. Note, however, that the exception related to totalization agreements does not apply to FUTA tax. Thus, the IRS position is that FUTA taxes apply to the remuneration for employment paid by the airline to the NRA flight attendants regardless of whether it is includible in the gross income of those employees. ■

DOL Issues Final Visa Rules for Temporary Agricultural Workers

The U.S. Department of Labor (DOL) issued final regulations, effective March 15, 2010, amending its regulations on the labor certification process for nonimmigrant temporary or seasonal agricultural workers, and the enforcement of the contractual obligations applicable to employers of such workers [75 F.R. 6884, 2-12-10; <http://edocket.access.gpo.gov/2010/pdf/2010-2731.pdf>].

Background

In 2008, the DOL issued final regulations on H-2A visa application procedures – effective January 17, 2009. Then the Department changed its mind and suspended the 2008 regulations. However, because the suspension was blocked by a court-ordered injunction, the 2008 regulations have remained in effect (see *PAYROLL CURRENTLY*, Issue No. 18, Vol. 17).

In announcing the new regulations, Secretary of Labor Hilda Solis explained that they are the result of the Department's review of the policy decisions underlying the 2008 regulations. The new regulations include stronger mechanisms for enforcing worker protection provisions required by the H-2A program.

Major features of the new final regulations

- The employer must provide documentation that it has complied with the prerequisites for bringing H-2A workers into the country, including the requirements related to recruiting for qualified U.S. workers, instead of simply attesting to compliance.
- Returns to using the USDA Farm Survey as the basis for determining the Adverse Effect Wage Rate (AEWR). The 2008 rule used the Occupational Employment Statistics Survey, which

resulted in a substantial reduction of worker wages (an average of over \$1.00/hour).

- Reinstates the critical role of the State Workforce Agencies (SWAs) in assisting employers by using their expertise on local labor market conditions and recruitment patterns, thereby expanding job opportunities for U.S. workers.
- Reinstates the requirement that the SWA inspect and approve employer-provided housing before an H-2A labor certification is issued.
- Requires that all employer-provided transportation meet, at a minimum, the same federal standards for vehicle safety, vehicle insurance, and driver licensure applicable to most other agricultural workers.
- Strengthens revocation and debarment authorities by providing the Wage and Hour Division with independent debarment authority (in addition to the Employment and Training Administration), raises civil money penalties, and expands audit authority to include housing.
- Continues to include logging as an H-2A occupation. The regulations as first proposed added other forestry-related occupations such as tree-planting and related reforestation activities, as well as pine straw gathering, but these were not included in the final rule in response to concerns about the costs and the workers' potential loss of MSPA (Migrant and Seasonal Agricultural Protection Act) protections, including a private right of action.
- Creates a national electronic job registry for all H-2A job orders to improve U.S. worker access to agricultural jobs and

help growers find workers from across the U.S.

- Extends H-2A program benefits to workers in “corresponding employment” (other workers employed by an H-2A employer in any work included in the job order and any work performed by the H-2A workers) to ensure that similarly situated employed U.S. workers are not provided with lower wages or fewer benefits.
- Requires employers to provide workers with copies of the job orders no later than before departure, including from the workers’ home countries, and to display a poster describing employee rights and protections in English and another language common to the workers at the worksite. *Note:*

Fire Investigators Were Not Covered by FLSA Fire Protection Rules

The Fair Labor Standards Act (FLSA) requires employers to pay employees at an enhanced rate when their workweek exceeds 40 hours (29 USC §207(a)(1)). Among the many exceptions to this rule are ones for public agencies engaged in fire protection and law enforcement. Under a partial exemption, a public employer does not owe overtime to an employee engaged in law enforcement activities until he works more than 86 hours per two-week period (29 C.F.R. §553.230). The analogous figure for an employee engaged in fire protection activities is 106 hours.

Gary Cremeens and seven other fire investigators employed by the city of Montgomery, Alabama, filed a lawsuit seeking overtime as law enforcement officers rather than as firefighters. In other words, they wanted to bridge the gap and be paid overtime under the lower threshold. A U.S. District Court decided the matter in favor of the city (see **PAYROLL CURRENTLY, Issue No. 2, Vol. 18**), but the Eleventh Circuit Court of Appeals has reversed that decision and ruled in favor of the investigators [*Cremeens v. City of Montgomery*, No. 09-15633, 2010 U.S. App. LEXIS 7028 (11th CA, 4-5-10)].

Background

Candidates for the job must graduate from state and national fire investigation academies, graduate from the Montgomery police academy, and be certified by the state as a peace officer. The city requires fire investigators to perform a firefighting drill every month and spend some time on firefighting duty every year, but an assistant fire chief admitted that most of the fire investigators’ duties are law enforcement duties, and that Cremeens and the other plaintiffs spend most of their time doing investigative work.

Overtime for firefighters

29 USC §203(y). In 1999, Congress enacted 29 USC §203(y). It defined an employee engaged in “fire protection activities” as an employee, including a firefighter, paramedic, emergency medical technician, rescue worker, ambulance personnel, or hazardous materials worker, who – (1) is trained in fire suppression, has the legal authority and responsibility to engage in fire suppression, and is employed by a fire department

The new poster is available for downloading at www.dol.gov/elaws/firststep/results2.htm.

- Prohibits the use of multi-area itineraries by H-2A labor contractors (LCs), ending the practice of moving H-2A workers from site to site in multiple areas of employment under one labor certification. LCs participating in this program will now have the same regulatory standards as fixed-site farmers. Required surety bond amounts for H-2ALCs have been increased.
- Prohibits the approval of labor certification applications for worksites where workers are on strike or locked out and protects U.S. workers who are denied employment or laid off. ■

of a municipality, county, fire district, or state; and (2) is engaged in the prevention, control, and extinguishment of fires or response to emergency situations where life, property, or the environment is at risk. The Department of Labor did not revise its long-standing overtime regulations for firefighters after §203(y) was enacted.

29 C.F.R. §553.213(b). Here, the question was whether §203(y) rendered obsolete the “dual assignment” provision of 29 C.F.R. §553.213, which controls public agency payments of overtime to employees who perform both fire protection and law enforcement activities. The court said it did not, and that the regulatory provision is still valid. Section 553.213(b) provides: *For those employees who perform both fire protection and law enforcement activities, the applicable standard is the one which applies to the activity in which the employee spends the majority of work time during the work period.*

The court’s analysis

The court found no conflict between §203(y) and the dual assignment regulation, saying that “the plain words of the regulation create no problematic interaction with the statute.”

Section 203(y) does not touch the dual assignment regulation. On its face, §203(y) does not strike down the dual assignment regulation, refer to dual assignment in any way, or suggest how overtime is to be paid. It simply defines who is an employee in fire protection activities.

The §203(y) list, while it is non-exclusive, nevertheless makes no reference to fire investigator, arson investigator, or law enforcement. It therefore does not speak directly to the issue here.

Dual assignment regulation does not alter §203(y)’s definition. Similarly, because the plain language of the dual assignment regulation does not purport to alter §203(y)’s definition of an employee engaged in fire protection activities, it does not conflict with it. The dual assignment regulation does no defining. Instead, it dictates how to apply the overtime rules to those employees who have already satisfied the definitions both for fire protection and law enforcement. ■

Supreme Court Denies Review of Case Involving FLSA Motor Carrier Exemption

The U.S. Supreme Court has refused to hear the appeal of a case involving a shuttle bus service whose main business was carrying cruise ship passengers between airports and hotels and cruise ship ports in Miami and Fort Lauderdale [*Walters v. American Coach Lines of Miami, Inc.*, No. 09-779 (U.S. Sup. Ct.,

4-5-10)]. As a result, the decision of the Eleventh Circuit Court of Appeals will stand. That court said the bus drivers were not required to be paid overtime under the Fair Labor Standards Act (FLSA) because they were covered by the motor carrier exemption (see **PAYROLL CURRENTLY, Issue No. 21, Vol. 17**). ■

Time Spent Donning and Doffing Police Uniform Was Not Compensable

The Ninth Circuit Court of Appeals has affirmed that the donning and doffing of police uniforms and related gear were not compensable activities where neither law, regulation, employer requirement, nor the nature of the work mandated donning and doffing at the employer's premises [*Bamonte v. City of Mesa*, No. 08-16206, 2010 U.S. App. LEXIS 6188 (9th CA, 3-25-10)].

WHAT THE LAW SAYS – Under the Fair Labor Standards Act (FLSA), activities that are “preliminary or postliminary” to an employee's principal work activity are not compensable work unless a contract or custom of the employer makes them compensable. A principal activity includes all activities that are “integral and indispensable” to the principal activity. This means that time spent by an employee to get ready for work or to get ready to leave work is not work time unless the activities engaged in are essential to the employee's principal work activity. If an employee must change clothes (“donning and doffing”) while at work at the beginning and end of a shift, the time spent changing clothes is work time if changing clothes is integral and indispensable to the employee's principal activity (see *The Payroll Source*®, pp. 2-63 and 2-64).

Officers can change at home or work

The city of Mesa, Arizona, requires its police officers to wear certain uniforms and related gear. Each officer is provided a locker room at the station, and facilities are available for the officers to don and doff their uniforms and related gear. While the officers have the option to don and doff at home or at work, no requirement is imposed on them by the city, with the exception of motorcycle officers, who are required to don and doff their uniforms and gear at home, because their shifts begin when they leave their residences.

No employer mandate or legal requirement

In prior cases that held donning and doffing time compensable, the employer mandated the donning and doffing be done at its premises. Here, however, with the exception of motorcycle officers, donning and doffing at the workplace is entirely optional. Further, no law, rule, or regulation mandates on-premises donning and doffing. And no obligation of either employer or employee would be fulfilled by on-premises donning and doffing. Finally, said the court, the reasons cited by the officers in favor of compensability (risk of loss or theft of uniforms, potential access to gear by family members or guests, risk of performing firearm checks at home, discomfort while commuting, risk of being identified as

an officer while off duty, and risk of exposing family members to contaminants and bodily fluids from encounters while in the line of duty) do not benefit the employer, but rather are of sole benefit to the employees.

Location option is key

DOL memo. The U.S. Department of Labor (DOL) advises that “donning and doffing of required gear is within the continuous workday only when the employer or the nature of the job mandates that it take place on the employer's premises. It is our longstanding position that if employees have the option and ability to change into the required gear at home, changing into that gear is not a principal activity, even when it takes place [on the employer's premises]” (W-H Adv. Memo. No. 2006-2, 5-31-06).

The court said this language narrowly focuses on the donning and doffing of gear where the “employees have the option and the *ability* to change into the required gear at home,” not just the option.

DOL handbook. The court also cited the DOL Field Operations Handbook, which instructs that “employees who dress to go to work in the morning are not working while dressing even though the uniforms they put on at home are required to be used ... during working hours. Similarly, any changing which takes place at home at the end of the day would not be an integral part of the employee's employment and is not working time” (§31b13, 12-15-00).

Legislative goals. Finally, the court noted that a location consideration supports Congressional goals by clarifying the circumstances under which employees must be compensated for the donning and doffing of uniforms and gear, thereby preventing unexpected and substantial liability to employers.

Conclusion

The court said the question here was not whether the uniform and safety gear are indispensable to the job – they most certainly are – but, rather, whether the nature of the work requires the donning and doffing process to be done on the employer's premises. Officers other than motorcycle officers have the complete option *and ability* to don and doff their uniforms and gear at home. There is no rule, regulation, policy, or practice of the city that limits the officers' option in any way. Although logical reasons exist for the police officers not to avail themselves of the at-home option, these reasons reflect preferences rather than mandates. ■

IRS Discusses Common Paymaster Scenarios at University Medical Schools

In two private letter rulings, the IRS looks at common paymaster scenarios involving physicians concurrently employed by a medical practice plan and a university, along with a related limited liability company (LLC). In both scenarios, the common paymaster applies [LTR 201003010, 10-15-09; www.irs.gov/pub/irs-wd/1003010.pdf; LTR 200944016, 7-21-09; www.irs.gov/pub/irs-wd/0944016.pdf].

Facts

LTR 200944016. Practice Plan A is a nonprofit corporation exempt from federal income tax under IRC §501(a). University

B is a public university that employs health professionals as faculty members at its medical school.

Beginning in 2009, various faculty practice plans and private physician groups are to be consolidated into Practice Plan A. Substantially all physicians employed by University B and a significant number of physicians not university-employed will become employees of Practice Plan A. More than 30% of the physicians employed by Practice Plan A will be concurrently employed by Practice Plan A and University B. Practice Plan A is the sole member of Company C, an LLC

created to provide administrative and managerial services to Practice Plan A. Practice Plan A will manage Company C as its sole member.

Many of the nonphysician employees associated with the clinical practices operated by both university-employed physicians and physicians not employed by the university will be employed by Company C.

The employment of nonphysician employees is being transferred from their current employers to Company C. The nonphysician employees will continue to provide the same services to Practice Plan A physicians that they currently provide. Company C will maintain a separate payroll to pay nonphysician employees. The services of the nonphysician employees are to be provided to Practice Plan A pursuant to a support services agreement.

LTR 201003010. University D is a public university that employs health professionals as faculty members at its medical school. Company E is a §501(c)(3) nonprofit corporation exempt from federal income tax and is organized and operated to carry out the purpose of University D and its medical school.

Company F is an LLC organized and operated exclusively to carry out the purposes of University D and its medical school, as well as Company E. Company F's operating agreement prohibits it from engaging in any activity that would: prevent it from becoming exempt from federal income taxation under §501(c)(3); cause it to lose such exempt status; or carry on any activity prohibited to a corporation, contributions to which are deductible under §170(c)(2).

Together, Company E and Company F are a faculty practice plan. Company E is the sole member of Company F and manages Company F. Company F employs physicians or health care professionals, who are required, as a condition of employment, to have a clinical faculty appointment at University D's medical school. More than 30% of Company F's employees are to be concurrently employed by University D and Company F.

WHAT THE LAW SAYS – Related corporations. Under IRC §3121(s), if remuneration received by an individual from related corporations is disbursed through a common paymaster, the total amount of social security taxes imposed is determined as though the individual has only one employer – the common paymaster. In other words, §3121(s) aggregates the remuneration paid to an employee by concurrent employers for purposes of determining the social security wage base.

One test to determine if corporations are considered related corporations is whether 30% or more of one corporation's employees are concurrently employees of the other corporation.

A common paymaster is not required to disburse remuneration to all the employees of the related corporations, but the common paymaster rules do not apply to any remuneration that is not disbursed through a common paymaster.

Special rule. In the case of certain medical faculty practice plans, a special rule provides that the following are related corporations:

- a state university that employs health professionals as faculty members at a medical school; and
- a faculty practice plan that employs faculty members of the medical school.

If a faculty practice plan meets these criteria, then all remuneration disbursed by the plan to the health professionals is treated, for FICA purposes, as if it were disbursed by the university as a common paymaster. In other words, the special rule shifts the obligation to withhold the employee portion of FICA tax and to pay the employer portion of FICA tax from faculty practice plans to the associated university.

LLCs. An LLC that has a single owner and has not elected to be taxed as a corporation is disregarded as an entity separate from its owner for income tax purposes. However, beginning January 1, 2009, IRS Reg. §301.7701-2(c)(2)(iv) (A) provides that an LLC with a single owner that has not elected to be taxed as a corporation will not be disregarded as an entity separate from its owner for employment tax purposes and the collection of income tax. For employment tax purposes, an entity that is otherwise disregarded as an entity separate from its owner but for §301.7701-2(c)(2)(iv) (A) is treated as a corporation separate from its single owner. As such, the LLC with a single owner must withhold, report, and remit employment taxes with respect to those individuals directly employed by the entity using its own name and EIN.

Rulings

LTR 200944016. Company C, a single member LLC, is treated as a corporation separate from its single owner for all employment tax purposes, including the common paymaster rules, as of January 1, 2009. Accordingly, Company C is a separate corporation distinct from Practice Plan A, its single member owner. Individuals solely employed by Company C are employees of Company C, not employees of Practice Plan A. The employees of Company C will not be included as employees of Practice Plan A for purposes of determining whether the 30% test has been satisfied.

However, the 30% test is satisfied because 30% or more of the employees of Practice Plan A, not counting the employees of Company C, are concurrently employed by the University. If the employees of Company C were counted for purposes of the 30% test, then less than 30% of the combined workforce of Practice Plan A and Company C would be concurrently employed by the University, and the University would not qualify for common paymaster treatment under IRC §3121(s).

LTR 201003010. Company F, whose sole member Company E is a tax exempt entity under §501(c)(3), will be treated as a separate entity for employment tax and related reporting requirements effective January 1, 2009.

University D and Company F are deemed to be related corporations because University D employs health professionals as faculty members at its medical school, Company F is a faculty practice plan that employs faculty members of the medical school, and 30% or more of Company F's employees are concurrently employed by the medical school.

University D and Company F can use the common paymaster rules for the healthcare professionals employed concurrently by University D and Company F. All remuneration disbursed by Company F to these healthcare professionals is treated as if it were disbursed by University D as common paymaster. All other remuneration disbursed by Company F is treated as disbursed by Company F, which is responsible for employment taxes with respect to wages paid to its employees who are not concurrently employed by University D. ■

Portion of Settlement Allocated to Back Pay and Front Pay Was Income

In 2007, Diane Josifovich sued a former employer, claiming that it had violated New Jersey laws relating to employee protection and discrimination. She sought damages for back pay, front pay, and emotional distress, plus attorney fees and costs. After the parties settled the case, Josifovich asked that the settlement proceeds be increased by the amount of any withholdings.

Withholding from settlement proceeds. An employer is required to deduct and withhold taxes when making payments of “wages,” which are defined as all remuneration for services performed by an employee for the employer (IRC §3401(a)).

The court said the amount of the settlement allocated to back pay (compensation for a period in which a former employee rendered services to an employer) was subject to

withholding. Likewise, the portion of the settlement allocated to front pay (what an employee would have earned) was subject to withholding. The court explained that “services performed” by an employee covers the entire employer-employee relationship and is not limited to work actually performed.

Grossing up settlement on account of withholding. Josifovich’s request that the court “equitably gross up” any settlement amounts subject to withholding was rejected. The court explained that Josifovich voluntarily entered into the settlement agreement aware that there would be tax consequences, so awarding her an additional amount would be a windfall [*Josifovich v. Secure Computing Corp.*, No. 07-5469 (FLW), 2009 U.S. Dist. LEXIS 67092 (D N.J., 7-31-09)]. ■

Outside Salesperson Was Common Law Employee, Not Statutory Employee

During 2004 and 2005, James Rosemann worked as an outside salesperson for Cooper Container Corp., soliciting orders for cardboard containers and packaging. The company provided Rosemann with a car for business use, and reimbursed him for his mileage and other documented business expenses. Cooper did not reimburse Rosemann when he used one of his own vehicles for work.

Along with his federal income tax returns for 2004 and 2005, Rosemann filed Schedule C, *Profit or Loss From Business*, claiming deductions for the business use of one of his own vehicles and other unreimbursed business expenses. He appealed to the Tax Court when the IRS issued a Notice of Deficiency and assessed an accuracy-related penalty, arguing that he was a statutory employee. The court rejected his argument, however, concluding that he was a common law employee. Therefore, he was liable for the deficiency and could not deduct his expenses on Schedule C [*Rosemann v. Commissioner*, T.C. Memo. 2009-185, No. 7573-08 (8-13-09)].

☞ **STATUTORY AND COMMON LAW EMPLOYEES** – A statutory employee is a worker who is not a common law employee but is treated as such for certain employment tax purposes. An employer’s payments to a statutory employee are not subject to federal income tax withholding, but are subject to withholding for social security and Medicare taxes. The employer must also pay the employer share of social security and Medicare taxes and may have to pay FUTA tax. Statutory workers fall into several categories, including traveling or city salespersons (see *The Payroll Source*®, pp. 1-10 and 1-11).

To decide whether a worker is a common law employee, courts consider: (1) the degree of control exercised by the principal over the details of the work; (2) which party invests in the facilities used in the work; (3) the opportunity of the worker for profit or loss; (4) whether or not the principal has the right to discharge the worker; (5) whether the work is an integral part of the principal’s regular business; (6) the permanency of the relationship; (7) the relationship the parties believe they are creating; and (8) whether the worker receives benefits consistent with employee status. No single factor controls the determination.

All factors pointed to common law employee status

The court explained that a worker can be a statutory employee only if the worker is not a common law employee. Here, all factors indicated that the Rosemann was a common law employee.

Although Rosemann had some flexibility in planning his sales work and contacting customers, Cooper maintained extensive control over his activities. Rosemann was required to attend weekly meetings at Cooper’s facility, had to work at least 40 hours a week during normal business hours, and had to comply with the company’s dress code. His productivity was periodically reviewed, and he was treated as an employee by company officers.

Rosemann did not invest in the company’s facilities. The company provided a vehicle for his use and reimbursed him for his out-of-pocket business expenses. Rosemann maintained a home office, but that alone did not make him an independent contractor, said the court.

Rosemann received a salary and commissions, but did not otherwise have the opportunity for profit or loss. Cooper retained the right to terminate his employment. The company was in the business of manufacturing and selling cardboard shipping containers and packaging, and Rosemann’s role in selling these products was an integral part of that business. He had worked for Cooper for more than 10 years, which indicated a permanent working relationship.

Cooper had no written employment contract with Rosemann, but it regarded him as an employee. The company did not check the “statutory employee” box on his W-2s and withheld employment taxes. In addition, Cooper provided employee benefits to Rosemann such as vacation and sick leave time, health and life insurance, and a 401(k) plan.

Change in IRS position impacted penalty assessment

The court said the fact that an IRS audit of Rosemann’s income tax returns for 1995 and 1996 determined Rosemann to be a statutory employee did not prevent the IRS from later contesting this status. “[E]ach taxable year stands alone, and the Commissioner may challenge in a succeeding year what

was condoned or agreed to in a previous year.” However, the outcome of the prior audit provided Rosemann with a reasonable basis and good faith to claim that he was a statutory employee, so the court did not impose an accuracy-related penalty related to his employment status. ■



STATE AND LOCAL NEWS

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Arizona

New withholding rates enacted. Effective for amounts withheld on or after 7-1-10, employee withholding rates will be based on a percentage of gross taxable wages (S.B. 1185, L. 2009). Currently, the amount withheld is a percentage of federal withholding. “Gross taxable wages” is the amount that will be included in Box 1 of federal Form W-2. Revised Form A-4, *Employee's Arizona Withholding Percentage Election*, and Form A-4V, *Voluntary Withholding Request for Arizona Resident Employed Outside of Arizona*, are available at www.azdor.gov/Forms/Withholding.aspx [Department of Revenue, News Release, 4-9-10].

Connecticut

Employee withholding allowance form, instructions corrected. The Department of Revenue Services (DRS) has corrected the employer instructions on page 2 of Form CT-W4, *Employee's Withholding Certificate*. It should now read “For any employee who does not complete Form CT-W4, you are required to withhold at the 5% marginal rate without allowance for exemption, unless the highest marginal rate applies. You are required to keep Form CT-W4 in your files for each employee. See Informational Publication 2010(1), *Connecticut Employer's Tax Guide, Circular CT*, for complete instructions.” Previously, employers were instructed to withhold tax at the highest rate for employees who did not complete Form CT-W4 [DRS, Forms/Publications Alerts, 4-12-10].

Idaho

Unclaimed wages: electronic reporting required, administrative agency changed. Effective 7-1-10, electronic reporting of unclaimed property is required for employers that have 10 or more items of unclaimed property. Electronic reports must be submitted in the NAUPA format via CD or through the Tax Commission's website at <https://www.accessidaho.org/secure/istc/filing/unclaimed.html>. Employers that act in good faith and without negligence in complying with the unclaimed property reporting requirements may have all or part of the penalties and interest due waived by the Tax Commission [H.B. 385, L. 2010].

Also effective 7-1-10, the state agency controlling and administering unclaimed wages will transition from the Tax Commission (TC) to the State Treasurer (ST). The TC and ST may enter into written agreements for the exchange of information relating to the names and current addresses of businesses in the state that have unclaimed property [H.B. 680, L. 2010].

Indiana

Electronic filing mandated for Forms W-2, annual reconciliation returns. Effective 1-1-11, employers or payroll service providers that file more than 25 Forms W-2 in a calendar year must file all Forms W-2 and Forms WH-3, *Annual Withholding Tax Form*, electronically with the Department of Revenue (this updates *The Payroll Source*®, p. 8-120) [H.B. 1086, L. 2010].

Maine

Tax amnesty program initiated. Maine Revenue Services (MRS) is authorized to conduct the 2010 Tax Receivables Reduction Initiatives program consisting of two components: (1) the short-term initiative – applies to tax liabilities assessed as of 12-31-09; and (2) the five-year initiative – applies to tax liabilities assessed as of 6-30-05. An employer that pays taxes owed is entitled to a waiver of 95% of the penalties for participating in the short-term initiative (but not an interest waiver) and a waiver of 95% of the penalties and interest for participating in the five-year initiative. An application to participate in the program must be filed from 9-1-10 to 11-30-10. A similar program took place in 2009 [H.B. 1183, L. 2010].

Withholding tables may be affected by referendum on tax reform. On 6-8-10, voters will decide at a referendum whether to approve suspended tax reform legislation (H.B. 1051, L. 2009). The current withholding tables are not based on this legislation. If approved, the four current tax rates (2%, 4.5%, 7%, and 8.5%) would be replaced with a flat tax of 6.5% on all taxable income, plus an additional 0.35% surcharge on taxable income greater than \$250,000 (for a rate of 6.85%). Also, the standard and itemized deductions would be replaced with several new tax credits. The effective date would be extended to 1-1-11 from 1-1-10 [H.B. 1321, L. 2010].

Mississippi

Lump sum payments for child support: expiration date for notification requirements extended. The expiration date for lump sum payment requirements for employers that was enacted last year has been extended to 7-1-11 (was 7-1-10). An employer must notify the Department of Human Services at least 45 days before making a lump sum payment of more than \$500 to an employee who owes child support arrears, or as soon as the decision is made to make the payment if that is less than 45 days. For more information, see www.mdhs.state.ms.us/cse_mesc.html or send an e-mail to lumpsum.payments@mdhs.ms.gov [H.B. 703, L. 2010].

Nevada

Minimum wage and daily overtime rates increase. There are two minimum wage tiers in Nevada. The lower tier may be paid to employees for whom qualifying health benefits have been made available by the employer. The higher tier must be paid to all other employees. Effective 7-1-10, the lower minimum wage will increase to \$7.25 an hour from \$6.55 an hour, and the higher minimum wage will increase to \$8.25 an hour from \$7.55 an hour (this updates *The Payroll Source*®, p. 2-70).

Eligible nonexempt employees who are paid a base rate of 1½ 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 7-1-10, daily overtime must be paid if an employee is paid less than \$12,375 an hour (\$8.25 x 1.5) or \$10,875 an hour (\$7.25 x 1.5) if the employer provides health benefits [Office of the Labor Commissioner, State of Nevada Minimum Wage and Daily Overtime 2010 Annual Bulletins, 4-1-10].

Utah

Private employers required to verify employment eligibility. Effective 7-1-10, a private employer in Utah that employs 15 or more employees may not hire a new employee to perform services in the state unless the employer: (1) is registered with a status verification system to verify the federal legal working status of any new employee; and (2) uses the status verification system to verify the federal legal working status of the new employee in accordance with the requirements of the system. A status verification system includes the federal E-Verify system, an equivalent federal program, the Social Security Number Verification Service (SSNVS), or a reliable independent third-party system [S.B. 251, L. 2010].

West Virginia

Withholding tax electronic filing and payment thresholds lowered. Effective for tax years beginning on or after 1-1-11, an employer with 50 or more (currently 250 or more) employees will be required to file withholding returns electronically. An employer that fails to do so will be subject to a fine of \$25 per employee for whom the return was not filed electronically, unless the failure was due to a technical inability to comply. Also effective for tax years beginning on or after 1-1-11, no employer will be required to pay withholding tax by electronic funds transfer (EFT) if the amount owed during the previous tax year was less than \$10,000. An employer with a total annual tax remittance for any single tax type of \$10,000 or more (currently \$100,000 or more) during the previous tax year will be required to file all returns for all taxes electronically [H.B. 4035, L. 2010].

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