KPMG

Payroll Insights

Employment tax news to guide you now and for the future

February 2025

John's *fresh take*: Addressing employee requests for W2 corrections

W2 forms are out the door! Let the W2C parade begin!

Employees have received their W2s and now feel the need to notify you that they moved six months ago to a no-tax state, they have just become substantially present in the US and now want to pay Federal Insurance Contributions Act (FICA) tax, or were overwithheld for their HSA and have no idea how to fix it. Form W2-C has been requested and now you get to determine whether the request is valid and how to proceed.

A little bit of relief was granted in 2017 when the IRS issued notice 2017-09, which provided guidance for handling W2s and 1099 corrections when amounts reported are incorrect by no more than $100 in income or $25 in tax withhold. No penalty will be imposed for failure to file correct information returns or payee statements if the corrections fall under the imposed thresholds.

Proceed with caution if the corrections involve credits of Social Security, Medicare, federal income tax, or state income tax. For FICA reductions, a FICA consent letter may be necessary. For federal and/or state income tax adjustments, unless an administrative error, the Internal Revenue Service (IRS) and state would expect any adjustment to flow through on the individual's personal tax return and not through a W2C.

In order to avoid W2Cs in the future, tracking the requests and identifying any trends or prevalent issues may help you to avoid similar issues in the future. This may be through employee communications or adjusted procedures in your payroll department.

Federal updates

Paid family leave guidance received from the IRS

Guidance was requested from payroll practitioners and the states that have mandatory paid family and medical leave (PFML) programs. In response to requests to clarify the income and employment tax treatment of contributions and benefits paid in certain situations under a state-paid family and medical leave program, the IRS provided guidance in Rev. Rul. 2025-4 (Rev. Rul. 2025-4, 2025-6 I.R.B. __ [February 3, 2025]; IR-2025-16 [January 15, 2025]).

In short, if an employer is paying the employee portion of paid family medical leave, which is allowable under state law and not considered income for state taxes, then the payment is considered includible in wages for federal income tax withholding, FICA, and Federal Unemployment Tax Act purposes.

Most of the states that offer PFML permit employers to set up their own programs in lieu of participating in the state program. The ruling covers state-mandated programs but does not provide any guidance to the tax treatment of the private plans.

IRS examination of employment tax determinations: Applicability of Section 530, Section 3509, and Section 7436 notices

The IRS has conducted an examination to determine the applicability of Section 530 of the Revenue Act of 1978 and the reduced rates under Section 3509 of the Internal Revenue Code in five distinct situations involving employment tax determinations. These situations revolve around taxpayers hiring individuals and classifying them as either nonemployees or employees, with disputes arising over whether bonuses should be treated as wages for federal employment tax purposes. In each scenario, the IRS audits the taxpayer and proposes to assess federal employment taxes, potentially leading to the issuance of a Notice of Employment Tax Determination under Internal Revenue Code Section 7436 if there is disagreement on employment status or entitlement to Section 530 relief.

In the first situation, the taxpayer classified workers as nonemployees and reported compensation on Form 1099-NEC, but the IRS reclassified them as employees. Section 530 relief could be applicable if the taxpayer meets the consistency and reasonable basis requirements, while Section 3509 reduced rates might apply if Section 530 relief is not granted but the taxpayer meets Section 3509 criteria. A Section 7436 Notice will be issued due to the disagreement over worker classification and Section 530 relief eligibility. The second situation involves the taxpayer treating individuals as employees for salary purposes but not for bonuses, reporting bonuses on Form 1099-NEC. Here, Section 530 and Section 3509 are not applicable since the individuals were already treated as employees, but a Section 7436 Notice will be issued due to the disagreement over Section 530 relief for bonuses.

In the third situation, similar to the second, bonuses were not reported on any form. Again, Section 530 and Section 3509 do not apply for the same reasons, and a Section 7436 Notice will be issued due to the disagreement over Section 530 relief for bonuses. The fourth situation mirrors the third, but the taxpayer did not claim Section 530 relief. Consequently, Section 530 and Section 3509 are not applicable, and no Section 7436 Notice is issued, as there is no claim or controversy over worker classification. In the fifth situation, the taxpayer paid year-end bonuses directly, not treating them as wages, while a third party handled regular payroll. As in previous cases, Section 530 and Section 3509 are not applicable since the individuals were treated as employees, but a Section 7436 Notice will be issued due to the disagreement over Section 530 relief for bonuses.

These IRS determinations emphasize the critical importance of consistent treatment and accurate reporting of worker compensation. For our clients, this means ensuring strict compliance with employment tax obligations and maintaining clear documentation to support worker classification decisions. Misclassification can lead to significant tax liabilities and penalties, as well as the issuance of Section 7436 Notices. Therefore, it is advisable for clients to seek professional guidance when dealing with complex worker classification issues to mitigate risks and ensure adherence to federal tax regulations.

Employee retention credit update: IRS delays in processing employee retention tax credit claims

A recent report to Congress highlights that many businesses and tax-exempt organizations are still awaiting their employee retention tax credit (ERC) refunds, with the IRS yet to process approximately 1.2 million claims as of October 26, 2024. Despite processing several hundred thousand claims recently, many have been pending for over a year, and delays are expected to continue as the IRS reallocates resources for the upcoming filing season.

The backlog in processing ERC claims is causing significant financial strain on businesses relying on these funds to stabilize operations. The IRS has paid an estimated $8.1 billion in interest on delayed refunds, adding to the government's financial burden. The ERC, designed to help businesses retain employees during the pandemic, has been challenging for the IRS to administer, leading to paused processing, disallowed credits, and relief measures for mistakenly claimed credits.

National Taxpayer Advocate Erin Collins noted that the IRS's assertion that 95 percent of ERC claims are fraudulent is questionable, as establishing fraud requires careful scrutiny of each case. The IRS's confusing disallowance notices, reverse audit process, and lack of claim status updates further complicate the situation. Collins recommended increased transparency, lifting the pause on new claims, and implementing a Fast Track program to expedite processing.

The IRS is also dealing with delays in processing amended returns and identity theft cases, with average processing times of 132 days for Forms 1040-X and 189 days for Forms 1120-X. Identity theft victims faced an average wait of 676 days in 2024. Despite these challenges, the taxpayer experience has improved due to multiyear funding from the Inflation Reduction Act of 2022, which is essential for enhancing taxpayer service and modernizing technology systems.

Now former IRS Commissioner Danny Werfel stated that the IRS aims to process an additional 500,000 ERC claims in 2025. Continued efforts to address processing delays and improve taxpayer service will be crucial, with sufficient resources needed to enhance digital capabilities and maintain adequate staffing levels year-round.

IRS to retire Form 944 after 2025

The IRS announced that it will no longer accept Form 944, Employer’s Annual Federal Tax Return, for calendar years after 2025. Current Form 944 filers may continue to use the form for the 2025 calendar year. However, these filers will receive a notice from the IRS indicating that the form is being retired and that they will need to transition to using Form 941, Employer’s Quarterly Federal Tax Return, starting in 2026.

To facilitate this transition, the IRS plans to introduce a free e-file option for Form 941, specifically for employers moving from Form 944 to Form 941. This e-file option will not require employers to purchase any software or third-party services.

Form 944, which is designated for employers with annual federal tax liabilities of up to $1,000, is being retired due to several factors. The IRS has observed a decline in the number of Form 944 filers and an increase in Form 941 filers. Additionally, some employers have struggled with understanding the rules for Form 944, leading to improper filings.

The IRS believes that eliminating Form 944 will enhance the taxpayer experience and address certain administrative challenges. By streamlining the filing process, the agency aims to improve overall efficiency and compliance.

New ACA reporting requirements

On December 23, President Biden signed two significant pieces of legislation affecting Affordable Care Act (ACA) reporting requirements: H.R. 3797, the Paperwork Burden Reduction Act, and H.R. 3801, the Employer Reporting Improvement Act. These laws introduce changes aimed at simplifying the reporting process for employers.

Changes to requirements

- **Form 1095-C by request only:** Starting with returns for calendar years after 2023, employers can furnish Form 1095-C, Employer-Provided Health Insurance Offer and Coverage, to individuals only upon request. Employers must provide clear, conspicuous, and accessible notice that the form is available upon request. If requested, the form must be furnished by January 31 of the following year or within 30 days of the request.
- **Electronic delivery with consent:** Effective for returns due after December 31, 2024, employers can deliver Form 1095-C electronically if the individual consents to receive it this way. The individual can revoke this consent in writing. This provision, previously part of IRS regulations, is now codified into law.

These changes are designed to reduce the administrative burden on employers while ensuring that individuals still have access to necessary information. For further details, please refer to the official guidelines or consult with a tax professional.

Residence-based taxation bill for US citizens abroad

On December 18, 2024, US Representative Darin LaHood introduced the Residence-Based Taxation of Americans Abroad Act, which proposes a significant shift from the current system of taxing US citizens on their worldwide income regardless of residence. This bill aims to implement a residence-based taxation system, providing relief for US citizens living overseas.

The US is one of only two countries that taxes its citizens on worldwide income based on citizenship. The introduction of this bill is a step towards ending double taxation for US citizens abroad, a promise made by President-elect Donald Trump. However, the bill's passage is uncertain due to other legislative priorities and the narrow Republican majorities in Congress.

Bill's proposals

- **Election to be treated as a nonresident:** US citizens living abroad can elect to be treated as nonresidents for tax purposes without renouncing citizenship, provided they comply with US tax obligations for the previous five years and pay any departure tax.
- **Benefits under income tax treaties:** Electing individuals can claim benefits under US tax treaties with their country of residence.
- **Exemption from certain reporting requirements:** Electing individuals are exempt from filing certain forms, such as Form 8938 and FinCEN Form 114.
- **Certificate of nonresidency:** Electing individuals can apply for a certificate of nonresidency to avoid Foreign Account Tax Compliance Act reporting requirements.
- **Departure tax for high-net-worth individuals:** A deemed sale tax applies to high-net-worth individuals, with exceptions for those below certain net-worth thresholds or meeting specific residency criteria.

This bill could benefit US citizens on long-term foreign assignments, but they must remain abroad for at least three years to retain the benefits. The proposed departure tax is similar to the existing expatriation tax but applies to individuals with a higher net worth. KPMG will continue to monitor the bill's progress and related proposals.

State updates

California business owner sentenced for employment tax fraud

A California man has been sentenced to one year and one day in prison for failing to pay employment taxes withheld from his company's employees. Shane Brightpath Mike, the owner and president of Excel Behavioral Services Inc., a home care provider for persons with disabilities in Campbell, California, was responsible for withholding Social Security, Medicare, and income taxes from his employees' wages and remitting those funds to the IRS. From the fourth quarter of 2014 through the third quarter of 2015, Mike failed to pay any of the withheld taxes to the IRS, except for a partial payment in the third quarter of 2014. In total, he did not remit over $1 million in taxes owed during these five quarters. Instead, Mike used the company's funds to cover his personal expenses. Additionally, Mike filed false personal income tax returns for 2014 and 2015, falsely claiming credit for federal tax withholdings from wages he received from Excel, despite knowing these withholdings had not been paid to the IRS. This resulted in a total tax loss of $1,177,947 to the IRS.

In addition to his prison sentence, US District Judge Beth Labson Freeman ordered Mike to serve three years of supervised release and to pay approximately $1,177,947 in restitution to the United States.

New York tax tribunal examines "necessity" in remote work taxation case

A pivotal case before the New York State Tax Appeals Tribunal is scrutinizing the "necessity" of remote work during the COVID-19 pandemic. The tribunal is evaluating whether a Connecticut resident was compelled to work from home when his Manhattan office closed, impacting the application of New York's "convenience of the employer" rule. This rule permits the state to tax nonresidents' income if their employer is based in New York and they are not required to work elsewhere.

The case, brought by Edward Zelinsky, a Cardozo Law School professor, argues that New York owes him a tax refund for income earned while working from Connecticut in 2019 and 2020. Zelinsky contends that taxing his income during the pandemic violates the US Constitution's due process and commerce clauses, especially since remote work was mandated by his employer.

The tribunal's decision will hinge on whether the remote work was a necessity, which could set a significant precedent for state taxation policies concerning remote workers. The outcome may influence how states apply tax rules to nonresident employees in future scenarios where remote work is essential.

This case also has substantial implications for companies with remote employees. If the tribunal rules in favor of Zelinsky, businesses may need to reassess their tax obligations and payroll processes for employees working remotely.

Virginia governor proposes exemption of service tips from state income tax

Virginia Governor Glenn Youngkin has announced a budget proposal aimed at exempting service tips from the state's income tax. Entering his final year in office, Youngkin's proposed budget amendment is expected to return an estimated $70 million annually to approximately 250,000 workers in the food service, personal service, and hospitality industries. The full details of his plan to amend the 2025–2026 budget, initially approved earlier this year, will be released on Wednesday.

Under the proposed plan, workers earning tips would be able to deduct them on their state tax return, provided the income is reported in their federal adjusted gross income. The Virginia Department of Taxation would utilize IRS and W-2 data to ensure compliance with this new measure.

Massachusetts guidance on covered employees for PFML

Massachusetts has provided additional guidance on the reporting requirements for covered employees under the Paid Family and Medical Leave program. This overview highlights the key points to ensure your business meets its obligations.

W-2 employees

- W-2 employees, whether full-time, part-time, or seasonal, are always considered covered individuals under the Massachusetts PFML program. Eligibility is generally determined based on the criteria under the state's unemployment insurance program. If you report a W-2 employee's wages to the Department of Unemployment Assistance, that employee should be counted, regardless of their state of residence.

1099-MISC independent contractors

- 1099-MISC workers are counted towards your total number of covered individuals only if they constitute more than 50 percent of your total workforce. Payments reported on IRS Form 1099-MISC, such as certain prizes, awards, and other income, are covered by the PFML program. However, nonemployee compensation reported on IRS Form 1099-NEC is exempt from PFML withholding and contributions starting January 1, 2020. For a 1099-MISC worker to be included in your Massachusetts workforce count, they must receive payments reported on IRS Form 1099-MISC, perform services as an individual entity, live in Massachusetts, and perform services in Massachusetts.

Required contributions

- Employers must submit quarterly contributions for all covered individuals. Contributions can be partially deducted from employee wages and payments to qualifying 1099-MISC workers. Employers with fewer than 25 covered individuals are not responsible for the employer share of the contribution but may choose to cover some or all of the employee's share. Employers with 25 or more employees must remit a contribution of 0.68 percent of eligible payroll, split between medical leave (0.56 percent) and family leave (0.12 percent).

Mississippi DOR voluntary disclosure lookback periods

The Mississippi Department of Revenue (DOR) has provided updated guidance on its voluntary disclosure program, which allows taxpayers who have not filed the required Mississippi tax returns to come forward and disclose their tax liabilities. According to the DOR, if a taxpayer has not filed the necessary returns, the DOR can review as many years as the taxpayer had taxable business transactions or income. Several factors influence the lookback period, including the type of tax involved, whether the taxpayer has been collecting but not remitting taxes, the duration of the taxpayer's presence in Mississippi, and the nature of the taxpayer's activities in the state. For instance, in cases where the taxpayer has been collecting and not remitting sales tax or withholding tax (referred to as "trust fund" taxes), the DOR will review the period from when the taxpayer began collecting the tax.

The voluntary disclosure program is designed to promote compliance and benefit taxpayers who discover a past filing obligation and liability that have not been discharged. The DOR's guidance emphasizes that the program is not intended for taxpayers who have engaged in income-shifting tax strategies, tax shelter activities, fraud, or negligence. Taxpayers can come forward anonymously and, upon acceptance into the program, provide their name along with the necessary forms, filings, and payment within 60 days of acceptance. This program aims to clarify the voluntary disclosure process and ensure compliance with state tax laws, providing a structured path for taxpayers to rectify past noncompliance issues.

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