

Payroll records are usually available because of the accounting and tax record-keeping requirements employers must meet anyway. These requirements encourage accurate record keeping for payroll paid. The employee's interest in receiving the full amount earned and the employer's competing interest in controlling costs provide the most effective check on payroll record accuracy. Therefore, payroll provides a reliable premium base that is relatively easy for a premium auditor to determine from existing records. (Businesses often also record hours worked, but not always with the same degree of accuracy as payroll.)

Because businesses must maintain payroll records for tax and accounting purposes, these records are difficult for insureds to manipulate, which some may want to do in an effort to reduce their insurance premiums. Premium auditors can verify payrolls by reconciling them with federal and state tax returns, financial statements, and other accounting records. An insured may manipulate the payroll by paying an employee as an independent contractor or by some similar means to avoid showing the payments on the regular payroll, but as long as the employer has made some payment, an alert premium auditor should be able to locate it.

Payroll also provides a premium base responsive to changing economic conditions. The same factors that cause loss settlements to rise also cause payrolls to increase, thereby generating more premium to pay the losses. That natural adjustment process reduces the need for more frequent workers' compensation rate increases.

### **PREMIUM BASIS FOR WORKERS' COMPENSATION**

For the reasons already mentioned, insurers almost always base workers' compensation premiums on payroll. When an insurer writes the policy, the policy defines the premium as a certain rate per \$100 of payroll for the policy period. Following the conclusion of the policy period, the premium auditor determines the actual payroll to compute the final earned premium. The *Basic Manual* provides rules regarding the forms of payroll that insurers should include in determining the total. The following discussion explains those rules and describes the exceptional situations in which payroll is not the premium base.

#### **Payroll**

The *Basic Manual* stipulates, "Premium is calculated on the basis of the total payroll paid or payable by the insured for services of individuals who could receive workers compensation benefits for work-related injuries as provided by the policy."<sup>3</sup> Employees covered by the policy are those whom the applicable workers' compensation statute may reasonably consider employees. Consequently, premium auditors must determine whether an



employer-employee relationship exists between the employer and the individuals who provide services to the employer. Payroll for services of employees covered by the policy also implies that the services occurred within the policy period, so premium auditors must establish the policy period cut-off dates for the audit. Total payroll paid by the insured is a slightly broader concept than most insureds realize. The *Basic Manual* rules, however, explain the concept and offer guidance to interpret various rules and definitions. According to the *Basic Manual*, **payroll** means money or substitutes for money. Inclusions and exclusions to payroll follow.

**Payroll**  
Money or substitutes for money.

## Inclusions

In addition to ordinary wages or salaries, payroll includes several other types of compensation.<sup>4</sup> Premium auditors may have to convince the insured that the workers' compensation premium base includes such items. Those inclusions generally create greater equity in the rating system. Employers may otherwise offer these alternate compensation forms along with lower wages, and therefore lower premiums. Rule 2.B.1. lists those additional items that the manual includes in the premium base. (Many states have exceptions to one or more of these items.) Premium auditors should know the specific rules for the following items in each state in which they conduct premium audits.

### Payroll Inclusions

- Wages or salaries
- Commissions
- Bonuses
- Extra pay for overtime work except as provided in Rule V.E.
- Pay for holidays, vacations, or periods of sickness
- Employer payments of amounts otherwise required by law to be paid by employees to statutory insurance or pension plans
- Payment to employees on any basis other than time worked
- Payment or allowance for hand tools
- Value of apartment or housing
- Value of lodging, other than apartment or house
- Value of meals
- Substitutes for money
- Payments for salary reduction, retirement, and cafeteria (IRC 125) plans
- Davis-Bacon wages paid to employees or placed by an employer into third-party pension trusts
- Annuity plans
- Expense reimbursement to extent that records do not substantiate the expense as having been incurred as a valid business expense
- Payment for filming of commercials



In general, however, the following items shown in the preceding box are included in payroll for premium base purposes:

- *Wages or salaries.* To eliminate confusion, the definition of payroll begins by including wages or salaries, including retroactive wages or salaries.
- *Commissions.* Many employers pay employees on a commission or commission-plus-salary basis. Those employees include salespeople, chauffeurs, and drivers for laundries, bakeries, bottling companies, oil and gas distributors, and milk dealers. They may drive their own automobiles or their employers' autos.

In a situation involving salary plus commission, the premium auditor must determine both the salary and the commission paid during the policy period. When a business hires an employee on a straight commission basis, the premium auditor must determine the full amount of commission paid. One way is to examine the insured's tax file, including IRS forms such as W-2 and 1099. Form 1099 is the form employers use to report compensation of persons whom the law does not consider employees for income tax withholding, FICA (Social Security), or FUTA (unemployment) purposes (although insurance coverages and laws may consider them employees).

Businesses often hire salespeople under a contract providing a drawing account against commission. If the commission is less than the drawing account or if the employee earns no commission, the insurer should include the drawing account in the premium base.

#### **Bonus**

Payroll given to an employee in addition to what is usual or strictly due from an employer.

- *Bonuses.* A **bonus** is payroll given to an employee in addition to what is usual or strictly due from an employer. Many employers give year-end bonuses. Unless the bonus is awarded as a special reward for individual invention or discovery, the premium auditor should include the bonus amount as part of the total payroll. Bonuses also include stock bonus plans and the value thereof.
- *Extra pay for overtime work.* Extra pay for overtime work is included in payroll unless it falls under an exception in Rule 2.B.2., which specifies the conditions under which insurers can exclude extra pay for overtime work from the premium base. If the increased pay does not result from overtime work as defined in the *Basic Manual* or if the insured does not meet the *Basic Manual's* record-keeping requirements, the premium auditor must include the extra pay in the premium base. In Utah, Delaware, and Pennsylvania, insurers must always include the extra pay for overtime work in the premium base.
- *Pay for holidays, vacations, or periods of sickness.* The *Basic Manual's* premium basis rule includes pay for unworked holidays, vacations, or sick time as payroll for premium determination. Some union contracts provide pay for days not worked because of jury duty, funerals, weddings, or birthdays. Under such circumstances, the insurer must also include this pay as payroll. This pay is only the regular pay for this time. Although insureds sometimes include holiday, vacation, and sick pay in an overtime record,

