



State of North Carolina

Department of State Treasurer

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Memorandum # 1083

TO: Local Government Staff, Officials and Board Members

FROM: Sharon Edmundson, Director, Fiscal Management

DATE: August 15, 2007

SUBJECT: Payroll Liabilities and Responsibilities

Over the last several months our staff has worked with several units of local government to resolve issues with payroll, specifically with the levy of penalties and accrual of interest by the Internal Revenue Service (IRS) and the North Carolina Department of Revenue (NCDOR) on late filing, late payment, and lack of filing and/or payment of required records and taxes. As a result, we have prepared this memorandum to reinforce what should be a matter of routine for all units of government with paid employees. We also will revisit the "employee or independent contractor" issue as we continue to get phone calls, questions, and comments about this topic.

First and foremost, any unit of government with paid employees must file certain reports with the IRS, the NCDOR, and the North Carolina Employment Security Commission (NCESC). No one is exempt from these filings; some units may have to file more frequently than others depending on the size of your payroll per pay period but everyone has to file, and everyone has to remit certain payments on a regular basis. The payments typically include the employer and employee share of FICA tax (social security and medicare), any federal and/or state income tax withheld from employee paychecks, and unemployment taxes to both the Federal and State government. The reports that must be filed include the IRS Forms 940 941, the NC-3 (either 3, 3M or 3A), NCUI 101, W-2, W-3, and the corresponding copies of the North Carolina wage statements, NC-5, and possibly others.

The penalties for filing late, failure to file, paying late, and failure to pay can be significant. Further, interest is charged on any payment not made on time, including penalty payments. The rate of interest charged is set by the IRS and is usually much higher than the rate of return local governments can earn on their funds. By failing to pay or by filing late, a unit of government is essentially participating in an unauthorized borrowing of funds, because it is "borrowing" money from the IRS and/or the NCDOR by not submitting the funds on time. While the IRS does permit payment of penalties and interest by installments, interest is assessed on the unpaid balance and again, this continues to be an unauthorized debt of the unit of government. The IRS also can place a lien on the assets of the unit to cover any unpaid balances, regardless of any payment plan in place. This lien may automatically disqualify a unit from receiving various federal grants or loans until the lien is satisfied. Finally, the IRS can seize assets of the unit, including bank accounts.

Board members and finance officers or treasurers that knowingly allow their unit to violate the law by not making timely tax payments and filings can be held liable for their lack of action in the matter.

As we stated earlier, the penalties and interest assessed can quickly become significant. The IRS is not likely to forgive any penalty assessed and as a matter of policy does not forgive any interest assessed. Several units over the last year have been assessed and paid penalties and interest in excess of \$50,000, and in some cases the amounts are much higher. These payments must be run through the unit's budget as separate items. Penalties and interest cannot be charged against salaries; they should be charged against the general government function. The budget must be amended to permit valid pre-audits of payment of penalties and interest. Amendments which must be approved by the Board will be required. We do not consider it sound public policy to expend taxpayer funds on penalties and interest payments to tax agencies. Units that habitually fail to complete payroll deposits and filings in a timely manner are not fulfilling their fiduciary responsibilities to their citizens.

In a related matter, the IRS is still targeting units of government and other non income taxed entities for payroll audits. We hear on a regular basis about various units that have been audited with less than desirable outcomes. As a reminder, please review your employees and independent contractors and evaluate their status. Volunteer fire personnel that are paid by the unit of government must receive a W-2 for their payments unless they are being reimbursed expenses under an accountable plan. Unit managers are considered employees by the IRS. In several instances, unit attorneys have been ruled to be employees. Please review our Memorandum #1079, IRS Publication 963 - the Federal, State, and Local Government Public Employer Tax Guide, and discuss this with your auditor and your NCLM or NCACC representative.

A common issue in all the units we have worked with recently on this problem is that all lacked sufficient internal controls over their payroll functions. Proper separation of duties and good internal control systems would have allowed payroll issues to come to light much sooner than they did in every case. The sooner the issue is addressed, the smaller the penalties and interest, if any, are going to be. Units must have adequate controls in place that do not permit one employee to be responsible for the entire payroll function. If this is not possible due to limited staff, one solution may be to contract out your payroll function. There are several reputable services available that offer payroll servicing at a variety of levels and price points. There are several advantages to using a payroll service. One, a service focuses strictly on payroll; it is their area of expertise. This frees the unit's staff to focus on other things. Two, using a service provides a great deal of the separation of duties that must be maintained over the payroll function. The unit's involvement in payroll becomes limited. Third, a payroll service assumed the responsibility of making the deposits and filings on time. As long as the unit provides the information to the service on a timely basis, which it will have to do in order for paychecks to be processed on a timely basis, the

liability payments and tax returns are handled by the service. The service also will provide the unit comprehensive files to document that all payments and filings are complete.

Please go over your payroll function carefully and completely. Verify that reports have been filed timely and that payments have been made by the due dates. Check that the drafts or checks for those payments cleared the unit's bank account in a reasonable amount of time. Verify that the proper year-end documents were prepared, distributed and remitted to the Social Security Administration and other recipients. Documents mailed to the IRS, NCEC and NCDOR that are time sensitive, as most of them are, should be mailed certified mail, return receipt requested so that the unit has proof of mailing. Documents filed online should generate some record that they were filed timely. Those records should be maintained as long as the payroll records are maintained. Make sure that adequate internal controls exist over the function such that one person is not responsible for it from the beginning to the end of the process.

In summary, payroll is a significant expenditure for all units of government. Failure to handle it properly can cost your unit not only in large dollar amounts but in time and damaged public relations with your citizens. If you have any questions about this memorandum please contact Dean Cunningham at (919) 807-2390 or dean.cunningham@nctreasurer.com.