Payroll Insights

Employment tax news to guide you now and for the future

June 2025

John's fresh take: Spring payroll cleanup

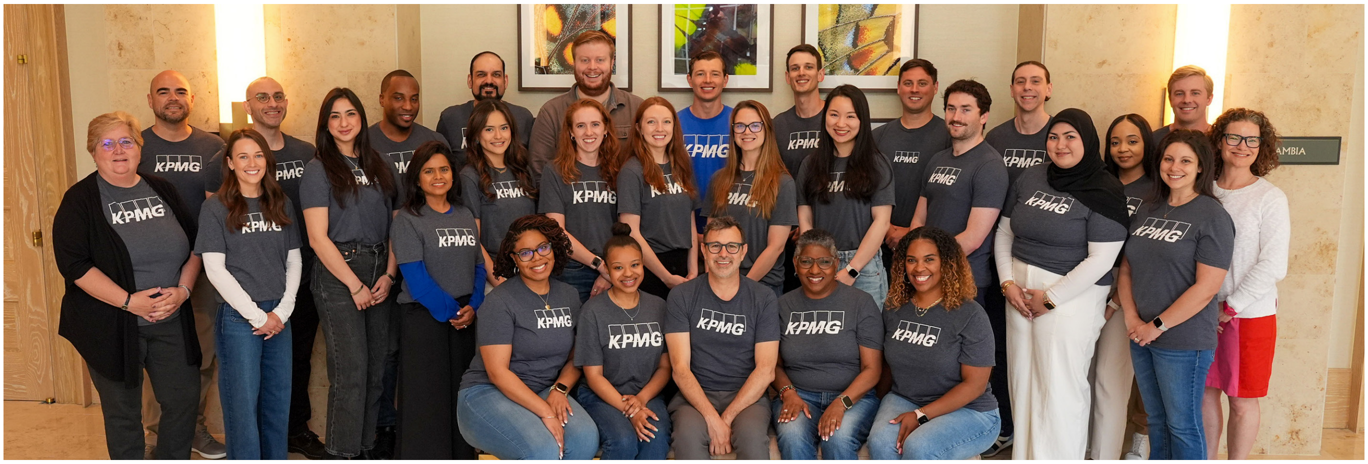
Spring is here, and PayrollOrg's Annual Congress has just concluded, giving the entire KPMG Employment Tax team the chance to catch up with colleagues and payroll professionals from across the country. Spring is also the time for Spring Cleaning! For payroll, this is the opportunity to catch a breather and perform some internal review, making sure you are ready to go into a smooth year-end. Now is the time to clear out the dust bunnies and skeletons that may be lurking in the payroll closet. Are you on top of the reporting requirements for all your remote employees? Are fringe benefits correctly reported as taxable? Are all of your earning and deduction codes correctly set up in your payroll system? Take advantage of the spring and summer months to review your payroll to determine if there are any areas that need further cleanup. We have noticed an uptick in state payroll tax audits. Preparing and ensuring your house is clean prior to an audit will help ensure minimal surprises should one occur.

Federal updates

Internal Revenue Service workforce reduction

Ever since the change in administration and creation of the Department of Government Efficiency, there has been concern over the impact it would have on the Internal Revenue Service (IRS) workforce and overall processing time. The current administration has issued several executive orders, in an attempt to reduce the federal workforce and cut costs.

The first wave of job cuts began in January 2025. To assist agency heads, the United States Office of Personnel Management issued guidance on "Probationary Periods, Administrative Leave and Details." The memorandum advises that, "generally employees in the competitive service with less than one year of service, and in the excepted service with less than two years of service, can be terminated without triggering Merit Systems Protection Board appeal rights." The probationary employees served as easy targets, and first step in the administration's mission to reduce the IRS workforce.



Another major story in January was the introduction of the Deferred Resignation Program, which allowed employees to resign voluntarily while still retaining pay and benefits through September 30, 2025. As of February 2025, the IRS had a total workforce of approximately 103,000 employees. After 7,315 probationary employees received termination notices, and 4,128 deferred employee resignations were approved, 11,443 employees were quickly removed from the roster. In the blink of an eye, the IRS's workforce was cut by 11 percent. Those departments hit hardest by the cuts were the Tax Exempt and Governments Entities Division (31 percent), the Large Business and International Division (25 percent), and the Small Business/Self-Employed Division (23 percent). An interesting point to monitor is the reduction in revenue agents (31 percent) within these agency functions. These revenue agents assist in audits, and in 2023 resulted in $32 billion in additional assessments.

Not all deferred resignation offers were approved, as about 10 percent were denied. The population of workers who were denied were deemed critical to the smooth flow of the tax filing season and were either denied the resignation entirely or delayed until May 15, 2025 (after the tax filing season). The positions that were denied resignation were found within Taxpayer Services, Information Technology, and the Taxpayer Advocate Service.

Throughout the winter and into the spring, the current administration continued to issue executive orders to assist with their large-scale Reduction in Force. Among the chaos and uncertainty, high-level IRS officials began to throw the "white flag" and hand in their letters of resignation. Below are some of the top-level executives who resigned:

- Melanie Krause, acting commissioner
- Kathleen Walters, chief privacy officer
- Teresa Hunter, chief financial officer
- Mike Wetklow, chief risk officer
- Rajiv Uppal, chief information officer.

The Treasury Inspector General for Tax Administration (TIGTA) released a report on May 2, 2025 providing a snapshot of the IRS workforce reductions as of March 2025. The report provides a timeline of the workforce reduction executive orders, along with demographics describing the affected employee populations. The report also notes (in April) the current administration extended another round of deferred resignation offers. This time 23,000 employees applied and 13,124 were approved—another group of IRS workforce quickly sent packing.

The 7,315 IRS probationary employees who were on administrative leave will be brought back to work by May 23. This decision follows court rulings that reinstated the workers, who were initially fired as part of a broader workforce reduction.

No Tax on Tips Act

On May 20, 2025, Senate Bill 129, No Tax on Tips Act, passed the Senate without amendment by unanimous consent. The bill proposes amending the Internal Revenue Code to "eliminate the application of the income tax on qualified tips through a deduction allowed to all individual taxpayers, and for other purposes." If enacted, as currently written, then a deduction of up to $25,000 in qualified tips per year should be allowed to taxpayers, subject to limitations based upon an individual's total compensation. It is anticipated that the federal income tax withholding tables and procedures will be subsequently updated to reflect this deduction.

In addition, the bill proposes extending to the beauty industry the FICA Tip Credit that is currently available to the food and beverage industry. In applying the credit, only tips received from customers or clients in connection with the following services should be considered:

"(A) the providing, delivering, or serving of food or beverages for consumption, if the tipping of employees delivering or serving food or beverages by customers is ordinary

(B) the providing of beauty services to a customer or client if the tipping of employees providing such services is customary."

"Beauty Service" is then defined to include (1) barbering and hair care, (2) nail care, (3) aesthetics, and (4) body and spa treatments.

The bill has not yet been signed into law; however, employers should continue to monitor its progression and prepare accordingly. Please follow updates to this legislation and other payroll changes that may occur through our GMS Flash Alerts. Read our latest one here.

Update to independent contractor misclassification guidance

On May 1, 2025, the US Department of Labor Wage and Hour Division released Field Assistance Bulletin No. 2025-1, which provides that the Federal Wage and Hour Division will no longer apply the "2024 Rule," which outlined the framework for determining employee or independent contractor status for federal purposes. Instead, there will be a return to the enforcement of the Fair Labor Standards Act (FLSA) in accordance with Fact Sheet #13, which was published in July 2008, and as further detailed by Opinion Letter FLSA 2019-6.

This reversal in how the Federal Wage and Hour Division reviews worker classification should make it easier for companies to classify individuals as independent contractors. However, the "2024 Rule" has not yet been repealed, and it is advised that payers/employers review each work arrangement individually in conjunction with all current information to determine the appropriate worker classification. In addition, employers should review current state worker classification laws, which may differ from the federal requirements.

Wage garnishments: Student loans

Beginning on May 5, 2025, the US Department of Education resumed collections on its defaulted federal student loan portfolio. Such collections had been put on hold since 2020. Employers should review any notices received to ensure validity and implement such garnishment requests based upon employee disposable pay. Failure to do so can result in employers becoming liable for underwithheld amounts, as well as penalties and interest.

2026 health savings account limits

IRS Revenue Procedure 2025-19 provides that for calendar year 2026, the annual limitation on health savings accounts contributions for an individual under a high-deductible health plan is $4,400, while the limitation for those with family coverage is $8,750.

State updates

California: Employee friendliness creates employer complexities

California is known to be one of the most employee-friendly states in the US, which is supported by its overtime requirements that are generally more advantageous for employees than the federal requirements prescribed by the FLSA. The differing overtime requirements within California create an added level of complexity for employers to ensure that such labor law requirements are factored into their payroll systems, while also considering any union agreements.

We continue to see employers struggle with capturing the regular rate of pay appropriately within California, and other states, which is a key component in calculating overtime correctly. Unfortunately, these struggles may go unnoticed or unaddressed until employee lawsuits are filed, which are becoming more and more frequent in the news for even some of the largest employers.

We urge employers to review their current overtime pay structure at both the federal and state level in order to ensure compliance and avoid costly lawsuits and negative publicity.

In addition, employers should be aware of the California labor law requirements with respect to the timing in which wages are required to be paid to employees. California Senate Bill 310, which had a committee hearing date of May 23, 2025, would amend California Labor Code Section 210 to result in employees being able to file individual civil lawsuits against their employers if wages are not paid timely (including termination pay). Historically, complaints would be filed by employees to the California Labor Commissioner, rather than through civil lawsuits.

If California Labor Code Section 210 is to be amended, then employers could face additional settlement requirements through civil lawsuits if wages are not paid timely.

Maryland: Paid family leave program delayed, again

On May 6, 2025 Maryland H.B. 102 was signed by Maryland Governor Wes Moore to yet again delay the onset of contributing to the Maryland Paid-Family Leave fund. Originally, contributions were set to begin July 1, 2025. This also further delays the family-leave benefits becoming available to Maryland employees, given that the benefits should become available in the year subsequent to when the contributions begin.

New York: Metropolitan commuter transportation mobility tax increase for large businesses

On May 8, 2025, Bill #A03009 was passed 103-46 within the State Assembly and 35-27 in the Senate. The bill is part of a larger $254 billion 2026 fiscal budget plan.

Bill A03009 is intended to address New York cost-of-living issues by reducing income tax rates for five of the nine tax brackets over a two-year period.

Another major aspect of the bill is the effect on businesses that are currently subject to the metropolitan commuter transportation mobility tax (MCTMT). Beginning in the third quarter of 2025, the MCTMT rates for Zone 1 should be as follows:

0.055%

of the payroll expense for employers with payroll expense greater than $312,500 and no greater than $375,000 in any calendar quarter.

0.115%

of the payroll expense for employers with payroll expense greater than $375,000 and no greater than $437,500 in any calendar quarter.

0.60%

of the payroll expense for employers with payroll expense greater than $437,500 and no greater than $2,500,000 in any calendar quarter.

0.895%

of the payroll expense for employers with payroll expense greater than $2,500,000 in any calendar quarter.

Beginning in the third quarter of 2025, the MCTMT rates for Zone 2 should be as follows:

0.055%

of the payroll expense for employers with payroll expense greater than $312,500 and no greater than $375,000 in any calendar quarter.

0.115%

of the payroll expense for employers with payroll expense greater than $375,000 and no greater than $437,500 in any calendar quarter.

0.34%

of the payroll expense for employers with payroll expense greater than $437,500 and no greater than $2,500,000 in any calendar quarter.

0.635%

of the payroll expense for employers with payroll expense greater than $2,500,000 in any calendar quarter.

This would be a significant change in the current MCTMT structure, resulting in larger costs for employers with higher payrolls within MCTMT districts.

The payroll tax rate increases are in response to the MCTMT and the Metropolitan Transportation Authority's (MTA) five-year capital plan, which hit a shortfall of $35.4 billion, to help fund improvements to subways and commuter rail lines. The bill increases taxes on certain employers in areas served by the regional transit system, while calling on the MTA to be more proactive in combating fare evasion. New York State and New York City both agreed to contribute $3 billion each to improve the subway and commuter rail line system.

New York: Unemployment relief for employers

New York Governor Kathy Hochul has signed a new legislation as part of the FY 2026 Enacted Budget that will pay off the debt due to the federal government (Federal Unemployment Insurance Trust Fund) that occurred as a result of the COVID-19 pandemic. Under the Federal Unemployment Tax Act (FUTA), states with an outstanding Federal Unemployment Account loan for a minimum of two years are subject to a credit reduction on their federal unemployment tax rate. This reduction continues until the loan is fully repaid.

Since 2023, New York has been operating with a credit reduction; however, the credit reduction should be lifted with New York repaying the loan. This should result in the return of New York employers receiving a full credit on New York state unemployment insurance wages and paying a maximum FUTA contribution of $42 per employee instead of the current $105.

North Carolina: Relief to those impacted by Hurricane Helene

On April 23, 2025, the North Carolina Department of Revenue released a notice announcing that the Department of Revenue will remove Late Action Penalties assessed against affected taxpayers for licenses, returns, or payments due on September 25, 2024, through September 25, 2025, if the license is obtained, the return is filed, or the tax is paid by September 2025 ("State Penalty Relief").

We recommend that businesses impacted by Hurricane Helene review current North Carolina Department of Revenue guidance to determine what relief is available based upon their circumstances. In addition, please keep in mind that businesses whose return filing and tax remittance obligations are not satisfied by September 25, 2025, may be subject to penalties and interest.

Arkansas: College athletes exempt from income tax

On April 17, 2025, Governor Sarah Huckabee Sanders signed bill H.B. 1917, making Arkansas the first state to exempt college athlete earnings from income tax collection. The bill will take into effect with the 2025 tax year.

Guided by the settlement agreement in *House vs. NCAA*, the bill will exempt income earned by college athletes through their name, image, and likeness deals, which are paid through a university collective or income earned through revenue-sharing income agreements. The bill states that athletes will not be considered employees of the university.

The new legislation is an attempt to attract more top recruits to the state, and to make themselves more competitive versus states with no income tax, such as with powerhouse NCAA Southeastern Conference rival universities in Florida, Tennessee, and Texas.

Beginning with the 2025–2026 school year, each college/university should be allowed to distribute a maximum of $20.5 million in revenue throughout their entire student-athlete population, across all sports.

Iowa: Overtime/Tips exemption proposals

On April 17, 2025, Iowa introduced two bills (H.F. 1024 and H.F. 1030) in an attempt to help reduce some of the state's income tax burden on taxpayers. The bills focus on hourly workers eligible for overtime and workers who collect tips.

Iowa H.F. 1024 would exempt overtime pay earned at a rate of at least 1.5 times the normal rate from state individual income taxation. Meanwhile, Iowa H.F. 1030 would exempt the first $25,000 in cash tips received by taxpayers with a net income of less than $155,000 from individual income taxation. If approved, the bills would take effect on January 1, 2026.

Montana: Income tax reform underway

On April 28, 2025, Montana Governor Greg Gianforte signed legislation cutting the top marginal tax rate over the next two years. The tax rate will decrease from the current rate of 5.9 percent to 5.65 percent in 2026 and 5.4 percent in 2027 and thereafter.

H.B. 337 also increased the income and net long-term capital gains thresholds, allowing more income to be taxed at a lower rate for individuals, heads of households, and joint filers. Below are lists of the threshold increases.

Income threshold increases

Individual filers:

$20,500 to $47,500

Heads of households:

$30,750 to $71,250

Joint filers:

$41,000 to $95,000

Net long-term capital gains threshold increases (each taxed at a rate of 3 percent)

Individual filers:

First $20,500 to first $65,000

Heads of households:

First $30,750 to first $97,500

Joint filers:

First $41,000 to first $130,000

It is interesting to note that H.B. 337 allows for inflation indexing. The bill triggers automatic annual adjustments to each tax bracket based on the cost of living. Montana implemented this strategy to prevent taxpayers from being pushed into a higher tax bracket even though they are not actually making more income. The new tax rates and thresholds will take effect on January 1, 2026.

Oregon: Employer assistance for labor law

On April 29, 2025, Oregon H.B. 2248 was passed by the Senate and established the Employer Assistance Division within the Bureaue of Labor and Industries. The mandate of the division is to "provide education, training and interpretive guidance, including advisory opinions, to employers to assist employers in complying with laws that are enforced by the bureau."

With it being a challenge for many employers to communicate effectively with state tax authorities, it is a relief to see a state expanding channels of communication for employers to utilize to comply with labor law requirements (e.g., unemployment insurance, overtime requirements, etc.).

South Carolina: 3-tax, 2-tax, 1-tax, No-tax

South Carolina is currently in the middle of passing significant state income tax reform, potentially eliminating income tax altogether in the future.

In March 2025, H. 4216 General Bill was initially introduced to eliminate the three individual income tax bracket system currently used, and replace it with a flat income tax rate of 3.99 percent.

On May 6, 2025, after multiple deliberations, the bill was amended to establish a two individual income tax bracket system, with the potential of eliminating the state income tax entirely down the road. The new proposal offers a 1.99 percent rate on the first $30,000 of taxable income and 5.39 percent on taxable income over $30,000 (minus a fixed offset of $1,020).

Starting in 2027, the bill would allow for annual cuts to the5.39 percent top tax rate, if the individual income tax revenues (excluding amounts credited to the Trust Fund for Tax Relief) are projected to grow by at least 5 percent relative to the current year. If the 5 percent revenue growth threshold is satisfied, then the Bill would trigger the 5.39 percent income tax rate to be permanently and cumulatively reduced by a percentage equal to an amount that reduces income tax revenue by $200 million or 25 percent of the recurring surplus in income tax revenue for the fiscal year, whichever is larger.

These reductions would continue until the 5.39 percent top tax rate reaches 1.99 percent. At this point, the state would convert to a flat income tax of 1.99 percent. However, the rate could continue to be reduced annually, eventually eliminating the state income tax permanently. The bill heads for a third reading in the House.

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