THE LOGISTICS OF PAYROLL TAX RECOVERY

By: Amy Borbely, CPA, *SDC CPAs, LLC*

Employee theft or employee dishonesty claims often include not just the amount of money received by the employee ("Net Pay"), but also deductions from the employee's gross pay, as well as payroll taxes paid by the employer. Assuming a covered loss is determined, can employers recoup from the IRS payroll taxes for employee dishonesty/employee theft claims involving unauthorized or excessive payroll? And if so, how?

1. The Basics

In most instances, employee theft or employee dishonesty claims involving misappropriated payroll amounts are submitted with the gross pay amount claimed including payroll taxes paid by the employer. However, the net pay amount of allegedly misappropriated paychecks represents the direct loss amount. Payroll taxes and other deductions represent indirect loss amounts, which are often recoverable by the insured from the IRS and state and local taxing entities. As such, settlements with the insured for these claims typically exclude indirect loss amounts and thus exclude payroll taxes and other deductions.

So what amounts and types of payroll taxes and deductions are included in gross pay? It varies. The following is a general illustration of typical tax deductions made to the gross payroll amount to arrive at an employee's net pay:

Gross Pay	$2,500.00
Less: Employee's Deduction	
Federal Withholding Taxes (Assume 15.00%)	375.00
FICA (Social Security Tax 6.20%)	155.00
Medicare Tax (1.45%)	36.25
State Tax (Assume 3.00%)	75.00
Total Deductions for Employee	641.25
Net Paycheck to Employee	$1,858.75
Employer's FICA & Medicare Portion	$191.25

In this illustration, the amount claimed by the insured against the insurer will be $2,691.25 ($2,500.00 + $191.25) which is the net pay received by the employee plus:

(a) the deductions from the employee's gross pay transmitted by the employer to a third-party;

(b) the matching OASDI (Social Security) and Medicare taxes paid by the employer; and

(c) perhaps also Federal and state unemployment taxes (FUTA for Federal and SUTA for state) paid by the employer.

It should be noted that there may be other deductions from an employee's gross pay not addressed here, such as union dues, medical insurance, and other payments made by the employer. Assuming employee dishonesty coverage exists, the settlement amount for this illustrated claim would exclude the recoverable taxes (indirect loss) and would be equal to the net pay amount of $1,858.75. Given the inability to recover these indirect losses from the insurer, how can excluded payroll taxes be recovered by the insured from taxing authorities?

2. Who Qualifies for Recovery of Payroll Taxes?

Employers are responsible for paying the payroll taxes to the IRS when it is legitimately earned payroll. If the payments are not for legitimate payroll, the employer can have the payroll taxes returned. These payments are initially made to the IRS with a Form 941. Form 941 is filed quarterly with the IRS and shows the employer's tax liability for each month of the quarter for all employees. Form 941 reports withholding taxes, Social Security (employee and employer), and Medicare (employee and employer) taxes. Form 940 is used to report FUTA (Federal Unemployment Taxes) and is filed annually. State income tax withholding and unemployment filings and payments vary by state.

The business itself (the insured) can file corrections. An insurance company that is subrogated or assigned to the insured's rights cannot file corrections for a refund of overpaid payroll taxes unless they have a Power of Attorney. Taxing entities will issue refund payments or credits to be applied to future tax liabilities only to the taxpayer (insured). If the insurer pays the gross amount of the claim (including indirect losses), the carrier would have to obtain reimbursement from the insured for any such refund payments or credits issued by the taxing entities.

3. How to Apply for a Refund of Overpaid Payroll Taxes

If an employee's gross pay was never actually earned, the payroll taxes withheld and paid related to the unearned gross pay are considered "overpaid" payroll tax. If payroll taxes are overpaid, an employer may obtain a refund or credit for such taxes paid within the previous three years (36 months).

- **Overpaid Federal Unemployment Taxes**
    - One must use the Form 940 for the year being revised to amend an incorrect Form 940.

- **Overpaid Federal Income Taxes, Social Security Taxes and Medicare Taxes**
    - Form 941-X is used to correct a prior quarterly report.
    - File a separate Form 941-X for each Form 941 that is being corrected to request refunds or credits.
    - Form 941-X should be filed separately, and not with Form 941.
    - Beginning in 2015, employee consents are required to support a claim for a refund. Corrected W-3s (W-3Cs) and corrected W-2s (W-2Cs) should be filed with the Social Security Administration for each year affected by the Form 941-X filed with the IRS. W-2Cs require the payee's name, address and Social Security number. (Individuals who may have filed erroneous tax returns will be responsible for their own income tax withholding liability.)
    - A Form 1099 should be issued to individuals who received monies (excess payroll) from the Insured as the individuals owe income taxes.

- **Overpaid State Taxes**
    - State forms will be different, but generally follow the IRS model for income, unemployment, etc.

4. Limitations

Typically, there is a three-year statute of limitations. As the tax is paid quarterly, the time period for claiming a refund is three years from the original date a quarterly return is filed (or from the date the original quarterly return was due if it was not filed on-time.) This means every three months the insured does not file the necessary amended returns, the amount of payroll taxes that could be recovered is reduced. As the claim on the insurance policy proceeds since the date of discovery, the quarterly tax periods pass and may exceed the time limit to be amended and recovered. In some cases, though, the IRS has allowed amendments up to five years.

5. Other Avenues of Recovery

The above procedures are applicable to refunds or credits requested through the IRS. It is possible other payroll expenses not addressed here, such as medical payments and union dues paid by the employer, can be recovered directly from the applicable entity.

6. Resources

- For help in completing Form 941-X, call the IRS Toll Free number at 1-900-829-4933.
- Additional help for completing Form 941-X may also be obtained from IRS Publication 15 (Circular E), Employer's Tax Guide and the Instructions for Form 941-X. Both documents can be downloaded from the IRS website: http://www.irs.gov/.
- Other information and resources are also available at http://www.irs.gov.

When considering employee theft or employee dishonesty claims involving covered losses for misappropriated payroll amounts, it is important to remember the claimed amount often includes payroll taxes and other deductions, which are indirect losses recoverable by the insured. Requirements and limitations to recovering overpaid payroll taxes will vary with the different taxing agencies of the federal, state and local governments. Timely filings are critical for maximum payroll tax recovery by the insured when the covered loss spans multiple years.

Amy Borbely is a Certified Public Accountant and Independent Adjuster at SDC CPAs, LLC in Aurora, Illinois.