How to avoid and correct common payroll tax mistakes

Payroll administration can be challenging for small business owners — and mistakes can create problems for both employers and employees. Incorrect paychecks can frustrate employees and require time and resources to fix. Errors involving tax withholding, deposits or reporting can also expose your business to interest and penalties.

Mistakes can happen even with payroll software or an outside payroll provider. Here are some steps you can take to reduce your risk.

Withhold and deposit taxes properly

Employers generally must withhold income tax and employees' share of Social Security and Medicare taxes from their wages, as well as pay the employer's share of Social Security and Medicare taxes. You're also responsible for depositing these amounts with the IRS and reporting them on the appropriate payroll tax returns. Additional rules may apply to the 0.9% additional Medicare tax, federal unemployment tax, and various state and local taxes.

Errors when entering information from an employee's Form W-4, "Employee's Withholding Certificate," can result in incorrect federal income tax withholding. Changes to an employee's name, address or visa status can create problems, too.

Perhaps the most dangerous mistake is failing to deposit withheld federal income tax, Social Security and Medicare taxes and the employer's share of Social Security and Medicare taxes on time. IRS penalties accrue quickly because they increase with the length of the delay. That is:

- If a deposit is one to five calendar days late, the penalty is 2% of the unpaid deposit,
- If a deposit is six to 15 calendar days late, the penalty is 5% of the unpaid deposit, and
- If a deposit is more than 15 calendar days late, the penalty is 10% of the unpaid deposit.

The penalty rate may increase to 15% if more than 10 calendar days elapse after the date of the first notice or letter from the IRS. Alternatively, a 15% penalty may apply on the day a notice or letter for immediate payment is received.

If the IRS can make the case that a failure to deposit *withheld* taxes (income tax and the employee's share of Social Security and Medicare taxes) was *willful*, a 100% penalty may apply. Such penalties can also be levied *personally* against all responsible individuals in an organization.

To reduce the risk of withholding and deposit errors, establish procedures for reviewing employee withholding information and monitoring deposit deadlines. Even if you use an outside payroll provider, your business generally remains responsible for making sure federal taxes are deposited and paid — and payroll tax returns are filed — on time. Regularly reconcile your payroll records with amounts reported and deposited, and promptly investigate any discrepancies.

Report *all* forms of taxable compensation

Remember, salaries or wages aren't the only items that must be included in employees' taxable income. You must also include the value of bonuses, awards and certain fringe benefits.

Failing to withhold sufficient amounts from employees' total reportable income can also result in noncompliance with IRS rules. In turn, this could lead to penalties for failing to properly withhold or deposit payroll taxes. What's more, the employer could be subject to information return penalties for incorrect Forms W-2, "Wage and Tax Statement."

To minimize your exposure, review the tax treatment of bonuses, awards and fringe benefits *before* processing them through payroll. This is particularly important when adding a new benefit or revising a compensation arrangement because the rules for federal income tax withholding, Social Security and Medicare taxes aren't always the same.

Correct mistakes promptly

Despite your best efforts, mistakes can happen. When you discover one, first determine:

- What went wrong,
- Which employees and payroll periods are affected, and
- Whether the error involves taxable wages, withholding, deposits or information reporting.

Then determine the appropriate correction. It's important to act promptly because available correction procedures may vary based on when you discovered the error.

Depending on the mistake, you may need to adjust an employee's pay, correct your payroll records, make an additional tax deposit or correct a previously filed employment tax return. For example, certain errors reported on Form 941, "Employer's Quarterly Federal Tax Return," may need to be corrected using Form 941-X, "Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund." An incorrect Form W-2 may require Form W-2c, "Corrected Wage and Tax Statement."

Keep records explaining the error and the steps taken to correct it. If employees' pay or tax information is affected, communicate with them promptly so they understand what happened and what, if anything, they need to do.

Keep your payroll on track

Payroll mistakes can be costly, but strong review procedures can reduce the likelihood that they'll occur — and prompt action can limit the damage when they do. If you discover a payroll error or have questions about your payroll tax obligations, contact us. We can help you understand the applicable rules and refine your payroll practices to stay in compliance.