

Payroll 101

Welcome to payroll 101.

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Payroll and Business Structure

Types of Businesses

It is important for you to understand the types of business entities you are and how that affects payroll. Often times business owners do not understand the payroll implications for their defined type of business.

Sole Proprietors

The most common and simple business structure is that of the sole proprietor. The business and the owner are one and the same. The business does not exist without the owner and the business is not a separate entity. All business liabilities belong to the owner and the owner undertakes all risks.

The sole proprietor reports his/her earnings from the business on a [Schedule C, Form 1040](#) as part of his/her individual income tax each year. Sole proprietors pay self-employment taxes on their earnings from the business.

Employee versus Independent Contractors?

Who is an employee?

An Employer must decide if each worker receiving payments for services performed is an employee or a non-employee. Payments to employees require employers to withhold taxes ([income](#), [Fica](#) and [Medicare](#)) and report wages on (Forms [941](#) and [W-2](#)). Employers are also responsible for employment taxes (i.e. [unemployment](#), [Fica](#) and [Medicare](#)). The employer may be required to withhold taxes ([backup withholding](#)) and report ([Form 1099-MISC](#)) payments to non-employees, depending on their status.

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Identifying an Employee

Generally, workers who perform services are employees if the employer controls what will be done and how it will be done. The employee may have great latitude in the process, but if the employer controls what the tasks are and how the tasks are completed, generally the worker is an employee. The key factor is whether the employer has the legal right to control the methods and results of the work to be done.

Employees

An individual is an employee when he or she:

- Maintains a continuous relationship with an employer
- Is subject to the control of the employer, even when the employer chooses not to exercise the control
- Performs work personally, receiving training, tools, equipment or supplies from the employer
- Works hours and locations assigned by the employer
- Qualifies for the company's benefit plans

Common Law Test

Under common law rules developed over many years of court decisions, every individual who performs services subject to the will and control of an employer, as to both what must be done and how it must be done, is an employee. It does not matter that the employer has the legal right to control both the method and result of the services.

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Two usual characteristics of an employer-employee relationship are that the employer has the right to discharge the employee and the employer supplies the employee with tools and a place to work.

If an employer-employee relationship exists, it makes no difference how it is described. For employment tax purposes, no distinction is made between classes of employees.

The common law test determines whether the employer controls the actions of the employee. When applying the common law test, seven questions are asked:

1. Who controls the work?
2. What work will be done?
3. How will the work be done?
4. Who supplies the tools and equipment required to complete the work?
5. When will the work be done?
6. Where will the work be done?
7. Does the worker have the ability to make a profit or suffer a loss?

The IRS has established a testing procedure to make the classification of workers easier for employers. Testing is accomplished by completing Form [SS-8](#), Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding.

While awaiting the IRS' response to the [SS-8](#), the **employer must treat the worker as an employee**. During this time, the worker must have the appropriate taxes withheld and reported. The taxes will not be refunded to the worker or the employer if the worker is found to be a worker and not an employee.

In addition to the IRS, several other governmental organizations are concerned with the classification of workers. The Wage and Hour Division of the [US Department of Labor](#) determines if the worker is being paid minimum wages and overtime appropriately as an employee. State unemployment commissions have jurisdiction when the worker requests

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unemployment benefits and the worker has not been covered by the employer's taxes or wage reporting.

All three agencies (IRS, Wage and Hour Division, and State Unemployment Commissions) work together to find misclassifications of employees as non-employees, and they share the information with each other.

Exercises

From the following descriptions of the worker's activities determine if the worker is an employee.

1)

A plumber has a large project to complete as a subcontractor for a construction company. To complete the work required, the plumber will be hiring additional workers. The workers will report to the job site at 7:30 each morning and leave at 4:30 each afternoon, unless additional work must be completed that day. Each worker will be provided a tool chest and must account for the parts used during the day.

Are they an independent contractor or an employee? Select one: independent contractor | employee

2)

A payroll service bureau expects a large, temporary increase in the data entry required for several pay periods. Accounting Personnel Staffing provides three data entry operators for those several pay periods.

Are they an independent contractor or an employee? Select one: independent contractor | employee

Family Employees

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Child employed by parents:

Payments for the services of a child under the age of 18, who works for his/her parent(s) in a sole proprietorship for partnership in which each partner is a parent of the child are not subject to [Fica](#) or [Medicare](#). These payments are not subject to Federal Unemployment Taxes ([FUTA](#)) until the child reaches the age of 21.

One spouse employed by another:

The wages for the services of an individual who works for his/her spouse in a trade or business are subject to income tax withholding, social security and Medicare taxes, but not [FUTA](#).

Parent employed by a child:

The wages for the services of a parent employed by his/her child are subject to income tax withholding, social security and Medicare taxes. These wages are not subject to [FUTA](#).

Covered services of a child or spouse:

The wages paid for the services of a child or spouse are subject to [income tax](#), [social security](#) and [Medicare](#) and [FUTA](#) if s/he works for:

1. A corporation, even if it is controlled by the child's parent or the individual's spouse,
2. A partnership, even if the child's parent is a partner, unless each partner is a parent of the child,
3. A partnership, even if the individual's spouse is a partner, or
4. An estate, even if it is the estate of a deceased parent.

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