

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's

Payroll Tax Deskbook



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Interactive Self-study CPE

Companion to PPC’s Payroll Tax Deskbook

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INTRODUCTION

Companion to PPC's Payroll Tax Deskbook consists of two interactive self-study CPE courses. These courses are companion courses to *PPC's Payroll Tax Deskbook* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **December 31, 2010**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

Taking the Courses

Each course is divided into lessons. Each lesson addresses an aspect of payroll tax. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

Qualifying Credit Hours—QAS or Registry

PPC is registered with the National Association of State Boards of Accountancy as a sponsor of continuing professional education on the National Registry of CPE Sponsors (Registry) and as a Quality Assurance Service (QAS) sponsor. Part of the requirements for both Registry and QAS membership include conforming to the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the standards). The standards were developed jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the standards. Each course is designed to comply with the standards. For states adopting the standards, recognizing QAS hours or Registry hours, credit hours are measured in 50-minute contact hours. Some states, however, require 100-minute contact hours for self study. Your state licensing board has final authority on accepting Registry hours, QAS hours, or hours under the standards. Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program or have adopted the standards and allow QAS CPE credit hours. Alternatively, you may visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours or have adopted the standards. Credit hours for CPE courses vary in length. Credit hours for each course are listed on the "Overview" page before each course.

CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

Obtaining CPE Credit

Online Grading. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the Test Instructions preceding the Examination for CPE Credit Answer Sheet. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

Print Grading. You can receive CPE credit by mailing or faxing your completed Examination for CPE Credit Answer Sheet to the Tax & Accounting business of Thomson Reuters for grading. Answer sheets are located at the end of all course materials. Answer sheets may be printed from electronic products. The answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for each course. Payment of \$79 (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. Please take a few minutes to complete the Course Evaluation so that we can provide you with the best possible CPE.

You may fax your completed **Examination for CPE Credit Answer Sheet** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

If more than one person wants to complete this self-study course, each person should complete a separate **Examination for CPE Credit Answer Sheet**. Payment of \$79 must accompany each answer sheet submitted. We would also appreciate a separate **Course Evaluation** from each person who completes an examination.

Express Grading. An express grading service is available for an **additional \$24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your Examination for CPE Credit Answer Sheet. Expedited grading requests will be accepted by fax only if accompanied with credit card information. Please fax express grading to the Tax & Accounting business of Thomson Reuters at (817) 252-4021.

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For all scores of 70% or higher, you will receive a *Certificate of Completion*. You should retain it and a copy of these materials for at least five years.

PPC In-House Training

A number of in-house training classes are available that provide up to eight hours of CPE credit. Please call our Sales Department at (800) 323-8724 for more information.

COMPANION TO PPC’S PAYROLL TAX DESKBOOK

COURSE 1

EMPLOYER LIABILITY, EMPLOYEE SHARING AND LEASING, AND EXEMPT EMPLOYMENT (PRLTG091)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an introduction to several payroll tax issues surrounding employer liability, sharing employees between business affiliates, leasing employees, and several special classes of exempt employment.

PUBLICATION/REVISION DATE: December 2009

RECOMMENDED FOR: Users of *PPC’s Payroll Tax Deskbook*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of payroll taxes.

CPE CREDIT: 8 QAS Hours, 8 Registry Hours
8 CTEC Federal Hours. 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.

Enrolled Agents: This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **December 31, 2010**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Basic Principles of Employer Liability

Completion of this lesson will enable you to:

- Identify the employer’s role in determining legal requirements regarding hiring employees.
- Identify considerations involved in determining the existence of an employer/employee relationship and determine when employer liability for payroll taxes and withholding begins and ends;
- Determine who has responsibility for employment tax in third-person payer situations;
- Distinguish between reporting agents, payroll agents, and service bureaus, determine responsibility for withholding and paying payroll taxes, and recommend the appropriate choice for a client; and
- Examine lender liability exposure for Trust Fund taxes under IRC Sections 3505 and 6672.

Lesson 2—Employee-sharing between Business Affiliates

Completion of this lesson will enable you to:

- Identify payroll tax considerations concerning mergers and acquisitions;
- Determine employer business affiliation and liability for shared employees, identify ways to avoid payroll tax duplication related to shared employees, and assess employer eligibility for using a common paymaster system;

- Identify rules and considerations related to common paymaster situations;
- Generalize rules and mechanics related to operating a common paymaster system, and calculate employer liability for employee compensation and payroll taxes; and
- Identify consequences of inappropriately pricing shared employee services between business affiliates.

Lesson 3—Employee Leasing

- Describe general aspects of employee leasing, and identify portions of the Internal Revenue Code dealing with, and other Code considerations related to, employee leasing and qualified retirement plans;
- Apply the employer/employee relationship rule and the control-of-wage-payments rule to employee leasing situations in order to determine employer payroll tax responsibility, and describe ways to avoid undesirable employer tax consequences;
- Determine who is a leased employee and discuss rules concerning leased employees in reference to retirement, welfare, and fringe benefits;
- Assess potential consequences concerning payroll taxes and qualified plans of improperly identifying and classifying leased workers; and
- Relate considerations and best practices related to selecting and using an employee leasing firm.

Lesson 4—Special Classes of Exempt Employment

- Determine various classes of employment that are exempt under different federal payroll tax statutes and apply the one-half rule to mixed employment;
- Identify payroll tax issues related to employment of family in a family-owned business and determine how the form of organization affects payroll tax liability;
- Apply covered employment rules related to casual labor and differentiate between payroll tax rules related to employing family members as regular employees and those related to employing family members as casual labor;
- Identify FICA coverage and exemptions for government employees; and
- Apply employment tax rules related to the clergy and recognize issues related to employing students at educational institutions.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters
Tax & Accounting—R&G
PRLTG091 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700**

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 323-8724 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Basic Principles of Employer Liability

INTRODUCTION

This lesson covers the basic rules and principles used to determine employer status under federal payroll tax statutes, as well as how these rules are applied. Also addressed are other topics such as when employer liability begins and ends, third-party payor responsibilities, and employer rules for payroll agents.

The terms employer and employer liability have different meanings. Much of this lesson is aimed at identifying who is an employer; however, this is but a preliminary (albeit necessary) first step in determining whether a person has employer liability. Generally, employers must withhold and pay payroll tax (and perform related compliance tasks) only if they hire employees who engage in covered employment activities for covered (i.e., taxable) compensation.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the employer's role in determining legal requirements regarding hiring employees.
- Identify considerations involved in determining the existence of an employer/employee relationship and determine when employer liability for payroll taxes and withholding begins and ends;
- Determine who has responsibility for employment tax in third-person payer situations;
- Distinguish between reporting agents, payroll agents, and service bureaus, determine responsibility for withholding and paying payroll taxes, and recommend the appropriate choice for a client; and
- Examine lender liability exposure for Trust Fund taxes under IRC Sections 3505 and 6672.

Duties and Responsibilities of Employer

The starting point in any situation where payments are made for services rendered (to a worker or group of workers) is to determine whether the payer is an employer. And even if the payer is determined to be an employer, the payer may not be liable for payroll taxes. Accordingly, the next step is to determine if the employer is actually liable to withhold or pay payroll tax. If so, the payroll tax laws charge this person with specific duties and responsibilities.

An employer who fails to properly discharge its payroll tax duties and responsibilities can be held liable for the amount of tax owed plus interest and penalties. The employer may also face penalties for failure to file payroll returns and related wage and information returns. Additionally, under changes made by the Small Business and Work Opportunity Act of 2007, a preparer of any employment tax return may face penalties for any part of a tax liability understatement that is due to an unreasonable position.

Verifying Eligible Employee Status

Although not tax-related, employers must also be aware of the requirements imposed by the Immigration Reform and Control Act of 1986 (IRCA). This law prohibits employers from knowingly hiring (or having in their employ) illegal aliens, and applies to the government, household and farm employers, and other business employers. On March 1, 2003, immigration services formerly provided by the Immigration and Naturalization Service (INS) were transitioned into the Department of Homeland Security (DHS) under the U.S. Citizenship and Immigration Services (USCIS). Additional information on USCIS is available at www.uscis.gov.

Under IRCA, no employer can lawfully hire *anyone* (U.S. citizens or aliens) without checking the person's identity and authorization for employment. Verification that an employee's identity and eligibility were checked is made by completing Form I-9 (Employment Eligibility Verification). All employees must complete Section 1, "Employee Information and Verification," of the I-9 at the time of hire, which is the date the employee actually begins working. Employers may have employees complete the form earlier, as long as the form is completed at the same point in the employment process for all employees. However, Form I-9 should not be completed before a job offer has been accepted. The employer is responsible for ensuring that Section 1 of the I-9 is timely and properly completed.

An employee's identity and eligibility must be reviewed and verified by the employer, or state employment agency if the applicant was referred by such agency. Within three business days of when employment begins, employers

must inspect certain documents proving the employee's identity and authorization to work in the United States. Verification that an employee's identity and eligibility were checked is made by completing Section 2, "Employer Review and Verification," of the I-9. Three lists of documents that meet the IRCA identity and employment authorization requirements are listed on the back of Form I-9, which can be found along with its related instructions at Form F119. Employers cannot specify which document(s) listed on the back of Form I-9 employees present to establish identity and employment authorization. Employees may present any List A document or a combination of a List B and a List C document. Documents not listed are not acceptable. However, according to the USCIS's Handbook for Employers (Form M-274), employers that participate in E-Verify may only accept List B documents that have a photograph. Employees must present original documents. The only exception is a certified copy of an employee's birth certificate. Additionally, all documents must not be expired to be acceptable. A document containing no expiration date, such as the social security card, is considered not expired.

Individuals may present a receipt showing that they have applied for a required document if the individual is unable to provide the required document(s) within three days of the date employment begins. The three types of acceptable receipts are:

1. *Application for a Replacement Document.* A receipt for the application of a List A, B, or C replacement document when the document was lost, stolen, or destroyed is a valid document. The employee must present the replacement document within 90 days from the date of hire or, in the case of reverification, the date employment authorization expires. An application for initial work authorization or an extension of expiring work authorization is not acceptable.
2. *USCIS Form I-94 (Arrival-departure Record) Indicating Temporary Evidence of Permanent Resident Status.* The arrival portion of a Form I-94 (or I-94A) with an attached photo and a temporary I-551 stamp is a valid List A document. When the stamp expires, or if the stamp has no expiration, one year from the date of issue, the employee must present the Form I-551 Permanent Resident Card.
3. *USCIS Form I-94 Indicating Refugee Status.* The departure portion of the Form I-94 (or I-94A) with an unexpired refugee admission stamp is a valid List A document. The employee must present, within 90 days from the date of hire, in the case of reverification, the date employment authorization expires, an unexpired, Form I-766 or a List B document and an unrestricted SS card.

Although not required by law, employers should consider making copies of the documents presented and retain such copies with the Form I-9 (for future reference if it is necessary to demonstrate compliance with the law). However, copies should not be maintained in the employee's personnel file (use a separate file instead) to avoid giving the USCIS access to information it is not legally entitled to see. The employer should retain any completed Form I-9 (and any copies of relevant documents) for the later of three years after the hire date or one year after the individual's employment is terminated.

In June 2006, the Department of Homeland Security (DHS) issued interim rules allowing employers to utilize electronic signatures and store Forms I-9 electronically. These interim rules closely follow the widely accepted electronic storage standards and requirements in previously published IRS guidance for electronic document retention. The interim rules generally require (1) the integrity, accuracy, and reliability of the electronic generation or storage system; (2) the prevention and detection of unauthorized or accidental creation, alteration, deletion, or deterioration of an electronically completed or stored form; (3) the attestations in the form be completed using a system for capturing an electronic signature that meets certain standards; (4) documents to be legible and readable; (5) the system structure, operation, and maintenance to be properly documented; (6) the data to be accessible by government personnel on premises; (7) specified indexing methodologies to be used; (8) the ability to reproduce legible and readable hardcopies; and (9) data and system inspections to be performed.

There are severe penalties for violating IRCA. These include civil and criminal penalties (from \$110 to \$11,000 per unauthorized employee, plus potential imprisonment of up to six months). There are also penalties for document fraud and recordkeeping violations. More detailed information regarding IRCA and completing Form I-9 is contained in the U.S. Citizenship and Immigration Service's *Handbook for Employers*, which is available at the nearest USCIS office or online at www.uscis.gov/files/nativedocuments/m-274.pdf.

Law Change: Final regulations issued by the Department of Homeland Security (DHS) describe an employer's legal obligations under current immigration law when it receives: (1) a letter from the SSA reporting that an employee's SHUN on Form W-2 does not match SSA records or (2) a letter from the DHS reporting that the immigration status or employment authorization documentation presented by an employee in completing Form I-9 does not match DHS records. The regulations state that if the discrepancy referred to in the no-match letter is not timely resolved, and the employee's identity and work authorization cannot be verified using one of the regulation's reasonable verification procedures, employers must choose between: (1) terminating the employee or (2) facing the risk that if they continue to employ the individual, DHS will determine that they had constructive knowledge of the employee being an unauthorized alien. The regulations were supposed to be effective September 14, 2007. However, after several lawsuits were filed to block enforcement of the regulations, the DHS announced that it will not enforce them and issued proposed regulations that will rescind them. DHS has indicated that it will rely on the E-Verify system (see the following discussion) to confirm that employees are eligible to work in the U.S.

Employers that enter into contracts with the federal government after September 7, 2009, are required to use E-Verify. Contracts that are exempt from this requirement include (1) prime contracts that are for \$100,000 or less, (2) subcontracts that are for \$3,000 or less, (3) contracts that are only for work that will be performed outside the United States, (4) prime contracts that are for a period of performance of less than 120 days, and (5) contracts for commercially off-the-shelf items.

If a federal contractor or subcontractor is required to use E-Verify it must use it for all new employees hired on or after the contract date and for all existing employees hired after November 6, 1986, who directly perform work on the contract and whose information has not previously been submitted through the E-Verify system. E-Verify can provide employers with a list of employees who have already been submitted to the system. Institutions of higher education, state and local governments, federally recognized Indian tribes, and sureties performing under a takeover agreement entered into with a federal agency pursuant to a performance bond need only verify employees assigned to a covered federal contract (i.e., they do not have to verify all employees).

New-hire Reporting

All states and U.S. possessions have a State Directory of New Hires where employers are required to send information about newly hired employees that is checked against the state's records of individuals with outstanding child support obligations, and is then forwarded to Washington, D.C., where it is checked against the national database. When a match is found at the state level, the state Office of Child Support Enforcement sends a withholding notice to the employer of the new hire, directing the employer to withhold the required child support from the employee's pay. When a match is found at the national level evidencing an outstanding child support obligation in a different state, the federal Office of Child Support Enforcement sends an interstate withholding notice to the employer of the new hire, directing the employer to withhold the required child support from the employee's pay.

The new-hire reporting requirements require employers with employees in only one state to report all new hires to that state. Multistate employers may either report the new hires to each of the different states in which the employees work, or they may report all of the employees to a single state of the employer's choice, so long as they do business in that state. Multistate employers reporting to a single state are required to provide the Department of Health and Human Services (DHHS) with written notification of their choice. The DHHS has developed a form that employers may (but are not required to) use for that purpose. Employers may also register online at www.acf.hhs.gov/programs/cse/newhire/employer/private/newhire.htm. In addition, multistate employers reporting to a single state must report either magnetically or electronically.

Unless the state has established more stringent reporting requirements, the employer must report new hires to the appropriate state agency within 20 calendar days of the date the employee is hired. An employee's date of hire is the first day the employee performs services for wages. If the employer reports electronically or magnetically, two monthly transmissions are required, at least 12 but no more than 16 days apart.

The information required to be reported is the name, address, and social security number of each new employee. A copy of the employee's Form W-4 can be used to provide the required information, or the employer can develop its own equivalent form. The report must also contain the employer's name, address, and employer identification number. States have the right to require additional information and may prepare their own optional form for

employers to use. Although employers will be obligated to provide the additional information, they cannot be required to use the state prepared form. States can impose penalties for failure to report the required information on new hires.

Verifying Social Security Numbers

The Social Security Administration has a social security number verification service that allows employers and third-party submitters to verify employees' names and social security numbers. The service will match the employer's or third-party submitter's record of employee names and social security numbers with SSA's records. The service is easy to use and there are several verification methods employers and third-party submitters can choose from based on the number of employees they want to verify.

Employer Identification Number (EIN)

An EIN (also known as a federal tax identification number) is a nine-digit number (e.g., 12-3456789) issued by the IRS, and used to identify a business entity for tax filing and reporting purposes. Form SS-4 (Application for Employer Identification Number) is used to apply for an EIN. Application can be made by mail, fax, telephone, or online at www.irs.gov.

Reasons for applying for an EIN include starting a new business or hiring employees. Other reasons for applying for an EIN can be found on Form SS-4 and in IRS Pub. 1635 (Understanding your EIN).

Example 1A-1 Sole proprietor with dependent child as employee must obtain an EIN.

Dave Mathis owns and operates a small business out of his home. The business is operated as a sole proprietorship, and Dave reports his income and expenses on Form 1040, Schedule C. Dave wants to hire his son Tom, who is 16 years old, to work part-time after school and during the summer break. Dave currently has no employees and does not have an EIN.

Is Dave required to obtain an EIN?

A taxpayer that pays wages to one or more employees must obtain an EIN. Services performed by Tom are exempt for FICA and FUTA purposes since he is under the age of 18 (21 for FUTA). However, Tom's employee service is subject to FIT and FITW, and Dave will likely have to withhold on his son's wages unless Tom claims exempt status on Form W-4 (Employee's Withholding Allowance Certificate). Dave must prepare Form W-2 to report wages paid to Tom, even if Tom claims exempt status on Form W-4. Therefore, Dave will need to file Form SS-4 to obtain an EIN for employer filing and reporting purposes.

Employer Statutory Definitions

This publication is concerned with the federal payroll tax laws (also called employment tax laws). It explains, in detail, federal income tax withholding (FITW), social security and Medicare taxes (FICA), and federal unemployment tax (FUTA). The federal payroll tax statutes use the following rules to define an employer:

1. *FITW*. An employer generally is a person for whom one or more individuals perform any service (past or present) as an employee. Thus, employer status generally focuses on the presence or absence of an employer/employee relationship.

The FITW statute also provides a special rule that overrides the employer/employee relationship rule when another person controls the payment of some or all of an employee's wages. This special rule provides that the person in control of payment is the employer with respect to such wages.

2. *FICA*. The FICA statute does not define an employer. However, the FICA regulations state that an employer is a person who employs one or more employees (i.e., the employer/employee relationship rule applies). Unlike FITW, the FICA statute does not expressly provide a special rule when another person controls the payment of some or all of an employee's wages. However, the Supreme Court held that a person who is

an employer under the Section 3401(d)(1) control-of-wage-payments rule, relating to income tax withholding, is also an employer for purposes of FICA withholding.

3. *FUTA*. Under the federal unemployment tax statute, a person is not an employer unless it satisfies the employer/employee relationship rule and meets either of the following two coverage tests during the current or preceding calendar year:
 - a. *\$1,500 Wage Test*. The person pays employee wages of \$1,500 or more during any calendar quarter for covered employment.
 - b. *1-in-20 Test*. The person employs one or more employees (who are engaged in covered employment) at any time in each of any 20 different calendar weeks.

Special FUTA coverage tests apply to agricultural and household employers. Also, services performed for IRC Sec. 501(c)(3) tax-exempt organizations are not subject to FUTA.

For FITW and FICA purposes, the number of employees, the number of days worked, the frequency of work, and the amount of wage payments have nothing to do with defining an employer for employment tax purposes. While these criteria may impact the dollar amount of an employer's liability, that issue is distinct from employer status.

Nonprofit Organizations

The term employer includes not only individuals and organizations engaged in a trade or business, but tax-exempt organizations as well. Tax-exempt organizations (also known as nonprofit organizations) include religious and charitable organizations, business leagues, trade associations, educational institutions, social organizations, labor unions, hospitals, and fraternities. The general rule is that nonprofit organizations (like other employers) must withhold employment taxes from their employees' wages and pay their portion of FICA and FUTA taxes. However, there are exceptions. For instance, a FICA exemption applies to an employee of a nonprofit organization that is wholly owned by a state or a political subdivision if the employee is a member of a public employee retirement system that provides a minimum level of benefits. And a FUTA exemption applies to nonprofit organizations described in IRC Sec. 501(c)(3) (e.g., organizations dedicated exclusively to religious, charitable, or scientific purposes; testing for public safety, literary, or educational purposes; fostering national or international amateur sports competition; or the prevention of cruelty to children or animals). (See IRS Pub. 15-A, "Employers Supplemental Tax Guide," for more information.)

Partnerships and Partners

While a partner can stand in different relationships with his or her partnership (including that of an employee or independent contractor), partners typically are not employees of the partnership because there is no employer-employee relationship. Therefore, for FITW purposes, amounts paid to partners are not taxable wages, and the services rendered by them are not covered employment for FICA or FUTA purposes. Rather, a partner's net earnings are considered self-employment (SE) income. Payments that are considered SE income and so subject to SE taxation include (1) the partner's distributive share of the income or loss generated by the partnership's trade(s) or business(es) and (2) guaranteed payments, which are payments for services rendered on behalf of or capital advances to the partnership that are determined without regard to partnership income. (Special rules apply to payments to limited partners and retired partners—see *PPC's 1065 Deskbook* for more information.)

Limited Liability Companies

For federal tax purposes, a limited liability company (LLC) may be classified as a partnership, a corporation, or an entity not separate from its owner. The rules that explain how LLCs determine their classification are commonly known as the check-the-box regulations. Under these regulations certain LLCs must be classified as corporations (e.g., insurance companies, publicly-traded partnerships, entities classified as corporations under state law, etc.), while all other LLCs (with at least two members) can choose to be classified as either partnerships or corporations. Special rules exist for single-member LLCs. For federal tax purposes, the owner of a single-member LLC can choose to be recognized as a separate entity classified as a corporation, or instead, disregard the existence of the separate entity in which case the LLC is treated as the same entity as its owner (i.e., a sole proprietorship, branch, or division).

Generally, an LLC is made up of members (rather than partners or shareholders). Once a multi-member LLC determines its classification, the federal payroll rules applicable to that entity apply to the LLC. For example, if a multi-member LLC is treated as a partnership, amounts paid to members for services rendered are treated the same as amounts paid to partners by a partnership for services rendered (i.e., generally are not taxable wages subject to FITW, FICA, or FUTA). In contrast, if the multi-member LLC is treated as a corporation, amounts paid to members for services rendered are treated the same as amounts paid to shareholders of a corporation for services rendered (i.e., generally are wages subject to FITW, FICA, and FUTA).

For wages paid after 2008, a single-member LLC that has chosen to be disregarded for federal tax purposes is not disregarded for employment tax purposes and, accordingly, is treated as a separate entity that is liable for employment taxes on wages paid to its employees and is responsible for satisfying other employment tax obligations (e.g., making timely deposits of employment taxes, filing employment tax returns, and providing Forms W-2 to employees). The single-member LLC is treated as a corporation for purposes of employment taxes and the related reporting requirements. A single-member LLC should not report its employment taxes using its owner's name and EIN. Instead, it must have its own EIN, which it uses for all its employment tax obligations.

Employment Tax Liability. CCA 200235023 sets forth the IRS's current position on who is liable for an LLC's employment taxes. Determining who is liable for a multi-member LLC's employment taxes depends on the LLC's election. If the multi-member LLC elected to be taxed as a corporation, then the LLC is liable for the tax. However, the members of the LLC may be liable for the trust fund recovery penalty under IRC Sec. 6672, depending on the facts and circumstances of each case. If there has been no corporate election, then the multi-member LLC is taxed as a partnership, which means that the partnership will be liable for the employment taxes. But, unlike the typical partnership situation where the IRS asserts an employment tax liability against the partners who are liable for the debts of the partnership under state law, the Service, absent fraudulent transfers or other special circumstances, will not assert an employment tax liability against the LLC members, nor will it levy on the property and rights to property of the members, because they are not liable for the LLC's debts under state law. These members, however, may be liable for the trust fund recovery penalty, depending on the facts and circumstances of each case.

For wages paid after 2008, a single-member LLC is treated as a corporation for purposes of employment taxes and, therefore, the LLC is liable for the tax. The owner of the single-member LLC is not liable for employment taxes or other employment tax obligations with respect to the single-member LLC's employees. However, the single-member owner and others may be liable for the trust fund recovery penalty, under IRC Sec. 6672, depending on the facts and circumstances of each case.

S Corporations

Compensation paid by an S corporation to an S shareholder for services rendered are treated as wages subject to FITW, FICA, and FUTA, while pass-through income (which increases as deductible salary decreases) and distributions from an S corporation are not subject to employment taxes or self-employment tax. Thus, it can be to an S shareholder/employee's advantage to replace salary with distributions. However, if an S corporation is not paying a "reasonable" salary to a shareholder who provides services to the corporation, the IRS may try to recharacterize nontaxable distributions to that shareholder as wages subject to payroll taxes.

A Qualified Subchapter S Subsidiary (QSub) is a subsidiary corporation that is 100% owned by an S corporation that has made a QSub election for that subsidiary. A QSub is disregarded for federal tax purposes because its assets, liabilities, and items of income, deduction, and credit are treated as owned by the parent S corporation.

However, for wages paid after 2008, a QSub that is disregarded for federal tax purposes is not disregarded for employment tax purposes and, accordingly, is treated as a separate entity that is liable for employment taxes on wages paid to its employees, and is responsible for satisfying other employment tax obligations (e.g., making timely deposits of employment taxes, filing employment tax returns, and providing Forms W-2 to employees). The QSub is treated as a corporation for purposes of employment taxes and the related reporting requirements. A QSub should not report its employment taxes using its owner's name and EIN. Instead, it must have its own EIN, which it uses for all its employment tax obligations. The QSub's owner is not liable for employment taxes or other employment tax obligations with respect to the QSub's employees. However, the QSub owner's shareholders may be liable for the trust fund recovery penalty under IRC Sec. 6672, depending on the facts and circumstances of each case.

Chapter 11 Debtors in Bankruptcy

Effective for bankruptcy cases filed after October 16, 2005, a debtor's gross earnings from post-petition services and post-petition property are generally included in the bankruptcy estate's gross income, rather than in the debtor's gross income. Within a reasonable time after the commencement of a Chapter 11 bankruptcy case, the debtor (or trustee) must provide the bankruptcy estate's EIN to persons (other than the debtor's employer) that are required to file information returns (e.g., Forms 1099) for the bankruptcy estate's gross income, gross proceeds, or other types of reportable payments. These persons should report these payments on information returns using the bankruptcy estate's name and EIN. If persons filing information returns improperly report payments to the debtor that should have been reported to the bankruptcy estate, the debtor (or trustee) must allocate the improperly reported income in a reasonable manner between the debtor and the estate.

Even though post-petition wages earned by a debtor are generally treated for income tax purposes as gross income of the estate, rather than the debtor, the reporting and withholding obligations of a debtor's employer have not changed because the bankruptcy code does not effect the determination of wages for purposes of income tax withholding and FICA or FUTA. Therefore, an employer should continue to report all wage income and tax withholding, whether pre-petition or post-petition, on a Form W-2 issued to the debtor under the debtor's name and social security number. The employer does not report any earnings on a Form W-2 using the bankruptcy estate's name and EIN. The debtor (or trustee) is responsible for allocating, in a reasonable manner, the amount reported in boxes 1 and 2 of the debtor's Form W-2 between the debtor and the bankruptcy estate. If reasonable, a simple percentage method may be used to make the allocation but the same method used to allocate income must be used to allocate withheld income tax.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Under the Immigration Reform and Control Act of 1986 (IRCA), who is responsible for ensuring that Sections 1 and 2 of the I-9 are properly completed in a timely fashion?
 - a. The employee.
 - b. The employer.
 - c. The INS.
 - d. The DHS.

2. Based on statutory, judicial, and regulatory enforcement authority, the term "employer" is defined for social security and Medicare taxes (FICA) and federal income tax withholding (FITW), as which of the following:
 - a. One who pays at least \$1,500 during any calendar quarter for covered employment.
 - b. One who pays covered employees at any time in each of any 20 calendar weeks.
 - c. One who pays, or controls the payment of some or all of an employee's wages.
 - d. One who pays an employee who works more than half-time for a calendar quarter.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Under the Immigration Reform and Control Act of 1986 (IRCA), who is responsible for ensuring that Sections 1 and 2 of the I-9 are properly completed in a timely fashion? **(Page 3)**
 - a. The employee. [This answer is incorrect. According to the IRCA, the employee is responsible for completing the relevant section of the I-9 and supplying appropriate documents, but the question goes more toward document processing than submission.]
 - b. The employer. [This answer is correct. The IRCA states that, the employer is legally charged with the responsibility of ensuring timely and proper completion of Section 1 of the I-9 and submission of all required supporting documentation. The employer is further charged with completing Section 2 of the I-9 to document review the documents submitted and verification of employee eligibility for employment in the United States.]**
 - c. The INS. [This answer is incorrect. In 2003, immigration services were transitioned from the Immigration and Naturalization Services to the Department of Homeland Security, therefore, the INS is no longer responsible for ensuring that Sections 1 and 2 of the I-9 are properly and timely completed.]
 - d. The DHS. [This answer is incorrect. In 2003, the Department of Homeland Security became the federal immigration oversight authority under the U.S. Citizenship and Immigration Services.]
2. Based on statutory, judicial, and regulatory enforcement authority, the term “employer” is defined for social security and Medicare taxes (FICA) and federal income tax withholding (FITW), as which of the following? **(Page 6)**
 - a. One who pays at least \$1,500 during any calendar quarter for covered employment. [This answer is incorrect. The \$1,500 Wage Test applies to federal unemployment tax (FUTA) tax considerations for defining who is an employer not FICA or FITW.]
 - b. One who pays covered employees at any time in each of any 20 calendar weeks. [This answer is incorrect. The “1-in-20” Test is one of two tests used, in addition to the employer/employee relationship rule, to define an employer for FUTA tax purposes.]
 - c. One who pays, or controls the payment of some or all of an employee’s wages. [This answer is correct. Although not specifically stated in the case of FICA tax, both the IRS and the courts have held that the control of wage payments rule is central to determining employer status for FICA and FITW tax purposes.]**
 - d. One who pays an employee who works more than half-time for a calendar quarter. [This answer is incorrect. Under IRC Sec. 3401(d), the number of days worked and frequency of work are irrelevant when defining an employer for FICA and FITW tax purposes.]

Determining Employer Status—Basic Rules

Any worker who receives compensation for services is either an independent contractor (i.e., self-employed) or an employee. If the worker is an employee, the employer incurs liability under the federal payroll tax laws. Two fundamental rules determine who is an employer:

1. *Employer/employee Relationship Rule.* This rule focuses on the presence or absence of an employer/employee relationship. Each federal payroll tax statute (FITW, FICA, and FUTA) uses this as the guideline for determining whether a person is an employer.
2. *Control-of-wage-payments Rule.* This rule centers on who controls an employee's wage payments. The FITW payroll tax statute uses this rule as a special exception to the general rule when a person other than the conventional business employer controls the payment of wages. When this rule applies, the person who controls wage payments has the responsibility to withhold income taxes. While the FICA and FUTA statutes do not expressly adopt this rule, the courts and the IRS apply this rule for purposes of withholding FICA taxes and reporting and paying FICA and FUTA taxes.

Employer/Employee Relationship Rule

The employer/employee relationship rule acknowledges that a person (i.e., a business) may hire two types of workers: (1) an employee of the business, or (2) an independent contractor. An employer is a person for whom a worker performs services as an employee. A person is not a worker's employer if the worker performs services as an independent contractor. Thus, with respect to any worker, employer status generally is determined by the presence or absence of an employer/employee relationship.

The process of determining whether a worker is an employee or independent contractor is called worker classification, and is discussed in-depth later in this lesson. While several different methods exist for determining whether a worker is an employee, the most common method centers on whether the hiring person possesses "the right to direct and control the worker's performance" both with respect to details (when, where, and how the work should be done) and the final results. If such control exists, the worker is an employee. The IRS uses a *categories of evidence* analysis—behavioral control, financial control, and relationship of the parties—to evaluate the degree of control or independence in the relationship of the worker and the business; collectively, these categories of evidence are known as the common law control test.

The common law control test is not the exclusive means by which a person can be deemed to be an employer (i.e., a statement such as "the common law definition controls who is an employer" is technically incorrect). This is because the common law control test is but one component of worker classification; other ways exist to establish an employer/employee relationship. Thus, the correct statement is that "under the employer/employee relationship rule, the relationship is determined using the worker classification rules, one component of which is the common law control test."

Example 1C-1 Employer/employee relationship rule.

Corporation X is engaged in the distribution of fruit and vegetable products. X hires and pays the following two workers during the current year:

- Worker A packs produce boxes and places them on trucks for delivery. X possesses the right to direct and control A's performance.
- Worker B is a company officer. Although X does not possess the right to control and direct B's performance, B meets the definition of a statutory employee.

Both A and B are employees under the worker classification rules. A is an employee under the common law control test. B is a statutory employee. Thus, X meets the employer/employee relationship rule, and is an employer for FITW and FICA purposes. X also is an employer for FUTA purposes if one of the coverage tests is met.

Control-of-wage-payments Rule

Under the FITW statute, a person who controls the payment of some or all of an employee's wages is the employer with respect to such wages. This rule expressly overrides the employer/employee relationship rule. While neither the FICA nor FUTA statute expressly adopts the control-of-wage-payments rule, since 1974 the courts (and, increasingly, the IRS) have begun to treat the person who controls the payment of wages as the employer (with respect to such wages) for withholding FICA taxes and reporting and paying FICA and FUTA taxes. This person is commonly referred to as a *Section 3401(d)(1) employer*.

Example 1C-2 Control-of-wage-payments rule.

XY Corporation establishes a trust fund (under a collective bargaining agreement) to provide supplemental unemployment compensation to its employees. Under the terms of the agreement, XY makes periodic payments to the trust fund. The trust then remits the funds to various employees in accordance with the terms established under the collective bargaining agreement. Who is the employer with respect to the supplemental unemployment compensation paid by the trust fund?

While XY controls the payment of regular wages to its employees, it does not exercise any control over the supplemental unemployment compensation payments. Once the funds are contributed to the trust fund, the trust fund controls the payment of supplemental compensation (i.e., the trust fund is not acting solely as an agent for XY). Accordingly, XY is the employer with respect to regular wages, while the trust fund is the employer with respect to the supplemental unemployment compensation payments.

Applying the Control-of-wage-payments Rule for FITW

The application of the control-of-wage-payments rule for FITW purposes is fairly clear-cut. The rule applies whenever someone other than the business employer has exclusive legal control over the payment of some or all of an employee's wages. There must be exclusive control for this rule to apply. The statute states that "if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term 'employer' [except for purposes of subsection (a)] means the person having control of the payment of such wages." This makes it clear that one person must have exclusive control in order for the rule to apply. Joint control or something less than exclusive control will not meet the requirement. Acting merely as an agent for the employer is not sufficient to establish exclusive legal control.

The litmus test is legal control. This means more than simply paying the wages. For FITW purposes, the courts examine who (1) makes up the payroll, (2) determines which employees are to be paid, and (3) determines the amount paid to each employee (*Arthur Venneri Co.*). These court-established factors clearly are more than simple administrative functions and truly determine who has substantive legal control over the payment of wages.

Thus, where an employer makes a lump-sum payment to an employees' union to settle a lawsuit, and the union determines how the amount is to be divided among employees, the union is the Section 3401(d) employer because it determines the amount paid to each employee. Also, a company that paid the wages of another business's employees under an informal reimbursement arrangement had control over the payment of the other business's wages and was liable for any unpaid taxes. The company that funded the payroll was performing more than a ministerial function when it paid the taxes out of its own funds, with its own checks, reported the taxes on its Forms 940 and 941, and issued Forms W-2 to the other business's employees.

In TAM 200704031, the IRS ruled that a state is not a Section 3401(d) employer when, in administering the Child Credit and Development Block Grant Act of 1990, it makes payments jointly to a common law employer and employee using a two-party check. The IRS ruled that the state did not have sole and legal control of the payments because under state law the two-party check had to be negotiated by both parties, thus giving legal control over the payment to the common law employer, not the state.

Advancing funds to an employer for the payment of wages or joint control of a bank account from which salaries are paid does not automatically make someone an employer under the control-of-wage-payment rules. However, under IRC Sec. 3505 lenders who advance an employer funds for the payment of wages are liable for the payment of trust fund taxes if the employer fails to remit them.

Applying the Control-of-wage-payments Rule for FICA and FUTA

In contrast to the rules for FITW purposes, the proper application of the control-of-wage-payments rule for FICA and FUTA purposes is more complex. Several cases have incorporated the Section 3401(d) control-of-wage payments definition of employer into FICA and FUTA. The Supreme Court held that a person who is an employer under the Section 3401(d)(1) control-of-wage-payments rule, relating to income tax withholding, is also an employer for purposes of FICA withholding. *Otte* involved a trustee in bankruptcy who was an employer under IRC Sec. 3401(d)(1) by virtue of having control over the payment of wages owed by the bankrupt company. The Court stated “the fact that the FICA withholding provisions of the Code do not define ‘employer’ is of no significance, for that term is not to be given a narrower construction for FICA withholding than for income tax withholding.” The *Otte* decision has been extended to provide that the person having control of the payment of wages is also an employer for FUTA purposes.

Similar results occurred in *Southwest Restaurant Systems, Inc.*, which involved a debtor corporation (one of four separate but commonly owned corporations) that had control over wage payments to the employees of all four corporations. The IRS asserted that the debtor corporation was liable for withheld employee FICA tax of all four corporations because it had exclusive control over the payment of wages. The bankruptcy trustee maintained that each corporation was liable as the employer for withheld FICA tax of their employees. The 9th Circuit Court agreed with the IRS stating, “When it finally comes to the point of deducting from the wages earned that part which belongs to the United States and matching it with the employer’s share of FICA taxes, the only person who can do this is the person who is in ‘control of the payment of such wages.’”

In Ltr. Rul. 9313004, the IRS applied the control-of-wage-payments rule to find a talent firm liable for employer FICA and FUTA tax. Citing *Armadillo Corp.*, the IRS specifically stated “this rule applies to other employment taxes including the FICA taxes and the FUTA tax.” In *Consolidated Flooring Services*, the Court of Federal Claims ruled that the taxpayer who controlled the wage payments [the Section 3401(d) employer], was liable for income tax withholding, both the employee and employer share of FICA taxes, and FUTA taxes. In *General Motors Corporation*, the court approved use of the control-of-wage-payments rule to establish liability for employment tax withholding.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

3. Which of the following is the process of determining if a worker is an employee?
 - a. Behavioral control analysis.
 - b. Financial control analysis.
 - c. Categories of evidence analysis.
 - d. Worker classification.

4. ErrandBoy began business December 1, 2008, opting for a calendar fiscal year, and hired three runners at minimum wage. Total sales and wages for 2008 were \$420 and \$105 respectively. Business was slow for the first ten months of 2009; sales were just \$2,000 and ErrandBoy paid wages of only \$500. Business increased dramatically during the last two months of the year, by December, year-to-date wages were \$1,625 on sales of \$5,900; gross profit was \$2,125. What is the base for calculating 2009 FUTA liability?
 - a. \$0.
 - b. \$1,625.
 - c. \$1,730.
 - d. \$2,125.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

3. Which of the following is the process of determining if a worker is an employee? **(Page 13)**
 - a. Behavioral control analysis. [This answer is incorrect. Behavioral control analysis is one of the tests used by the IRS to determine employer/employee relationship.]
 - b. Financial control analysis. [This answer is incorrect. Financial control analysis is an element of a broader analysis the IRS uses to determine if a worker is an employee.]
 - c. Categories of evidence analysis. [This answer is incorrect. The IRS uses categories of evidence analysis, also known as the common law control test, to determine if an employer/employee relationship exists.]
 - d. Worker classification. [This answer is correct. According to the IRS, Worker classification is the process of determining the existence of an employer/employee relationship. There are several methods for making this determination. Categories of evidence analysis, also known as the common law control test, is a component of the process.]**

4. ErrandBoy began business December 1, 2008, opting for a calendar fiscal year, and hired three runners at minimum wage. Total sales and wages for 2008 were \$420 and \$105 respectively. Business was slow for the first ten months of 2009; sales were just \$2,000 and ErrandBoy paid wages of only \$500. Business increased dramatically during the last two months of the year, by December, year-to-date wages were \$1,625 on sales of \$5,900; gross profit was \$2,125. What is the base for calculating 2009 FUTA liability? **(Page 14)**
 - a. \$0. [This answer is incorrect. The threshold for liability was crossed in 2009.]
 - b. \$1,625. [This answer is correct. Once covered wages for the year reaches the \$1,500 threshold, all covered wages for the year are subject retroactively to FUTA liability.]**
 - c. \$1,730. [This answer is incorrect. FUTA liability is calculated for each year individually.]
 - d. \$2,125. [This answer is incorrect. Gross profit has nothing to do with the calculation of FUTA liability.]

Third-person Payer Transactions—Employment Tax Responsibilities

Generally, wages are paid by the person for whom an employee performs services. Nonetheless, situations arise where the person for whom services are rendered does not have control over wage payments. In these instances, the term employer means the person who has control over the payment of wages.

Because of the uncertainty on how to apply the employer rules to third-person situations, the practitioner should avoid generalizations and approach each situation as unique. Each fact situation should be measured against cases and administrative rulings that are as factually similar as possible to the circumstances at issue. The following discussion highlights common types of third-person transactions and provides examples of how to apply the employer rules in each situation.

Third-person Payer Transactions

A person other than the business employer may make wage or compensation payments to an employee in a *third-person payer* transaction. Typical examples include the following:

1. Insurance company pays sick pay.
2. Bankruptcy trustee pays a bankrupt employer's payroll.
3. Pension administrator makes qualified plan distributions.
4. Fiduciary organization handles some or all aspects of the employer's payroll pursuant to a collective bargaining agreement.

These third persons clearly are not employers within the customary meaning of the term (i.e., they do not direct and control the employees' performance, or directly compensate them in exchange for the performance of services). Nonetheless, the federal payroll tax statutes may, in some circumstances, treat these third persons as "employers" for employment tax liability purposes when they have exclusive control over the wage payments.

Example 1D-1 Pension plan distributions.

Employee A has worked for Company X for many years and will retire on January 1. For the last 10 years, X has contributed cash to an employee pension plan on behalf of A. At retirement, A begins to receive distributions from the pension plan. Who is the employer (for FITW purposes) with respect to the pension fund distributions?

The pension plan trust exercises exclusive control over the payment of the pension fund distributions. It is the employer for withholding purposes because X does not exercise any control over the pension fund distributions. (In fact, X loses control once the funds are contributed to the plan.)

The IRS concluded that a factor that purchased wage claims from the employees of a Chapter 11 debtor is the employer with respect to such payments. Therefore, the factor, rather than the common law employer, is the party responsible to withhold and pay the employment taxes and report the wage payments. The Service also held that a nonqualified plan trust established to provide employees with supplemental retirement benefits is the employer and must withhold and pay the employment taxes on supplemental benefits paid under the plan.

Shared-employee Transactions

Related business affiliates often share employees. Here, the question is which affiliate or affiliates are employers of the shared employees.

Example 1D-2 Shared employee transactions.

ABC Partnership and X Corporation are business affiliates with common ownership. Executive T and Controller C perform services for both entities. Depending on the facts and circumstances, these employees may be

concurrently employed by both business affiliates or employed solely by one business affiliate and then loaned out to the second business affiliate. The specific details of the transaction will determine which business affiliate is the employer.

Employee Leasing

Historically, employee leasing has involved an employer (called a subscriber or client company) transferring its employees to a third-party leasing company, which leases these employees back to the subscriber. The leasing company takes over all or part of the employer's responsibilities for the leased employees, such as paying wages, providing benefits, and participating in the hiring, reviewing, and firing of employees.

Independent Contractors as Employers

A business employer may hire an independent contractor who in turn hires its own helpers or assistants. Here, the question is whether the business employer is liable (as an employer) for the independent contractor's assistants or helpers. This issue frequently arises when the independent contractor fails to withhold and pay employment taxes on its assistants' or helpers' wages, and then becomes unable to pay the neglected taxes. If the independent contractor fails to comply with federal payroll tax laws, the IRS may attempt to treat its assistants or helpers as employees of the business employer.

The initial task is to ensure the business employer truly has a contract relationship with its independent contractor. If not, and the independent contractor is actually an employee, it is almost certain the assistants and helpers will also be considered employees of the business employer. If a valid contract relationship exists between the business employer and the independent contractor, each party's relationship within the transaction must be tested. The following rules of thumb apply:

1. If an employer/employee relationship is present between the independent contractor and its assistants or helpers, the independent contractor will likely be the employer of the helpers. Here, it is unlikely that the business employer possesses enough control of the assistants or helpers to establish an employer/employee relationship.
2. As always, consideration must be given to who controls the wage payments made to the assistants or helpers. Exclusive control by the business employer is not permitted. To guard against being liable for an independent contractor's payroll taxes, the business employer should ensure it does not have exclusive legal control of wage payments. In addition, under IRC Sec. 3505 lenders who advance an employer funds for the payment of wages are liable for the payment of trust fund taxes if the employer fails to remit them.
3. If the business employer assumes control of the project and exercises control over the payment of wages, it will be the employer for payroll tax liability purposes.

Example 1D-3 Independent contractors as employers.

Metals Corporation sells prefabricated metal buildings to commercial businesses. Metals negotiates the deal and then (acting as a general contractor) contracts with local subcontractors to erect the buildings. While Metals does not actually perform the installation, its supervisors work closely with the subcontractors throughout the entire process. Each project lasts three months.

Local subcontractors will often hire helpers to assist them. Metals has a company policy that requires each local contractor to remain responsible for the actions and performance of any helpers or assistants hired. (Metals's supervisors review only the overall work of the subcontractor.) Furthermore, each subcontractor is required to pay its own helpers and then request reimbursement from Metals, which has no control over the payment of wages. Who is the employer of the helpers?

First, it must be determined if Metals is the employer of the subcontractors. It appears that Metals does not possess the right to direct and control the independent contractors' performance and otherwise is not their employer under the employer/employee relationship rule.

Given this, it is necessary to examine each party's relationship within the transaction. Here, it appears that an employer/employee relationship exists between the local contractors and their helpers and assistants. (Metals is not an employer of these employees under the employer/employee relationship rule.) As long as Metals does not control the payment of wages to these helpers and assistants, it should be free from employer liability.

Determining Employer Liability

Being an employer is a preliminary but essential step toward actual employer liability. The following discussion moves past the employer status issue and discusses when employer liability actually begins and ends.

Employer FITW and FICA Liability

The liability to withhold federal income tax (FITW), and to withhold and pay social security and medicare (FICA) taxes, begins the first day an employer has a worker who is engaged in a *covered employment* activity and is paid *covered (taxable) wages* or compensation. Both of these elements must be in place before employer liability exists under FITW and FICA. An employer's liability under the FITW and FICA statutes ends when it has no employees engaged in covered employment and receiving covered compensation.

Example 1E-1 When employer FITW and FICA liability begins and ends.

On November 1, 2007, Lucy Black opens a seasonal gift shop. Lucy intends to operate it during the last two months of each calendar year and the first month of the subsequent year. For 2007, Lucy hires one employee for November and December and pays him \$600 per month (paid out at the end of each month). During the first month of 2008, Lucy pays her employee \$500 to help her wind up the holiday business. For the last two months of 2008, Lucy hires an additional employee (she now has two employees) and pays each employee \$800 per month. She pays one of these employees \$500 to help her wrap up holiday business during the first month of 2009. On February 1, 2009, Lucy decides to cease her business. Accordingly, Lucy terminates it as of that date.

Lucy's employer liability for FITW and FICA begins on the first day she employs an employee in covered employment and pays covered compensation. Here, this occurs as of November 30, 2007. This is the date Lucy first pays out covered compensation to her employee. Lucy must withhold FITW, and withhold and pay FICA, on wages paid on or after this date. She must also begin to comply with appropriate reporting and information return procedures as of this date.

Lucy's employer liability to withhold FITW, and to withhold and pay FICA, ends when she has no employees engaged in covered employment and receiving covered compensation. This occurs on February 1, 2008. However, Lucy will have to file a final payroll return (either a first quarter Form 941 or an annual Form 944 marked "final return"), and she must comply with year-end information reporting procedures for amounts paid during 2009.

Employer FUTA Liability

An employer's liability for FUTA begins as of January 1 of the year in which it meets either coverage test (i.e., the \$1,500 wage test or the 1-in-20 test). An employer's liability for FUTA ends when it fails to meet a coverage test for two consecutive years. This means liability ends as of January 1 of the second year. Because the coverage tests apply to the current and preceding year, employer liability for FUTA, once established, continues for a minimum of two years.

Example 1E-2 When employer FUTA liability begins and ends.

Assume the same facts as in Example 1E-1. When does Lucy's employer liability under the FUTA payroll tax statute begin and end?

The rule is that Lucy's employer liability for FUTA begins on January 1 of the first calendar year in which she satisfies either the \$1,500 wage or 1-in-20 test. Neither of the coverage tests is satisfied during calendar year

2007. However, as of November 30, 2008, Lucy meets the \$1,500 wage test. (Wages of \$2,100 have been paid out during calendar year 2008 as of that time.) Accordingly, Lucy's employer liability for FUTA begins on January 1, 2008. (It is retroactive to the beginning of the year.) This means Lucy must pay employer FUTA tax on the wages paid during all of 2008.

Lucy's employer liability for FUTA ends when she fails to meet a coverage test for two consecutive years. This does not occur until January 1, 2010. Thus, Lucy is liable for FUTA purposes for the wages paid in 2009, and must comply with the FUTA reporting requirements through the 2009 calendar year.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. Which of the following would be considered liable for FITW?
 - a. An outsourcer who files payroll reports based on information supplied by the client company.
 - b. An outsourcer who prepares payroll and makes tax deposits using client information.
 - c. A subcontractor who exercises daily supervision of the general contractor's employees.
 - d. The administrator of a trust fund who makes monthly discretionary distributions to beneficiaries.

6. Barker Controls went into Chapter 11 bankruptcy in June 2009. Advantage Factors bought the outstanding payroll claims against Barker in August of that same year. Who is deemed liable for applicable payroll taxes regarding these claims?
 - a. The bankruptcy court.
 - b. Advantage Factors.
 - c. The bankruptcy trustee.
 - d. Barker Controls.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

5. Which of the following would be considered liable for FITW? **(Page 19)**
- a. An outsourcer who files payroll reports based on information supplied by the client company. [This answer is incorrect. The outsourcer is simply filing reports. The outsourcer exhibits no element of control concerning the client or its employees. According to Reg. 31.3401(d)-1(q), acting merely as an agent for the employer is not sufficient to establish exclusive legal control.]
 - b. An outsourcer who prepares payroll and makes tax deposits using client information. [This answer is incorrect. The client is making the payroll decisions and supplying the information. The outsourcer has no control over the client's employees. According to Reg. 31.3401(d)-1(q), acting merely as an agent for the employer is not sufficient to establish exclusive legal control.]
 - c. A subcontractor who exercises daily supervision of the general contractor's employees. [This answer is incorrect. For purposes of assigning liability for FITW, the subcontractor's control of the daily activities of the general contractor's employees would be overridden by other considerations. According to Reg. 31.3401(d)-1(q), acting merely as an agent for the employer is not sufficient to establish exclusive legal control.]
 - d. **The administrator of a trust fund who makes monthly discretionary distributions to beneficiaries. [This answer is correct. The distributions are discretionary, meaning the administrator exercises exclusive financial control over the payments. For purposes of assigning liability for FITW, the trust fund administrator would be considered the "employer."]**
6. Barker Controls went into Chapter 11 bankruptcy in June 2009. Advantage Factors bought the outstanding payroll claims against Barker in August of that same year. Who is deemed liable for applicable payroll taxes regarding these claims? **(Page 19)**
- a. The bankruptcy court. [This answer is incorrect. The bankruptcy court approves the bankruptcy plan. The court has no relationship to the workers of Barker Controls and is not liable for applicable payroll taxes per IRS Notice 2006-83.]
 - b. **Advantage Factors. [This answer is correct. By purchasing the payroll claims, Advantage has assumed control of the wage payments and therefore has stepped into the role of employer for purposes of withholding and paying employment taxes.]**
 - c. The bankruptcy trustee. [This answer is incorrect. The bankruptcy trustee performs a number of duties including monitoring the business operation of the debtor in possession, but has no direct relationship to the workers of Barker Controls, and is not liable for applicable payroll taxes per IRS Notice 2006-83.]
 - d. Barker Controls. [This answer is incorrect. Barker continues to meet the IRS requirements for an employer/employee relationship, but has transferred the liability for taxes on outstanding payroll claims to Advantage Factors.]

Agent or Service Bureaus

Employers sometimes retain the services of third persons to handle some or all of their payroll tax duties and responsibilities. These third-party agents, fiduciaries, or other persons that act on behalf of (or as) the employer may be authorized by the IRS to perform payroll tax functions, including withholding taxes from employer wages and filing payroll returns. Typical situations include:

1. Use of a commercial payroll agency or service bureau to handle payroll-related functions.
2. Creation of a central agency by a group of related or unrelated employers to perform payroll-related functions.
3. Establishment of a fiduciary trust fund (often under a collective bargaining agreement) to make certain payments to employees and perform the related payroll tax duties.

Reporting Agents

A reporting agent is an accounting service, franchiser, bank, service bureau, or other entity authorized to perform certain acts on behalf of the taxpayer. Such acts include (1) signing and filing certain returns; (2) making deposits and payments for certain returns; (3) receiving duplicate copies of tax information, notices, and written communication regarding any authority granted; and (4) providing the IRS with information to aid in penalty relief determinations related to the authority granted.

Form 8655 (Reporting Agent Authorization) is the appropriate authorization form for a taxpayer to use for designating a reporting agent to (1) file and sign numerous forms including Forms 940, 941, 943, 944, and 945; (2) make federal tax deposits (FTDs) and other federal tax payments (FTPs) and submit FTD and FTP information electronically for taxes reported on numerous forms including Forms 940, 941, 943, 944, and 945; (3) receive duplicate copies of official notices, correspondence, deposit requirements, transcripts, or other information related to certain tax returns; or (4) receive duplicate copies of official notices, correspondence, deposit requirements, transcripts, or other information about FTDs and FTPs. The form also allows taxpayers to grant reporting agents the authority to receive confidential taxpayer information from the IRS to assist in responding to notices relating to Form W-2 and Form 1099 series information returns filed by the reporting agent on behalf of the taxpayer. See Rev. Proc. 2007-38 for information on the requirements for completing and submitting Form 8655.

Example 1F-1 Business employer is liable for reporting agent's performance.

Que Corporation appoints Quick-and-Easy Payroll Filings, Inc. as its reporting agent, to make its tax deposits and prepare and file its quarterly payroll returns and annual information returns. One year later, Quick-and-Easy, after failing to remit Que Corporation's payroll tax deposits to the IRS, goes bankrupt. The IRS may proceed against Que Corporation for the unpaid employer and employee payroll taxes (and impose penalties and interest), and may hold Que Corporation responsible for any unfiled payroll or information returns.

Payroll Agents

A payroll agent is an agent, fiduciary, or other person who is authorized to perform acts required of employers under the Federal employment tax statutes. A payroll agent obtains authorization to file payroll tax returns and deposit and pay employment or other withholding taxes by filing Form 2678 (Employer/Payer Appointment of Agent) with the IRS before the date the employer wants the appointment to become effective. See Form F125 for a copy of Form 2678, including the form instructions that have a list of the IRS Service Center filing addresses.

The appointment is not effective until the IRS approves the request. The IRS will send a letter to the agent after the request is approved. After the IRS approves the appointment, payroll agents should follow the reporting, deposit, and payment procedures in Rev. Proc. 70-6 for employment taxes (unless the agent is a subagent for a state agent under IRS Notice 2003-70) and Rev. Proc. 84-33 for backup withholding. Rev. Proc. 70-6 deals only with authorization to act as a payroll agent for FITW and FICA purposes. A Form 2678 must be completed for each employer for whom the agent will act.

Difference between Form 8655 and Form 2678. A Form 8655 reporting agent acts for the employer, using the employer's (or client's) EIN to file separate returns for each client and pay the client's taxes. A Form 2678 payroll agent, however, acts as the employer, assuming joint liability with the employer for the employer's employment tax responsibilities. A Form 2678 agent files aggregate returns using the agent's EIN. Unlike Form 2678, Form 8655 can be used to designate a reporting agent to file Form 940.

Once authorized by the IRS, a payroll agent essentially steps into the employer's shoes with respect to payroll tax duties and is able to discharge the employer's total payroll tax compliance function for FITW and FICA purposes. However, the employer remains fully liable if the payroll agent or service bureau fails to properly discharge its payroll tax duties and responsibilities. There is no actual shifting of employer liability away from the business employer. Because the business employer remains liable for the payroll agent's actions (or lack thereof), it should exercise due diligence when selecting an agent and should thereafter monitor the agent's performance. The business should avoid the temptation to treat the payroll agent as the responsible party and should carefully review all calculations and returns. The IRS will not hesitate to move against the business employer if the payroll agent fails to meet its obligations.

Example 1F-2 Requesting authorization to become a payroll agent.

X Corporation, XY Partnership, and XYZ Limited Company (LC) are each owned 100% by Individual A. To streamline the payroll tax compliance process and improve efficiency, the business affiliates decide that XY should act as payroll agent for X and XYZ LC.

Both X and XYZ LC should complete and submit a Form 2678 designating XY to act as their payroll agent. XY must also complete part of each Form 2678. The IRS will send written notice of authority to XY to act as the payroll agent, along with any terms and conditions that may attach to the authority granted.

Service Bureaus

As illustrated in the preceding example, while some businesses use an affiliated entity as their payroll agent, others use an independent service bureau to fulfill some or all of their payroll and human resource information system needs. Service bureaus usually operate standard payroll systems, but many also provide custom modifications. For some companies, a service bureau serves as their payroll processing department, while for others it supplements other in-house data processing capabilities. Since they perform payroll services for many clients, service bureaus normally have a strong technical staff to stay abreast of legal and tax changes that affect payroll.

The payroll services offered by service bureaus can be classified as either (1) basic preparation service, where the service bureau simply prepares the payroll, generates the reports and paychecks, and returns the information to the client (i.e., no other services are performed); or (2) payroll agency service, where the service bureau not only processes the client's payroll but also prepares the withholding tax reports, remits payment to the taxing authorities on the client's behalf, and pays the client's employees and applicable tax agencies from its own bank account.

The advantages and disadvantages of using a service bureau (compared with using in-house prepackaged or custom-designed software) are summarized as follows:

Advantages	Disadvantages
Minimal processing downtime because service bureaus have more computers and larger staffs trained to handle problems.	Special requests take longer to process, making a company's last-minute changes difficult.
Various reports have been developed from experience with similar customers, and in some (but not all) cases custom reports are also available.	Because service bureaus serve more than one customer, keeping on schedule is vital. However, timesharing capabilities may alleviate this restriction.
Fewer people from within the company can access payroll; therefore, earnings information will more likely remain confidential. Security identification and access codes are required.	Besides the rate charged to have the payroll processed each month, service bureaus charge additional fees (e.g., for additions, deletions, or changes to an employee pay record) that a company would avoid by doing the payroll in-house.

Advantages	Disadvantages
Because payroll processing is the service bureau's main business, these firms are motivated to stay abreast of the constant tax and nontax law revisions.	The company's pay information must be communicated and entrusted to outside sources, thus increasing disclosure risks.
The service bureau's staff minimizes the need for on-site support personnel.	Users do not have any control over the computer hardware or software modifications. The vendor may go out of business and no longer offer support to users.

Furthermore, the company should:

1. Require timely proof the bureau has actually performed the requested services.
2. Determine if the company should perform some activities itself. For example, the company may ask the service bureau to prepare the withholding reports and send them to the company for review. After reviewing the reports, the company can make the deposit directly.
3. Investigate the service bureau's financial condition and credit standing, both initially and on a periodic basis thereafter. How are the company's funds isolated from financial problems to which the bureau or its other clients may suffer, and what coverage and conditions apply to fiduciary bonds of service bureau employees? This is important because little protection or recourse is available to employers whose service bureau misuses funds intended for payroll tax payments and then goes bankrupt. Having the funds held in trust will also protect the funds from an IRS levy of the service bureau's bank account.
4. Document clearly in the contract the service bureau's policy on indemnifying the client for interest and penalties that the service bureau's errors cause.
5. Regularly monitor tax accounts including a biannual review of tax transcripts looking for short, late, or missing payments and returns.
6. Require the bureau to use the Electronic Federal Tax Payment System (EFTPS). Employers can use EFTPS to confirm that the service bureau made the employment tax payments on time and in the proper amount.

Typically, service bureaus charge a fixed fee for each pay period, plus fees for processing each transaction and changing payroll information. Additionally, a company that has on-line access to the service bureau must also cover the cost of a workstation or microcomputer setup plus Internet access costs

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

7. Which of the following is true concerning a reporting agent, a payroll agent, and a service bureau?
 - a. The reporting agent uses its own EIN while the payroll agent uses that of the client.
 - b. A payroll agent must be unaffiliated with the client except for the agency contract.
 - c. A service bureau can function as both a reporting agent and a payroll agent.
 - d. A service bureau pays payroll taxes from the client's bank account via EFT.

8. Davidson Company is a heavy construction company with 50 full-time employees and numerous day laborers, some of whom are immigrant workers. The owner of Davidson, Frank Dean, has little or no affinity for the finer points of immigration, payroll, and payroll tax laws, but he wants to make sure Davidson complies with them. On the other hand, he cannot afford to hire the necessary specialists. Davidson has only a small office staff and currently, payroll requires the efforts of three full-time employees; these employees are not payroll specialists and are needed in contracts, billing, and accounts payable. Dean has consulted Ed Josephs, CPA for recommendations. What should Josephs recommend?
 - a. Davidson should hire and train the requisite payroll staff.
 - b. Davidson should investigate the use of a service bureau.
 - c. Davidson should supplement existing staff with a reporting agency.
 - d. Davidson should replace existing personnel with a payroll agency.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

7. Which of the following is true concerning a reporting agent, a payroll agent, and a service bureau? **(Page 26)**
- a. The reporting agent uses its own EIN while the payroll agent uses that of the client. [This answer is incorrect. The reporting agent uses the client's EIN and the payroll agent uses its own EIN.]
 - b. A payroll agent must be unaffiliated with the client except for the agency contract. [This answer is incorrect. The payroll agent organization and the client are sometimes affiliated by common ownership.]
 - c. A service bureau can function as both a reporting agent and a payroll agent. [This answer is correct. Service bureau payroll services are classified as either basic preparation service or payroll agency service.]**
 - d. A service bureau pays payroll taxes from the client's bank account via EFT. [This answer is incorrect. A service bureau pays payroll taxes from its *own* account.]
8. Davidson Company is a heavy construction company with 50 full-time employees and numerous day laborers, some of whom are immigrant workers. The owner of Davidson, Frank Dean, has little or no affinity for the finer points of immigration, payroll, and payroll tax laws, but he wants to make sure Davidson complies with them. On the other hand, he cannot afford to hire the necessary specialists. Davidson has only a small office staff and currently, payroll requires the efforts of three full-time employees; these employees are not payroll specialists and are needed in contracts, billing, and accounts payable. Dean has consulted Ed Josephs, CPA for recommendations. What should Josephs recommend? **(Page 26)**
- a. Davidson should hire and train the requisite payroll staff. [This answer is incorrect. Dean has made it clear that maintaining a staff of payroll specialists is not cost feasible so this recommendation does not answer the needs of the client.]
 - b. Davidson should investigate the use of a service bureau. [This answer is correct. Dean has clearly expressed a desire to outsource all payroll, tax payment, and reporting activities. Contracting payroll services with a service bureau is a logical option in this case.]**
 - c. Davidson should supplement existing staff with a reporting agency. [This answer is incorrect. A reporting agency could make federal tax deposits and other federal tax payments, file forms 941, 943, and others, and perform certain other acts on behalf of Davidson, but existing personnel would still be required for processing payroll, paying employees, etc. Dean has made it clear that he wants to eliminate or radically reduce payroll department staff at Davidson.]
 - d. Davidson should replace existing personnel with a payroll agency. [This answer is incorrect. A payroll agency can make tax deposits, certain filings, etc. on behalf of Davidson, but the payroll department would still be required to process new hires, timesheets, etc. Dean has made it clear that requisite training and staffing in the payroll department is not cost feasible.]

Trust Fund Taxes—Avoiding Lender Liability

IRC Sec. 3505 holds lenders who pay or advance funds for payment of an employer's wages liable for the payment of trust fund taxes (i.e., the employees' withheld FITW and FICA) if the employer fails to remit them. This provision is broad enough to ensnare not only traditional lenders such as banks or financial institutions or sureties, but also other persons such as manufacturers and general contractors that finance the payroll of suppliers, subcontractors, etc. However, the term *other person* does not include a person acting only as a payroll agent.

Note the following significant aspects of the lender liability provision:

1. Lender liability applies only if the employer is unable or fails to pay. It may apply if the lender (a) pays the wages directly, or (b) advances to the debtor/employer the funds needed to pay the wages. Each situation is subject to different rules and creates different lender liability.
2. Lender liability applies only to trust fund taxes not paid by the employer. The employer remains liable for employer payroll taxes (i.e., employer's share of FICA tax and FUTA tax).
3. The lender is not required to file payroll returns, file annual wage information returns, or perform other compliance-related functions. These duties and responsibilities remain with the employer.
4. The lender liability provision of IRC Sec. 3505 differs from the responsible party provision of IRC Sec. 6672.

Example 1G-1 Scope of the lender liability provision.

Corporation Z manufactures steel products. Z has a longstanding relationship with Supplier A, which provides raw materials for use in Z's manufacturing process. On January 1, 2009, A notifies Z that it is undergoing severe financial hardship and will have difficulty meeting Z's standing order for product. Z agrees to advance A's net payroll for the next two-month period to ensure a continuous flow of raw materials.

If A fails to remit to the government the amount of trust fund taxes due on these wages, Z may be held liable under IRC Sec. 3505. (This result is achieved irrespective of whether Z might also be liable as an employer under the control-of-wage-payments rule.)

Lender Pays Wages Directly

If the lender directly pays the wages of an employer, the lender is liable for 100% of trust fund taxes on this compensation if the employer defaults, including interest from the due date of the applicable quarterly or annual payroll tax return. This liability is imposed whether or not the lender knows or believes the employer/debtor cannot, or will not, pay its trust fund taxes. For these reasons, the prudent lender will personally withhold and pay the trust fund payroll taxes on the employer's payroll. Form 4219 (Statement of Liability of Lender, Surety, or Other Person for Withholding Taxes) is used by the lender to remit the trust fund taxes to the IRS. A separate Form 4219 should be submitted, in duplicate, for each employer and for each calendar quarter or year for which a lender incurs liability under Section 3505.

Example 1G-2 Lender pays wages directly.

Assume the same facts as in Example 1G-1 (and that A paid the trust fund taxes for January and February), except that Corporation Z is unable to find another supplier of its critical raw material product. Z agrees to continue financial assistance to Supplier A for an additional one-month period (March 2009). Rather than advance funds to A, Z opts to pay A's net wages directly. Net wages and the applicable taxes for March 2009 are as follows: net wages of \$110,000, employee FITW and FICA tax of \$30,000, and employer FICA tax of \$10,000.

If A fails to remit the trust fund taxes of \$30,000 to the government, Z may be held liable for this amount under IRC Sec. 3505(a). Furthermore, Z could be held liable for interest on it from the due date of A's Form 941 quarterly payroll tax return (April 30) to the date paid.

Lender Supplies Funds to Pay Employer's Wages

Rather than pay the wages outright, the lender may advance to the employer the amount needed to pay the employer's wages (i.e., the specific purpose of the loan is to pay wages). Under IRC Sec. 3505(b), the lender may

be liable if it has "actual notice or knowledge" the employer either is not able to, or does not intend to, make timely payment of its trust fund taxes. A lender's liability under this provision is limited to 25% of the funds advanced to the employer to pay wages. (This amount may be further limited if the lender finances only a portion of the employer's payroll.) Form 4219 is used by the lender to remit the taxes to the IRS.

The lender is deemed to have "actual notice or knowledge" of any event that would have come to the attention of the person in its office conducting the transaction if the lender had exercised due diligence by maintaining and complying with reasonable communications routines. While the lender does not have to affirmatively seek out information on the employer's intentions or abilities to pay trust fund taxes, if the lender obtains information that would cause a reasonable person to suspect the taxes will not be paid, it must investigate further.

Example 1G-3 Lender supplies funds to pay employer's wages.

Assume the same facts as in Example 1G-2 except that Z lends A the money necessary to pay its employee's net wages (\$110,000) and knows that A may not be able to pay the trust fund taxes. If Supplier A fails to pay over the March 2009 trust fund taxes, Corporation Z's liability under IRC Sec. 3505(b) will be the lesser of \$30,000 (the trust fund taxes) or \$27,500 ($\$110,000 \times 25\%$). While the IRS would like to collect interest on the \$27,500, the 25% limit includes both the trust fund taxes and interest, so its total recovery would be limited to \$27,500.

IRC Sec. 3505(b) does not apply to ordinary working capital loans. This is true even if the lender knows that some of the funds may be used by the employer to pay wages in the ordinary course of business. However, this exception is not applicable if the lender has actual notice or knowledge at the time of the advance that the funds, or a portion thereof, are to be used specifically to pay net wages, whether or not the written agreement under which the funds are advanced states a different purpose. Whether or not a lender has actual notice or knowledge that the funds are to be used to pay net wages, or merely that the funds may be so used, depends upon the facts and circumstances of each case. For example, a lender who has actual notice or knowledge that the withheld taxes will not be paid will be deemed to have actual notice or knowledge that the funds are to be used specifically to pay net wages when substantially all of the employer's ordinary operating expenses consist of salaries and wages, even though funds for other incidental operating expenses may be supplied pursuant to an agreement described as a working capital loan agreement.

Comparison of IRC Secs. 3505 and 6672

The IRS sometimes contends a lender is liable under the trust fund recovery penalty provisions of IRC Sec. 6672 as well as under IRC Sec. 3505. Generally, it is more difficult for the IRS to recover under IRC Sec. 6672 because it must prove the lender was responsible and willfully failed to pay taxes over to the government. A lender can pay wages directly to employees without actually controlling, or having the authority to control, the employer's finances. In such case, the lender may not meet the Section 6672 test for being a *responsible person*, but will be liable under IRC Sec. 3505.

While the IRS may find it easier to meet the substantive requirements for assessing liability under IRC Sec. 3505, IRC Sec. 6672 is preferred from a procedural standpoint because the IRS cannot administratively recover (i.e., through its lien and levy procedures) a lender's Section 3505 liability. The IRS can recover under IRC Sec. 3505 only by assessing the amount, and then filing the appropriate civil action in District Court. On the other hand, IRC Sec. 6672 allows the IRS to make an immediate assessment against the responsible person(s) and then use its administrative collection powers to extract the money.

From a revenue perspective, the IRS may simultaneously pursue both theories of recovery. While the trust fund penalty authorizes the IRS to collect the full amount of unpaid trust fund taxes from the responsible person(s), only interest accruing after the date of the assessment can be collected. Conversely, under IRC Sec. 3505, the IRS can collect prejudgment interest from the due date of the employment tax return (subject to the 25% limitation previously discussed). Accordingly, one IRS strategy may be to assess the trust fund recovery penalty under IRC Sec. 6672 to initiate administrative collection (i.e., lien and levy) action, and also pursue recovery under IRC Sec. 3505 to collect prejudgment interest.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. According to IRC Section 3505, which of the following statements is most accurate?
 - a. A lender may be held liable for FITW, FICA, and FUTA taxes if the debtor/employer fails to pay them.
 - b. The term "lender" extends beyond normal financial institutions to include customers and suppliers.
 - c. The lender is charged with performing compliance-related functions on the debtor/employer trust fund payment default.
 - d. Lender liability for debtor/employer trust fund payment default only applies if the lender pays the wages directly.

10. Better Bank covered payroll check overdrafts totaling \$12,000 for Bangor Corporation. Total net payroll was \$20,000. Trust fund taxes were \$5,455; the portion applicable to overdrafts was \$3,273. Employer FICA tax liability was \$1,818. Excluding any interest, what is Better Bank's potential exposure if Bangor defaults under IRC Section 3505?
 - a. \$3,000.
 - b. \$3,273.
 - c. \$5,000.
 - d. \$5,455.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. According to IRC Section 3505, which of the following statements is most accurate? **(Page 31)**
- a. A lender may be held liable for FITW, FICA, and FUTA taxes if the debtor/employer fails to pay them. [This answer is incorrect. The lender's liability under IRC Section 3505 extends only to trust fund taxes.]
 - b. The term "lender" extends beyond normal financial institutions to include customers and suppliers. [This answer is correct. IRC Section 3505 defines the term "lender" in broad terms such that it can include circumstances and sources outside normal financial lending channels.]**
 - c. The lender is charged with performing compliance-related functions on the debtor/employer trust fund payment default. [This answer is incorrect. Under IRC Sec. 3505, responsibility for compliance-related functions remains with the debtor/employer.]
 - d. Lender liability for debtor/employer trust fund payment default only applies if the lender pays the wages directly. [This answer is incorrect. Under IRC Sec. 3505, lender liability may also apply if the lender advances the funds needed for wage payments.]
10. Better Bank covered payroll check overdrafts totaling \$12,000 for Bangor Corporation. Total net payroll was \$20,000. Trust fund taxes were \$5,455; the portion applicable to overdrafts was \$3,273. Employer FICA tax liability was \$1,818. Excluding any interest, what is Better Bank's potential exposure if Bangor defaults under IRC Section 3505? **(Page 31)**
- a. \$3,000. [This answer is correct. According to the IRS, Better Bank's potential exposure is the lesser of 100% of the trust fund tax owed or 25% of the payroll loaned. In this case, 25% of the \$12,000 in covered overdrafts is less than the trust fund taxes applicable to the overdrafts.]**
 - b. \$3,273. [This answer is incorrect. Trust fund tax liability must be compared to a benchmark in order to determine Better Bank's exposure.]
 - c. \$5,000. [This answer is incorrect. Since Better Bank did not loan the entire payroll they would not be liable for the taxes on the total payroll.]
 - d. \$5,455. [This answer is incorrect. Better Bank's exposure would not extend to total trust fund taxes for the payroll since the loan was for less than the total payroll.]

EXAMINATION FOR CPE CREDIT**Lesson 1 (PRLTG091)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. If the employee presents a receipt showing application for a replacement document, (i.e., USCIS Form I-94) the employer must have the actual document.
 - a. Within 3 days of employment date.
 - b. Within 12 days of employment date.
 - c. Within 90 days of employment date.
 - d. Do not select this answer choice.

2. Which of the following statements is correct regarding wages for a single-member LLC after 2008?
 - a. It should use the member's employer identification number for payroll tax purposes.
 - b. It should determine employer status for payroll tax purposes based on entity form chosen.
 - c. It is treated as a corporation for purposes of employment taxes and related reporting requirements.
 - d. It may opt between two methods acceptable by the IRS for payroll tax purposes.

3. The control-of-wage-payments rule is an express override of the employer/employee relationship rule in the statute concerning which of the following?
 - a. FITW.
 - b. FICA.
 - c. FUTA.
 - d. Medicare.

4. Plush Furniture opened December 31, 2007 with no employees as a sole proprietorship. On January 10, 2008, Plush hired 10 employees for its only store. On June 28, 2009, Plush terminated all employees. On July 5, 2009, Plush Furniture filed for bankruptcy. The owner hired covered wage day labor from August 1 to August 7 to help with final cleanup. Bankruptcy was final December 31 of the same year. When did Plush Furniture's liability for FICA end?
 - a. June 28, 2009.
 - b. July 5, 2009.
 - c. August 7, 2009.
 - d. December 31, 2009.

5. What is the overriding factor when determining responsibility for withholding and payroll tax payments?
 - a. The existence of a common law employment relationship between the parties.
 - b. Whether one party is a common law third-party beneficiary to the agreement.
 - c. Whether one party exerts control over the monetary distributions to the other.
 - d. The existence of a gratuitous bailment in a third-party distribution.

6. Peabody Company and Variman Corporation are wholly-owned subsidiaries of Johnson Inc. Peabody has entered into an employee leasing agreement with OurJob Staffing and shares employees with Variman when needed. OurJob handles all HR and payroll tasks for the workers and bills Peabody monthly. Peabody controls the effort of the workers and has right to reject a worker for performance. OurJob will replace rejected workers within 24 hours. Who is liable for withholding and payment of employment taxes?
 - a. Johnson Inc.
 - b. OurJob Staffing.
 - c. Peabody Company.
 - d. Variman Corporation.

7. Ultimate responsibility for withholding and paying employment taxes lies with which of the following?
 - a. Reporting agency.
 - b. Payroll agency.
 - c. Service bureau.
 - d. Client entity.

8. Jared Investigations employs 25 full-time investigators and has an accounting staff of 3 employees, one of whom processes new-hires, terminations, etc., and performs all payroll functions. Mike Jared, the owner, wants to relieve this employee of some of the processing burden. He has decided that the employee should no longer make payroll tax deposits and related filings, but he still wants tax payments to be made by EFT from his company's payroll account to the taxing authority. He has approached Roger Freeman, CPA for advice. What should Freeman recommend?
 - a. Jared should hire another payroll clerk.
 - b. Jared should hire a reporting agency.
 - c. Jared should hire a payroll agency.
 - d. Jared should hire a service bureau.

9. Under IRC Section 3505, a lender who advances money to a debtor specifically to pay wages should do which of the following?
 - a. File Form 4219 to remit applicable taxes to the IRS.
 - b. File Form 941 on behalf of the debtor/employer.
 - c. Notify the IRS of the loan to ensure taxes are properly collected.
 - d. Contractually obligate the debtor/employer to pay trust fund taxes.

10. Which of the following statements concerning the trust fund recovery penalty provisions of IRS Sections 6672 and 3505 are correct?
 - a. A lender found liable under IRC Section 6672 will be precluded from liability under IRC Section 3505.
 - b. A finding of lender liability under IRC Section 6672 requires proving the lender was a responsible party.
 - c. Under IRC Section 6672, a lender can be found liable for 100% of tax due plus prejudgment interest.
 - d. IRC Section 3505(b) applies to working capital loans even if the lender has no cause to suspect unpaid trust fund taxes.

Lesson 2: Employee-sharing Between Business Affiliates

INTRODUCTION

Business affiliates often share employees. The workers can hold many different types of positions from clerical and administrative staff to rank-and-file employees to technical specialists to management. The tasks these workers perform may include marketing, management, administration, technical, or related services. This lesson covers some of the key employer liability issues (including the minimization of payroll taxes) encountered when business affiliates share employees or when business affiliates combine through acquisition or merger.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify payroll tax considerations concerning mergers and acquisitions;
- Determine employer business affiliation and liability for shared employees, identify ways to avoid payroll tax duplication related to shared employees, and assess employer eligibility for using a common paymaster system;
- Identify rules and considerations related to common paymaster situations;
- Generalize rules and mechanics related to operating a common paymaster system, and calculate employer liability for employee compensation and payroll taxes; and
- Identify consequences of inappropriately pricing shared employee services between business affiliates.

Acquisitions and Mergers—Payroll Considerations

Ordinarily, if an employee has more than one employer during the calendar year, the FICA and FUTA wage limits apply to the wages paid by each employer, not to the aggregate wages paid by all employers. However, a successor employer can use the wages paid that calendar year by the predecessor to calculate its FICA tax liability for an employee who continues working after the acquisition. As a result, the FICA taxes owed by the successor are reduced in the year of the acquisition by the FICA taxes paid for the same employees by the predecessor.

For FUTA purposes, wages paid by a predecessor employer can be counted by the successor in figuring the wage limit if the predecessor and successor are both covered employers for the calendar year in which the acquisition occurred. A successor employer can get a credit against its FUTA tax for the state unemployment taxes paid by the predecessor if the predecessor is not a covered employer. To qualify for the credit, the successor must acquire substantially all the property used in a trade or business (or in a separate unit of a business) of the predecessor, and immediately after the acquisition employ one or more of the predecessor's employees. The credit equals the amount of the FUTA credit the predecessor would have been entitled to if it had been a covered employer.

Successor/Predecessor Relationship

A *successor employer* is an employer who acquires substantially all the assets used by the predecessor employer in its trade or business (or in a separate unit of its trade or business), and immediately after the acquisition employs individuals that worked for the predecessor immediately before and during the same calendar year as the acquisition. The method of acquisition is immaterial. Such an acquisition can occur through the incorporation of a business by a sole proprietor or a partnership, the continuance without interruption of the business of a previously existing partnership by a new partnership, or by purchase or any other transaction where substantially all the property used in a trade or business or a separate unit of a trade or business of one employer is acquired by another employer.

Substantially all the property used in a separate unit of a trade or business can consist of property used in the performance of an essential operation of the trade or business, or property used in a relatively self-sustaining part of the trade or business. For example, where an appliance manufacturer stops making motors and transfers all the property used in that operation to another company, the successor is considered to have acquired a separate unit of the trade or business of the predecessor. Similarly, where a clothing store chain transfers one store to a rival chain, the successor has acquired a separate unit of the trade or business of the predecessor.

Statutory Merger or Consolidation

There is no successor/predecessor relationship in a statutory merger or consolidation (i.e., where one corporation is absorbed by another) because there is considered to be one continuing employer. For FUTA purposes, the resulting corporation is subject to FUTA tax for the premerger or preconsolidation employees of the absorbed corporation if the continuing company is a covered employer for the year in which the transaction occurs, taking into account the absorbed and continuing corporations' wage and employment histories for the current and preceding year. Similarly, in calculating FICA liability, wages paid to employees who work for both the absorbed and the continuing company are considered paid by the same employer, so the social security wage base (\$106,800 for 2009) is applied to the combined wages.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. Lively Company purchased the Midland division of Freemart Ltd in July 2009 and retained all its employees. For FUTA tax purposes, Lively is a covered employer; Freemart is not a covered employer, but pays FUTA. This means which of the following?
 - a. Lively is entitled to a credit for FUTA tax paid by Freemart on Midland in 2009.
 - b. Freemart must pay FUTA tax on Midland employees for the first half of 2009.
 - c. Lively Company must pay FUTA on Midland employees at its rate for all of 2009.

12. Which of the following statements concerning a statutory merger or consolidation is correct?
 - a. In a statutory merger, FUTA tax is based on pre- and post-merger wage and employment history for the current and two prior years.
 - b. For FUTA tax purposes in a statutory merger, the continuing company must not be a covered employer.
 - c. The successor can count wages paid by the predecessor in FUTA wage limit calculations if both successor and predecessor are covered employers.
 - d. The successor can count wages paid by the predecessor in the aggregate for calculating post-acquisition FICA tax liability.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

11. Lively Company purchased the Midland division of Freemart Ltd in July 2008 and retained all its employees. For FUTA tax purposes, Lively is a covered employer; Freemart is not a covered employer, but pays FUTA. This means which of the following? **(Page 39)**
- a. **Lively is entitled to a credit for FUTA tax paid by Freemart on Midland in 2009. [This answer is correct. The covered successor employer is entitled in the year of acquisition to the credit for FUTA tax that the predecessor employer would have enjoyed had it been a covered employer as specified by IRS regulations.]**
 - b. Under IRS regulations, Freemart must pay FUTA tax on Midland employees for the first half of 2009. [This answer is incorrect. Under IRS regulations, Freemart is not a covered employer and therefore does not owe FUTA tax.]
 - c. Lively Company must pay FUTA on Midland employees at its rate for all of 2009. [This answer is incorrect. According to IRS regulations, Lively is only responsible for FUTA tax on the Midland employees from the date of acquisition.]
12. Which of the following statements concerning a statutory merger or consolidation is correct? **(Page 40)**
- a. In a statutory merger, FUTA tax is based on pre- and post-merger wage and employment history for the current and two prior years. [This answer is incorrect. According to IRS regulations, only the current and preceding year are considered.]
 - b. For FUTA tax purposes in a statutory merger, the continuing company must not be a covered employer. [This answer is incorrect. IRS regulations require the continuing company to be a covered employer in the year the statutory merger occurs.]
 - c. **The successor can count wages paid by the predecessor in FUTA wage limit calculations if both successor and predecessor are covered employers. [This answer is correct. Under IRS rulings, the successor can include predecessor wage payments when calculating the FUTA wage limit if both successor and predecessor are covered employers during the calendar year in which the acquisition occurred.]**
 - d. The successor can count wages paid by the predecessor in the aggregate for calculating post-acquisition FICA tax liability. [This answer is incorrect. According to IRS regulations, the successor can count wages paid by the predecessor for calculating FICA tax liability, but this consideration is on an employee-by-employee basis.]

Shared Employee Transactions and Employer Liability

Business affiliates most often share employees under (1) a concurrent employment arrangement, or (2) an employee loan-out arrangement.

Concurrent Employment

A concurrent employment arrangement involves simultaneous employment of a worker by two or more business affiliates. This means the worker is actually an employee of each business affiliate. Often, the employee is hired to work primarily for a single entity, but also does limited work under the direction and control of one or more other business affiliates. In a concurrent employment arrangement, each business affiliate has a separate payroll tax responsibility for the employee and is liable for employer FICA and FUTA tax on the employee's wages up to the taxable wage limit. However, see following sections for use of a common paymaster to limit the resulting payroll tax liability.

Concurrent employment exists only so long as a simultaneous employment relationship continues. An employee on leave or temporarily inactive with respect to either business affiliate (or both affiliates) generally is still held to be concurrently employed. On the other hand, no concurrent employment exists if the employee's employment relationship with all but one of the affiliates ceases to exist.

Example 2B-1 Concurrent employment arrangement.

AB Partnership and Z Corporation are business affiliates sharing common ownership. Executive T, Accountant C, and Engineer Y are employees of both entities. Each affiliate separately pays these employees and controls their performance and services.

AB and Z employ T, C, and Y under a concurrent employment arrangement. Each business affiliate is responsible for payroll tax compliance for the services these employees perform for them.

Employee Loan-out

An employee loan-out arrangement involves one business affiliate (the renderer) agreeing to provide employee services for one or more business affiliates (the recipients). Here, the employee works under the direction and control of a single business affiliate (the renderer) and is paid solely by this entity, but performs services for more than one business affiliate. The type of work and the selection of employees to perform the contracted services can be made by a participating affiliate or by mutual agreement. A great deal of latitude exists in how the arrangement can be structured.

In an employee loan-out arrangement, the renderer business affiliate is the employee's sole employer. It has payroll tax responsibility and is liable for employer FICA and FUTA tax on the employee's wages.

Example 2B-2 Employee loan-out arrangement.

X Corporation and Y Corporation are members of a controlled group of corporations and both manufacture alcohol fuel products. X employs workers with special expertise in the engineering and production aspects of the production process, while Y's employees do not have this technical expertise. X contracts with Y to provide engineering and production consulting services on an as needed basis. Under the terms of the agreement, X retains control over the performance of its employees who provide services to Y and pays the employees for the services performed. Y then reimburses X at an arm's length fair value for the services performed.

X is considered the employer of the employees performing services under the employee loan-out arrangement. It has payroll tax responsibility for these employees.

Liability for Employment Taxes

When business affiliates share employees, each employer (business affiliate) must withhold employee income and FICA taxes and pay employer FICA and FUTA taxes on the employee's wages. Each payroll tax statute has its own

definition of employer. Accordingly, it is possible for a business affiliate to be an employer for purposes of some, but not all, of the payroll tax statutes.

The rules for identifying employer business affiliates may be summarized as follows:

1. For FITW, the focus is on the presence or absence of an employer/employee relationship. The FITW statute also provides a special rule that overrides the employer/employee rule when another person controls the payment of some or all of an employee's wages. This special rule provides that the person in control of payment is the employer with respect to such wages. The IRS and the courts agree on this.
2. For FICA and FUTA, the courts generally adopt the common law control test to determine whether an employer/employee relationship exists. They hold that the entity that controls the worker is the employer. However, the courts have sometimes allowed control over wage payments to take precedence over the common law control test. While none of these cases involved employee sharing between business affiliates, it is possible that, as an emerging concept, the courts might apply this principle to these situations.
3. For FICA and FUTA, the IRS officially adopts the common law control test to determine which business affiliates are employers. While recent private letter rulings have acknowledged the court's preference for the control-over-wage-payments principle over the common law control test (indeed, the Service has even adopted this position in some letter rulings), none of these letter rulings involved employee sharing between business affiliates.

The IRS has issued several revenue rulings that address the more common scenarios under which business affiliates engage in shared employee transactions. However, these rulings were issued prior to 1975, when the courts first began applying the control-over-wage-payments principle. Thus, they may not be consistent with the IRS's current thinking.

Employer Payroll Tax Computation and Wage Base Limit

As part of the Federal Insurance Contributions Act (FICA), a social security tax (the OASDI component of the FICA tax) is imposed on the employer up to a maximum amount of employee wages (the *social security wage base limit*). Wages in excess of the social security wage base limit (\$106,800 for 2009) are exempt from the social security tax. Conversely, there is no limit on the amount of earnings subject to the Medicare tax component of the FICA tax.

In a concurrent employment arrangement, each business affiliate is liable for the employer social security tax on wages the employee earns performing services for the affiliate. Consequently, if the employee's total wages from all business affiliates exceed the social security wage base limit, the affiliates pay a greater combined employer social security tax than would a single employer. The same is true for FUTA tax purposes if the employee's total wages from all business affiliates exceed the FUTA wage base limit (\$7,000 for 2009).

Example 2C-1 Concurrent employment arrangement creates excess payroll tax expense.

TB Partnership, TB Corporation, and TB Limited Liability Company (LLC) are business affiliates. Z is a key executive who is concurrently employed by each affiliate. Z's 2009 salary and each affiliate's separately calculated employer FICA and FUTA tax on this salary are as follows:

<u>Entity</u>	<u>Salary</u>	<u>Employer Payroll Tax</u>			<u>Total</u>
		<u>OASDI (at 6.2%)</u>	<u>Medicare (at 1.45%)</u>	<u>FUTA (at .8%)</u>	
TB Partnership	\$ 25,000	\$ 1,550	\$ 363	\$ 56	\$ 1,969
TB Corporation	70,000	4,340	1,015	56	5,411
TB LLC	20,000	1,240	290	56	1,586
	<u>\$ 115,000</u>	<u>\$ 7,130</u>	<u>\$ 1,668</u>	<u>\$ 168</u>	<u>\$ 8,966</u>

If only one of these entities employed and paid Z, the total employer FICA and FUTA tax attributable to Z's wages would be as follows:

<u>Entity</u>	<u>Employer Payroll Tax</u>				
	<u>Salary</u>	<u>OASDI</u>	<u>Medicare</u>	<u>FUTA</u>	<u>Total</u>
Combined	<u>\$ 115,000</u>	<u>\$ 6,622</u>	<u>\$ 1,668</u>	<u>\$ 56</u>	<u>\$ 8,048</u>

Here, Z's concurrent employment ends up costing the business affiliates \$620 (\$8,966 – \$8,346) in duplicated payroll taxes.

The excess employer payroll tax expense problem can be avoided in several ways. One way is to adopt an employee loan-out arrangement. Another option exists if the business affiliates meet the prerequisites for implementing a common paymaster system.

Using an Employee Loan-out Arrangement to Avoid Payroll Tax Duplication

In a properly structured employee loan-out arrangement, the renderer affiliate is solely liable for the employer tax on wages of employees who participate in the loan-out. Thus, the business affiliates combined pay no more employer FICA or FUTA tax than would a single employer.

Example 2C-2 Using an employee loan-out arrangement to avoid payroll tax duplication.

Assume the same facts as in Example 2C-1 except that Executive Z is employed as an officer solely by TB Corporation. TB Corporation enters into an agreement with TB Partnership and TB LLC by which Z will perform services for these affiliates as needed, and each entity will reimburse TB Corporation for these services. Z is an officer (under state law) of TB Corporation but not of TB Partnership or TB LLC. Z is paid solely by TB Corporation.

Here, Z is considered an employee only of TB Corporation. The employer tax attributable to Z's \$115,000 salary will be computed as follows (i.e., there is no payroll tax duplication):

<u>Entity</u>	<u>Employer Payroll Tax</u>				
	<u>Salary</u>	<u>OASDI</u>	<u>Medicare</u>	<u>FUTA</u>	<u>Total</u>
TB Corporation	<u>\$ 115,000</u>	<u>\$ 6,622</u>	<u>\$ 1,668</u>	<u>\$ 56</u>	<u>\$ 8,346</u>

The real audit hot spot within employee loan-out arrangements involves company officers, key executives, and other highly paid employees. These employees are most likely to exceed the social security wage base if employed by a single entity. IRS agents will look closely for situations in which these workers are actually employees of several business affiliates but claim employee status with only one. (If a significant amount of services are rendered by the worker to a recipient business affiliate and the recipient exercises some element of control over the worker's performance, the IRS may attempt to treat the worker as an employee of that business affiliate.) To combat this, the practitioner should ensure that workers truly are employees solely of the renderer business affiliate. This means ensuring they are hired by, and under the sole direction and control of, the renderer business affiliate.

How a Common Paymaster System Can Prevent Payroll Tax Duplication

Related corporations may avoid payroll tax duplication by implementing a common paymaster system. If two or more related corporations concurrently employ the same worker and pay the worker through a common paymaster that is one of the related corporations, only the common paymaster must withhold and pay employer FICA and FUTA tax. (This is true even though the worker's wages reflect services performed for several corporations.) If all wages of the concurrently employed worker are disbursed by the common paymaster, the group combined pays no more employer tax than would a single employer.

Example 2C-3 How a common paymaster system can prevent payroll tax duplication.

Assume the same facts as in Example 2C-1, except the three business entities are now incorporated. If they qualify for common paymaster treatment and elect for TB Corporation to act as their common paymaster, Z's wages are treated as paid by a single employer—the common paymaster. The applicable employer payroll tax is now as follows:

<u>Entity</u>	<u>Employer Payroll Tax</u>				
	<u>Salary</u>	<u>OASDI</u>	<u>Medicare</u>	<u>FUTA</u>	<u>Total</u>
TB Corporation	<u>\$ 115,000</u>	<u>\$ 6,622</u>	<u>\$ 1,668</u>	<u>\$ 56</u>	<u>\$ 8,346</u>

Since TB Corporation pays all payroll taxes, there is no payroll tax duplication.

Common Paymaster System Use

In general, each employer must pay FICA and FUTA taxes on wages paid to any employee up to the taxable wage limit. (For 2009, the taxable wage limits are \$106,800 and \$7,000 for the social security component of FICA and FUTA, respectively.) However, once a common paymaster system has been established for the concurrently employed workers, total FICA and FUTA taxes are calculated as if there was a single employer—the common paymaster.

A common paymaster system can be used for FICA and FUTA tax purposes. No such provision is necessary within the FITW statute because, under the FITW statute, the paying entity is always considered the employer. Thus, the fact that the common paymaster corporation controls payment of the employee's wages is enough to make it the employer for FITW purposes.

For state unemployment tax (SUTA) purposes, the rules regarding common paymasters vary by state.

The common paymaster system rules only apply to qualified related corporations (both C corporations and S corporations). Other types of business entities (proprietorships, partnerships, LLC's treated as partnerships for federal tax purposes, estates and trusts, etc.) may not use these provisions. However, a state or state university employing health professionals as faculty members at a medical school and a Section 501(c)(3) tax-exempt faculty practice plan are deemed to be related corporations that can use a common paymaster system if 30% or more of the plan's employees are concurrently employed by the medical school. Additionally, the common paymaster system rules apply independently of the consolidated income tax return rules. Affiliated corporations filing a consolidated income tax return still must comply with the common paymaster rules to avoid payroll tax duplication.

Common Paymaster System Must Meet Three Eligibility Requirements

Corporate business affiliates wanting to implement a common paymaster system must satisfy the following three fundamental requirements:

1. *Relationship.* The corporations must be related as that term is defined in the common paymaster regulations. This requirement is considered met for the entire calendar quarter if it is met at any time during the calendar quarter.

Related corporations can have more than one common paymaster. A corporation can be the common paymaster for certain related corporations or classes of employees while a different corporation can be the common paymaster for other corporations or classes of employees. Similarly, a corporation can use one common paymaster for some employees and another common paymaster for others.

2. *Authorization.* The corporations must authorize a corporation to be the common paymaster. This common paymaster must be a member of the group of related corporations participating in the arrangement and must assume responsibility for the common paymaster system.

3. *Concurrent Employment.* The corporations must concurrently employ workers. Concurrent employment means the worker simultaneously maintains an employee relationship with the common paymaster corporation and one other related corporation participating in the common paymaster arrangement. Only wage payments related to services performed while an employee is concurrently employed qualify under the common paymaster system.

Example 2D-1 Three eligibility requirements for common paymaster system.

Corporations P and S are related corporations (as per the common paymaster regulations). Executive A has worked concurrently for both corporations since 2001. While A's combined salary has historically exceeded the FICA and FUTA wage base limit, no common paymaster election has been made. Effective January 1, 2009, P authorizes S to act as its payroll agent.

On March 2, 2009, S hires a controller and an administrator. P and S decide that, effective April 1, these employees will work concurrently for both corporations. Because each will have combined wages exceeding the FICA and FUTA wage base limit, on March 9, 2009, the corporations authorize S to act as common paymaster. How do the common paymaster system rules apply?

The related corporations requirement is met for the entire calendar quarter if it is met at any time during the quarter. Here, it is considered in place as of January 1, the beginning of the calendar quarter. The authorization of a common paymaster corporation takes place on March 9. This is the start-up date for the common paymaster system.

Because A is already engaged in concurrent employment, wages paid to him by S after March 9 qualify as made under the common paymaster system. The new controller and administrator begin their concurrent employment on April 1. Only wages paid by S for services performed by these employees after March 31 qualify as made under the common paymaster system.

Related Corporations Requirement

Corporations are considered related for an entire calendar quarter if they satisfy any one of the following tests at any time during that quarter:

1. *Stock Ownership Test.* This includes corporations that meet the controlled group definition under IRC Sec. 1563, substituting a "more than 50%" threshold in place of the traditional "at least 80%" requirement.
2. *Common Director Test.* Where one or more of the corporations do not issue stock (e.g., certain nonprofit entities), the corporations either (a) share at least 50% common members on their boards of directors or (b) have common voting membership of at least 50%.
3. *50% Common Officer Test.* At least 50% of one corporation's officers are concurrently officers of the other corporation.
4. *30% Common Employee Test.* At least 30% of one corporation's employees are concurrently employees of the other corporation.

These tests examine the relationship between the common paymaster corporation and each corporate business affiliate wanting to participate in the common paymaster system. If an affiliate meets any one definition with respect to its relationship to the common paymaster, that corporation may participate in the arrangement. It is not necessary for a similar relationship to exist between the corporate business affiliate and all other participating affiliates.

Example 2D-2 Related corporations requirement tests relationship between common paymaster corporation and each participating affiliate.

Byte Corporation and Data Corporation are each owned 100% by Stockholder X. Chip Corporation is owned 100% by Stockholder Y. X and Y are close friends but are not related parties for federal tax purposes. Company officers A, B, and C are concurrently employed by Byte and Chip. Data employs officers D and E.

(None of the corporations employ any other company officers but each of the corporations has other regular workers.) While all three companies also concurrently employ individual J, a systems administrator, no other regular workers are concurrently employed. The corporations want to name Byte the common paymaster.

Here, the related corporation requirement must be applied to test the relationship between Byte and Data, and Byte and Chip. Byte and Data are a brother-sister controlled group as defined in IRC Sec. 1563. This meets the stock ownership test under the related corporations requirement. While Byte and Chip do not meet the stock ownership test (they are not related under IRC Sec. 1563 because there is no common ownership), they do concurrently employ the same company officers and thus meet the 50% common officer test.

Thus, the wages of the concurrently employed company officers and J, if paid by Byte (the common paymaster), qualify as made under the common paymaster system. The fact that Data and Chip are not related corporations (their relationship fails all four tests) has no impact.

Applying the Stock Ownership Test

The stock ownership test adopts the basic IRC Sec. 1563 rules but also introduces three key modifications:

1. The necessary percentage is reduced from "at least 80%" to "more than 50%." This opens up use of the common paymaster rules to a much larger population of corporate groups.
2. IRC Sec. 1563(a)(4), which excludes insurance companies subject to taxation under IRC Sec. 801, is ignored. Thus, insurance companies that are members of a controlled group can be included in a common paymaster system.
3. IRC Sec. 1563(b) does not apply. Hence, foreign corporations, exempt corporations, certain insurance companies, and franchised corporations are all eligible to participate in a common paymaster system.

Applying the 50% Common Officer and 30% Common Employee Tests

For purposes of the 50% common officer and the 30% common employee tests, any concurrent employment during the calendar quarter allows the employee to be counted toward the test. The regulations also make it clear that these percentage requirements must be met by either the common paymaster corporation or the related corporation being tested, but need not be met by both. This rule ensures that corporate affiliates with a disproportionate number of officers or employees will be eligible for common paymaster treatment.

Caution: The regulations do not state whether officers are included as employees for purposes of the 30% common employee test. However, the authors see no reason to exclude officers from this test.

Example 2D-3 Applying the 30% common employee test.

Loan Corporation employs individuals A, B, D, E, F, G, and H. Finance Corporation employs individuals A, B, and C. Bank Corporation employs individuals A, C, I, J, K, and L. The corporations have no common stockholders, officers, or directors.

Loan and Finance are related corporations because at least 30% of Finance's employees (A and B) are also employees of Loan. (Note that the 30% rule must be met by only one of the corporations.) Finance and Bank are related corporations because at least 30% of Finance's employees (A and C) are also employees of Bank. However, Loan and Bank are not related corporations because neither corporation has 30% of its employees concurrently employed by the other.

The only way all three can participate in a single common paymaster system is to designate Finance as the common paymaster. Otherwise, Loan and Finance could establish a common paymaster system, and Finance and Bank could establish a separate common paymaster system.

Concurrent Employment

Wage payments must be earned while an employee is concurrently employed to qualify under the common paymaster system. Concurrent employment means the worker simultaneously maintains an employer/employee

relationship with the common paymaster and at least one other related corporation participating in the arrangement.

Concurrent employment need not necessarily exist when the wages are paid. The requirement focuses on the existence of a concurrent employment relationship at the time the wages are earned, not when they are paid. [Reg. 31.3121(s)-1(b)(3) says that the concurrent employment relationship must exist “at the time the individual performs the services for which the remuneration is paid.”] Also, note that the common paymaster may pay concurrently employed individuals by one combined paycheck (drawn on a single account) or by separate paychecks drawn by the common paymaster on the accounts of one or more employing corporations.

Example 2D-4 Wages must be earned during concurrent employment.

Individual C is concurrently employed by Corporations T and Z between April 1, 2009, and June 30, 2009. Thereafter, C works solely for Z. Z is the common paymaster, and pays C the following amounts during the year:

<u>Date Paid</u>	<u>Amount</u>	<u>Related Work Period</u>
June 15	\$20,000	April 1 to May 31
July 15	10,000	June 1 to June 30
August 15	10,000	July 1 to July 31

The first two payments relate to services performed while C is concurrently employed and are deemed made under the common paymaster system. (This is true even though the second payment is made after the period in which C is concurrently employed.)

The third payment relates to services performed during a period in which no concurrent employment exists. It is not considered as made under the common paymaster system. However, in determining whether the third payment to C is subject to the social security portion of the FICA tax, Z can count the June 15 and July 15 payments disbursed while C was concurrently employed towards C's social security wage base.

The concurrent employment requirement is satisfied only if the employee has a concurrent employment relationship with the common paymaster corporation and a related corporation.

Example 2D-5 Employment nexus with the common paymaster and a related corporation.

Ag Corporation owns 100% of the stock of Seed Corporation and Grass Corporation. Seed is the group's common paymaster. Ag employs individuals A, B, D, and E. Seed employs individuals A, B, C, and J. Grass employs individuals A, C, E, and K.

In determining whether an employee is concurrently employed, it is necessary to examine the employee's employment relationship with the common paymaster and the related corporation. If the worker is employed concurrently by each of these two corporations, the concurrent employment test is met, and the common paymaster becomes the worker's employer for payroll tax purposes.

<u>Employee</u>	<u>Employer</u>		
	<u>Ag</u>	<u>Seed</u>	<u>Grass</u>
A	x	x	x
B	x	x	
C		x	x
D	x		
E	x		x
J		x	
K			x

A, B, and C are deemed concurrently employed under the common paymaster system because each is an employee of both the common paymaster and a related corporation. D, J, and K have a single employer and

may not participate in the common paymaster system. E is concurrently employed, but this concurrent employment does not include the common paymaster (Seed). Hence, E may not participate in this common paymaster system (although Ag and Grass can establish another common paymaster system for E).

Determining Whether Concurrent Employment Exists

Both the common paymaster and the related corporation must be able to prove that they employ the worker. For regular employees, the normal worker classification rules determine whether a worker is an employee of a particular corporation. Generally, the common law control test will apply, and the IRS will want evidence that each corporation actually controls and directs the employee's performance. (For company officers, special rules apply to determine employee status.)

Although the regulations do not require concurrent employment to exist for any particular length of time, they do say that "an individual who does not perform substantial services in exchange for remuneration from a corporation is presumed not employed by that corporation." Furthermore, the employee's services must specifically benefit each of the employing corporations; that is, the services cannot be merely for the "collective benefit" of the group.

Determining whether an employee has terminated his employment relationship with a business affiliate or is simply on leave or temporarily inactive is a frequent problem. Concurrently employed workers often exhibit sporadic work patterns. The employee may, during a particular period, work almost exclusively for a corporate affiliate, with little or no activity occurring for other corporate business affiliates. Then, the situation may flip-flop and the employee may work mostly for another corporate business affiliate. It is when the employee shifts his work efforts away from a particular corporation and toward a related corporation that questions about "terminated employment" begin to arise.

The IRS treats an employment relationship as nonexistent and effectively terminated when all rights and obligations between the employer and employee have terminated. While there are no steadfast guidelines, the employer should be aware that termination or forfeiture of some or all of the following rights and benefits may mean the employment relationship has terminated:

1. Participation in deferred compensation plans.
2. Seniority claims.
3. Availability of sick pay or vacation pay, or similar fringe benefits.

Example 2D-6 Determining whether concurrent employment exists.

M, N, and O are related corporations located in separate cities that use N as a common paymaster. A, an officer, performs substantial services for each company. A does not work a set length of time at each corporate headquarters. When A leaves one headquarters, it is not known when she will return, although it is expected she will return.

The corporations each maintain cafeterias for their employees. B is an assistant cafeteria manager who has worked at N's headquarters for many years. In the current year, the cafeteria manager at O's headquarters retires. B is transferred to O's headquarters to temporarily help fill the position of cafeteria manager. O controls B's performance and services while he is on-site and considers him to be an employee. O has indicated to B that he is being groomed for the cafeteria manager position and, if things go well, O will soon award B this position. N has not formally terminated B's employment status and still provides him with insurance and related employee benefits (but no salary).

It is clear that A is concurrently employed by all three companies. Although it is uncertain just how much work she will perform for each (and when she will perform it), there is an expectation on the part of each company that A will perform substantial services for it during the year.

B's situation is more precarious. Here, the IRS may argue that B has terminated his employment with N and is solely employed by O. The Service may ignore the fact that N continues to provide employee benefits to B, claiming that they are being provided by N for O. If the IRS successfully terminates B's employment status with N, O will be deemed to be B's employer and will be separately responsible for employer payroll tax on its share of B's current-year wages. This may result in payroll tax duplication.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. Marco Enterprises owns JB Overton and Knox LLP. Marco employs 50 employees, Overton employs 10 employees, and Knox employees 15 employees. John Tanner is employed by all three companies as a draftsman. Which of the following statements is correct?
- a. Marco meets the common law control test, is Tanner's employer, and has sole responsibility for related payroll tax.
 - b. To minimize payroll tax duplication, Marco should set up a common paymaster system with Overton and Knox.
 - c. With proper structuring, Marco could set up an employee loan out arrangement with Overton and Knox concerning Tanner.
 - d. Marco should incorporate Knox in order to expand the range of options available to minimize payroll taxes.
14. Gregg Co., Franklin Inc., Fry Co., and Davis Corp. are all C corporations. Gregg employs A, B, E, P, Q, and S. Franklin employs C, D, and E. Fry employs A, D, F and G. Davis employs E, G, P and T. Which company could function as common paymaster for all companies?
- a. Gregg.
 - b. Franklin.
 - c. Fry.
 - d. Davis.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

13. Marco Enterprises owns JB Overton and Knox LLP. Marco employs 50 employees, Overton employs 10 employees, and Knox employees 15 employees. John Tanner is employed by all three companies as a draftsman. Which of the following statements is correct? **(Page 44)**
- a. Marco meets the common law control test, is Tanner's employer, and has sole responsibility for related payroll tax. [This answer is incorrect. According to IRS rules, Marco's ownership of the other two companies is insufficient by itself to support such a conclusion.]
 - b. To minimize payroll tax duplication, Marco should set up a common paymaster system with Overton and Knox. [This answer is incorrect. Knox is a limited liability partnership and by IRS rules, does not qualify for a common paymaster system. Even if that were not so, Tanner does not meet the common employee test percentage for such treatment.]
 - c. **With proper structuring, Marco could set up an employee loan out arrangement with Overton and Knox concerning Tanner. [This answer is correct. Marco could assume full control of Tanner's activities as renderer for services provided to the other two affiliates, bill the recipient affiliates for Tanner's services, and pay all payroll taxes related to Tanner's services. Under IRS rules, this would avoid payroll tax duplication that might otherwise occur.]**
 - d. Marco should incorporate Knox in order to expand the range of options available to minimize payroll taxes. [This answer is incorrect. While corporations do indeed have more flexibility for minimizing payroll taxes than unincorporated entities, there is no indication that either Marco or Overton are incorporated, therefore simply incorporating Knox may not provide the flexibility sought—and even if that were the case, Tanner does not meet the common employee test percentage to provide options not already available.]
14. Gregg Co., Franklin Inc., Fry Co., and Davis Corp. are all C corporations. Gregg employs A, B, E, P, Q, and S. Franklin employs C, D, and E. Fry employs A, D, F and G. Davis employs E, G, P and T. Which company could function as common paymaster for all companies? **(Page 46)**
- a. Gregg. [This answer is incorrect. Under the IRS regulations, Gregg does not meet the common employee test for Fry.]
 - b. **Franklin. [This answer is correct. Franklin meets the IRS 30% common employee test for each of the other employers. Note that the other employers do not also have to meet this test for Franklin to qualify.]**
 - c. Fry. [This answer is incorrect. Under the IRS regulations, Fry does not meet the common employee test for any of the other employers.]
 - d. Davis. [This answer is incorrect. Under the IRS regulations, Davis does not meet the common employee test for Franklin.]

Common Paymaster Corporation Selection

The common paymaster corporation must be a member of the group of related corporations participating in the common paymaster arrangement. A common paymaster of a group of related corporations is the group member that disburses wage payments to employees of two or more of those corporations on their behalf and that is responsible for keeping books and records for the payroll with respect to those employees.

The participating corporations must authorize a corporation to be the common paymaster. The regulations contain no express directions on how this authorization should occur. One simple option is an oral or written agreement between the corporations, setting forth the payment and recordkeeping duties and responsibilities of the common paymaster. A more formal approach is to place the authorization in the annual business meeting minutes or pursuant to a corporate resolution. Still another common practice is to submit a statement to the IRS with the first Form 941 (or Form 944) filed under the common paymaster rules. Doing so notifies the IRS of the arrangement and the companies involved.

Considerations in Selecting a Common Paymaster Corporation

The following rules of thumb should guide the selection of a common paymaster corporation:

1. While the common paymaster corporation may be any one of the related corporations, there must be at least one of the specified relationships between the common paymaster and each other corporation that will participate in the arrangement.
2. The common paymaster should be the corporation that (a) employs the most concurrently employed workers whose wages exceed the taxable wage base limits and (b) is likely to maintain the most concurrent employment relationships. (Recall that to be covered, the employee must perform services for the common paymaster.) Holding companies (that often employ primarily officers) generally are not good choices as common paymasters, unless the election is aimed specifically at concurrently employed officers.
3. Consideration should be given to authorizing multiple common paymaster corporations (see the following discussion), especially for corporate groups in which corporations are clustered into industries or businesses.
4. Most corporate groups choose to implement a common paymaster system at the beginning of a calendar quarter or calendar year. That makes cutoffs and related start-up relatively simple and straightforward. However, it is possible to implement the system at any time during the year. If the common paymaster system is started in midyear, payroll tax duplication might still occur since each corporation will already have paid separate employer FICA and FUTA taxes on concurrently employed workers. Here, the corporations may want to designate as common paymaster (at least for the remainder of such initial year) the corporation that has already disbursed the greatest amount of compensation for concurrently employed workers.
5. Corporations cannot switch common paymasters mid-year (even if the same entities are involved in the arrangement) and aggregate the wages paid by the previous common paymaster in applying the FICA wage base limit for the year of change. Here, the corporations may want to wait until the beginning of the year to change. There are very limited circumstances, such as the predecessor/successor exceptions, that allow an employer to aggregate the wages it pays to an employee with wages paid by another employer for purposes of applying the FICA wage base limit.

Example 2E-1 Considerations in selecting a common paymaster.

X Corporation is a holding company that owns 100% of the stock of Y Corporation and Z Corporation. While all three corporations employ Individual A as their company president, only X and Y employ the same group of five other corporate officers. Y and Z also concurrently employ the services of various middle management employees, engineers, and technical specialists, who in total comprise 45% of Y's workforce. These are highly paid employees whose total wages routinely exceed the FICA and FUTA wage base limits.

The related corporation requirement is met because X, Y, and Z are a controlled group of corporations as defined in IRC Sec. 1563, which includes parents and subsidiaries, and brother/sister corporations. (In addition, X and Y meet the common officer test, while Y and Z meet the common employee test.) Thus, the required nexus exists between all three corporations, and any one could be authorized to be the common paymaster.

The best choice for common paymaster is Y because it employs the greatest number of concurrently employed workers. Z is not as good a choice since it does not employ all company officers. X, a holding company, is not a good choice since it concurrently employs only company officers and no other employees.

When to Use Multiple Common Paymaster Corporations

The use of multiple common paymaster corporations is allowed. (This means some of the related corporations may use one common paymaster and other related corporations another paymaster, and a corporation may use different common paymasters to pay the wages of different employees.) Thus, where different or even overlapping groups of related corporations are present within a single corporate family structure, as many common paymasters can be established as are necessary. This rule allows corporations to retain their legal, business, and economic relationships without having to realign for common paymaster tax purposes.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. Which of the following is correct concerning common paymasters?
- a. Common paymaster rules apply to all business entities regardless of organizational form and structure.
 - b. The only precondition for a company to become a common paymaster is that it is a member of the controlled group.
 - c. Multiple common paymaster arrangements are permissible within and between members of the controlled group.
 - d. There are very formal rules related to authorizing a company to become common paymaster for participating companies.
16. Feral Industries is a corporation with 100% stock ownership of Beale Corporation, Gravitass Inc., and Hammer Co; together, these companies employ 7,500 employees. Feral maintains a strict policy concerning executive compensation and the same slate of 10 corporate officers perform their duties for all corporations in the group. Beale shares 55% of its non-officer employees with Gravitass and 10% of its non-officer employees with Hammer. Hammer shares 35% of its non-officer employees with Beale, and Gravitass shares 20% of its non-officer employees with Hammer. Which company would be the most likely candidate for common paymaster?
- a. Feral.
 - b. Beale.
 - c. Gravitass.
 - d. Hammer.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. Which of the following is correct concerning common paymasters? **(Page 53)**
- a. Common paymaster rules apply to all business entities regardless of organizational form and structure. [This answer is incorrect. Common paymaster rules apply only to C and S corporations, and then only if they meet certain criteria.]
 - b. The only precondition for a company to become a common paymaster is that it is a member of the controlled group. [This answer is incorrect. The common paymaster must be a member of the controlled group but it also must meet other conditions, such as being authorized by the other participating companies in the group.]
 - c. **Multiple common paymaster arrangements are permissible within and between members of the controlled group. [This answer is correct. Multiple common paymaster arrangements may be used to accommodate overlapping groups of related corporations in a single corporate family structure.]**
 - d. There are very formal rules related to authorizing a company to become common paymaster for participating companies. [This answer is incorrect. Current IRS regulations give no express guidance concerning the authorization, only that there must be one.]
16. Feral Industries is a corporation with 100% stock ownership of Beale Corporation, Gravitass Inc., and Hammer Co; together, these companies employ 7,500 employees. Feral maintains a strict policy concerning executive compensation and the same slate of 10 corporate officers perform their duties for all corporations in the group. Beale shares 55% of its non-officer employees with Gravitass and 10% of its non-officer employees with Hammer. Hammer shares 35% of its non-officer employees with Beale, and Gravitass shares 20% of its non-officer employees with Hammer. Which company would be the most likely candidate for common paymaster? **(Page 53)**
- a. Feral. [This answer is incorrect. Feral shares only the corporate officers. Since part of the reason for maintaining a common paymaster system is to avoid payroll tax payment duplication, Feral would not be the best choice for accomplishing that goal.]
 - b. **Beale. [This answer is correct. Beale meets the common employee test in its relationship with Gravitass and Hammer, and meets the common officer test with Feral. Payroll taxes would potentially be impacted for the greatest number of employees by authorizing Beale as the common paymaster for the group.]**
 - c. Gravitass. [This answer is incorrect. Gravitass does not meet the common employee test in its relationship with Hammer.]
 - d. Hammer. [This answer is incorrect. Hammer fails the common employee test in its relationship with Gravitass.]

Common Paymaster System Operations

The term *common paymaster system* does not mean a formalized payroll system that exists in addition to or outside of the common paymaster corporation's standard payroll system. Rather, the term simply recognizes that the common paymaster will have additional administrative activities to undertake with respect to concurrently employed workers (e.g., capturing wage information from related corporations, allocating payroll taxes paid on such wages between the related corporations, etc.). Notwithstanding these special activities, the common paymaster corporation will continue to operate its payroll system in much the same manner as it always has.

Reporting and Filing Requirements

Each related corporation usually maintains separate timesheets or time cards tracking the services performed for it by each concurrently employed worker. These totals are submitted to the common paymaster, who uses this information to compute the employee's wages and withholding and the amount of employer payroll tax due. The common paymaster will then deposit and pay these amounts, report them on its payroll tax returns, and include them on its annual Form W-2 filings.

For reporting and payment purposes, the common paymaster should include payroll-related information for concurrently employed individuals on its regular quarterly and annual payroll tax returns. Since the government considers the common paymaster to be operating a single payroll system, it is not necessary to separately identify these amounts.

The common paymaster must actually maintain payroll records and perform the payroll compliance function for wages paid to concurrently employed workers. The IRS has held this to be a critical factor in determining whether authorization of a common paymaster has occurred.

Example 2F-1 Administering the common paymaster system.

The XY corporate group authorizes X Corporation as common paymaster. X employs 200 workers, while Y Corporation employs 100 workers. Included in these totals are 10 concurrently employed workers. This means X has payroll tax compliance responsibility for the wages paid to its 190 solely employed workers plus the wages paid to its 10 concurrently employed workers. Y has payroll tax compliance responsibility for the wages paid to its 90 solely employed workers.

At a minimum, X's responsibilities for concurrently employed workers under the common paymaster system include the following functions: (1) maintaining Forms W-4; (2) calculating total wages, employer payroll tax, and employees' withheld payroll tax; (3) paying the employees' wages; (4) depositing and paying over withheld tax; (5) filing payroll returns (i.e., Form 941 or 944) that include payroll information for the concurrently employed individuals; and (6) preparing Forms W-2 and related annual information returns.

X, as common paymaster, files one quarterly Form 941 (or if applicable, one annual Form 944) reflecting wages paid to its concurrently and nonconcurrently employed workers. Similarly, it files a single annual Form 940 and Form W-3 to report the wages of both sets of workers.

Y must complete similar payroll tax functions for wages paid to its employees who are not concurrently employed (that is, its 90 solely employed workers). It must also discharge these payroll tax functions for any payments it makes outside the common paymaster system to the 10 concurrently employed workers. (For example, cash compensation paid by Y or taxable fringe benefits provided by Y to the 10 concurrently employed workers would be reported on Y's payroll system.) Thus, Y files a quarterly Form 941 (or if applicable, one annual Form 944) reflecting wages paid to nonconcurrently employed workers. Included on this Form 941 (or Form 944) are any wage payments made to concurrently employed workers outside of the common paymaster system. In a similar manner, it files a single annual Form 940 and Form W-3.

Cash Payment Rule

Wage payments must be made in the form of money, check, or similar instrument to qualify as made under the common paymaster system. (This is the so-called *cash payment rule*.) Taxable fringe benefits do not qualify as cash payments for this purpose and are not considered as made under the common paymaster system.

This means the common paymaster corporation is considered the sole employer of concurrently employed workers with respect to (1) cash wage payments under the common paymaster system, and (2) any taxable noncash fringe benefits it provides to the concurrently employed worker. The practical effect of the cash payment rule is that noncash fringe benefits should be provided solely by the common paymaster corporation. These taxable fringe benefits will then build on the taxable wage base already established by the cash wages paid under the common paymaster system.

Example 2F-2 Cash payment rule discourages fringe benefit compensation from related corporations.

Shoe Corporation owns 100% of the stock of Leather Corporation. The companies concurrently employ Executive B. Shoe, as the common paymaster, pays B's cash salary.

Shoe provides B with use of a company airplane. For the current year, B's personal use of the plane results in a taxable fringe benefit of \$10,000. Leather provides B with a company car. B's personal use of the car results in a taxable fringe benefit of \$5,000. These taxable fringe benefits do not meet the cash payment rule and are not considered as made under the common paymaster system.

While the airplane fringe benefit provided to B by Shoe does not technically fall within the common paymaster system, this result is achieved anyway. Shoe used a single employer approach to calculate the employer payroll tax on (1) the taxable airplane fringe benefit, and (2) all cash wages paid to B under the common paymaster system. Here, the taxable fringe benefit builds on B's wage base already being established by cash wage payments under the common paymaster system.

The company car fringe benefit provided by Leather receives much less favorable treatment. Leather is considered the employer with respect to this amount, must separately report it as taxable compensation for B, and must pay the employer FICA and FUTA tax on this amount.

Wage Disbursement Guidelines

Wage disbursements under the common paymaster system are subject to the following guidelines:

1. The common paymaster corporation must actually disburse paychecks to concurrently employed workers. Thus, the actual handling and delivery of the checks must be performed by the common paymaster corporation's employees.

While this normally means the common paymaster cuts a single paycheck for these amounts, the regulations permit multiple bank accounts, separate or combined paychecks, or any variation thereof. Furthermore, the common paymaster can use separate or combined checks of the related corporations provided such checks are drawn by the common paymaster corporation on the bank accounts of the related corporations.

2. The common paymaster has the flexibility to pay some, but not all, concurrently employed individuals. It may limit payments to regular employees, or officers, or to any number or cluster of workers. Also, a concurrently employed worker can receive wage payments from both the common paymaster and a related corporation. However, in all these situations only wages disbursed by the common paymaster qualify as paid under the common paymaster system.

Example 2F-3 Wage disbursement guidelines.

Cray Awn, an individual, owns 100% of the stock of Yellow Corporation, Blue Corporation, and Green Corporation (a brother-sister controlled group). Yellow is the common paymaster and, for the last several years, has paid each concurrently employed worker by means of a single check—drawn on its own bank account—for the total services provided by the worker to each company.

Blue and Green have recently complained that concurrently employed workers exhibit more loyalty to Yellow than to them because, they maintain, these employees receive a paycheck only from Yellow. To alleviate the

problem, the corporations decide that concurrently employed workers will receive separate paychecks from each corporation for services rendered. Yellow will continue to process the payroll and will draw separate checks on the related corporation's bank accounts for their share of the employee's wages. Yellow's personnel will then disburse all the checks to concurrently employed workers. This arrangement is acceptable under the common paymaster rules.

Wage Payments Outside of the Common Paymaster System

Ideally, all wages paid to concurrently employed workers during the tax year should funnel through the common paymaster system. In practice, this does not (or cannot) always occur. The result is that both the common paymaster corporation and the related corporation(s) sometimes end up with employer liability for the wages of concurrently employed workers and must calculate and report employer payroll tax.

Example 2F-4 Calculating payroll tax when some wages are outside of the common paymaster system.

Corporations X, Y, and Z adopt a common paymaster system on April 1, 2009. (Z is the common paymaster.) The common paymaster system is terminated on June 30, 2009. Employee B is concurrently employed by the three corporations throughout the year. Z pays all of B's cash wages during the second quarter when the common paymaster system is in place. Each corporation separately pays B's cash wages for the first and third quarters.

B's cash wages and taxable fringe benefits for each of the first three quarters of 2009 are as follows:

<u>Employee B</u>	<u>X</u>	<u>Y</u>	<u>Z</u>	<u>Total</u>
Cash Wages	\$ 7,300	\$ 13,000	\$ 50,000	\$ 70,300
Noncash taxable fringe benefits	<u>5,000</u>	<u>1,000</u>	<u>—</u>	<u>6,000</u>
Quarterly wages	<u>\$ 12,300</u>	<u>\$ 14,000</u>	<u>\$ 50,000</u>	<u>\$ 76,300</u>

The corporations assemble the following wage base information to calculate the employer social security tax (OASDI tax) for B's wages (cash and noncash) for the first three quarters of 2009:

<u>Quarter</u>	<u>B's OASDI Wage Base</u>			
	<u>X</u>	<u>Y</u>	<u>Z</u>	<u>Total</u>
1st	\$ 12,300	\$ 14,000	\$ 50,000	\$ 76,300
2nd	5,000	1,000	56,800	62,800
3rd	<u>12,300</u>	<u>14,000</u>	<u>—</u>	<u>26,300</u>
Total	<u>\$ 29,600</u>	<u>\$ 29,000</u>	<u>\$ 106,800</u>	<u>\$ 165,400</u>

For the first quarter, no common paymaster system is in place. Thus, each corporation is responsible for employer payroll tax on wages paid to the employee for services rendered. Each corporation computes its own taxable wage base for B, calculates employer tax thereon, and reports this amount on its quarterly payroll tax return.

For the second quarter, the common paymaster system is in place. Note the following with respect to B's second quarter wages:

1. X and Y remain fully liable for employer tax on \$5,000 and \$1,000, respectively, of taxable fringe benefits they provide to B. X and Y must report these amounts on their quarterly payroll tax returns.
2. Z (the common paymaster) combines wages it paid prior to the start-up date of the common paymaster system with wage payments under the common paymaster system in determining B's taxable wage base. Because of this, Z reaches the 2009 social security taxable wage base limit in

the second quarter. Thus, only \$56,800 of the \$70,300 (\$7,300 + \$13,000 + \$50,000) of second quarter wage payments attributable to Z are subject to employer social security payroll tax.

As of the beginning of the third quarter, the common paymaster system is terminated.

Note the following with respect to B's third quarter wages:

1. X reports employer tax liability for the \$7,300 cash wages and the \$5,000 fringe benefits provided B on its quarterly payroll tax return.
2. Y reports employer tax liability for the \$13,000 cash wages and the \$1,000 fringe benefits provided B on its quarterly payroll tax return.
3. Z's third quarter wages tack on to its taxable wage base for the previous quarter. Hence, Z has no employer social security payroll tax liability for the third quarter.

Even though the common paymaster system was in effect only during the second quarter, social security tax was avoided on wages of \$13,500 (\$70,300 – \$56,800). At the employer's 6.2% OASDI tax rate, the common paymaster system saved \$837.

Allocating Payroll Tax Deductions among Related Corporations

Generally, the common paymaster corporation remits to the IRS the employer and employee payroll taxes associated with wages disbursed under the common paymaster system. The common paymaster then requests reimbursement from the related corporations for their share of the employer payroll tax. The regulations provide rules for establishing how the employer payroll tax paid by the common paymaster should be allocated among the participating corporations for reimbursement and deduction purposes.

Under the allocation guidelines, each related corporation should reimburse, and may deduct, a portion of the total payroll taxes paid by the common paymaster. This is based on each related corporation's pro rata share of the total wages paid by the common paymaster for concurrently employed workers.

If the corporations maintain records of the wages disbursed to concurrently employed workers for services performed for each corporation, the remuneration-based allocation guidelines illustrated in Example 2F-5 apply. If no records are maintained, the regulations simply provide the IRS with the authority to make a "group-wide" allocation of payroll taxes among the corporations in an "appropriate manner." Allocation in an appropriate manner varies according to circumstances. It may be based on sales, property, payroll, or any other basis that reflects the manner in which services were performed. If practical, the IRS may use the principles of Reg. 1.482-2(b) to make allocations for wages paid after 1978 and before August 1, 2009. For wages paid after July 31, 2009, the IRS may use the principles of Reg. 1.482-9. Employers may also elect to apply the principles of Reg. 1.482-9 for wages paid before August 1, 2009 according to the rules in Reg. 1.482-9(n)(2).

Example 2F-5 Allocating payroll tax deductions among related corporations.

Slam Corporation and Dunk Corporation are related corporations that use Dunk as common paymaster for their salaried executives. Executive A is concurrently employed for 2009. A's monthly wage payment for the first month of 2009 and the related payroll taxes thereon are as follows:

Wages for Services Rendered			Employer Tax		Employee Tax	Total
Slam	Dunk	Total	FICA	FUTA	Tax	
\$ 4,000	\$ 1,000	\$ 5,000	\$ 383	\$ 40	\$ 383	\$ 806

Here, 80% of the total wages paid to A are for services rendered to Slam ($\$4,000 \div \$5,000 = 80\%$). Accordingly, Slam should reimburse Dunk for \$338 of employer payroll tax [$80\% \times (\$383 + \$40)$], and deduct this amount. This is its allocable/deductible share of employer payroll tax. Dunk's deduction is for the remaining \$85 of employer payroll tax [$(\$383 + \$40) - \$338$].

Establishing Each Corporation’s Liability for Unpaid Taxes

The common paymaster corporation has primary liability for employer and employee payroll tax on wages paid under the common paymaster payroll system. If the common paymaster is unable or fails to properly remit these amounts, each related corporation participating in the common paymaster system is jointly and severally liable for its appropriate share of these taxes. However, each related corporation’s liability is limited to the lesser of:

1. the common paymaster’s remaining unpaid liability, or
2. the liability the related corporation would have incurred if a common paymaster system was not used, reduced by its share of taxes previously paid by the common paymaster. (This reduction is calculated by allocating the amount of payroll taxes previously paid by the common paymaster to each related corporation based on the related corporation’s pro rata share of the payroll taxes originally due.)

Example 2F-6 Establishing each corporation’s liability for unpaid taxes.

Assume the same facts as in Example 2F-5, except that Dunk Corporation remits none of the payroll taxes to the IRS. Slam Corporation is liable for the lesser of (1) \$806 (the unpaid liability of the common paymaster); or (2) the entire amount due as if Slam had not used a common paymaster system, calculated as follows:

<u>Wages for Services Rendered</u>	<u>Employer Tax</u>		<u>Employee Tax</u>	<u>Total</u>
	<u>FICA</u>	<u>FUTA</u>		
\$ 4,000	\$ 306	\$ 32	\$ 306	\$ 644

Here, the government may proceed against Slam for the entire \$644 of unpaid payroll tax.

Assume instead that Dunk remits \$20 of payroll taxes, then defaults on the remainder. Slam’s liability is reduced by its prorata share of the \$20 tax payment previously made by the common paymaster. Since Slam had an 80% allocable share of the original payroll tax (see Example 2F-5), it may offset its liability by 80% of the \$20 previously paid by Dunk. Thus, the IRS could proceed to collect from Slam the lesser of (1) \$786 (\$806 – \$20), or (2) \$628 [\$644 – (\$20 × 80%)].

Under a special allocation rule, in the event that the common paymaster corporation is unable or fails to properly remit the FUTA taxes to the IRS, the credit for state unemployment taxes paid is calculated as if each corporation were a separate employer.

Common Paymasters—State Rules

Some states have chosen to adopt rules that are the same as or similar to the federal tax law’s common paymaster provisions. In these states, employers using a common paymaster provision may realize a significant tax savings in state unemployment insurance. This SUTA tax savings is achieved much like the FUTA tax savings realized through the use of a common paymaster. Employers should contact a state’s revenue department to see if the state allows common paymasters and, if it does, the specific requirements for operating one.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

17. Which statement is correct concerning a common paymaster system?
- a. The cash payment rule prohibits cash payments to employees by the common paymaster or any of the related companies.
 - b. States do not recognize federal common paymaster systems for purposes of allocating SUTA tax liability for shared employees.
 - c. The common paymaster must perform compliance and other functions concerning concurrently employed worker wages.
 - d. The common paymaster must disburse wage payments to concurrently employed workers according to exact instructions.
18. Valley Corp, Red Inc, and Cloud Co establish Valley as common paymaster for the group. Richard Jefferson performs drafting duties for, and is concurrently employed by, all three companies. Jefferson received a monthly salary of \$6,000 for each month during 2009. Cloud also supplied Jefferson with a company car for both business and personal use; this car was provided for the benefit of all three companies. The taxable benefit to Jefferson was \$3,600 (\$300 per month) during 2009. Red also provided Jefferson with box seats at the local sports arena as a special benefit; taxable value of these seats was \$2,400 for 2009. Assuming a 0.8% FUTA tax rate, how much FUTA tax liability should Cloud report concerning Jefferson for 2009?
- a. \$0.
 - b. \$10.
 - c. \$16.
 - d. \$29.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

17. Which statement is correct concerning a common paymaster system? **(Page 57)**
- a. The cash payment rule prohibits cash payments to employees by the common paymaster or any of the related companies. [This answer is incorrect. The cash payment rule stipulates that wage payments be made in cash, check, or similar instrument to be considered as made under the common paymaster system.]
 - b. States do not recognize federal common paymaster systems for purposes of allocating SUTA tax liability for shared employees. [This answer is incorrect. Some states have indeed chosen to follow rules similar to federal provisions.]
 - c. **The common paymaster must perform compliance and other functions concerning concurrently employed worker wages. [This answer is correct. The IRS considers payroll recordkeeping and compliance functions to be critical in proving the authorization of a common paymaster.]**
 - d. The common paymaster must disburse wage payments to concurrently employed workers according to exact instructions. [This answer is incorrect. The common paymaster has certain flexibility concerning wage disbursements. For instance, the common paymaster can limit payments to a class or cluster of workers.]
18. Valley Corp, Red Inc, and Cloud Co establish Valley as common paymaster for the group. Richard Jefferson performs drafting duties for, and is concurrently employed by, all three companies. Jefferson received a monthly salary of \$6,000 for each month during 2009. Cloud also supplied Jefferson with a company car for both business and personal use; this car was provided for the benefit of all three companies. The taxable benefit to Jefferson was \$3,600 (\$300 per month) during 2009. Red also provided Jefferson with box seats at the local sports arena as a special benefit; taxable value of these seats was \$2,400 for 2009. Assuming a 0.8% FUTA tax rate, how much FUTA tax liability should Cloud report concerning Jefferson for 2009? **(Page 59)**
- a. \$0. [This answer is incorrect. Under IRS rules, Cloud has a duty to report and pay tax on certain payments made to Jefferson outside the common paymaster system during 2008.]
 - b. \$10. [This answer is incorrect. The common paymaster did not pay a share of the non-taxable benefits and would not therefore share in the tax liability.]
 - c. \$16. [This answer is incorrect. Red provided the box seats to Jefferson of its own accord. Valley and Cloud would not share tax liability for this benefit.]
 - d. **\$29. [This answer is correct. Non-taxable fringe benefits are considered paid outside the common paymaster system. As a result, Cloud must report and pay FUTA tax on the taxable benefit Cloud provided by way of the company car.]**

Pricing Shared Employee Services Guidelines

Pricing is a fundamental concern in all types of shared employee transactions. If the IRS determines that the business affiliates have not properly priced a concurrent employment or employee loan-out arrangement, it may use IRC Sec. 482 to reallocate the transaction's price. IRC Sec. 482 is designed to place the transaction on an arm's length basis by recasting the tax consequences to properly reflect what the IRS believes would have resulted from an independent transaction involving unrelated parties. Unfortunately, few guidelines exist regarding when and how the IRS may impose IRC Sec. 482, and what type of business affiliate relationships may be captured by its provisions. Thus, the IRS has a great deal of freedom to impose these rules in almost any manner it pleases.

Concurrent Employment Arrangement

In a concurrent employment arrangement, the IRS will reallocate a shared employee's wages or salary if it believes that the amount paid to the employee by each affiliate does not accurately reflect the value of the services the employee performed for each affiliate.

Example 2H-1 IRS reallocation in a concurrent employment arrangement.

Blue Corporation and Gray Corporation are members of a brother/sister controlled group owned 100% by a sole shareholder. Blue is extremely profitable and has been so for many years, while Gray has been unprofitable for many years. Executive A is concurrently employed by both companies but devotes 60% of his time and efforts to reviving Gray's failing operations. (Assume that this allocation of time is reflective of A's value to each corporation). A's compensation of \$100,000 is paid \$90,000 by Blue and \$10,000 by Gray.

On its face, this wage structure does not seem to represent an arm's length transaction. The corporations are open to an assertion that they are attempting to mitigate the payroll tax duplication problem and minimize the amount of unusable NOL Gray generates by having Blue pay a disproportionately large portion of A's salary. The IRS may attempt to use the Section 482 rules to reclassify this transaction and treat 60% (or more) of A's compensation as paid by Gray. This would result in the following:

1. Reduce Blue's compensation deduction by up to \$50,000 [$\$90,000 - (\$100,000 \times 40\%)$] and reduce the employer payroll tax deduction by an appropriate amount.
2. Treat the amount of disallowed compensation deduction (and related payroll taxes) as a dividend distribution to Blue's shareholder, who is then treated as recontributing this amount to Gray as a capital contribution. Blue's shareholder may have taxable dividend income or capital gain for the amount of deemed dividend distribution.
3. Increase Gray's compensation payment to A by \$50,000 (from \$10,000 to \$60,000). Additional payroll taxes may be assessed on this deemed compensation, creating payroll tax duplication and imposing additional payroll tax liability. The deemed compensation payment also increases Gray's unusable NOL.

Blue ends up with additional income tax liability (as a result of the disallowed deductions), while Gray ends up with additional payroll taxes and a larger unusable NOL.

Employee Loan-out Arrangement

In an employee loan-out arrangement, the IRS may reallocate the service contract's price if it believes the established price is not arm's length. Then, the IRS will attempt to use (what it calls) a price that unrelated entities would pay for similar services.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. Where the IRS finds unreasonable allocations of shared employee cost between business affiliates, it has limited latitude to force reallocations of those costs.
 - a. True.
 - b. False.

20. Brad Johnson wholly owns, but does not manage, Mulberry Co and Vine Corp. The two companies share employment of Arthur Gray. Mulberry pays 80% of Gray's salary; Vine pays the other 20%. If the IRS finds that Vine actually uses 80% of Gray's effort, what is one likely consequence?
 - a. The IRS will charge Vine Corp with the responsibility for all of Gray's payroll taxes.
 - b. Gray will have to pay additional FIT on amounts that should have been withheld.
 - c. Brad Johnson may have adverse tax consequences as a result of imputed dividends.
 - d. The officers of Mulberry and Vine will be charged with collusion to commit fraud.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. Where the IRS finds unreasonable allocations of shared employee cost between business affiliates, it has limited latitude to force reallocations of those costs. **(Page 65)**
- a. True. [This answer is incorrect. IRC Sec. 482 gives the IRS broad latitude to force reallocations.]
 - b. False. [This answer is correct. The IRS under Code Sec. 482 is quite free to determine what constitutes an unreasonable allocation and specify the "correct" allocation that should be used to restate employee costs and payroll tax liabilities for each business affiliate in the employee sharing arrangement.]**
20. Brad Johnson wholly owns, but does not manage, Mulberry Co and Vine Corp. The two companies share employment of Arthur Gray. Mulberry pays 80% of Gray's salary; Vine pays the other 20%. If the IRS finds that Vine actually uses 80% of Gray's effort, what is one likely consequence? **(Page 65)**
- a. The IRS will charge Vine Corp with the responsibility for all of Gray's payroll taxes. [This answer is incorrect. Any reallocation by the IRS would likely be based on the 80% usage finding.]
 - b. Gray will have to pay additional FIT on amounts that should have been withheld. [This answer is incorrect. Gray's FIT liability should not change as a result of a reallocation.]
 - c. Brad Johnson may have adverse tax consequences as a result of imputed dividends. [This answer is correct. The IRS may choose to regard the transfer of funds between Mulberry and Vine resulting from the inappropriate allocation of payroll costs and payroll taxes concerning Gray as a dividend from Mulberry to Johnson accompanied by an investment by Johnson in Vine.]**
 - d. The officers of Mulberry and Vine will be charged with collusion to commit fraud. [This answer is incorrect. The IRS has broad latitude in its course of action in this case, but the facts as stated do not support a conclusion that fraud charges would be likely.]

EXAMINATION FOR CPE CREDIT**Lesson 2 (PRLTG091)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

11. Predecessor/successor payroll tax considerations apply to all **except** which of the following:
 - a. The incorporation of a sole proprietorship.
 - b. The incorporation of a partnership.
 - c. A partner death in a continuing partnership.
 - d. A combination by statutory merger.

12. Johnson Company acquired Able Ltd in 2009. Which of the following must be true for Johnson to be eligible for a credit for FUTA tax paid by Able?
 - a. Johnson must employ all of Able's employees.
 - b. Johnson must acquire substantially all of Able's business property.
 - c. Both companies must be current on all payroll taxes prior to the acquisition.
 - d. The acquisition transaction must be classified as a statutory consolidation.

13. Which of the following is most correct concerning identification of employer business affiliates?
 - a. For FITW, court rulings have established the common law control test as an overriding principle.
 - b. Business affiliates must meet three tests to be eligible for preferred tax treatment in any employee sharing arrangement.
 - c. For FICA, the IRS has issued several rulings specific to employee sharing by business affiliates.
 - d. For a common paymaster system, corporations must meet all of three tests to be considered related.

14. BoxCar LLP, LoadEmUp Freight, and CarsGo Inc. are business affiliates. Bill is a key executive who is concurrently employed by each affiliate. Which of the following is correct?
 - a. The companies can not avoid FUTA tax duplication by setting up an employee loan-out arrangement.
 - b. The company who employs Bill the most hours is solely liable for FICA tax on all wages paid to Bill.
 - c. The companies must each pay FICA tax up to the wage base limit for Bill.
 - d. Do not select this answer choice.

15. Which is correct concerning a common paymaster system?
- a. A common paymaster system is advisable for controlled groups of Schedule C companies.
 - b. The common paymaster can be changed once each quarter to accommodate changing business situations.
 - c. Once chosen, the common paymaster handles all payroll recordkeeping for all employees in the related companies.
 - d. The agreement to establish a common paymaster can range from extremely informal to extremely formal.
16. Mattress has been designated common paymaster for Dream Corp and Headboards Inc. Dream employs A, B, C, D, J, K, L, and M. Mattress employs A, B, P, Q, X, and Z. Headboards employs L, M, N, O, P, and Q. How many employees are accounted for by Mattress in the common paymaster system?
- a. 4.
 - b. 6.
 - c. 14.
 - d. 20.
17. Which of the following is correct concerning the common paymaster system?
- a. The common paymaster cuts the checks and distributes them to related companies for delivery to concurrently employed workers.
 - b. Checks cut by the common paymaster from related company accounts will not be considered made within the common paymaster system.
 - c. Noncash taxable fringe benefits are considered cash equivalents for purposes of inclusion in the common paymaster system.
 - d. Wage payments to concurrently employed workers by related companies will not be considered made within the common paymaster system.
18. Jay Co has been designated common paymaster in its relationship with Kay Corp. During 2009, total payroll tax liability for the two companies is \$24,000 (\$6,000 and \$18,000 for Jay and Kay respectively), but Jay miscalculated the appropriate payments and now finds its liability exceeds its current ability to pay. Jay made total tax payments of \$10,000. What is Kay's payroll tax liability?
- a. \$0.
 - b. \$10,500.
 - c. \$14,000.
 - d. \$18,000.

19. The IRS may re-price and employee loan-out arrangement if it believes pricing does not reflect an arm's length agreement.
- a. True.
 - b. False.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.
20. Knight Co and Bishop Corp are members of a brother/sister controlled group owned 100% by a sole shareholder. Tom is concurrently employed by both companies. Tom spends 55% of his time working at Bishop. Tom's annual compensation is \$100,000. Knight pays \$85,000 and Bishop pay \$15,000. The IRS determines that Tom's services should be valued at more than \$15,000. Which of the following results are correct for Knight?
- a. Bishop ends up with additional income tax liability, while Knight ends up with additional payroll taxes.
 - b. Additional payroll taxes will be assessed on the deemed compensation, creating payroll tax duplication.
 - c. Knight will treat the amount of disallowed compensation deduction as a capital gain to Knight's shareholder.
 - d. Do not select this answer choice.

Lesson 3: Employee Leasing

INTRODUCTION

Employee leasing generally entails a leasing company/lessor furnishing workers to a business/lessee (also known as the subscriber or recipient) under an arrangement that results in the workers being treated as employees of the lessor. This means the leasing company retains payroll tax responsibilities for the leased employees. Employee leasing can also involve a transfer by an employer of its employees to a third party, in which case the third party then assumes all (or part) of the employer's duties.

This lesson discusses the tax rules that govern employee leasing, with an emphasis on identifying the employer of leased employees for payroll tax and qualified retirement plan purposes. Other topics include the consequences of failing to properly classify leased employees, and factors to consider when selecting a leasing firm.

Learning Objectives:

Completion of this lesson will enable you to:

- Describe general aspects of employee leasing, and identify portions of the Internal Revenue Code dealing with, and other Code considerations related to, employee leasing and qualified retirement plans;
- Apply the employer/employee relationship rule and the control-of-wage-payments rule to employee leasing situations in order to determine employer payroll tax responsibility, and describe ways to avoid undesirable employer tax consequences;
- Determine who is a leased employee and discuss rules concerning leased employees in reference to retirement, welfare, and fringe benefits;
- Assess potential consequences concerning payroll taxes and qualified plans of improperly identifying and classifying leased workers; and
- Relate considerations and best practices related to selecting and using an employee leasing firm.

Employee Leasing Overview

Leased employees are workers provided by an employee leasing firm to a business (the subscriber) to perform tasks that would otherwise be done by the business's employees. The concept is similar to temporary help agencies except that (1) leased workers are often recently resigned or terminated employees of the business, (2) the lease period is expected to be long-term rather than temporary, and (3) usually all (or nearly all) of the business's workers performing a given job are leased.

Why Use an Employee Leasing Arrangement?

Employee leasing offers businesses a way to relieve themselves of the burdens associated with human resources, payroll administration, and benefits negotiation. Specifically, leasing firms advertise the following benefits to their services:

1. Expert payroll, employee benefits, and personnel administration—from simple payroll and benefits compliance to complete human resources administration. Many leasing firms market their services as freeing businesses from payroll administration and personnel matters.
2. The ability to get larger group discounts on medical and retirement benefits and more comprehensive fringe benefit programs. (A few leasing firms also claim they can obtain improved worker's compensation rates.)

Employee Leasing and Tax Code Provisions

No single provision within the Internal Revenue Code (the Code) deals comprehensively with employee leasing transactions. Rather, Congress has chosen to (1) enact Code provisions to deal specifically with certain qualified retirement plan aspects of employee leasing, and (2) cover all other aspects of employee leasing under the conventional rules of federal taxation.

Qualified Plan Aspects

Part I of Subchapter D of the Code is entitled "Pension, profit-sharing, stock bonus plans, etc." Several key employee leasing rules have been placed within this subchapter, making it clear that qualified retirement plans are a primary concern of the employee leasing rules. Part I of Subchapter D, which includes IRC Secs. 401–420, applies the following rules to employee leasing:

1. *IRC Sec. 414(n)*. This provision is the heart and soul of the employee leasing rules. It includes a definition of a leased employee, provides the general rule that the subscriber is deemed to be the employer of leased employees (for certain coverage and nondiscrimination requirements applicable to qualified plans), and sets forth a special exception to the general rule for safe harbor plans.
2. *IRC Secs. 414(b) and (c)*. For applying most qualified plan coverage and nondiscrimination requirements, all commonly controlled entities (including leasing entities) are treated as a single employer.
3. *IRC Sec. 414(m)*. For applying most qualified plan coverage and nondiscrimination requirements, certain entities (including leasing entities) are treated as affiliated with organizations primarily in the business of providing services.
4. *IRC Sec. 414(o)*. This provision authorizes the IRS to issue regulations that prevent the avoidance of certain employee benefit requirements.

The Service has yet to issue final (legislative) regulations to cover the employee leasing rules. Proposed regulations issued under IRC Sec. 414(n) have been withdrawn, leaving this area without any regulatory guidance. Until final regulations are issued, IRS Notice 84-11 is the leading authority for employee leasing questions, and that notice does not reflect amendments made to IRC Sec. 414(n) effective after 1984.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Employee leasing arrangements currently focus on which of the following?
 - a. Eliminating employee FUTA tax liability.
 - b. Providing enhanced key officer retirement benefits.
 - c. Relieving companies of certain payroll duties.
 - d. Eliminating safe harbor plans for tax compliance.

22. Which of the following statements regarding IRC Section 414 is correct?
 - a. Is primarily concerned with employer payroll tax liability for leased employees.
 - b. Defines the term "leased employee" and contains qualified plan coverage guidance.
 - c. Its amendments are specifically addressed by IRS Notice 84-11, amended 2006.
 - d. Has become the primary guidance regarding employee leasing questions.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. Employee leasing arrangements currently focus on which of the following? **(Page 73)**
- a. Eliminating employee FUTA tax liability. [This answer is incorrect. Employee leasing may transfer or reduce liability for FUTA tax, but it will not eliminate it altogether.]
 - b. Providing enhanced key officer retirement benefits. [This answer is incorrect. TEFRA foiled attempts to circumvent qualified plan coverage and nondiscrimination provisions.]
 - c. Relieving companies of certain payroll duties. [This answer is correct. Employee leasing companies can perform payroll tax compliance and human resources duties.]**
 - d. Eliminating safe harbor plans for tax compliance. [This answer is incorrect. One would certainly not want to eliminate safe harbor plans, since they are intended to help simplify tax compliance.]
22. Which of the following statements regarding IRC Section 414 is correct? **(Page 73)**
- a. Is primarily concerned with employer payroll tax liability for leased employees. [This answer is incorrect. Congress has chosen to cover employer payroll tax liability for leased employees under conventional rules of taxation.]
 - b. Defines the term “leased employee” and contains qualified plan coverage guidance. [This answer is correct. IRC Section 414(n) defines the term “leased employee” and several sections of IRC 414 treat qualified plan coverage and applicable nondiscrimination requirements.]**
 - c. Its amendments are specifically addressed by IRS Notice 84-11, amended 2006. [This answer is incorrect. IRS Notice 84-11 does not currently address amendments to IRC Section 414(n) effective after 1984.]
 - d. Has become the primary guidance regarding employee leasing questions. [This answer is incorrect. IRS Notice 84-11 is the current guidance for employee leasing questions.]

Leased Workers Classified as Employees for Payroll Tax Purposes

For payroll tax purposes, the key to the leased employee rules is to determine whether the subscriber or the leasing firm is the employer. The determination of which of two potential employers is treated as the employer for employment tax purposes is made by examining the relationship between the worker and each potential employer entity. Under the federal payroll tax statutes, the entity that has an employer-employee relationship with the leased workers generally is the employer. However, if the entity with the employer-employee relationship does not have control of the wage payments, the employer is the entity that controls the payments (see the discussion later in this section).

A worker who receives compensation for services is either an independent contractor or an employee. If the worker is an employee, the employer incurs liability under the federal payroll tax laws. Two basic rules determine who is an employer: (1) the employer/employee relationship rule, which focuses on the presence or absence of an employer/employee relationship, and (2) the control-of-wage-payments rule, which centers on who controls the payment of the employee's wages.

Employer/Employee Relationship Rule Applied to Employee Leasing Transactions

Under the federal payroll tax statutes, the entity that has an employer/employee relationship with the leased workers generally is the employer. To make this determination, it is necessary to examine the relationship between (1) the subscriber and the leased workers, and (2) the leasing firm and the leased workers. This in turn will determine whether, under the worker classification rules, the leased workers are employees of the subscriber or the leasing firm.

Example 3C-1 Employer/employee relationship rule applied to leased employees.

Corporation X terminates its employees. A leasing firm hires X's former employees, and then contracts with X to lease back the former employees as independent contractors. Under the contract, X has the right to demand that a particular worker be replaced. However, X has no right to fire the leased employee or to otherwise alter the terms of the employment contract between the leased employee and the leasing firm. The leasing firm can require the leased employee to work for any subscriber (not just X) and has the right to transfer the leased employee between subscribers. The fee arrangement is a markup of the worker's cost to the leasing firm.

The leasing firm is responsible for (1) employee recruitment and testing; (2) hiring, training, evaluation, discipline, and termination; (3) all aspects related to paying the employee; and (4) providing unemployment insurance, workers compensation, and other fringe benefits.

Under these facts, X has relinquished virtually all vestiges of day-to-day direction and control over the leased employees. (This control is now exercised by the leasing firm.) Here, the leasing firm is clearly the employer of the leased employees under the employer/employee relationship rule. Thus, X has the desired independent contractor relationship with its former employees.

If the subscriber maintains an employer/employee relationship with the leased employees, the IRS will likely (1) treat the subscriber as the employer, (2) treat the leasing firm as an agent of the subscriber, and (3) consider the leasing firm's payroll duties and activities as nothing more than administrative payroll acts on behalf of the subscriber. This means the subscriber will be liable for payroll taxes and responsible for payroll tax compliance with respect to those employees.

Control-of-wage-payments Rule Applied to Employee Leasing Transactions

Consideration must also be given to whether the subscriber or the leasing firm has exclusive legal control over the payment of wages to the leased employees and the implications of this under federal payroll tax statutes.

1. For FITW, the person (subscriber or leasing firm) with exclusive legal control over the payment of wages will be the employer regardless of whether an employer/employee relationship exists with the leased

workers. This rule (known as the control-of-wage-payments rule) specifically overrides the employer/employee relationship rule. If neither the subscriber nor the leasing firm has exclusive legal control, this rule does not apply and the employer/employee relationship rule determines who is the employer.

2. The FICA and FUTA statutes do not expressly use the control-of-wage-payments rule. However, both the courts and the IRS have applied this rule for purposes of withholding FICA taxes and reporting and paying FICA and FUTA taxes.

Frequently, the person who controls the payment of a leased worker's wages also has an employer/employee relationship with the worker. Thus, the control-of-wage-payments rule often reaches the same conclusion (about who is the employer) as does the employer/employee relationship rule.

Example 3C-2 Control-of-wage-payments rule applied to leased employees.

Turfboy Corporation manufactures lawn mowers. Turfboy desires to add a mulching mower to its product line. Toward this end, it contracts with Engineer Leasing Company (ELC) to obtain additional design engineers (who have mulching mower design expertise) to supplement its engineering staff. The leasing contract will continue for a period of not less than two years, and it states that ELC is the employer for payroll tax purposes and is responsible for withholding and remitting the proper amount of payroll tax. Only ELC (1) knows how much each leased engineer is being paid, (2) provides fringe benefits, and (3) keeps financial records on each leased engineer.

The leased engineers are highly trained specialists who work with minimal supervision. Each leased engineer maintains his own time sheet, obtains approval by Turfboy of the number of hours worked, and then submits his time sheet to ELC headquarters, where it is used as the basis for paying the leased engineer's wages and fringe benefits. ELC periodically bills Turfboy for the services provided by the leased engineers.

With respect to the leased engineers, Turfboy handles the following matters:

1. Maintenance of a file on each leased engineer that contains only telephone numbers and contact persons in the event of emergency. (Turfboy does not maintain any other personnel records on the leased engineers.)
2. Review of the leased engineers' resumes to ensure that they have the proper qualifications for the particular jobs that need to be accomplished.
3. Control of the leased engineers' day-to-day performance. Turfboy exercises this control in much the same manner as it does for its own employees. Specifically, Turfboy switches leased engineers from one project or one lawn mower to another, or transfers them from one group manager to another.

Under the payroll tax statutes, who is the employer of the leased engineers? Since ELC appears to have exclusive legal control of the leased engineer's wage payments, it should be the employer for FITW purposes.

Officially, the IRS uses the employer/employee relationship rule (not the control-of-wage-payments rule) to determine whether there is a liability for FICA and FUTA purposes. Here, it appears Turfboy exercises common law control over the leased engineers and has an employer/employee relationship with them. Given this, the IRS audit position likely would be that Turfboy is the employer for determining how much FICA and FUTA, with ELC acting as payroll agent. The IRS probably would look first to ELC (as payroll agent) to collect the appropriate amount of payroll tax. If ELC properly withholds and remits the employee and employer payroll tax due, the IRS does not care who is the employer—it has gotten its share of the appropriate taxes.

But if ELC goes bankrupt, would the IRS try to collect the payroll taxes from Turfboy? As discussed previously, the IRS likely would maintain that Turfboy controls the engineers' work performance and, as such, is the common law employer under the employer/employee relationship rule—at least with respect to any FICA and FUTA tax due. Thus, the IRS would proceed against Turfboy for these unpaid payroll taxes. As a secondary argument, the IRS also could claim Turfboy had exclusive legal control over the payment of wages. Here, the Service would argue that ELC was nothing more than a disbursing agent, performing administrative tasks

under the direction and control of Turfboy. (However, given the facts of this case, the IRS likely would not be successful with this argument.)

Based on emerging case law, the courts might determine that responsibility for withholding and payment of all payroll taxes (FITW, FICA, and FUTA) is directed toward the person who controls the payment of wages and not the person who controls the worker's duties. Thus, the courts might disregard Turfboy's employer/employee relationship and concentrate on who has exclusive legal control of the payment of wages. In its fact-finding, the court could conclude that:

1. Turfboy does not have legal control over the payment of wages since it does not (a) know how much each leased employee was paid, or (b) maintain relevant financial records that would allow it to compute proper withholding and payroll taxes.
2. ELC's activities with respect to these functions are more than simple administrative tasks, meaning ELC has exclusive legal control of the payment of the leased employees' wages.

Under this reasoning, the court might rule that ELC is the employer for FITW, FICA, and FUTA purposes, and also might prohibit the IRS from pursuing Turfboy for the unpaid taxes.

Two Alternatives for Handling the Employer Payroll Tax Liability Issue

As Example 3C-2 illustrates, determining the employer of leased employees for payroll tax purposes is not a clear-cut issue. In some instances, the employer/employee relationship rule controls. In others, the control-of-wage-payments rule is the deciding factor. In many instances, there simply is no clear answer. Until further guidance (in the form of regulations or rulings, enforcement actions, or more fully developed case law) becomes available, the cautious subscriber will either:

1. *Treat the Leased Employee Just Like Any Other Independent Contractor.* This means relinquishing (a) actual direction and control of the leased worker's performance, and (b) control of the payment of the leased worker's wages. The leasing firm must have exclusive legal control of the payment of wages to be considered the employer under the control-of-wage-payments rule.
2. *Retain Common Law Control over Hiring, Compensation, Work Rules, Supervision, Termination, etc., but Delegate Administrative Payroll and Personnel Activities to the Leasing Firm.* In this situation, the subscriber remains the employer and the leasing firm is its agent. The subscriber should avoid the temptation to treat the leasing firm as the responsible party and should carefully (and routinely) review its compliance with qualified plan rules, payroll-related rules, and overall performance. The IRS will not hesitate to move against the subscriber if the leasing firm fails to observe the proper rules.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. JetCo has an employee leasing arrangement with Workers America. JetCo supervises the daily activities of the leased workers and has the right to request removal and replacement of a leased worker, but Workers America maintains exclusive right to hire and terminate workers, makes all compensation decisions, and uses a timekeeper system to track leased worker time. Each month Workers America bills JetCo for hours worked based on contractually stipulated rates. Which of the following statements is correct?
- a. Workers America is considered leased worker employer for FITW liability purposes.
 - b. If Workers America defaults on FUTA payments, JetCo has satisfied its obligation.
 - c. Under strict statute interpretation, Workers America is liable for FUTA.
 - d. Based on emerging case law, JetCo is liable for FICA.
24. Barker LLP has an employee leasing arrangement with Greene Leasing. One way for Barker to reduce the chance of being assessed liability for employer tax issues is to do which of the following?
- a. Issue 1099s to Greene and to each leased worker at year end.
 - b. Relinquish all legal and financial control of leased workers.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

23. JetCo has an employee leasing arrangement with Workers America. JetCo supervises the daily activities of the leased workers and has the right to request removal and replacement of a leased worker, but Workers America maintains exclusive right to hire and terminate workers, makes all compensation decisions, and uses a timekeeper system to track leased worker time. Each month Workers America bills JetCo for hours worked based on contractually stipulated rates. Which of the following statements is correct? **(Page 78)**
- a. **Workers America is considered leased worker employer for FITW liability purposes. [This answer is correct. Workers America meets the control-of-wage-payments test, which overrides the common law control test.]**
 - b. If Workers America defaults on FUTA payments, JetCo has satisfied its obligation. [This answer is incorrect. JetCo can argue the control-of-wage-payments rule but the IRS will likely maintain agency between Workers America and JetCo, who cannot escape liability by showing that it already paid Workers America.]
 - c. Under strict statute interpretation, Workers America is liable for FUTA. [This answer is incorrect. FUTA tax liability is statutorily subject to the common law control test. As such, JetCo meets that test and would be liable for the FUTA tax payments.]
 - d. Based on emerging case law, JetCo is liable for FICA. [This answer is incorrect. Emerging case law seems to lean toward applying the control-of-wage-payments test to determine liability for FICA. Workers America, not JetCo, meets that test.]
24. Barker LLP has an employee leasing arrangement with Greene Leasing. One way for Barker to reduce the chance of being assessed liability for employer tax issues is to do which of the following? **(Page 79)**
- a. Issue 1099s to Greene and to each leased worker at year end. [This answer is incorrect. Issuing a 1099 to leased workers would provide no protection against IRS claims of liability. Whether Barker or Greene is determined to be the employer, the leased workers would get W-2s, not 1099s.]
 - b. **Relinquish all legal and financial control of leased workers. [This answer is correct. One way for Barker to reduce or eliminate potential exposure to IRS claims for unpaid employer payroll taxes is to ensure that Barker fails both the common law control test and the control-of-wage-payments test.]**

Leased Workers Classified as Employees for Qualified Plan Purposes

Leased employees who have performed services for the employer (subscriber) on a substantially full-time basis for at least one year and who perform such services under the primary direction or control of the subscriber generally must be considered employees of the subscriber for qualified plan purposes. Nonetheless, a leased employee is treated as an employee of the leasing company for qualified plan purposes if covered by a safe harbor plan maintained by the leasing company.

Whether the leased employee is under the primary direction or control of the subscriber is based on facts and circumstances. These include determining whether the subscriber directly supervises the actions of the leased employee and whether the leased employee performs services in accordance with the directions of the subscriber (i.e., how, when, and where services are to be performed).

A person is considered to have performed services on a substantially full-time basis if during any consecutive 12-month period that individual has worked the lesser of 1,500 hours of service or 75% of the average number of hours customarily performed by an employee of the subscriber in the same job position as occupied by the leased employee.

Determining whether an individual is a leased employee is made after consideration of whether the individual is a common-law employee of the subscriber. A leased employee who in fact is the employer's common-law employee must be treated as any other employee of the employer, regardless of the leasing arrangement under which the individual works.

However, the fact that an individual meets the requirement of a leased employee by being under the primary direction or control of the subscriber does not necessarily mean that the individual is a common-law employee. An individual would not be under the primary direction and control of the subscriber if, for example, the leasing organization retained the responsibility to direct and supervise the individual's job performance.

Example 3D-1 Determining leased employees.

Bright Smiles Dental Clinic, P.C. has a calendar-year profit-sharing plan that covers the four doctors and the hygiene staff. Early in the current year, the doctors sell their practice to National Dental Care (NDC) but continue to maintain the P.C. Members of the hygiene staff become employees of NDC and continue to perform the same tasks as before the sale. Toward the end of the current year, Bright Smiles Dental Clinic, P.C. makes a 15% contribution to the profit-sharing plan which now covers only the four doctors. NDC makes a 5% contribution to its plan.

Are members of the hygiene staff considered to be leased employees of the P.C.?

Yes, the staff meets the definition of leased employees since they performed services for the P.C. under the primary direction or control of the P.C. and have performed those services for the P.C. on a substantially full-time basis for at least one year.

Since the members of the hygiene staff are leased employees, must they be covered by the P.C.'s profit-sharing plan?

Assuming that each of the four doctors is a highly compensated employee, the leased employees must be covered by the P.C.'s plan so it will pass the minimum coverage tests under IRC Sec. 410(b). In addition, their service as common-law employees of Bright Smiles and their service as leased employees to Bright Smiles count as participation and vesting service under the P.C.'s plan.

Excluding Leased Employees under a Safe Harbor Plan

Leased employees are not considered for coverage testing purposes if such employees constitute 20% or less of the subscriber's nonhighly compensated workforce and if those employees are covered by a nonintegrated, money purchase pension plan maintained by the leasing organization. The money purchase plan must provide for

full and immediate vesting; must have a contribution of at least 10% of compensation; and each employee of the leasing organization (other than employees who perform substantially all their services for the leasing organization) must be allowed immediate participation in the plan. However, there is an exception to the immediate participation rule for individuals whose compensation from the leasing organization is less than \$1,000 annually for the four-year period ending with the plan year under consideration. The organization that leases the employee to the subscriber can be any organization and, therefore, not necessarily an organization that conducts a business leasing employees.

For purposes of the *year of service* and *hour of service* rules, employees of certain related organizations are treated as if they are employed by a single employer. It is believed a leased employee's years of service with the subscriber count in the same way as years of service of a common-law employee of that subscriber. However, IRS Notice 84-11, Q&A 15, affirmatively states that leased employees may be excluded as a class from participation under a subscriber's retirement plan if the nondiscriminatory coverage requirements of IRC Sec. 410(b) are satisfied.

Plan Document May Exclude Leased Employees

The terms of the plan document determine whether leased employees fall into an eligible class of employees and thereby must participate in the plan. Therefore, leased employees may also be excluded from plan participation by defining in the plan document that such employees are not eligible to participate. However, the plan must still be able to meet the minimum participation and coverage requirements for nondiscrimination testing, taking the leased employees into account.

Under ERISA Sec. 202(a)(4), an employee who satisfies the minimum age and service requirements and who is otherwise entitled to participate in the plan must be permitted to join the plan. The "otherwise entitled" language has generated numerous lawsuits. A district court looking at IRC Sec. 414(n)(1)(A) and Reg. 1.410(b)-9 ruled that leased employees could not be excluded by category. This decision was reversed by the 10th Circuit, which said ERISA does not prohibit an employer from providing benefits for some employees but not others. In a similar case, the court found that it is well established under ERISA that employers may exclude specific categories of employees as long as the distinction is not based on age or length of service.

In a long-running case involving Microsoft Corporation and a class of workers it had tried to exclude from its employee benefit plans, the 9th Circuit held that any workers who are common-law employees of Microsoft are eligible for benefits even if they were hired as employees of temporary employment agencies. In this case, the plan expressly extended eligibility to all common-law employees. Therefore, exclusion of Microsoft's leased and temporary employees (who were common-law employees) would result in the loss of the plan's qualified status.

In a similar case, the 9th Circuit ruled that leased employees cannot be excluded from the client company's qualified pension and health plans solely on the basis that they are leased employees. The recipient employer must first determine whether the workers are leased employees or common-law employees. Then the recipient employer can determine whether the plan permits that particular class of workers to participate in the plan.

Additionally, several courts have ruled that a subscriber could exclude leased and temporary workers from its employee benefit plans, even though the workers were properly classified as common-law employees, because the plans specifically excluded them. In one case, the plan stated that only regular employees, and not any temporary employees, could participate in the plans. In another case, the plan excluded from participation common-law employees who were defined as leased employees under company policy. In a third case, the 9th Circuit ruled that a publishing company could exclude temporary workers who were employed through and on the payroll of a staffing agency from the company's retirement and health plans because, regardless of their common law status, the workers failed the plans' eligibility requirements that limited participation to persons on the company's payroll.

If a subscriber employer wishes to exclude leased employees (as a class of workers) from its qualified plan, the plan document should specifically exclude these workers. Then, even if the worker is also a common-law employee, the worker is not eligible for participation in the qualified plan.

Classifying Leased Workers for Welfare and Fringe Benefit Plan Purposes

Generally, the rules previously discussed here are equally applicable with respect to the subscriber's welfare and fringe benefits plans. Therefore, leased employees who have performed services for the employer (subscriber) on a substantially full-time basis for at least one year and who perform such services under the primary direction or control of the subscriber generally must be considered employees of the subscriber for employee welfare and fringe benefit plan purposes.

The following welfare and fringe benefits are subject to this rule.

1. Group-term life insurance.
2. Group health insurance benefits, including COBRA.
3. Qualified tuition reduction programs.
4. Cafeteria plans.
5. Educational assistance programs.
6. Dependent care assistance programs.
7. Statutory fringe benefits.
8. Adoption assistance programs.
9. Employee achievement awards.

The Section 414(n)(3) provisions are also applicable with respect to the additional requirements that IRC Sec. 505 imposes on certain Section 501(c) organizations.

For purposes of testing the employee benefit provisions described in IRC Sec. 414(n)(3), the safe harbor plan exception of IRC Sec. 414(n)(5) does not apply (i.e., all leased employees must be counted even if they are covered by a welfare or fringe benefit plan maintained by the leasing company). Therefore, even if leased employees are not eligible to participate in the subscriber employer's welfare and fringe benefit plans, they may have to be counted as employees for nondiscrimination testing purposes.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

25. Which of the following is **not** one of the tests a leased worker must meet to be considered an employee of the subscriber for qualified plan purposes?
- a. The leased worker must be under the primary control or direction of the subscriber.
 - b. The leased worker has worked for the subscriber for at least one full year.
 - c. The leased worker must be covered by the leasing company's safe harbor plan.
 - d. The leased worker must work substantially full-time for the subscriber.
26. Which of the following statements is correct concerning testing for whether the leased worker should be considered an employee of the subscriber for qualified plan purposes?
- a. Such testing should be secondary to determining whether the subscriber meets common law employer tests.
 - b. Leased workers may be excluded from consideration if they occupy no more than 10% of the subscriber's non-highly compensated workforce and are covered by a leasing company pension plan that meets certain other stipulations.
 - c. Plan documents may exclude leased workers as a class and thereby remove them as a factor in plan nondiscrimination tests.
 - d. Leased workers must be included for consideration if they meet safe harbor requirements.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

25. Which of the following is **not** one of the tests a leased worker must meet to be considered an employee of the subscriber for qualified plan purposes? **(Page 83)**
- a. The leased worker must be under the primary control or direction of the subscriber. [This answer is incorrect. This is one of the tests to determine whether the subscriber exercises common law control over the leased worker and therefore is considered an employee of the subscriber.]
 - b. The leased worker has worked for the subscriber for at least one full year. [This answer is incorrect. One of the tests for determining whether leased workers must be considered employees of the subscriber for qualified plan purposes is whether they have worked for the subscriber for a consecutive twelve-month period.]
 - c. The leased worker must be covered by the leasing company's safe harbor plan. [This answer is correct. The leased worker will not be counted as the subscriber's employee for qualified plan purposes if covered by the leasing company's safe harbor plan.]**
 - d. The leased worker must work substantially full-time for the subscriber. [This answer is incorrect. Leased workers may be considered employees of the subscriber for qualified plan purposes if they meet certain tests for continuous and substantial effort provided to the subscriber.]
26. Which of the following statements is correct concerning testing for whether the leased worker should be considered an employee of the subscriber for qualified plan purposes? **(Page 83)**
- a. Such testing should be secondary to determining whether the subscriber meets common law employer tests. [This answer is correct. If the subscriber meets the common law tests for employer, the worker must be treated as an employee despite any leasing arrangement.]**
 - b. Leased workers may be excluded from consideration if they occupy no more than 10% of the subscriber's non-highly compensated workforce and are covered by a leasing company pension plan that meets certain other stipulations. [This answer is incorrect. The leased workers may occupy no more than 20% of the subscriber's non-highly compensated workforce.]
 - c. Plan documents may exclude leased workers as a class and thereby remove them as a factor in plan nondiscrimination tests. [This answer is incorrect. The plan must include leased workers in meeting minimum participation and coverage requirements for nondiscrimination tests even though leased workers are excluded as a class by plan documents.]
 - d. Leased workers must be included for consideration if they meet safe harbor requirements. [This answer is incorrect. Leased workers are excluded for plan coverage testing purposes if they do not exceed certain workforce minimums and are covered by a leasing company plan that meets other safe harbor requirements.]

Failure to Properly Classify Leased Employees Consequences

Generally, most subscribers want to have the leased workers treated as employees of the leasing company to avoid the tax, legal, and administrative hassles associated with employment. This is often the principal reason the subscriber is entering into the lease agreement. (Otherwise, the subscriber might just as well have hired the workers as employees to begin with.) Thus, in most instances the subscriber initially considers the leased workers to be independent contractors.

In case of an audit, the IRS may challenge this classification and attempt to reclassify the leased workers as employees of the subscriber for qualified plan purposes, for payroll tax purposes, or both. If the IRS is successful, the following can occur:

1. *Qualified Plans.* The subscriber may be required to treat the leased workers as employees in testing compliance with the qualified plan rules. This can result in partial or complete disqualification of the subscriber's qualified retirement plan even if the employee leasing arrangement meets the Section 414(n)(5) safe harbor plan rules. If an individual is the subscriber's employee under the common law rules, such individual is an employee for all purposes and without regard to the employee leasing rules under IRC Sec. 414(n).
2. *Payroll Tax.* The subscriber may be liable for FITW, FICA withholding and payment, and FUTA payment with respect to the leased employee's wages. Should the employee leasing firm fail to withhold and remit these taxes, the IRS will proceed against the subscriber for these amounts. Penalties and interest, perhaps equaling or exceeding the amount of assessed tax, may be added to the business's tax bill.

The IRS is devoting significant new resources to compliance with federal employment tax regulations and the prosecution of employment tax fraud. The Service has identified employee leasing as an area of particular concern and intends to closely examine employee leasing arrangements. The IRS believes that it is hard for the leasing firm to be the employer, in part because the subscriber generally is the business entity that is controlling the worker.

Employee Leasing Firm Selection

Several steps can help a business hire a quality employee leasing firm. First, the business must identify the services and tasks to turn over to the employee leasing firm. This is critical for the following reasons:

1. This information should be presented to each employee leasing firm involved in the bidding. If each firm develops its fee quote and analysis using the same comparative data, the business will be in a position to make a true comparison of each leasing firm. Otherwise, the business cannot comprehensively compare the leasing firms in terms of services, benefits, and costs.
2. Once identified, these services and tasks can be quantified in terms of the cost of internally performing these tasks. The business can then determine whether using an outside leasing firm truly saves time and money.

Second, the business should make a list of questions and important issues to discuss with each prospective leasing firm.

Third, the business should select a minimum of two or three potential leasing firms and arrange interviews with each. (Lists of employee leasing organizations are available through trade associations, trade shows, business colleagues, etc.) Multiple bids are appropriate for comparative purposes. Reputable firms understand this and are willing to supply the information necessary to make a decision. The business should request references and should thoroughly check them out. If the state licenses employee leasing firms, the business should determine that licenses are properly current.

Once an agreement is reached with a particular firm, a service agreement should be drafted outlining the terms of the agreement. The contract should be reviewed by legal counsel for compliance with federal and state laws. The service agreement should provide a clear understanding of what will be delivered and when and how it will be

delivered. Roles and responsibilities of both the leasing firm and the business should be clearly defined in the agreement and it should also include the criteria for evaluating the quality of the services being performed. The agreement should also specifically spell out the role and degree of authority of the leasing firm's on-site supervisor(s). This may well determine who is the employer for payroll tax purposes.

Because the business remains liable for the leasing firm's actions, it should not only use due diligence in selecting a leasing firm, but thereafter should monitor its performance. To help protect itself, the subscriber should also:

1. Keep records showing that its payments to the leasing firm were sufficient to cover wages and payroll taxes.
2. Have indemnification clauses (including the cost of defense) in the contract.
3. Have the leasing company provide its own supervisor at the worksite to make discipline and discharge decisions.
4. Have an attorney summarize the subscriber's exposures in being classified as an employer or joint employer under the applicable federal and state laws.
5. Consider carving out contractual arrangements with the leasing company to have payroll funds set aside in trust fund accounts until paid to taxing authorities, giving those funds priority in the event of the leasing company's bankruptcy proceedings. Having the funds held in trust will also protect the funds from an IRS levy of the leasing company's bank account.
6. Regularly monitor its tax accounts, which can be done on the Internet for federal and most state taxes. Also consider at least a biannual review of tax transcripts (available upon request from the IRS), which can yield valuable information about short, late, or missing payments and returns.
7. Never allow its address of record with the IRS to be changed to that of the leasing company. Changing the address of record provides an unscrupulous or poorly managed leasing company the opportunity to keep the subscriber from seeing any IRS notices about missing deposits or other problems with the account.
8. Ensure that the leasing company has verified an employee's eligibility to work in the U.S.

After the agreement is signed, the leasing firm will arrange for the employees to sign the appropriate payroll and health enrollment forms. Once the forms are completed, the business (now subscriber) should determine (1) the first payroll date, (2) the payroll cut-off dates, (3) who will coordinate the payroll and benefits activities for the business, and (4) when employee benefits will begin (since this will trigger the appropriate employee payroll deductions, if any).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

27. Franklin Co has an employee leasing agreement with Plyco. Franklin closely supervises the daily activities of the leased workers, approves their wage rates and time sheets, and reserves the right to hire and terminate workers. Plyco performs all other HR and payroll functions and bills Franklin monthly. Franklin's qualified plan does not meet nondiscrimination testing if leased workers are included so Plyco established a pension plan in concert with a lease agreement that meets safe harbor requirements. Which of the following is most accurate?
- a. The IRS will disqualify Franklin's qualified plan.
 - b. Safe harbor provisions apply for nondiscrimination testing.
 - c. Leased workers are due back-wages.
 - d. Franklin owes leased workers retirement benefits retroactively.
28. Weldco has had an employee leasing agreement with Mountain Leasing for the last two years, effectively employing all of its previous workers through Mountain. Weldco closely supervises the leased workers but Mountain performs all other HR and payroll functions including payroll tax compliance, wage and performance reviews, hiring and termination, etc. Mountain covers leased workers with pension and fringe benefits.
- a. Weldco , not Mountain, is liable for FITW on leased workers.
 - b. Mountain, not Weldco, is strictly liable for FUTA on leased workers.
 - c. Weldco must include leased workers in qualified plan nondiscrimination tests.
 - d. Without safe harbor, Weldco must exclude leased workers from fringe benefits tests.
29. A critical first step in selecting an employee leasing firm is to do which of the following?
- a. Identify the services and tasks to be required of the leasing company.
 - b. Prepare a list of potential bidders and send invitations to bid.
 - c. Prepare an interview checklist for a pre-bid meeting.
 - d. Review the service agreement stipulations with company legal counsel.
30. To minimize exposure for unpaid employer tax liability, subscribers should do which of the following?
- a. Have the address of record changed to that of the leasing company.
 - b. Have their own supervisors overseeing daily efforts of leased workers.
 - c. Specify contractually that funds for payroll taxes be escrowed until remittance.
 - d. Ensure I-9 compliance issues are the employee leasing company's responsibility.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

27. Franklin Co has an employee leasing agreement with Plyco. Franklin closely supervises the daily activities of the leased workers, approves their wage rates and time sheets, and reserves the right to hire and terminate workers. Plyco performs all other HR and payroll functions and bills Franklin monthly. Franklin's qualified plan does not meet nondiscrimination testing if leased workers are included so Plyco established a pension plan in concert with a lease agreement that meets safe harbor requirements. Which of the following is most accurate? **(Page 89)**
- The IRS will disqualify Franklin's qualified plan. [This answer is correct. Franklin meets the common law control test and the control-of-wage-payments test and is therefore considered the employer. This renders Plyco's shielding efforts ineffective.]**
 - Safe harbor provisions apply for nondiscrimination testing. [This answer is incorrect. Franklin is the common law employer. Plyco's pension plan and the leasing agreement are therefore incapable of shielding Franklin from including leased workers in qualified plan nondiscrimination tests.]
 - Leased workers are due back-wages. [This answer is incorrect. Nothing suggests that the employees have not been paid.]
 - Franklin owes leased workers retirement benefits retroactively. [This answer is incorrect. Leased workers have to be counted for testing but they do not actually have to be covered by Franklin's retirement plan.]
28. Weldco has had an employee leasing agreement with Mountain Leasing for the last two years, effectively employing all of its previous workers through Mountain. Weldco closely supervises the leased workers but Mountain performs all other HR and payroll functions including payroll tax compliance, wage and performance reviews, hiring and termination, etc. Mountain covers leased workers with pension and fringe benefits plans. Mountain declares bankruptcy in year three of the agreement. Which of the following is correct? **(Page 89)**
- Weldco, not Mountain, is liable for FITW on leased workers. [This answer is incorrect. Mountain meets the control-of-wage-payments test; this overrides the common law control test.]
 - Mountain, not Weldco, is strictly liable for FUTA on leased workers. [This answer is incorrect. Mountain meets the common law control test. Case law considers control-of-wage-payments in determining the employer, but strict statutory interpretation makes no such allowance therefore Weldco is liable for FUTA.]
 - Weldco must include leased workers in qualified plan nondiscrimination tests. [This answer is correct. Mountain had pension and fringe benefits plans, but no safe harbor compliance is indicated. Weldco's close supervision of leased workers for a consecutive twelve-month period while they worked for Weldco on a substantially full-time basis qualifies Weldco as the employer for qualified plan tests.]**
 - Without safe harbor, Weldco must exclude leased workers from fringe benefits tests. [This answer is incorrect. Safe harbor has no effect on fringe benefits nondiscrimination tests.]

29. A critical first step in selecting an employee leasing firm is to do which of the following? **(Page 89)**
- a. **Identify the services and tasks to be required of the leasing company. [This answer is correct. By identifying services and tasks to be required, the company can better understand and communicate its expectations, standardize bidder responses, and quantify potential savings from outsourcing.]**
 - b. Prepare a list of potential bidders and send invitations to bid. [This answer is incorrect. Preparing a list of potential bidders is okay, but sending invitations to bid as the first step would be premature.]
 - c. Prepare an interview checklist for a pre-bid meeting. [This answer is incorrect. An interview checklist could perhaps be prepared in concert with the first step, but it would not be the first step.]
 - d. Review the service agreement stipulations with company legal counsel. [This answer is incorrect. A review by company legal counsel would be appropriate after a bid award and before final contracts are signed.]
30. To minimize exposure for unpaid employer tax liability, subscribers should do which of the following: **(Page 90)**
- a. Have the address of record changed to that of the leasing company. [This answer is incorrect. Subscribers should ensure that they continue to receive IRS communications so that they are aware of any problems that might occur because of leasing company fraud or mismanagement.]
 - b. Have their own supervisors overseeing daily efforts of leased workers. [This answer is incorrect. To distance themselves from common law control issues, subscribers should insist that the leasing company maintain its own supervisors on-site so that subscribers can communicate instructions directly to them and not the leased workers.]
 - c. **Specify contractually that funds for payroll taxes be escrowed until remittance. [This answer is correct. This will help ensure that unpaid taxes remain funded and have priority in the event of leasing company bankruptcy.]**
 - d. Ensure I-9 compliance issues are the employee leasing company's responsibility. [This answer is incorrect. I-9 compliance tasks may be assigned, but the responsibility cannot. The subscriber should periodically review the leasing company's I-9 compliance.]

EXAMINATION FOR CPE CREDIT**Lesson 3 (PRLTG091)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

21. Which of the following statements is correct concerning leased employees?
 - a. Leased employees often provide services the subscriber's employees cannot.
 - b. The lease contract term is for short, renewable durations.
 - c. Leased workers make up a small percentage of the subscriber's workforce performing a given job.
 - d. Leased workers are quite often the subscriber's former employees.

22. Which part of IRC Section 414 deems the subscriber to be the employer of leased workers for application of certain qualified plan coverage and nondiscrimination requirements?
 - a. 414(b).
 - b. 414(m).
 - c. 414(n).
 - d. 414(o).

23. Ardco maintains an employee leasing agreement with Gem Leasing. Ardco supervises the daily activities of leased workers and approves their timesheets for submission to Gem. Ardco also determines worker compensation issues based on annual performance reviews and can hire and terminate workers. Gem, for its part, processes all payroll, pays workers, makes tax payments and filings, and issues the W-2s at the end of the year. Which statement is correct?
 - a. Gem Leasing is considered the leased worker's employer for FITW liability purposes.
 - b. Ardco has satisfied its obligation if Gem defaults on FUTA payments.
 - c. Gem Leasing is liable for FUTA under strict statute interpretation.
 - d. Ardco is liable for FICA payments based on emerging case law.

24. Marco Ltd has an employee leasing agreement with Arch Leasing. Marco is also part of a common paymaster system with Bright Inc, and an employee loan-out arrangement with Nellco. Marco has the right to specify where leased employees work, but Arch maintains all other rights and responsibilities and bills Marco according to a contractually stipulated rate sheet. During 2009, Marco specified that three leased workers would be located at Nellco to help with completion of a difficult project. While there, Arch worked with Nellco to see that work was completed satisfactorily and Nellco gave the three workers a bonus at the end of the project. Which of the following is most accurate regarding the three workers?
 - a. Arch owes payroll tax for all monies the three workers received.
 - b. Marco owes payroll tax on the three workers, except for the bonuses.
 - c. Nellco owes payroll tax related to the bonuses paid the three workers.
 - d. Bright owes payroll tax for the bonuses paid as common paymaster.

25. One of the tests for considering a leased worker as an employee of the subscriber for qualified plan purposes is whether they work substantially for the subscriber. To meet this requirement, the leased worker must work the lesser of 1,500 hours annually or a percentage of the average hours normally required by the subscriber for an employee performing this function. What is this percentage?
- 50%.
 - 65%.
 - 75%.
 - 90%.
26. Johnson Co has a leased employee arrangement with E-Lease, who has a properly structured safe harbor plan. Johnson can exclude leased workers from consideration as subscriber employees for purposes of welfare and fringe benefit plan nondiscrimination testing.
- True.
 - False.
 - Do not select this answer choice.
 - Do not select this answer choice.
27. RayMart has an employee leasing agreement with Gladly Leasing. RayMart closely supervises the leased workers, but Gladly performs all other HR and payroll functions including hiring, terminating, annual compensation and performance reviews, payroll tax compliance, etc. The leasing agreement complies with safe harbor requirements and Gladly maintains its own pension, welfare, and fringe benefits plans for its employees. Which of the following is correct?
- The safe harbor will shield RayMart from FITW claims if Gladly defaults.
 - RayMart must count leased workers for fringe benefits nondiscrimination testing.
 - The safe harbor will shield RayMart from FUTA claims if Gladly defaults.
 - Do not select this answer choice.
28. If the IRS challenges leased worker classification to assess liability and penalties, it will most likely do so on the basis of which of the following?
- Safe harbor.
 - Common paymaster liability.
 - Nondiscrimination testing.
 - Employee control.
29. Selecting a quality employee leasing firm is critical to a business. The business remains liable for the leasing firm's actions. Which of the following steps is **not** one of the steps a business should take to hire a quality employee leasing firm?
- Identify the services and tasks to turn over to the employee leasing firm.
 - Make a list of questions to discuss with each leasing firm.
 - Tell the potential firms how much you are willing to pay for their services.
 - Select potential firms and arrange for interviews.

30. Who is ultimately responsible for payroll tax payments?
- a. The employee leasing company.
 - b. The common paymaster.
 - c. The independent service bureau.
 - d. The client employer.

Lesson 4: Special Classes of Exempt Employment

INTRODUCTION

Once an employer/employee relationship has been established, further consideration must be given to the nature of the employee's work. Employee service that is subject to one or more federal payroll tax statutes is known as covered employment. While most types of employee services are covered employment (and so fully subject to payroll taxes), some special classes of employment are exempt from federal payroll taxes. Other special classes of employment are partially exempt. Common examples of fully or partially exempt employment include certain farm labor, employee service for federal or state governments, and family employment.

This lesson explains the basic rules and principles for covered and exempt employment, discusses how each federal payroll tax statute defines covered and exempt employment, and applies these rules to specific employment situations.

In an employer/employee relationship, employee compensation generally is covered under federal payroll tax laws unless (1) the employee's services constitute exempt employment, or (2) the compensation (including noncash compensation) paid in exchange for the employee's service is not wages. Hence, a two-pronged requirement exists, and both aspects must be checked to determine whether the federal payroll tax rules apply to compensation paid for a particular employee's services.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine various classes of employment that are exempt under different federal payroll tax statutes and apply the one-half rule to mixed employment;
- Identify payroll tax issues related to employment of family in a family-owned business and determine how the form of organization affects payroll tax liability;
- Apply covered employment rules related to casual labor and differentiate between payroll tax rules related to employing family members as regular employees and those related to employing family members as casual labor;
- Identify FICA coverage and exemptions for government employees; and
- Apply employment tax rules related to the clergy and recognize issues related to employing students at educational institutions.

Exempt Employment Definition

Each federal payroll tax statute separately lists special classes of employment that may be fully or partially exempt from the covered employment rules. These rules may be summarized as follows:

1. *FITW*. IRC Sec. 3401(a)(1)-(6), (8)-(11), (13), and (17) lists employee services that are fully or partially exempt from federal income tax withholding (FITW). These exempt services include active combat service, federal employees in the peace corps, casual labor, and services performed by ordained ministers. IRC Sec. 3401(a) also exempts ten types of compensation from the FITW rules.
2. *FICA*. IRC Sec. 3121(b) sets forth 21 paragraphs listing employee services that are fully or partially exempt from coverage under the social security and Medicare (FICA) payroll tax provisions. This list includes some, but not all, of the FITW classes of exempt employment. Exempt employment rules for FICA are also found in IRC Sec. 3121(a).
3. *FUTA*. IRC Sec. 3306(c) sets forth 21 paragraphs listing employee services that are fully or partially exempt from coverage under the federal unemployment (FUTA) payroll tax provisions. While many of these employee services are the same as those found in the FITW and FICA provisions, some are unique to the FUTA statute. An example would be an insurance agent who is commission based.

Because each statute adopts a somewhat different list of special classes of exempt employment, the rules must be applied using a statute-by-statute approach in order to isolate any differences and accord the proper treatment under each federal payroll tax statute.

One-half Rule for Mixed Employment Application

An employee may perform both covered (nonexempt) and exempt employment duties for the same employer during a pay period. If this occurs, the federal payroll tax statutes apply a one-half rule for treating these so-called mixed employment duties:

1. If at least half of the number of hours worked during the pay period is spent on covered employment duties, all of the employee's service is considered covered employment.
2. If less than half of the number of hours worked during the pay period is spent on covered employment duties, all of the employee's service is considered exempt employment.

The term *pay period* is defined as a period of not more than 31 consecutive days for which the payment of wages is ordinarily made to the employee. When the employer uses pay periods of uniform duration that are less than 31 days, each period constitutes a pay period. If the pay periods occasionally vary in duration, the pay period is the period ordinarily used even though it may not coincide with the actual pay period for which a particular payment is made.

Example 4B-1 One-half rule determines whether mixed employment is covered or exempt.

The Wolverine Club, a student club located on university premises, hires Max to perform domestic service (cleaning) for the club and to keep the club's books. Max is enrolled in and regularly attending classes at the university. The domestic service performed by Max is exempt employment for FITW, FICA, and FUTA. (For FUTA purposes assume Wolverine did not pay total cash wages of \$1,000 or more for all domestic service in any quarter in the current or preceding calendar year.) Max's service as the club's bookkeeper is covered employment.

During the month of January, Max worked 20 hours in performing domestic service and 40 hours as the club's bookkeeper. During February, Max worked 30 hours in the performance of domestic services and 15 hours in keeping the club's books. Since at least half the hours worked during January was for covered employment, all of Max's employee service during January is covered employment. His compensation for domestic service and bookkeeping is subject to FITW, FICA, and FUTA. Since less than half of the hours worked during February was for covered employment, all of Max's service during February is treated as exempt employment under the federal payroll tax provisions. His compensation for domestic service and bookkeeping for February will be exempt for FITW, FICA, and FUTA purposes.

If the one-half rule does not apply, the employer must make an allocation of the employee's time between covered and exempt employment. The covered portion may then be subject to the federal payroll tax rules.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

31. Which of the following is considered a special class of employment, exempt from FICA and FUTA tax?
- a. Federal employees who are members of the Peace Corp.
 - b. Family members employed in a family-owned business.
 - c. Commission-based insurance agents.
 - d. Certain members of religious orders.
32. Joe is a newspaper carrier for The County News. He also works around the newspaper office doing odd jobs and custodial service while he learns the ropes. Joe is paid each Friday for work performed in the previous payroll week that begins each Monday. In the first full week of June, Joe worked 25 hours as a newspaper carrier and 20 hours performing other duties. Of the hours Joe worked during the period, how many are considered covered for federal payroll tax purposes?
- a. 0.
 - b. 20.
 - c. 25.
 - d. 45.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

31. Which of the following is considered a special class of employment, exempt from FICA and FUTA tax? **(Page 99)**
- a. Federal employees who are members of the Peace Corp. [This answer is incorrect. Compensation paid to Peace Corp employees is exempt from FITW, but not from FICA and FUTA.]
 - b. Family members employed in a family-owned business. [This answer is correct. Compensation paid to family members employed in a family-owned business may, under certain circumstances, be considered exempt from FICA and FUTA tax.]**
 - c. Commission-based insurance agents. [This answer is incorrect. Commissions paid to commission-based insurance agents are exempt from FUTA but not FICA.]
 - d. Certain members of religious orders. [This answer is incorrect. Compensation to ministers and certain members of religious orders is exempt from employer FICA tax but not FUTA.]
32. Joe is a newspaper carrier for The County News. He also works around the newspaper office doing odd jobs and custodial service while he learns the ropes. Joe is paid each Friday for work performed in the previous payroll week that begins each Monday. In the first full week of June, Joe worked 25 hours as a newspaper carrier and 20 hours performing other duties. Of the hours Joe worked during the period, how many are considered covered for federal payroll tax purposes? **(Page 100)**
- a. 0. [This answer is correct. A newspaper carrier is considered a special class of exempt employment. Less than half of the hours Joe worked are considered covered (nonexempt). Under the one-half rule for mixed employment, if less than half of the hours worked during the pay period are nonexempt, all of the hours worked are counted as exempt.]**
 - b. 20. [This answer is incorrect. Although Joe worked 20 hours during the pay period performing covered duties, this answer does not comply with the one-half rule.]
 - c. 25. [This answer is incorrect. Joe worked 25 hours during the period performing duties considered part of a special class of exempt employment.]
 - d. 45. [This answer is incorrect. Joe's hours for the period constitute mixed employment. This answer does not comply with the one-half rule.]

Family-owned Business and Family Employment

It is common for parents, sons, daughters, or even grandchildren to work in a family business. Generally, family employment is treated like any other employment, and the employee service performed for the business by family members is covered employment subject to federal income tax withholding (FITW), social security and Medicare (FICA) taxes, and federal unemployment (FUTA) tax. However, in limited instances, a family member's employee service may be exempt employment for FICA or FUTA purposes (although in such case it remains subject to FITW).

Employing the owner's child in the owner's closely held business can be an effective tool to reduce the overall family tax burden. For example, a child can earn up to \$9,100 in 2009 without paying any income taxes (standard deduction equal to earned income up to a maximum of \$5,100, plus \$4,000 deductible IRA contribution). Wages paid to a child also create opportunities to shift earned income to the child's lower bracket and to reduce the income and FICA taxes of the family unit. This is particularly true when the child can take advantage of the 10% income tax rate at lower income levels. Perhaps even more importantly, wages paid to a child may help avoid imposition of the onerous kiddie tax rules for a child who is 18 years old (19 to 23 years old if the child is a student) if the child provides more than half of his or her own support with earned income (2008 rules). But as in all cases in which a child is employed by his parent or an entity controlled by his parent(s), the IRS can be expected to scrutinize carefully whether the income was in fact earned, and at a reasonable hourly rate for the work actually performed.

In general, the definition of a family member for purposes of these rules includes spouses, lineal descendants (sons, daughters, or collectively children), and ancestors. While the government says the definition of a lineal descendant includes adopted children, foster children, and stepchildren, the courts have not always agreed with this.

These rules apply solely to family employment within the context of a family-owned business. Family employment may also become an issue when parents or other family members hire relatives as employees to perform various domestic services or when a family member is hired to perform casual labor.

Form of Business Affects Family Employment Rules

Application of the family employment rules varies based on the form in which the business operates. Accordingly, the starting point is to identify the type of legal and tax entity through which the family business is conducted. The family employment rules accord sole proprietorships preferential treatment, deal harshly with corporations, and employ a somewhat middle ground for partnerships.

Employer Is a Sole Proprietorship. The typical situation involves a family business operated as a sole proprietorship (when income and expenses are reported by the sole proprietor on Schedule C of Form 1040.) Another family member's employee service for the family's sole proprietorship may be considered exempt employment for FICA and/or FUTA purposes in three instances:

1. *Son or Daughter Exemption.* Service performed by a child under the age of 18 employed by a parent is exempt for FICA purposes. A similar rule applies for FUTA purposes except that the age limit is increased to under 21.
2. *Spouse Exemption.* Service performed by an individual employed by a spouse is exempt for FUTA purposes. (FICA taxes apply to spousal employment.)
3. *Father or Mother Exemption.* Service performed by a parent employed by a child is exempt for FUTA purposes. (FICA taxes apply to parental employment.)

In all other instances, the family member's employee service for the family's sole proprietorship is covered (i.e., nonexempt) employment. Thus, the employment of a spouse is subject to FITW and FICA. Similarly, the employment of a parent by a child is subject to FITW and FICA.

Employer Is a Family Corporation. The family business may be operated through a C or S corporation, or as an association taxable as a corporation. Here, all employee service (including employee service by all family mem-

bers) is covered employment for FITW, FICA, and FUTA tax purposes. There are no special rules or exemptions. Neither age nor family relationship makes any difference.

Employer Is a Family Partnership. The family business may be operated as a partnership. Here, each family member's employee service is covered employment for FICA and FUTA purposes *unless* the son or daughter exemption applies and the parents are the only partners in the partnership.

The regulations state only that the requisite family relationship must exist between the family member employee and each of the partners. The Social Security Handbook takes things one step further and states the relationship must be that of a son or daughter employee in a partnership consisting only of parents as partners. Oddly, the requisite relationship requirement apparently is not met when the relationship is that of a father or mother employee in a partnership consisting only of siblings as partners.

Example 4C-1 Family business operated as a sole proprietorship.

John Brown owns and operates Compu-Plus, a retail computer store. The business is operated as a sole proprietorship, and John reports his income and expenses on Form 1040, Schedule C. The following six employees worked in John's store during the year: (1) Jack Gragg and Fred Harder are unrelated employees who worked full-time in the business who earned \$18,000 each; (2) Susy Brown (John's wife) earned \$1,000 during the summer; (3) Tim Brown (John's son), who is 17 years old, worked part-time after school and during the summer break and earned \$3,000; (4) Joe Brown (John's father) helped during the holidays and earned \$2,000; and (5) Jake Brown (John's brother) also helped during the holidays and earned \$1,000.

In analyzing his payroll, John reaches the following conclusions concerning the covered employment status of each employee's service:

1. Jack and Fred engage in fully covered employment. Their employee service is subject to FITW, FICA, and FUTA.
2. Susy's employee service is covered employment for FITW and FICA purposes, but not FUTA (a spouse's employee service is exempt for FUTA purposes). While John must withhold on Susy's wages and pay FICA tax, there is no FUTA tax obligation.
3. Service performed by Tim is exempt for FICA and FUTA purposes since he is under the age of 18 (21 for FUTA). However, Tim's employee service is subject to FITW, and John will likely have to withhold on his son's wages unless Tim claims exempt status on Form W-4 (Employee's Withholding Allowance Certificate).
4. Service performed by Joe is subject to FITW and FICA, but exempt for FUTA purposes.
5. Jake's employee service is fully covered employment for FITW, FICA, and FUTA purposes. John's brother is not a family member for purposes of these rules.

Example 4C-2 Family business operated as a corporation.

Assume the same facts as in Example 4C-1 except the business is operated through a corporation. Here, each employee's service (including service by Susy, Tim, and Joe) is covered employment for FITW, FICA, and FUTA. No special exemptions or rules apply when the business is operated through a corporation. Neither family relationship nor age matters.

Example 4C-3 Family business operated as a partnership.

Assume the same facts as in Example 4C-1 except the business is owned through a partnership. Here, the only possible exempt employment would involve Tim, John's son. The key is who owns the partnership. If John and Susy co-own the business and there are no other partners, Tim's service would be exempt employment for FICA and FUTA tax purposes. Conversely, no special rules or exemptions will apply if someone other than John or Susy is a partner in the partnership. Instead, the partnership is treated like the corporation in Example 4C-2, and all employee service by family members is fully covered employment.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

33. Considering payroll tax rules regarding employing family members in a family-owned business, wages paid for services are exempt for purposes of employer FICA tax in which of the following instances?
- a. Along lines of consanguinity.
 - b. Along lines of affinity.
 - c. Along lineal descendant lines.
 - d. Along lineal ancestor lines.
34. Sherry is 20 years old and a college student. She began working for her family's business earlier this year. Which of the following is correct concerning Sherry's wages for FUTA tax purposes?
- a. They are exempt if the family business is a C corporation owned by her parents.
 - b. They are not exempt if the family business is an S corporation of at least six owners.
 - c. They are exempt if the family business is a sole proprietorship owned by her father.
 - d. They are not exempt if the family business is her parent's 2-member partnership.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

33. Considering payroll tax rules regarding employing family members in a family-owned business, wages paid for services are exempt for purposes of employer FICA tax in which of the following instances? **(Page 103)**
- a. Along lines of consanguinity. [This answer is incorrect. Not all lines of consanguinity are exempt for purposes of employer FICA tax.]
 - b. Along lines of affinity. [This answer is incorrect. An uncle by marriage might be considered family, but his wages are subject to employer FICA tax.]
 - c. Along lineal descendant lines. [This answer is correct. Wages earned by a son or daughter of a parent employer are considered exempt for employer FICA tax purposes under certain conditions.]**
 - d. Along lineal ancestor lines. [This answer is incorrect. Wages earned by a father or mother as an employee of their offspring are considered exempt for FUTA, but not FICA, tax purposes.]
34. Sherry is 20 years old and a college student. She began working for her family's business earlier this year. Which of the following is correct concerning Sherry's wages for FUTA tax purposes? **(Page 103)**
- a. They are exempt if the family business is a C corporation owned by her parents. [This answer is incorrect. A corporation treats all employees as covered for payroll tax purposes, regardless of familial affiliation.]
 - b. They are not exempt if the family business is an S corporation of at least six owners. [This answer incorrect. The number of S corporation owners is irrelevant.]
 - c. They are exempt if the family business is a sole proprietorship owned by her father. [This answer is correct. Sole proprietorships and partnerships meeting certain criteria are awarded special favor for payroll tax purposes versus other forms of organization.]**
 - d. They are not exempt if the family business is her parent's 2-member partnership. [This answer is incorrect. Because Sherry is under 21 years old, and because her parents are the sole partners, Sherry's wages would be considered exempt for FUTA tax purposes.]

Covered Employment Rules of Casual Labor

Casual labor includes any service by an employee that is occasional, incidental, or irregular and does not promote or advance an employer's trade or business. Minimal amounts of cash pay for casual labor (i.e., amounts not exceeding certain dollar amount thresholds) may be exempt from some or all payroll taxes. In addition, noncash payments for casual labor are fully exempt from payroll taxes. See the discussion later in this lesson for more information on these coverage rules.

The casual labor rule typically applies when an individual (i.e., an employer) who does not operate a trade or business employs a worker to perform employee service for the employer's nonbusiness activity. (An employer/employee relationship exists—although it is clearly outside a business context.) Casual labor is not the same as domestic household service. Domestic household service is of a household nature performed in or about a private home. Thus, routine work performed by a caretaker or handyman, work in the residence by a maid, butler, etc., or work as a chauffeur for family use is domestic service.

Example 4D-1 Nonroutine home repair.

Steve Hart employs Tim Sullivan, a student, to perform carpentry and painting work on Steve's private home. Tim works every day in June. Tim receives \$800 for the work. Here, two questions arise: First, is Tim an employee of Steve or an independent contractor? Whether Tim is an employee or independent contractor depends on the facts and circumstances and an analysis of relevant common law. However, if Steve controls both the results and the manner in which Tim performs his work, Tim will be an employee. This is true even though the employment is of relatively short duration.

The second question is whether this is casual labor or domestic service. Whether private home repair is domestic service or casual labor hinges on whether the service is ordinarily and customarily performed as an integral part of household duties. When the worker is employed as a caretaker or handyman on a continuous basis for tasks related to routine upkeep of a private home, the worker is likely engaged in domestic service. In contrast, when the worker is employed on an isolated or nonroutine basis to perform carpentry, painting, or similar skilled tasks that are not ordinarily a part of home duties and involve the use of skilled or special training, the work is likely casual labor. Since Tim's employment appears to fall within the latter category, it is arguably casual labor.

Casual labor is covered employment for FITW and FUTA purposes only if, during a calendar quarter: (1) cash payments to the employee are \$50 or more; and (2) for the current or preceding calendar quarter, the employee works more than 23 days of casual labor for the employer. For purposes of this 23-day test, count any day or portion thereof on which the employee actually works, and any day or portion thereof on which the employee does not work but for which the employee is nevertheless paid, such as a vacation or sick day. Casual labor is covered employment for FICA purposes only if, during a calendar year, cash payments are \$100 or more during the year (i.e., no regularly employed requirement exists for FICA purposes).

For purposes of determining if the \$100 FICA threshold has been met, cash paid in a calendar year, rather than cash earned in a calendar year, is used. Additionally, only cash payments are considered [i.e., noncash payments (clothes, food, lodging, transportation passes, etc.) are not taken into account in determining if the \$100 threshold has been met]. Once the \$100 cash threshold is exceeded, all cash payments are treated as FICA wages. The first \$100 of cash payments made before the threshold is met are deemed to be paid when cash payments for the year reach \$100. If the employee works for more than one employer, the \$100 threshold is applied separately to each employer.

Example 4D-2 Casual labor FICA cash-pay test based on calendar year of payment.

On March 31, 20X2, John Smith pays employee Shelly Davis \$100 cash for casual labor. The payment is wages subject to FICA taxes when paid in March 20X2 even though \$10 is for services performed by Shelly for John in December 20X1.

Example 4D-3 Collector uses nonbusiness employee.

Frank West is an avid sports fan who actively collects old sports memorabilia. His personal hobby collection is continually growing, and he devotes most of his free time to it. When Frank is unable to attend local sports memorabilia shows, he hires Steve Harder, a college student with a similar interest, to attend in his place. Frank pays Steve by the hour. For the first quarter of the year, Steve works (i.e., attends shows on Frank's behalf) for 20 days and receives cash wages of \$400. Steve performs no work during the second quarter and works for only one day during the third quarter (for which he receives a \$20 cash wage). However, for the fourth quarter of the year, Steve works for 10 days and receives cash wages of \$200. Therefore, Steve's total cash wages for the year equal \$620.

For FITW and FUTA purposes, a two-pronged test is applied on a quarterly basis to determine whether casual labor is covered or exempt. If both requirements are met, the casual labor is covered employment. Otherwise, it is exempt employment. Here, Steve meets the cash pay test (his compensation for the first and fourth quarters is \$50 or more) but not the regularly employed requirement in either of these quarters or the remaining calendar quarters of the year. Thus, Steve's service is exempt employment for FITW and FUTA purposes for all four quarters.

For FICA purposes, the cash pay requirement applies on a calendar year basis to determine whether the casual labor is covered or exempt. Here, Steve received cash pay of \$100 or more during the year. Accordingly, all of his casual labor with respect to the sports memorabilia show attendance is covered employment for FICA purposes.

The casual labor issue might also arise when an unincorporated employer asks an employee to perform services that are not business-related (e.g., a retail store owner requires a delivery person to pick up and deliver personal packages for the owner). However, it appears the one-half rule discussed earlier in this lesson would cause this type of casual labor to be treated as covered employment. Thus, when an employee in the normal course of a weekly or monthly pay period performs certain exempt casual labor activities in addition to his regular employee services, and the casual labor duties are less than 50% of his time, all employment duties would be covered employment under the one-half rule.

Guidelines for Applying the Casual Labor Rules

Casual labor may involve family members (e.g., a father hires his son to paint the family home or to assist him in a hobby or recreational activity). A family member's employee service for casual labor may be considered exempt employment for FICA and FUTA purposes in three instances:

1. *Son or Daughter Exemption.* Service performed by a child under the age of 21 employed by a parent is exempt for FICA purposes. An identical rule applies for FUTA purposes.
2. *Spouse Exemption.* Service performed by an individual employed by a spouse is exempt for FICA and FUTA purposes.
3. *Father or Mother Exemption.* Service performed by a parent employed by a child is exempt for FICA and FUTA purposes.

In no other instance is the family member's employee service for casual labor exempt unless it falls under the previously discussed cash pay and regularly employed requirements. For example, when a husband is hired to perform recordkeeping for his wife's hobby, the husband's employee service would be exempt for FICA and FUTA (but not FITW) under the family employment rules. Then, the cash pay and regularly employed requirements should be applied to determine whether the husband's employee service is exempt for FITW purposes.

Casual labor does not include the following types of employees or services:

1. Corporate employees, since all corporate activities are considered to be conducted in a trade or business.
2. Farm employees on a farm operated for profit.
3. Domestic service in a household, local college club, or local chapter of a college fraternity or sorority.

Casual labor and domestic household service have different cash pay dollar amount thresholds for when federal income tax withholding (FITW), social security and Medicare (FICA) tax, and federal unemployment (FUTA) tax liability kicks in. Under the casual labor rules, cash pay is exempt for FITW and FUTA only if it falls below a \$50 quarterly cash pay threshold. A \$100 yearly cash pay threshold applies for FICA. Under the domestic household service rules, cash pay generally is exempt for FITW but is subject to FUTA if cash wages are \$1,000 or more (not inflation adjusted) in any calendar quarter during this year or last year. For 2009 a \$1,700 yearly cash pay (to any one employee) threshold applies for FICA. In Example 4D-1, if Tim's employee service is domestic service, it is exempt from FITW, FICA, and FUTA taxes. However, if it is casual labor, it is subject to FITW and FUTA taxes since cash payments are \$50 or more and Tim works more than 23 days during the month, and is also subject to FICA since cash payments exceed the \$100 yearly cash pay threshold. (The payroll liability rules for casual labor and domestic household service also vary for noncash payments.) If an employee receives cash payment from an employer in a calendar year for both domestic household service and casual labor, each type of service is subject to its own cash-pay test.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

35. Germaine is 19 years old and will enter college in the fall. She is doing odd jobs for various employers this summer to earn money for her college books and expenses. Mathis Co agrees to pay Germaine to clean out and prepare the flower beds surrounding their building. The job starts on June 25 and will end July 5. Mathis pays Germaine \$40 to begin the job and will give her another \$100 when the job is complete. Mathis also agrees to buy Germaine's books in the fall, up to \$150; this amount will be paid directly to the bookseller. Which of the following is correct?
- a. \$40 is covered for FITW and FUTA tax purposes in June.
 - b. \$100 is covered for FITW and FUTA tax purposes in July.
 - c. \$140 is covered for FICA tax purposes in July.
 - d. \$290 is covered for FICA tax purposes for the year.
36. Which is true concerning wages earned by a child in the employment of his or her parent?
- a. Regular employment wages are exempt from FICA if the child is under 21 years old.
 - b. Regular employment wages are covered for FUTA if the child is over 18 years old.
 - c. Casual employment wages are exempt from FICA if the child is under 21 years old.
 - d. Casual employment wages are covered for FUTA if the child is over 18 years old.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

35. Germaine is 19 years old and will enter college in the fall. She is doing odd jobs for various employers this summer to earn money for her college books and expenses. Mathis Co agrees to pay Germaine to clean out and prepare the flower beds surrounding their building. The job starts on June 25 and will end July 5. Mathis pays Germaine \$40 to begin the job and will give her another \$100 when the job is complete. Mathis also agrees to buy Germaine's books in the fall, up to \$150; this amount will be paid directly to the bookseller. Which of the following is correct? **(Page 107)**
- a. \$40 is covered for FITW and FUTA tax purposes in June. [This answer is incorrect. Germaine's wages do not meet the minimum dollar test for the quarter.]
 - b. \$100 is covered for FITW and FUTA tax purposes in July. [This answer is incorrect. Germaine does not meet the minimum for the regularly employed requirement.]
 - c. \$140 is covered for FICA tax purposes in July. [This answer is correct. Once Germaine receives cash payments of \$100 or more during the calendar year in exchange for casual labor performed, all such cash payments received during the calendar year are considered covered for FICA tax purposes. Non-cash payments, such as the books, are considered exempt.]**
 - d. \$290 is covered for FICA tax purposes for the year. [This answer is incorrect. Non-cash payments, such as the books purchased directly from the bookseller by Mathis, are considered exempt.]
36. Which is true concerning wages earned by a child in the employment of his or her parent? **(Page 107)**
- a. Regular employment wages are exempt from FICA if the child is under 21 years old. [This answer is incorrect. The correct age is 18 years old.]
 - b. Regular employment wages are covered for FUTA if the child is over 18 years old. [This answer is incorrect. Regular employment wages are exempt from FUTA until the child is 21 years old.]
 - c. Casual employment wages are exempt from FICA if the child is under 21 years old. [This answer is correct. This differs from the FICA exemption for regular employment, where the child is required to be under 18 years old.]**

State and Local Government Employees—FICA Coverage

The Omnibus Budget Reconciliation Act of 1990 (OBRA '90) significantly changed the rules for FICA coverage of employee service by state and local government employees. Effective July 2, 1991, services of most state or local government employees (other than for employees of the District of Columbia, Guam, and American Samoa) who are not members of the state or local government employer's retirement system are covered under both social security and Medicare.

FICA Coverage for Employee Service after July 1, 1991

Before 1986, a state or local government employee could be covered by FICA only under an agreement made by his or her state or local governmental employer with the Secretary of Health and Human Services for voluntary coverage under §218 of the Social Security Act (a so-called Section 218 agreement). If state or local government employees are covered under a Section 218 agreement, their wages are subject to FICA. However, many state and local government employees at that time were not covered under a Section 218 agreement and, thus, not subject to FICA. In 1985, however, Congress mandated Medicare (HI) coverage (with certain exceptions) for all state and local government employees hired or rehired after March 31, 1986. Then, as part of the OBRA '90, Congress mandated full FICA coverage after July 1, 1991 for all state and local government employees (again with certain exceptions) who are not members of a state or local retirement system.

State or local government employees subject to both social security and Medicare taxes under a Section 218 agreement are not affected by mandatory FICA coverage (i.e., they are subject to FICA because of the Section 218 agreement and the mandatory coverage laws enacted in 1985 and 1990 do not apply to them). However, with the effective dates of the mandatory coverage laws and depending on years of continuous service and participation in a state or local retirement system, there are a variety of possible combinations of FICA coverage for state and local government employees who are not covered under a Section 218 agreement.

1. Employees who are not members of a state or local retirement system are subject to mandatory full (social security and Medicare) coverage in the same manner as private-sector employees, regardless of when the employee became employed.
2. Employees hired or rehired after March 31, 1986 who are members of a state or local retirement system are subject to only the Medicare portion of FICA.
3. Employees who have been working for the state or locality continuously since March 31, 1986 and who are members of a state or local retirement system are exempt from both social security and Medicare taxes. Rev. Rul. 86-88 (as supplemented by Rev. Ruls. 88-36 and 2003-46) contains guidelines for determining if an employee has been continuously employed. School district employees who were previously exempt under the continuing employment exception will continue to qualify for the exemption following the unification of school districts. If wages of an employee meeting the continuing employment exception are subject to FICA solely because he is not a member of a state or local retirement system, his wages will no longer be subject to FICA if he subsequently becomes a member of a retirement system.

State and local government employers are entitled to reduced tax rates under IRC Sec. 3509 with respect to employment tax liabilities for workers who were not treated as covered by a Section 218 agreement and are later determined by the IRS to be employees for FICA purposes who should have been covered under the Section 218 agreement (PMTA 2009-034).

All state and local government employers who hire new employees not covered by social security must provide Form SSA-1945 (Statement Concerning Your Employment in a Job Not Covered by Social Security), to the new employee before employment begins. For more information and a copy of the form, go to www.socialsecurity.gov.

State or Local Retirement Systems

An employee who is a qualified participant in a retirement system offered by the state or local government in conjunction with employment is not subject to the social security (OASDI) portion of the FICA tax. Under this rule,

the definitions of who is a qualified participant and what is a retirement system become critical. The IRS has issued regulations and a revenue procedure providing comprehensive guidance on these definitions.

1. An employee is a qualified participant only if he or she actually participates in the system (e.g., an employee who is ineligible to participate because of age or service conditions contained in the plan is not a qualified participant). Also, an employee is not a qualified participant if participation in the retirement plan is elective and the employee elects not to participate. A series of complex rules apply to determine who is a qualified participant, and they vary depending upon the type of retirement plan.
2. A retirement system is any pension, annuity, retirement, or similar fund or system established by a state, or political subdivision or instrumentality thereof, to provide retirement benefits to its employees who are participants. Whether the plan provides retirement benefits is determined on a case-by-case basis. The legal form of the system generally is not relevant. Thus, a pension plan, a profit-sharing plan, a tax-sheltered annuity plan, a nonqualified deferred compensation plan, or some other plan providing retirement benefits may qualify as a retirement system; however, the social security system does not qualify.

To qualify as a retirement system, a plan must provide a minimum level of benefits that is comparable to the social security (OASDI) portion of the FICA tax. This determination is made employee by employee. Thus, a pension plan that is not a retirement system for one employee might be for other employees.

Exempt Service

Employee service that entails any of the following is exempt from FICA (OASDI and Medicare) coverage (except in certain cases where the employee is eligible for and the service is specifically covered under a Section 218 agreement):

1. individuals who are employed to be relieved from unemployment;
2. patients or inmates in hospitals, homes, or other institutions;
3. emergency personnel serving on a temporary basis on account of a fire, storm, snow, earthquake, flood, or similar emergency (the exemption applies only to wages for services related to the emergency for which the employee was temporarily hired);
4. election officials or workers who are paid less than \$1,000 per year (\$1,500 for 2009 as indexed for inflation) (a state may optionally include the services of election workers paid less than the threshold amount under a Section 218 agreement);
5. public officials compensated solely by fees received directly from the public who are treated as self-employed by the municipality (a state may optionally include this position under a Section 218 agreement);
6. nonresident aliens with F-1, J-1, M-1, or Q-1 visas for services they perform to carry out the purposes for which they were admitted to the United States; or
7. individuals performing services that would be excluded if performed for a private employer (a state may optionally include certain agricultural services under a Section 218 agreement).

The rules also generally exempt students employed in public schools, colleges, and universities, although coverage may be provided at the option of the state government under a Section 218 agreement.

Example 4E-1 Exempt service for temporary workers performing services in response to a natural disaster.

Local government Y hires temporary employees to clean up hurricane debris. This employee service is exempt from FICA since these emergency personnel are serving on a temporary basis as a result of a natural disaster (see item 3 above). Y also requires its police officers to work overtime to enforce a curfew imposed following the hurricane. This employee service would be subject to the regular rules for FICA coverage because the police officers are not newly hired on a temporary basis to perform services in response to an emergency.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

37. What is the first question to ask when determining FICA coverage of a state employee?
- a. Does the retirement system provide Medicare only coverage in certain cases under a Section 218 agreement?
 - b. Is the employee subject to the Medicare continuing employment exception?
 - c. Is the employee a member of a public retirement system?
 - d. Is the employee's position covered by a Section 218 agreement?
38. Disregarding exceptions, the services of which of the following state or local employees would be considered exempt for FICA tax purposes?
- a. A justice of the peace whose sole compensation is from fees charged the public for his services.
 - b. A secretary who works 20 hours each week during the year for the local emergency response service.
 - c. A county election worker who works only during the election period and earns \$3,000 or less.
 - d. A resident alien who works no more than six months of the year in a U.S. protectorate.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

37. What is the first question to ask when determining FICA coverage of a state employee? **(Page 114)**
- a. Does the retirement system provide Medicare only coverage in certain cases under a Section 218 agreement? [This answer is incorrect. This is an important consideration, but certain determinations must be made prior to asking this question.]
 - b. Is the employee subject to the Medicare continuing employment exception? [This answer is incorrect. The answer to this question determines whether the employee is exempt from mandatory Medicare. This is important, but it is not the first determination to be made.]
 - c. Is the employee a member of a public retirement system? [This answer is incorrect. Asking this question requires a precursor, so this is not the first question that must be asked.]
 - d. Is the employee's position covered by a Section 218 agreement? [This answer is correct. The first question that must be asked is whether the position is covered by a Section 218 agreement. The term "Section 218 agreement" is derived from Section 218 of the Social Security Act and refers to an agreement between the federal government and the (in this case) state government that state government employee wages will be subject to FICA tax.]**
38. Disregarding exceptions, the services of which of the following state or local employees would be considered exempt for FICA tax purposes? **(Page 114)**
- a. A justice of the peace whose sole compensation is from fees charged the public for his services. [This answer is correct. The justice of the peace is receiving no compensation directly from the municipality and would likely be considered self-employed.]**
 - b. A secretary who works 20 hours each week during the year for the local emergency response service. [This answer is incorrect. The continuous nature of the secretary's employment indicates that her services are not temporary and not for a specific emergency.]
 - c. A county election worker who works only during the election period and earns \$3,000 or less. [This answer is incorrect. The worker can earn no more than \$1,500 in 2009.]
 - d. A resident alien who works no more than six months of the year in a U.S. protectorate. [This answer is incorrect. A nonresident alien with the appropriate visa is exempt, but not a resident alien.]

Ministers and the Special Employment Tax Rules

There are several provisions in the Code that are unique to ministers. These include (1) the exemption of ministers from income tax withholding, unless the minister enters into a voluntary withholding arrangement, (2) the exemption of ministers from FICA (social security and Medicare) coverage, (3) the treatment of ministers as self-employed for social security tax purposes, unless the minister elects to be exempt from self-employment tax, and (4) the Section 107 income tax exclusion for housing allowances and the fair rental value of church-owned parsonages provided to the minister. This passage focuses on how ministers are treated for employment tax purposes. See *PPC's Specialized Industry Tax Guide* for detailed coverage of the unique income and employment tax provisions applicable to ministers.

Employee or Independent Contractor

Practitioners must initially determine whether a minister is an employee or independent contractor. This factual determination involves the classic common law control test of whether an employer has control over the manner in which the work is performed, including the right to control the employee when appropriate and necessary. In *James*, the Tax Court determined that the extent of control required for a professional worker such as a minister is less than what would be required for a nonprofessional worker performing routine duties.

Minister's Employment Tax Treatment

Income Tax Withholding (FITW). Salary earned for qualified services performed by a minister is subject to federal income tax (FIT) but is not subject to. The FITW exemption applies even if the minister is an employee. Ministers may want to make estimated tax payments to avoid underpayment penalties since their earnings are not subject to withholding.

Social Security Tax (FICA). Services performed by a minister in the exercise of his ministry are subject to SE tax unless the minister has requested and received an exemption from SE tax. (See "Electing Out of Self-employment Tax" later in this lesson for more information on the SE tax exemption.) This is true even if a minister is an employee for income tax purposes. That is, although often considered to be employees of the church under the common law control rules, payment for services as a minister is considered income from self-employment and is not subject to FICA taxes. Accordingly, ministers treated as employees under the common law rules receive a W-2 for wages paid with no FICA withholdings on the Form W-2 wages (because the minister is deemed to be self-employed for employment tax reasons). As noted previously, a minister who is an employee of the church can enter into a voluntary withholding agreement with the church to cover any SE tax that may be due.

Federal Unemployment Tax (FUTA). Ministerial services rendered by a minister are excluded from the definition of covered FUTA employment through the exemption granted for services in the employ of religious organizations and other nonprofit organizations covered under IRC Sec. 501(c)(3).

Example 4F-1 Minister's income and employment tax treatment.

Senior Pastor (SP), an employee of First Church, receives \$30,000 church salary. SP's \$30,000 salary is exempt from FITW, FICA, and FUTA, although First Church must report this amount as taxable wages for federal income tax purposes on Form W-2. SP is considered self-employed for social security purposes with respect to his ministerial services, and accordingly reports the \$30,000 salary as self-employment income on his personal tax return. (First Church does not withhold or pay FICA tax on SP's ministerial salary.) SP may, however, enter into a voluntary withholding arrangement with First Church to cover any income and self-employment tax that may be due on his salary.

Electing Out of Self-employment Tax

Ministers and religious workers must pay self-employment tax on their ministerial earnings unless one of the following exemptions apply:

1. *Vow of Poverty.* Members of a religious order who have taken a vow of poverty are exempt from paying self-employment tax on their earnings. Similarly, earnings of a member of a religious order who has taken

a vow of poverty are considered tax-free to the individual; rather, the earnings are considered the income of the religious order. No election is necessary under this exemption (i.e., members of a religious order who have taken a vow of poverty are automatically exempt from self-employment tax on earnings for services performed for the member's church or its agencies). However, if services performed by a member of a religious order are not considered directed or required by the order, the taxpayer and the outside party for whom the taxpayer works are considered employee and employer (i.e., the vow of poverty rules do not apply).

2. *Ministers, Members of Religious Orders, and Christian Science Practitioners.* Ministers, members of religious orders who have not taken a vow of poverty, and Christian Science practitioners who are conscientiously opposed to, or because of religious principles opposed to, the acceptance of any public insurance that makes payments (a) in the event of death, disability, old age, or retirement, or (b) toward the cost of or provides services for medical care, are entitled to exemption from self-employment tax. Persons electing this exemption must properly notify the ordaining, commissioning, or licensing body of the church or order that he or she is opposed to such insurance and must file Form 4361 (Application for Exemption from Self-Employment Tax for use by Ministers, Members of Religious Orders and Christian Science Practitioners) with the IRS. Form 4361 must be filed by the due date (including extensions) for the second tax year in which the individual filing the exemption has net earnings from self-employment of at least \$400, if any of the earnings comes from ministerial services. The election, once granted, is irrevocable. Individuals granted such an exemption are deemed to not be involved in a trade or business for self-employment tax purposes.
3. *Members of a Recognized Religious Sect.* Members of a recognized religious sect may also choose to be exempt from social security and Medicare taxes, but only if he or she is a member of a religious sect or division opposed to social security and Medicare taxes. The exemption does not apply to any services of the individual as a minister of a church or as a member of a religious order. Members make the irrevocable election by filing Form 4029 (Application for Exemption from Social Security and Medicare Taxes and Waiver of Benefits) with the IRS. Form 4029 can be filed at any time, but once approved, terminates if the taxpayer fails to meet the eligibility requirements or if the Social Security Commissioner determines the sect or division fails to meet the requirements.

Additionally, churches and church-controlled organizations can elect not to pay the employer's portion of social security and Medicare tax by certifying to the IRS that, for religious reasons, the church or organization is opposed to paying these taxes. This election applies to all current and future employees of the church or organization.

Parsonage Allowance

Ministers are allowed to exclude a parsonage allowance from gross income under IRC Sec. 107. To be excludable under IRC Sec. 107, the fair rental value of the parsonage or the parsonage allowance must be reasonable in amount. A parsonage allowance includes the following:

1. the rental value, including utilities, of a furnished home, or
2. a cash allowance paid to a minister for purposes of renting or purchasing the home.

A parsonage (or rental) allowance includes church provided parsonages, rental allowances with which the minister may rent a home, and housing allowances with which the minister may purchase a home. A minister can receive a parsonage allowance for only one home. The term home means a dwelling place, including furnishings, and the appurtenances thereto (e.g., garage).

The value of the parsonage allowance is excludable in computing taxable income and should not be included in Form W-2 wages. However, the parsonage allowance is subject to self-employment tax. Therefore, the fair rental value of a parsonage provided to the minister (including the cost of utilities furnished with the property), and any rental allowance paid to the minister under IRC Sec. 107 (including any amount for payment of utilities) must be included in calculating the minister's net earnings from self-employment on Schedule SE of Form 1040. Although the parsonage allowance is not included in Form W-2 boxes 1, 3, or 5, it can be reported in box 14 so that the minister knows how much to pay self-employment tax on.

When a cash allowance is received by a minister, the IRS has indicated that the income tax exclusion is limited to the lesser of:

1. the amount the employing church designated as a parsonage allowance in an employment contract, minutes of the church governing body, etc.
2. the amount actually used to provide a home, or
3. the fair rental value of the home, including furniture and utilities.

Student Employment at an Educational Institution and Payroll Tax Rules

FICA Exemption

IRC Sec. 3121(b)(10) exempts from FICA tax services performed for a school, college, university, or certain affiliated organizations described in IRC Sec. 509(a)(3) by a student enrolled and regularly attending classes at such school, college, or university. Rev. Proc. 98-16 provided generally applicable standards for determining whether services performed by students before April 1, 2005 were exempt from FICA. For services performed after March 31, 2005, employers should follow the guidance found in final regulations and Rev. Proc. 2005-11, which are discussed in the following paragraphs, although as discussed later in this lesson, recent court activity may invalidate this IRS guidance.

Primary Function Requirement. In order for services performed for a school, college, or university to be eligible for the student FICA exemption, the school, college, or university's *primary* purpose must be education. This primary purpose requirement will be met if an institution's primary function is the presentation of formal instruction, it normally maintains a regular faculty and curriculum, and it normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on.

Student versus Employee Status. To qualify for the student FICA exemption, an employee must be a student who is enrolled in and regularly attending classes at the school, college, or university. The regulations set forth several guidelines to clarify who is a student enrolled in and regularly attending classes for this purpose.

Whether an employee has the status of student is determined based on the relationship between the employee and the organization employing the employee. To satisfy the student status requirement, the employee must perform services in the employ of a school, college, or university at which he or she is enrolled and regularly attending classes in pursuit of a course of study. In addition, the employee's services must be incident to and for the purpose of pursuing a course of study at the school, college, or university. Whether an employee's services are incident to and for the purpose of pursuing a course of study is determined separately with respect to each academic term.

The educational aspect must predominate over the service aspect of the relationship between the employer and the employee, in order for the employee's services to be incident to and for the purpose of pursuing a course of study. Except in the case of a full-time employee (see the following discussion), whether the educational aspect or the service aspect predominates is determined by considering all the relevant facts and circumstances.

Whether an employee is eligible to receive one or more employment benefits is a relevant factor in evaluating the service aspect of an employee's relationship with the employer. For example, eligibility to receive vacation, paid holiday, and paid sick leave benefits; eligibility to participate in a retirement plan or arrangement described in IRC Sec. 401(a), 403(b), or 457(a); or eligibility to receive employment benefits such as reduced tuition [other than qualified tuition reduction under IRC Sec. 117(d)(5) provided to a teaching or research assistant who is a graduate student], or benefits under IRC Secs. 79 (life insurance), 127 (qualified educational assistance), 129 (dependent care assistance programs), or 137 (adoption assistance) suggest that the service aspect of an employee's relationship with the employer is predominant. Eligibility to receive health insurance employment benefits is not considered in determining whether the service aspect of an employee's relationship with the employer is predominant.

The weight to be given to an employee being eligible for a particular employment benefit may vary depending on the type of benefit. For example, eligibility to participate in a retirement plan is generally more significant than

eligibility to receive a dependent care employment benefit. Additional weight is given to the fact that an employee is eligible to receive an employment benefit if the benefit is generally provided by the employer to employees in positions generally held by nonstudents. Less weight is given to the fact that an employee is eligible to receive an employment benefit if eligibility for the benefit is mandated by state or local law.

If an employee has the status of a professional employee, then that suggests he or she is not a student. For this purpose, a professional employee is an employee whose primary duty consists of the performance of services requiring knowledge of an advanced type in a field of science or learning, whose work requires the consistent exercise of discretion and judgment in its performance, and whose work is predominantly intellectual and varied in character. Additionally, if the individual is required to be licensed under state or local law in order to perform the services the individual provides to the school, college, or university then he or she is a licensed professional, which further suggests that the individual is not a student.

The student FICA exception does not apply to services performed by an employee who is considered a full-time employee based on the employer's standards and practices. However, an employee whose normal work schedule is 40 or more hours per week is always considered a full-time employee. An employee's normal work schedule is not affected by increases in hours worked caused by work demands unforeseen at the start of the academic term. However, whether an employee is a full-time employee is reevaluated for the remainder of the academic term if the employee changes employment positions.

Example 4G-1 Medical resident with full-time employee status not eligible for student FICA exception.

John is employed by State University (SU) to teach classes in the accounting department. He is considered a full-time employee by SU under its standards and practices. In addition, John is enrolled and regularly attending classes at SU in pursuit of an MBA degree. His course load is considered a half-time course load for graduate studies.

While John is employed by SU, a school, college, or university as defined in Reg. 31.3121(b)(10)-2(c), he is considered a full-time employee by SU under its standards and practices. John's services are not incident to and for the purpose of pursuing a course of study. The fact that some of his services have an educational, instructional, or training aspect does not affect that conclusion. Accordingly, John's services do not qualify for the student FICA exception and there is no need to consider other relevant factors, such as whether John is a professional employee or whether he is eligible for employment benefits.

Safe Harbor for Part-time Students. A safe harbor exists for undergraduate and graduate students who are not (1) full-time employees, (2) professional employees, or (3) eligible to receive employment benefits. Generally, a half-time undergraduate student or a half-time graduate or professional student qualifies for the student FICA exception for services performed for an institution of higher education where the employee is enrolled or for a Section 509(a)(3) organization that is affiliated with the institution of higher education. A half-time undergraduate or half-time graduate or professional student is a student who is in the last semester, trimester, or quarter of a course of study requiring at least two semesters, trimesters, or quarters to complete and is enrolled in the number of credit or unit hours needed to complete the requirements for obtaining a degree, certificate, or other recognized educational credential offered by that institution of higher education even if enrolled in less than half the number required of full-time students.

FICA Exemption for Medical Residents

Medical residents are generally common-law employees of the hospitals for which they work and, therefore, are subject to social security and Medicare taxes [unless they are excepted by a Section 218 Agreement. As previously discussed, IRC Sec. 3121(b)(10) provides an exception for students employed by a school, college, or university who are enrolled and regularly attending classes at the school, college, or university. However, for services performed after March 31, 2005, postdoctoral students or fellows, medical residents, or medical interns whose normal work schedule is 40 or more hours per week are considered full-time employees who are not eligible for the student FICA exception.

The U.S. District Court for the Southern District of Florida, in one of the first cases brought by the government against a hospital that filed a FICA refund claim, issued a summary judgment that medical residents working at

hospitals have never qualified as students exempt from payment of employment taxes under the Social Security Act. The court concluded that the student exception, as a matter of law, does not include medical residents. It said that to interpret the student exception to include medical residents would conflict with the clear intent of Congress to reserve the student exception for students working few hours and earning nominal compensation. The court rejected Mt. Sinai's reliance on a decision in an 8th Circuit case that had concluded medical residents could qualify for the student FICA exemption. However, upon review, the 11th Circuit determined that a case-by-case approach was required to determine whether particular services qualified for the student exception. Accordingly, the 11th Circuit set aside the summary judgment and sent the case back to the district court.

Several other district courts have also ruled on the subject. Four U.S. District Courts (Ohio, South Dakota, Minnesota, and Illinois) have rejected the IRS's position that medical residents are ineligible for the student FICA exemption and instead ruled that an analysis of the facts and circumstances is required to determine if medical residents are eligible for the student exemption.

For services performed before April 1, 2005, the law was not as clear and many hospitals and individuals believed that their medical residents, interns, etc., qualified for the student exception and filed FICA refund claims pertaining to those services. The IRS's position is that medical residents do not qualify for the student FICA exemption before or after April 1, 2005 and, therefore, it had denied the FICA refund claims. Several district courts, as well as the 7th, 8th, and 11th Circuit Courts, have ruled that an analysis of the facts and circumstances is required to determine if medical residents are eligible for student exemptions. Alternatively, two U.S. District Courts (Eastern District of Michigan and Northern District of New York) agreed with the IRS's position and determined that medical residents do not qualify for the student exemption. Similarly, the 2nd Circuit vacated the rulings in Albany Medical Center and Memorial Sloan-Kettering regarding whether medical residents are ineligible for the student exception as a matter of law. The Circuit Court noted that Congress has not defined the term "student" in such a way that a postgraduate doctor could never be eligible for the exception. The Court remanded both cases back to the district courts with instructions to examine the specific facts to determine whether the residents qualified under the student exception.

For services performed after March 31, 2005, final regulations specifically deny the Section 3121(b)(10) student FICA exemption to employees who are postdoctoral students or fellows, medical residents, or medical interns because their normal work schedule is 40 or more hours per week, which makes them full-time employees who are not eligible for the student FICA exemption. The final regulations were challenged in Mayo Foundation (2) and University of Minnesota, and the district courts ruled that the regulations were invalid. However, on appeal, the 8th Circuit reversed the district courts' decisions. The Circuit Court noted that the statute was ambiguous or silent on the question of whether a medical resident working for a school full-time is considered a student who is enrolled and regularly attending classes, and therefore, subject to reasonable interpretation by the IRS. It concluded that the IRS's interpretation that the services of a full-time employee would not meet the exception for student FICA exemption was reasonable and consistent with the statute.

FITW and FUTA

Services performed by student employees, including those enrolled in work-study programs, are generally subject to FITW.

In general, services performed by a student at a public or private school, college, or university at which he or she is enrolled and regularly attending classes are exempt from FUTA. This includes service performed by a full-time student for academic credit and combining instruction with work experience if the program was not established by or on behalf of an employer or group of employers. Services performed by the spouse of a student who is enrolled and regularly attending classes are also exempt from FUTA, provided the spouse is advised that (1) the employment is provided under a program to provide financial assistance to the student by the institution and (2) the employment will not be covered under an unemployment benefit program. The rules for determining whether an organization is a school, college, or university and if an employee is a student for FUTA exemption purposes are in Reg. 31.3306(c)(10)-2 and are similar to the FICA exemption rules previously discussed.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

39. John is a full-time minister for a local church. Which of the following is correct?
- a. John's wages are exempt from FIT.
 - b. John's wages are subject to FITW.
 - c. John's wages are not covered for FUTA.
 - d. John's wages are not subject to FICA.
40. For purposes of FICA tax exemption under IRC 3121(b)(10) which of the following is correct?
- a. The service aspect of the employer/employee relationship must dominate.
 - b. Once compliance is established, it will remain until degree-work ceases.
 - c. The student's spouse may be exempt from FICA if work is associated with the student.
 - d. The primary function of the institution must be for educational purposes.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

39. John is a full-time minister for a local church. Which of the following is correct? **(Page 117)**
- a. John's wages are exempt from FIT. [This answer is incorrect. John will have to report his wages and pay income tax as appropriate.]
 - b. John's wages are subject to FITW. [This answer is incorrect. John's wages as a minister are exempt from FITW, even if John is considered an employee of the church.]
 - c. John's wages are not covered for FUTA. [This answer is correct. John's wages are exempt from FUTA because his services are rendered in the employ of a 501(c)(3) organization.]**
 - d. John's wages are not subject to FICA. [This answer is incorrect. John must pay SE tax.]
40. For purposes of FICA tax exemption under IRC 3121(b)(10) which of the following is correct? **(Page 119)**
- a. The service aspect of the employer/employee relationship must dominate. [This answer is incorrect. The educational aspect of the relationship must dominate.]
 - b. Once compliance is established, it will remain until degree-work ceases. [This answer is incorrect. Compliance is determined separately for each academic term.]
 - c. The student's spouse may be exempt from FICA if work is associated with the student. [This answer is incorrect. Under certain circumstances, the spouse's wages may be exempted from FUTA tax if the spouse's employment is provided under the educational institution's program to provide financial aid to the student.]
 - d. The primary function of the institution must be for educational purposes. [This answer is correct. The institution must regularly carry on formal educational instructional activities involving a regularly enrolled body of students, regular faculty, curriculum, etc.]**

EXAMINATION FOR CPE CREDIT**Lesson 4 (PRLTG091)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

31. Which of the following does **not** consider classes of employment that may be exempt from covered employment rules?
- a. IRC 3401(a).
 - b. IRC 3401(d).
 - c. IRC 3121(a).
 - d. IRC 3121(b).
32. Terry is a newspaper carrier for The State Gazette. He also works as an apprentice photographer for the newspaper. Terry is paid weekly. Last period, Terry worked 20 hours as a carrier and 20 hours as an apprentice photographer. Applying the one-half rule to the hours Terry worked during the period, how many are considered subject to federal payroll tax?
- a. 0.
 - b. 10.
 - c. 20.
 - d. 40.
33. Harry's father, James, owns Bronson LLC. James has elected to report Bronson for tax purposes on Form 1120. Harry turned 16 years old last month and immediately went to work for Bronson as a delivery boy. Because of his lineal descendant status, Harry's wages are exempt for employer FICA tax purposes.
- a. True.
 - b. False.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.
34. Terry owns a dress shop and reports it for tax purposes on Schedule C. Her mother, Bea, works for her as a seamstress at a semi-monthly salary of \$1,200. Which of the following is most accurate?
- a. Bea's wages are considered exempt for FITW purposes.
 - b. Bea's wages are considered covered for FUTA purposes.
 - c. Bea's wages are considered covered for employer FICA purposes.
 - d. Bea's wages are considered exempt for employee FICA purposes.

35. Bonnie turned 16 years old in February. Grange Inc hired her on March 1 at \$8 per hour to help with staging and take-down tasks related to a series of special company events. Grange pays on the first work day of each month. Bonnie's employment ended June 25. Bonnie was sick for 2 days during March employment, but Grange generously paid her 2 hours for each of those days. Bonnie physically worked 2 hours for each of 22 days in March. Bonnie worked 2 hours in each of 10 days in April, 2 hours for each of 10 days in May, and 2 hours for each of 4 days in June. On what day was Bonnie's wages covered for purposes of FUTA tax?
- March 31.
 - April 1.
 - June 30.
 - July 1.
36. A key difference between regular employment and casual employment of a spouse or parent by a family-owned business is that:
- FICA is exempt for regular employment.
 - FICA is exempt for casual employment.
 - FUTA is exempt for regular employment.
 - FUTA is exempt for casual employment.
37. Disregarding exceptions, which state employees are exempt for both Social Security and Medicare?
- Employees who are not members of a state retirement system, hired before March 31, 1986.
 - Employees who are members of a state retirement system, hired before March 31, 1986.
 - Employees who are not members of a state retirement system, hired after March 31, 1986.
 - Employees who are members of a state retirement system, hired after March 31, 1986.
38. Mike works as a police officer for the city. On May 16, the city experienced a flood that resulted in power outages and city service disruptions for the rest of the month. Extra hours were authorized for all police personnel and additional police personnel were temporarily hired to meet the needs of the city and its citizens. Mike normally earns \$5,000 each month, but with the extra overtime he earned \$8,000 in May. How much of Mike's earnings are exempt for FICA purposes?
- \$0.
 - \$3,000.
 - \$5,500.
 - \$8,000.
39. Which of the following regarding employment of ministers is correct?
- A parsonage allowance must be included in gross wages.
 - No more than two homes can be included in the parsonage allowance.
 - The parsonage allowance is reported on Schedule SE.
 - The parsonage allowance may not be applied to the minister's mortgage.

40. Bob works full-time for the university where Sue, his spouse, is a full-time student. Bob gained his employment as part of the university's student financial aid program. Under certain circumstances, Bob's wages may be exempt from:
- a. FUTA.
 - b. FITW.
 - c. FICA.
 - d. FIT.

GLOSSARY

Casual Labor: Involves any service by an employee that is occasional, incidental, or irregular and does not promote or advance an employer's trade or business (e.g., when an individual is hired to assist with a person's hobby). Minimal amounts of casual labor can be exempt employment.

Common Law Control Rules: Under these rules, the distinction between an employee and independent contractor is based on the right to control and direct the worker's performance, including the details and methods by which the work is accomplished. For independent contractors, the business merely has the right to control what must be done; conversely, for employees, the business has the right to control both what must be done and how it must be done.

Common Paymaster: One of two (or more) related corporations (as defined in the common paymaster regulations) authorized as a common paymaster and paying compensation to an employee who works concurrently for both (or all) corporations. Companies qualifying for a common paymaster arrangement are considered a single employer for purposes of meeting the FICA and FUTA wage bases.

Concurrent Employment: Simultaneous employment of a worker by two or more business affiliates. Each affiliate is the worker's employer and is liable for FICA and FUTA tax on the employee's wages up to the taxable wage limit (unless a common paymaster is used).

Control-of-wage-payments Rule: Under the Federal Income Tax Withholding (FITW) statute, a person who controls the payment of some or all of an employee's wages is considered to be the employer with respect to those wages. While neither the FICA nor FUTA statutes follow this rule, the courts and the IRS sometimes apply this rule for FICA and FUTA purposes.

Covered Employment: While most types of employee service are covered employment (and so fully subject to all employment taxes), some special classes are exempt and other classes are partially exempt (e.g., certain farm labor and family employment).

Employee Leasing: Generally entails a corporation/lessor furnishing workers to a business/lessee under an arrangement in which the lessor is the employer and retains employment tax responsibilities for the leased employees.

Employee Loan-out: Involves one business affiliate (the renderer) agreeing to provide workers for one or more other affiliates (the recipients). The workers are employed and paid by the renderer, who is liable for employer FICA and FUTA tax on the employees' wages.

Lender Liability: Certain lenders that pay wages directly to employees or supply funds for wage payments can be held liable for unpaid trust fund taxes under IRC Sec. 3505.

Payroll Agent: An agent, fiduciary, or other person who is authorized to perform acts required of employers under the federal employment tax statutes. A payroll agent obtains authorization to file payroll tax returns and deposit and pay employment or other withholding taxes by filing Form 2678 (Employer/Payer Appointment of Agent).

Reporting Agent: An accounting service, franchiser, bank, service bureau, or other entity authorized by the employer (1) to sign and file employment tax returns, (2) make tax deposits and submit information about deposits, and (3) receive copies of tax return and deposit information. A reporting agent may also receive duplicate copies of official notices, correspondence, transcripts, or other information and may provide the IRS with information to aid in penalty relief determination related to the authority granted. Authorization is obtained by filing Form 8655 (Reporting Agent Authorization).

Third Party Payor: A person other than the employer that pays wages or other forms of compensation to an employee, such as an insurance company paying sick pay. Third party payors may be treated as employers if they have exclusive control over the wage payments.

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COMPANION TO PPC'S PAYROLL TAX DESKBOOK

COURSE 2

BENEFIT PLANS (PRLTG092)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an introduction to several payroll tax issues surrounding benefit plans. The first lesson deals with the tax treatment and reporting requirements of benefits purchased under a cafeteria plan. Also covered are general tax treatment of dependent care assistance programs, employer-provided educational assistance, and adoption assistance programs. The second lesson covers requirements for the employer and employee concerning health insurance, life insurance, and retirement plans.

PUBLICATION/REVISION DATE: December 2009

RECOMMENDED FOR: Users of PPC's Payroll Tax Deskbook

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of payroll tax and benefit plans

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

8 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.

Enrolled Agents: This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **December 31, 2010**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Cafeteria Plans, and Dependent Care, Educational, and Adoption Assistance

Completion of this lesson will enable you to:

- Explain the requirements and characteristics concerning a qualified cafeteria plan and determine the appropriate tax treatment for certain plan aspects.
- Identify the issues related to qualified flexible spending arrangements (FSAs) and determine the appropriate reporting and disclosure requirements for the cafeteria plan in question.
- Identify the requirements for, and issues concerning, a dependent care assistance program (DCAP).
- Describe the various types of available educational assistance and related requirements under current tax law, and determine appropriate tax treatment of such assistance.
- Describe the adoption assistance requirements under current tax law and determine appropriate tax treatment of such assistance.

Lesson 2—Health Insurance, Life Insurance, and Retirement Plans

Completion of this lesson will enable you to:

- Explain various issues concerning health plans and related contributions and reimbursements, describe tax requirements, and determine appropriate tax treatments.
- Describe executive supplemental medical reimbursement plans, characterize AD&D insurance, and describe related tax treatment.
- Differentiate between HSAs and FSAs, explain LTC insurance and disability income plans in general terms, and determine appropriate tax treatments related to MSAs, HSAs, FSAs, LTC insurance, and disability income plans.
- Describe rules and requirements related to group-term life and split-dollar life insurance, and determine appropriate tax treatments.
- Identify retirement plan categories, characterize 403(b) plans, and describe related tax issues.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

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Lesson 1: Cafeteria Plans, and Dependent Care, Educational, and Adoption Assistance

INTRODUCTION

Cafeteria plans and dependent care, educational, and adoption assistance are popular employee benefits. These benefits are popular because they generally are either funded by employee pretax contributions or are provided tax-free to the employee, either of which provides tax savings to the employee and employer.

This lesson discusses various payroll tax aspects of cafeteria plans. The payroll tax treatment of employer-provided dependent care assistance under a dependent care assistance program (DCAP) is discussed.

Several types of employer-provided educational assistance are discussed. The two most common programs: (1) educational assistance provided through a qualified educational assistance plan, and (2) job-related educational assistance as a working condition fringe benefit is the focus of later discussion. The payroll tax treatment of employer-provided assistance is summarized as well.

Learning Objectives:

Completion of this lesson will enable you to:

- Explain the requirements and characteristics concerning a qualified cafeteria plan and determine the appropriate tax treatment for certain plan aspects.
- Identify the issues related to qualified flexible spending arrangements (FSAs) and determine the appropriate reporting and disclosure requirements for the cafeteria plan in question.
- Identify the requirements for, and issues concerning, a dependent care assistance program (DCAP).
- Describe the various types of available educational assistance and related requirements under current tax law, and determine appropriate tax treatment of such assistance.
- Describe the adoption assistance requirements under current tax law and determine appropriate tax treatment of such assistance.

Cafeteria Plan Tax Treatment of Benefits

Cafeteria plans are written plans that must allow participants to choose among two or more benefits consisting of cash (including cash equivalent benefits) and qualified taxable or nontaxable benefits. This topic discusses the income and payroll tax treatment of employer and employee contributions paid out as cash or used to purchase benefits under a cafeteria plan, and explains how to withhold on the purchase of taxable benefits. It also covers the income and payroll tax treatment of disability insurance coverage, group-term life insurance coverage, and paid time off (PTO) provided under a cafeteria plan.

Cafeteria Plan Requirements

To qualify for special tax treatment as a cafeteria plan, the plan must meet the requirements specified in IRC Sec. 125(d). These requirements are explained in detail in *PPC's Guide to Compensation and Benefits*.

Cafeteria plans may offer up to four options for purchasing benefits. Employees can purchase plan benefits by flex credits, salary reduction [i.e., employee elective (pretax) contributions], payroll (after-tax) deduction, paid time off (PTO) sell, or a combination of the four. Each of these options is discussed in the following paragraphs.

Flex Credits (Employer Contributions)

Under this funding option, employees are given a specified dollar amount (or specified percentages of compensation) of employer contributions with which to purchase benefits. These employer contributions are commonly referred to as "flex credits." Flex credits may be used to purchase qualified (nontaxable) benefits, qualified (taxable) benefits, and cash equivalent benefits.

Flex credits used to purchase qualified (nontaxable) benefits generally are exempt from federal income tax withholding (FITW), social security and Medicare (FICA) taxes, and federal unemployment (FUTA) tax, and are not reported as taxable wages on Form W-2.

Flex credits used to purchase qualified (taxable) benefits or cash equivalent benefits are included in the employee's gross income and reported as taxable wages on Form W-2. As discussed later in this lesson, qualified (taxable) benefits are subject to the withholding and reporting rules of IRS Ann. 85-113, which also apply when these benefits are offered outside the cafeteria plan. Cash equivalent benefits are deemed paid for withholding and employment tax purposes when the employer actually pays or provides the benefit.

Example 1A-1 Nontaxable and taxable benefits purchased with employer contributions.

Denise, an employee of Atlas Corporation, uses flex credits to purchase group medical coverage and \$70,000 of group-term life coverage under Atlas' cafeteria plan. Atlas pays the premiums for the group medical coverage and the \$70,000 of group-term life coverage Denise elects. The medical and group-term life plans meet the applicable income and employment tax exclusion requirements under the Internal Revenue Code. Thus, Atlas' (employer) contributions under the cafeteria plan to purchase group medical coverage and the first \$50,000 of group life coverage are exempt from income and payroll taxation. The employer contributions are exempt from FIT, FITW, FICA, and FUTA and are not reported as taxable wages on Denise's Form W-2. In this regard, the employer contributions, when made under the cafeteria plan, are treated no differently than if they were made outside the plan.

The excess group-term life insurance coverage (i.e., the amount of coverage in excess of the \$50,000 statutory coverage limit of IRC Sec. 79) is a qualified (taxable) benefit. The taxable cost of this excess coverage, to the extent it exceeds Denise's after-tax contributions toward the cost of the policy, is subject to the same income and payroll tax rules that apply to excess group-term coverage when offered outside the cafeteria plan. The taxable cost of the excess coverage is determined under an IRS table (Table 1) reduced by Denise's after-tax contributions. Atlas must value this excess coverage and report it as taxable wages on Denise's Form W-2. This amount is also subject to FICA, but is exempt from income tax withholding (FITW) and FUTA.

Cash Payments. A cafeteria plan may, under certain circumstances, provide employees with cash benefits. Cash benefits from employer contributions generally are provided under one of the following circumstances:

1. *Waiver of Group Health Coverage.* Under some plans, a cash payment is included with the employees' regular wages if an employee waives coverage under a group health plan.
2. *Unused Flex Money.* Under some plans, the employee is given a cash payment equal to the difference between the value of the benefits selected under the plan and the total flex dollars available from the employer. For instance, an employee who has \$3,000 in flex dollars available and purchases group medical and life insurance for a total value of \$2,500 would receive a cash payment of \$500.
3. *PTO Cashout.* Plans that provide elective PTO (i.e., PTO elected under a cafeteria plan) may allow employees to cash out their unused PTO.

Employer cash payments under a cafeteria plan are subject to FITW, FICA, and FUTA when paid and are reported as taxable wages on Form W-2. The employer treats the cash payments as wages because they represent additional compensation to the employees.

Example 1A-2 Cash payment for unused employer flex credits is taxable wages.

Employee Brad has \$3,000 of employer flex credits available for the plan year under his employer's cafeteria plan. Brad elects \$2,150 for medical insurance, \$250 for dental insurance, and \$100 for \$50,000 of group-term life insurance coverage, meaning he has \$500 in flex credits remaining. Under the plan, Brad is paid the remaining flex credits of \$500 in cash over the plan year. The \$2,500 of employer flex credits used to purchase qualified (nontaxable) benefits is exempt for federal income tax (FIT), FITW, FICA, and FUTA purposes. The \$500 of cash payments for unused flex credits is subject to FIT, FITW, FICA, and FUTA when paid and is reported as taxable wages on Brad's Form W-2.

Employee Elective (Pretax) Contributions

Employee elective (pretax) contributions under a cafeteria plan used to purchase qualified (nontaxable) benefits during the coverage period are exempt from FITW, FICA, and FUTA, and are not reported as taxable wages on Form W-2. [However, employee elective 401(k) contributions made and qualifying adoption expenses paid or reimbursed under a cafeteria plan are subject to FICA and FUTA as if made outside the plan.] Elective contributions paid out in cash or cash equivalent benefits (e.g., PTO purchased with employee elective contributions but cashed out before year end) or used to purchase qualified (taxable) benefits are subject to FIT, FITW, FICA, and FUTA when actually received by the employee in the same manner as if offered outside the cafeteria plan.

Employee Payroll (After-tax) Deductions

Employees can pay for benefits with after-tax dollars. For some benefits (e.g., disability insurance), using after-tax contributions to pay for the benefit can be preferable to making pretax contributions. (Example 1A-5 explains the advantages of using after-tax contributions to purchase disability insurance.) Employee contributions deducted from the employee's wages on an after-tax basis (by payroll deduction) and used to purchase cafeteria plan benefits are treated as cash equivalent benefits. They are subject to FIT, FITW, FICA, and FUTA and are reported as taxable wages on the employee's Form W-2.

Example 1A-3 Nontaxable and cash equivalent benefits purchased with employee contributions.

PowerFlame, Inc., (PFI) pays the \$150 monthly premium for health insurance coverage on its employees, but requires employees to pay the \$250 monthly premium due for dependent coverage under a family policy. Employees are also allowed to purchase \$40,000 group-term life insurance coverage (monthly premium cost of \$10) and disability insurance (monthly premium cost of \$5) using after-tax dollars. PFI adopts a cafeteria plan under which employees may elect to purchase dependent medical coverage and \$40,000 of group-term life coverage using elective (pretax) contributions. However, disability coverage still must be purchased using after-tax dollars.

Steve Hill, a married employee with two children, elects to pay the monthly premiums for dependent medical coverage and group-term life coverage using pretax contributions. Previously, Steve used after-tax compensation (via payroll deduction) to pay for these benefits.

Assuming that Steve's monthly salary is \$3,000, his monthly net wages are calculated as follows:

Regular wages	\$ 3,000
Cafeteria plan items:	
Dependent medical	(250)
Group-term life	(10)
Taxable wages	<u>2,740</u>
Payroll deductions:	
Disability insurance	(5)
FITW (15% × \$2,740)	(411)
FICA (7.65% × \$2,740)	<u>(210)</u>
Net wages	<u><u>\$ 2,114</u></u>

The employee elective contributions used to purchase medical and group-term life insurance coverage are exempt from FIT, FITW, FICA, and FUTA and are not reported as taxable wages on Steve's Form W-2. The \$5 payroll deduction for disability coverage is a cash equivalent benefit (i.e., Steve's FITW and FICA are computed on taxable earnings before the wage deduction for the disability coverage is made).

PTO Sell

Plans can allow employees to apply the cash value of earned or awarded PTO (paid with employer contributions) toward the purchase of benefits. The PTO's cash value may be used to purchase qualified (nontaxable) benefits, qualified (taxable) benefits, and cash equivalent benefits.

The cash value of PTO used to purchase qualified (taxable) benefits or cash equivalent benefits is included in the employee's gross income and reported as taxable wages on Form W-2. As discussed later in this lesson, qualified (taxable) benefits are subject to the withholding and reporting rules of IRS Ann. 85-113, which also apply when these benefits are offered outside the cafeteria plan. Cash equivalent benefits are deemed paid for withholding and employment tax purposes when the employer actually pays or provides the benefit.

A cafeteria plan can also allow participants to elect to receive either additional or fewer paid PTO days than the employer otherwise provides to employees.

Withholding and Reporting on Taxable Benefits

As noted earlier, a cafeteria plan may offer some benefits that are qualified (taxable) benefits (i.e., taxable noncash benefits) and others that are cash equivalent benefits. The distinction between these two classifications is important for withholding and reporting purposes:

1. Qualified (taxable) benefits are treated as taxable noncash benefits when offered through the cafeteria plan. They are subject to the withholding and reporting requirements of IRS Ann. 85-113. Under those rules, the taxable noncash benefit can be deemed paid as infrequently as once per year (e.g., at the end of the year if the employer desires). Thus, an employer that provides discriminatory health insurance coverage to key employees through a cafeteria plan (i.e., the premiums are taxable to key employees) can treat the noncash benefit realized by the employee as paid annually under IRS Ann. 85-113 even though the employer actually pays the premiums monthly.
2. Cash equivalent benefits are treated as cash for all purposes of the cafeteria plan rules. These cash equivalent benefits are deemed paid for withholding and reporting purposes when the employer actually pays or provides the benefit.

Example 1A-4 Withholding and reporting on taxable benefits.

Assume the same facts as in Example 1A-1 in which Denise uses flex credits to purchase \$7,000 of group-term life coverage under Atlas Corporation's cafeteria plan. Atlas must value the excess coverage (i.e., the amount of coverage in excess of \$50,000) and report it as taxable wages on Denise's Form W-2. This amount is subject to FIT and FICA but exempt from FITW and FUTA. Because this is a noncash benefit [i.e., a qualified (taxable) benefit not treated as cash], Atlas may treat the taxable cost of this coverage as paid at year-end for FICA withholding and payment purposes.

In addition, assume Atlas provides Denise with group auto insurance under its cafeteria plan. Premiums are remitted quarterly. Assume the cost of the premium for Denise on a quarterly basis is \$150. Because the group auto insurance coverage is a cash equivalent benefit, Denise is treated as receiving the compensation value of this coverage on a regular basis throughout the year (i.e., the compensation is deemed paid to her when Atlas pays the premiums). Thus, Atlas must withhold and report on these premium payments throughout the course of the year. If these policies were provided outside the cafeteria plan, Atlas could treat the compensation value of this coverage (i.e., a noncash benefit) as paid once at year-end in accordance with IRS Ann. 85-113.

Long-term and Short-term Disability Coverage

Premiums paid by the employer for disability income insurance coverage (not treated as a cash equivalent benefit) are exempt from income tax withholding and are not reported as taxable wages on the employee's Form W-2. These employer contributions are also exempt from FICA and FUTA taxes if paid under a plan or system established by the employer. However, disability payments are includable in the employee's income when later received to the extent attributable to employer contributions.

Employee Contributions. If the employee contributes to the cost of the disability coverage under a cafeteria plan, the proper income and payroll tax treatment depends on whether the dollars used to purchase the coverage are pretax or after-tax dollars of the employee:

1. *Pretax Contributions.* Employee elective (pretax) contributions used to pay premiums for disability coverage are exempt from FIT and FITW and are not reported as wages on Form W-2. Elective contributions

for disability coverage also are exempt from FICA and FUTA taxes if paid under a plan or system established by the employer. However, any subsequent disability benefits received are fully taxable to the extent they are attributable to the employee's pretax contributions.

2. *After-tax Contributions.* Contributions withheld from an employee's pay to purchase disability coverage on an after-tax basis are subject to FIT, FITW, FICA, and FUTA when withheld and are reported as taxable wages on Form W-2. The same tax result occurs if the employer purchases the coverage but treats the fair value of the coverage as a cash equivalent benefit. (If this is done, the employee is deemed to have received cash and then used this cash to purchase the benefit on an after-tax basis.) For withholding purposes, the cash equivalent benefit is deemed paid when the employer actually provides or pays for the coverage. Disability benefits received are excludable from income to the extent they are attributable to the after-tax contributions.

Example 1A-5 Disability coverage purchased with employee after-tax contributions.

XYZ Corporation maintains a cafeteria plan under which employees may elect to fund the premium coverage for disability insurance coverage using pretax employee elective contributions. The employee may also purchase the insurance coverage with after-tax dollars (i.e., payroll deduction). Assume the annual cost of the premiums is \$70 per employee. Employee Tom Wilson determines he wants to receive long-term disability coverage on an after-tax basis. Hence, XYZ deducts the \$70 of premium payment from Tom's paycheck on an after-tax basis. Any disability benefits Tom receives later will be excluded from his gross income.

Group-term Life Insurance

Group-term life insurance coverage on the life of an employee that does not exceed \$50,000 purchased with employer flex credits or employee elective (pretax) contributions is a qualified (nontaxable) benefit when offered under a cafeteria plan. The cost of premium coverage for this benefit is exempt from FIT, FITW, FICA, and FUTA and is not reported as taxable wages on the employee's Form W-2.

Excess Group-term Coverage. Employer provided group-term life insurance coverage in excess of the \$50,000 statutory exclusion is a qualified (taxable) benefit. The taxable cost of the excess group-term coverage is reported as taxable wages on Form W-2 and is subject to FICA taxes. However, this taxable cost is exempt from FITW and the payment of FUTA. For withholding and reporting purposes, the employer may treat the taxable cost as though paid by the pay period, by the quarter, or on any other basis so long as it is treated as paid at least once a year. The amount included in income is computed under the rules of Reg. 1.79-3. The taxable cost of the excess coverage is determined under an IRS table reduced by after-tax contributions made by the employee. Under this table (known as Table I), cost is computed with respect to uniform premiums on the basis of five-year age brackets, given the employee's age at December 31. The entire amount of pretax salary reduction and employer flex credits used to purchase the group-term life insurance coverage is excluded from the employee's income.

Example 1A-6 Excess group-term life insurance purchased with employer contributions.

Janet, an employee age 40, uses \$100 of employer flex credits to purchase \$110,000 of group-term life insurance coverage under T Corporation's cafeteria plan for the current calendar year. The \$100 of flex credits is excluded from Janet's income. The \$60,000 of excess group-term life coverage (i.e., the amount of coverage in excess of the \$50,000 statutory coverage limit of IRC Sec. 79) is a qualified (taxable) benefit. The taxable cost of the excess coverage for the year is \$72 [$(\$60,000 \div \$1,000) \times \0.10 (from Table I) $\times 12$ months], which is reported as taxable wages on Janet's Form W-2 and is subject to FICA taxes. However, it is exempt from FITW and FUTA.

Because this is a noncash benefit [i.e., a qualified (taxable) benefit not treated as cash], T may treat the taxable portion as paid at year-end for withholding and reporting purposes. T withholds \$5.51 ($\$72 \times 7.65\%$) from Janet's wages and matches this amount for FICA purposes.

When calculating the taxable amount of the excess group-term life insurance, the employer reduces the taxable cost of the excess coverage by any after-tax contributions made by the employee toward the cost of the policy. However, the employee will have had to pay tax up front on these after-tax contributions. The after-tax contributions are subject to FITW, FICA, and FUTA and are reported as taxable wages on the employee's Form W-2.

Dependent Group-term Coverage. Group-term life insurance on the life of anyone other than an employee (i.e., an employee's spouse or dependent) cannot be offered under a cafeteria plan.

Cafeteria Plan May Provide Elective Paid Time Off (PTO)

A cafeteria plan may include elective PTO (i.e., vacation days, sick days, or personal days) as a permitted taxable benefit by allowing participants to receive more PTO than the employer otherwise provides to employees on a nonelective basis, but only if the plan does not operate to defer the receipt of the compensation for the PTO beyond the end of the current plan year. To ensure the PTO purchase benefit option does not operate in such a way as to allow the deferral of compensation, purchased PTO must not be carried forward into a future plan year. In addition, a participant is deemed to use nonelective PTO days (i.e., the PTO days for which the employee had no election under the plan) before elective PTO days (i.e., additional PTO days purchased with employee elective contributions).

Example 1A-7 Purchased elective PTO days cannot defer receipt of compensation.

Employee Tim earns 10 PTO days and uses elective contributions to purchase six additional PTO days as a cafeteria plan option. Tim takes 14 days of PTO in the plan year. The 10 nonelective days of PTO must be counted first. Thus, Tim forfeits two of the purchased (elective) PTO days (16 PTO days – 10 accrued PTO days used – 4 purchased PTO days used).

PTO Cashout Option. Sometimes, employees purchase PTO but realize they will be unable to use it by the end of the plan year. Rather than lose the dollars set aside for PTO (and subject to applicable state law), the employee may be able to cash out the PTO. To ensure this does not result in the deferral of compensation, the employee must cash out the elective PTO days on or before the last day of the cafeteria plan's year to which the elective contributions used to purchase the unused PTO relate. The payment resulting from the cashed-out PTO days is subject to FIT, FITW, FICA, and FUTA and is reported as taxable wages on the employee's Form W-2.

Example 1A-8 Cashing out elective PTO days.

Steamboat Corporation provides each employee with two weeks of PTO each calendar year and allows employees to bank or cash out any unused PTO pay. Participants in the company's cafeteria plan can also purchase an additional week of paid PTO using employee elective (pretax) contributions. Employees Mable, Sheri, and Don each elect to purchase one additional week of PTO using elective contributions.

Mable uses all three weeks of PTO during the year, so there is no carryover issue. Sheri uses two weeks of PTO and is treated as having used the two company-provided (nonelective) weeks. Allowing her to carry over the unused elective week to the next year (or to use the value of that one week to purchase other benefits) would result in the deferral of compensation. However, Sheri can be allowed (assuming state law permits) to cash out the value of the unused vacation week before the end of the plan year. If she does this, the cash payment is subject to FIT, FITW, FICA, and FUTA when paid and is reported as wages on her Form W-2.

Don uses one PTO week during the year. He is treated as using one nonelective week and keeping one nonelective week as well as one elective week of PTO. Because the nonelective PTO days are not part of the cafeteria plan, Don may be permitted to bank the one nonelective week and carry it over to the next year. However, the cafeteria plan must require Don to either forfeit the remaining elective PTO week or cash out the elective PTO week before the end of the cafeteria plan year.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Employer-provided group term life insurance that exceeds \$50,000 statutory exclusion is considered which of the following?
 - a. Qualified (taxable) benefit.
 - b. Qualified (nontaxable) benefit.
2. Leslie Summer works for Farmland Insurance. She was given \$3,000 by her employer to purchase benefits. What are these employer contributions called?
 - a. Cafeteria plans.
 - b. Flex credits.
 - c. Cash benefits.
3. John Johnson is an executive for Johnson Co. As part of the executive cafeteria plan, Johnson Co. pays monthly premiums for group health insurance and quarterly premiums for group auto insurance. Which of the following is correct?
 - a. Johnson Co. should remit FUTA at year-end for the group auto insurance premium payments.
 - b. Johnson Co. should remit FUTA at year-end for the group health insurance premium payments.
 - c. Johnson Co. may remit FICA at year-end for the group health insurance premium payments.
 - d. Johnson Co. may remit FICA at year-end for the group auto insurance premium payments.
4. Greg's employer offers long-term disability as part of its cafeteria plan. Greg decides to participate via payroll deduction. Greg contributed with after-tax dollars. Which of the following is correct?
 - a. Greg's employer will report taxes on premium payments once, at year end.
 - b. Greg's employer will exclude premium payments from FITW, but not FICA.
 - c. A portion of long-term disability benefits Greg receives will be excluded from income.
 - d. Long-term disability benefits will be taxable up to the amount of premiums paid.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Employer-provided group term life insurance that exceeds the \$50,000 statutory exclusion is considered which of the following? **(Page 135)**
 - a. **Qualified (taxable) benefit. [This answer is correct. Per the Internal Revenue Code, employer provided group-term life insurance coverage in excess of the \$50,000 statutory exclusion is a qualified (taxable) benefit. The taxable cost of the excess group-term coverage is reported as taxable wages on Form W-2 and is subject to FICA taxes.]**
 - b. Qualified (nontaxable) benefit. [This answer is incorrect. Proposed regulations state that group-term life insurance coverage on the life of an employee that does not exceed \$50,000 purchased with employer flex credits or employee elective (pretax) contributions is a qualified (nontaxable) benefit when offered under a cafeteria plan.]
2. Leslie Summer works for Farmland Insurance. She was given \$3,000 by her employer to purchase benefits. What are these employer contributions called? **(Page 135)**
 - a. Cafeteria plans. [This answer is incorrect. Cafeteria plans are written plans that allow participants to choose among two or more benefits consisting of cash and qualified taxable nontaxable benefits.]
 - b. **Flex credits. [This answer is correct. This is a funding option used by employers to give employees a specific dollar amount (or specified percentage of wages) for the employee to purchase benefits.]**
 - c. Cash benefits. [This answer is incorrect. Cash benefits can be an option in an employer's cafeteria plan. The cash can be paid if an employer waives group health coverage, has unused flex money, or cashes out unused PTO.]
3. John Johnson is an executive for Johnson Co. As part of the executive cafeteria plan, Johnson Co. pays monthly premiums for group health insurance and quarterly premiums for group auto insurance. Which of the following is correct? **(Page 135)**
 - a. Johnson Co. should remit FUTA at year-end for the group auto insurance premium payments. [This answer is incorrect. Group auto insurance is a cash equivalent benefit. FUTA should be remitted when the premiums are paid.]
 - b. Johnson Co. should remit FUTA at year-end for the group health insurance premium payments. [This answer is incorrect. This is a qualified taxable noncash benefit, but it is not subject to FUTA.]
 - c. **Johnson Co. may remit FICA at year-end for the group health insurance premium payments. [This answer is correct. Because the benefit is considered discriminatory due to only being paid for key employees, the premiums for health insurance are qualified taxable noncash benefits. Johnson may; therefore, remit FICA as if the benefit was paid once at year-end in accordance with IRS Ann. 85-113.]**
 - d. Johnson Co. may remit FICA at year-end for the group auto insurance premium payments. [This answer is incorrect. Because this is a cash equivalent benefit paid within the executive cafeteria plan, Johnson must remit FICA throughout the year.]

4. Greg's employer offers long-term disability as part of its cafeteria plan. Greg decides to participate via payroll deduction. Greg contributed with after-tax dollars. Which of the following is correct? **(Page 135)**
- a. Greg's employer will report taxes on premium payments once, at year end. [This answer is incorrect. Contributions withheld from an employee's pay to purchase disability coverage on an after-tax basis are subject to payroll taxes when withheld.]
 - b. Greg's employer will exclude premium payments from FITW, but not FICA. [This answer is incorrect. Premiums paid on an after-tax basis are subject to FITW, FIT, FICA, and FUTA. Pretax contributions which are elective by employees are exempt from FIT and FITW.]
 - c. A portion of long-term disability benefits Greg receives will be excluded from income. [This answer is correct. Greg paid the premiums with after-tax money. The disability benefits received are excluded from income to the extent they are attributable to the after-tax contributions.]**
 - d. Long-term disability benefits will be taxable up to the amount of premiums paid. [This answer is incorrect. If the premiums would have been paid by Greg's employer, the disability benefits would be taxable up to the amount attributable to employer contributions. Because Greg paid the premium himself with after-tax dollars, he will pay tax on the benefits in excess of the after-tax contributions.]

Using Flexible Spending Arrangements in a Cafeteria Plan

Flexible spending arrangements (FSAs), also commonly referred to as flexible spending accounts, are qualified benefit programs that reimburse employees for qualified medical, dependent care, and/or adoption expenses. Reimbursements are subject to limits and other conditions as discussed in this lesson. In order to qualify as an FSA, the maximum amount of reimbursement that is reasonably available to a participant for a plan year must be less than 500% of the total payment for the coverage (including both employee-paid and employer-paid portions) for the plan year.

Coverage Period Must Be 12 Months

The period of coverage for an FSA must be 12 months, except for the initial plan year or a short plan year resulting from a change in the plan year. FSAs for health care, dependent care, and adoption assistance are each permitted to have a separate 12-month period of coverage, which may be different from the cafeteria plan's plan year. Participants cannot be allowed to increase or decrease the level of coverage under an FSA during the 12-month coverage period. However, certain changes can be made if the cafeteria plan permits changes during the plan year for the change-in-status events listed in Reg. 1.125-4(c)(2).

Use-it-or-lose-it Rule

Participants must forfeit any amount remaining in their FSAs at the end of the plan year or grace period, if allowed. Forfeited amounts must revert to the employer and are typically used to offset the administrative costs of maintaining the plan. This forfeiture rule is commonly referred to as the "use-it-or-lose-it" rule and may cause the employer to recognize an FSA experience gain. However, health savings accounts are not subject to the use-it-or-lose-it rule even though they may be part of a cafeteria plan. For a limited time, employers are allowed to roll over certain unused health FSA balances to an HSA on a one-time only basis if certain conditions are met.

Exception to the Use-it-or-lose-it Rule. A cafeteria plan document may, at the employer's option, provide for a grace period, not to exceed 2½ months, immediately following the end of each plan year. If provided, the grace period must apply to all plan participants who are covered on the last day of the plan year, including participants whose coverage is extended to the last day through COBRA coverage. Expenses for qualified benefits incurred during the grace period may be paid or reimbursed from benefits or contributions remaining unused at the end of the immediately preceding plan year. A participant who has unused benefits or contributions relating to a particular qualified benefit from the immediately preceding plan year, and who incurs expenses for that same qualified benefit during the grace period, may be paid or reimbursed for those expenses as if the expenses had been incurred in the prior plan year. A grace period is available for all qualified cafeteria plan benefits except elective contributions to a 401(k) plan and elective PTO.

During the grace period, a cafeteria plan may not permit unused benefits or contributions to be cashed-out or converted to any other taxable or nontaxable benefit. For example, unused amounts elected to pay or reimburse medical expenses in a health FSA may not be used to pay or reimburse dependent care expenses incurred during the grace period. If any unused benefits or contributions from the prior plan year exceed the expenses for the qualified benefit incurred during the grace period, the remaining unused balance may not be carried forward and is forfeited under the use-it-or-lose-it rule. The grace period rules may apply to the current plan year (as well as future plan years) if the employer amends the cafeteria plan document before the end of the current plan year.

Example 1B-1 Adoption of a grace period for a FSA.

Blue Sky, Inc. offers its employees a cafeteria plan that has a year ending on December 31, 2009. The plan document provides for a 2½-month grace period that allows all participants to apply unused benefits or contributions remaining at the end of the plan year to qualified benefits incurred during the grace period immediately following that plan year. The grace period for 2009 ends on March 15, 2010. Betty, a Blue Sky employee, timely elected a salary reduction of \$1,000 for a health FSA for the plan year ending December 31, 2009, and \$1,500 for the plan year ending December 31, 2010. As of December 31, 2009, Betty has \$200 remaining unused in her health FSA. During the January 1–March 15, 2010 grace period, Betty incurs \$300 of unreimbursed medical expenses. The unused \$200 from the plan year ending December 31, 2009 is used to

reimburse \$200 of Betty's \$300 of medical expenses incurred during the grace period. Thus, as of March 16, 2010, Betty has no unused benefits or contributions remaining for the plan year ending December 31, 2009. The remaining \$100 of medical expenses incurred between January 1 and March 15, 2010 is paid or reimbursed from Betty's health FSA for the plan year ending December 31, 2010. As of March 16, 2010, Betty has \$1,400 remaining in the health FSA for the plan year ending December 31, 2010.

Example 1B-2 Unused balances at end of grace period for a FSA.

The facts are the same as in Example 1B-1 except that Betty incurs \$150 of medical expenses during the January 1–March 15, 2010 grace period. As of March 16, 2010, Betty has \$50 of unused benefits or contributions remaining for the plan year ending December 31, 2009. The unused \$50 cannot be cashed-out, converted to any other taxable or nontaxable benefit, or used in any other plan year (including the plan year ending December 31, 2010). The unused \$50 is subject to the “use-it-or-lose-it” rule and is “forfeited.” As of March 16, 2010, Betty has the entire \$1,500 elected in the health FSA for the plan year ending December 31, 2010.

Example 1B-3 Targeting elective medical costs during a grace period.

Carla, a single individual, participates in a cafeteria plan with a 2½-month grace period. Based on the plan rules and Carla's compensation, she may only electively defer up to \$3,000 annually for medical costs. Anticipating an elective medical procedure (laser eye surgery) that will cost \$4,500, Carla schedules the procedure in January of the next year. By authorizing an amount for the current year that provides a carryover into the next year, Carla is able to utilize authorizations from two calendar years to cover the cost of the surgical procedure from cafeteria plan deferrals.

Although unused FSA balances must be forfeited by participants, the overall “experience gain” the employer realizes resulting from the plan's operation during the year may be retained by the employer, used to defray expenses to administer the plan, or allocated among employees contributing through salary reduction on a reasonable and uniform basis.

Medical Expense Flexible Spending Arrangements (Health FSAs)

Generally, employee medical expenses not otherwise reimbursed by a health plan (e.g., co-pay or deductible amounts, eye glasses, etc.) are paid with after-tax dollars. Furthermore, these expenses are not deductible on the employee's tax return if the employee does not itemize deductions or itemizes and has total medical expenses less than the 7.5% of adjusted gross income threshold. A health FSA allows the employee to fund such expenses with pre-tax dollars and eliminates the need to try to claim a deduction on the employee's tax return.

Under a health FSA, medical expense reimbursement accounts are established for participating employees. Typically, these accounts are funded with employee pretax contributions uniformly withheld from each paycheck throughout the year. The balances in these accounts are used to reimburse expenses incurred by the employee during the year for medical care as defined in IRC Sec. 213(d). The IRS imposes no specific dollar limit on health care FSA contributions, though plans typically have a dollar or percentage maximum for elective contributions made through salary reductions. Employers set limits to reduce losses from employees who quit or die when their withdrawals (which might total the year's allowable draw) exceed their contributions from salary reductions. Participants are not entitled to reimbursement if they may receive cash or any other taxable or nontaxable benefit (including health coverage for an additional period) regardless of whether medical expenses were incurred during the period of coverage.

A health FSA must provide uniform coverage throughout the coverage period. (The uniform coverage rule does not apply to FSAs for dependent care and adoption assistance.) Each employee's designated maximum reimbursement amount must be available for reimbursement at all times during the coverage period, properly reduced as of any particular time for prior reimbursements for the same coverage period. This is true regardless of whether the employee has made the required contributions. Thus, the maximum reimbursement at any particular time during the coverage period cannot relate to the contributions the participant has made to that point. Likewise, the payment schedule for the required contributions may not be based on the rate or amount of covered claims incurred during the coverage period.

Only Expenses for Medical Care as Defined in IRC Sec. 213(d) Can Be Reimbursed. A health FSA can only reimburse expenses for medical care as defined in IRC Sec. 213(d). Expenses for medical care include amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body. In addition, over-the-counter (OTC) (nonprescription) drugs can be reimbursed through a health FSA, but amounts for dietary supplements (like vitamins) that are merely beneficial to the employee's general health cannot.

Only Substantiated Claims May Be Reimbursed. A health FSA may reimburse a medical expense only if the participant provides information from an independent third party describing the service or product, the date of the service or sale, and the amount. Self-substantiation or self-certification of an expense by an employee does not satisfy the substantiation requirements. Additionally, the specific requirements in IRC Sec. 105(b) must be satisfied as a condition of reimbursing expenses for qualified benefits.

Reimbursements of Debit or Credit Card Expenses. With proper substantiation, employees can exclude from gross income medical and dental expense reimbursements made under health FSAs through debit or credit cards. Before any employee participating in a health FSA receives the debit or credit card, the employee must agree in writing that he or she will (a) only use the card to pay for medical expenses of the employee or his or her spouse or dependents or equals an exact multiple of not more than five times the dollar amount of a copayment, (b) not use the debit or credit card for any medical expense that has already been reimbursed, (c) not seek reimbursement under any other health plan for any expense paid for with a debit or credit card, and (d) acquire and retain sufficient documentation (including invoices and receipts) for any expense paid with the debit or credit card.

When a debit or credit card is used, health FSA reimbursements are deemed properly substantiated and, therefore, excluded from income, if (1) the dollar amount of a charge matches a copayment or equals an exact multiple of not more than five times the dollar amount of a copayment; (2) recurring expenses are made on a regular basis for the same amount and at the same provider (e.g., for an employee who refills a prescription drug on a regular basis at the same provider for the same amount); or (3) charges are made at a merchant, service provider, or other independent third party that at the point of sale provides information to the employer (including electronically by email, the Internet, Intranet, or telephone) that the charges are medical expenses. All other debit or credit card charges are treated as conditional and, therefore, potentially taxable, pending confirmation via third-party information, such as merchant or service provider receipts, indicating the service or product, the date provided, and the amount.

Health FSA debit or credit cards may not be used at any store, vendor, or merchant that does not have health care related merchant category codes (i.e., supermarkets, grocery stores, discount stores, and wholesale clubs) unless the store, vendor, or merchant has implemented an inventory information approval system. Additionally, health FSA debit cards may not be used at stores with the Drug Stores and Pharmacies merchant category code unless the store participates in the inventory approval system, or on a location-by-location basis, at least 90% of the store's gross receipts for the prior year consisted of items that qualified as expenses for medical care under IRC Sec. 213(d).

Under the "inventory information approval system," only merchants using standard SKUs (inventory numbers) can be participating merchants. The payment card processor provides a system for approving and rejecting card transactions using inventory control information. When an employee uses the card, a participating merchant's system will collect information about the items purchased using the inventory control information. The system compares the inventory control information for the items purchased against a list of items, the purchase of which qualifies as expenses for medical care under IRC Sec. 213(d). The Section 213(d) medical expenses are totaled and the merchant's or payment card processor's system approves the use of the card only for the amount of those qualified medical expenses subject to coverage under the health FSA. If the transaction is only partially approved, the employee is required to pay the additional amounts.

Use-it-or-lose-it Rule. The balance in the health FSA not used to reimburse qualified medical expenses incurred during the plan year and, if the plan allows, during the 2¹/₂-month (or shorter) grace period, must be forfeited (i.e., are subject to the use-it-or-lose-it rule previously discussed), which may cause the employer to recognize an FSA experience gain.

Dependent Care Flexible Spending Arrangement (Dependent Care FSA)

Under a dependent care FSA, dependent care reimbursement accounts are established for participating employees. Typically, these accounts are funded with employee pretax contributions uniformly withheld from each paycheck throughout the year. The balances in these accounts are used to reimburse specific dependent care expenses incurred during the year, subject to a reimbursement maximum. A participant in the dependent care FSA is entitled to reimbursement solely for dependent care expenses.

To provide employees with nontaxable dependent care assistance, the dependent care FSA must generally comply with the requirements applicable to an employer-provided dependent care assistance program (i.e., IRC Sec. 129 dependent care assistance program). These programs are discussed later in this lesson.

The uniform coverage rule that applies to health FSAs does not apply to dependent care FSAs. This means the amount available currently to an employee for reimbursement of dependent care expenses under the program is limited to the amount of employee contributions made at that point, reduced for any prior reimbursements. Additionally, dependent care expenses may not be reimbursed before the expenses are incurred. Dependent care expenses are considered to be incurred when the care is provided and not when the employee is billed, charged for, or pays for the dependent care. This rule can cause problems for employees because many daycare providers charge customers on the first of the month for the entire month's care. These expenses are not reimbursable until the end of the month, despite the fact the employee paid on the first.

Example 1B-4 Spend-down provision for dependent care expenses.

For the calendar year, Rodney elects \$5,000 salary reduction for dependent care assistance through the cafeteria plan offered by his employer, L&M. Rodney works for L&M from January 1 through June 30 of Year 1, when he terminates employment with L&M. As of June 30, Rodney had paid \$2,500 in salary reduction and had incurred and was reimbursed for \$2,000 of dependent care expenses. Rodney does not work again until October 1 of Year 1, when he begins work for Nations, Inc.

While employed by Nations from October 1 through December 31 of Year 1, Rodney incurred \$500 of dependent care expenses. During all periods of employment in the plan year, Rodney satisfied all requirements in IRC Sec. 129 for excluding payments for dependent care assistance from gross income. L&M's cafeteria plan allows terminated employees to "spend-down" unused salary reduction amounts for dependent care assistance, if all Section 129 requirements are satisfied. After Rodney's claim for \$500 of dependent care expenses is substantiated, L&M's plan reimburses him for \$500 (the remaining balance) of dependent care expenses incurred during his employment for Nations. L&M's cafeteria plan and operation are consistent with IRC Sec. 125.

The maximum reimbursement allowed per employee (or per family for married employees) under the dependent care FSA (and, thus, the maximum funding) for a one-year coverage period is \$5,000 (\$2,500 if married filing separately). The reimbursement is also subject to the earned income limitation.

Dependent care expense claims must be substantiated by a third party who is independent of the employee and the employee's spouse and dependents. The independent third party (e.g., child care provider) must provide information describing the dependent care service, the date of service, and the amount. Self-substantiation or self-certification of an expense by an employee does not satisfy the substantiation requirements. Additionally, substantiating only a percentage of expenses, or expenses above a certain dollar amount is insufficient. The specific requirements in IRC Sec. 129 must also be satisfied as a condition of reimbursing expenses for qualified benefits.

Use-it-or-lose-it Rule. The balance in the reimbursement account not used to reimburse dependent care expenses incurred during the plan year and, if the plan allows, during the 2½-month (or shorter) grace period, must be forfeited, and the employer may recognize an FSA experience gain.

Adoption Assistance Flexible Spending Arrangement (Adoption Assistance FSA)

Under an adoption assistance FSA, adoption reimbursement accounts are established for participating employees. Typically, these accounts are funded with employee pretax contributions uniformly withheld from each

paycheck throughout the year. The balances in these accounts are used to reimburse qualified adoption expenses incurred during the year, subject to a reimbursement maximum. A participant in the adoption FSA is entitled to reimbursement solely for adoption expenses.

To provide employees with nontaxable adoption assistance, the adoption assistance FSA must generally comply with the requirements applicable to an employer-provided adoption assistance program (i.e., a Section 137 adoption assistance program).

The uniform coverage rule that applies to health FSAs does not apply to adoption assistance FSAs. This means the amount available currently to an employee for reimbursement of adoption expenses under the program is limited to the amount of employee contributions made at that point, reduced for any prior reimbursements.

The maximum reimbursement allowed for qualified adoption expenses is based on a *per child* limit, not an *annual* limit. However, the per child limit is annually indexed for inflation. The per child limit in 2009 is \$12,150. Therefore, if no prior adoption assistance benefits have been received by an employee for qualified adoption expenses for a particular child, the maximum funding for an adoption assistance FSA for a one-year coverage period in 2009 is \$12,150. However, if qualified expenses for a particular child's adoption have been received in a prior year, those reimbursements reduce the amount available for reimbursement in the current year.

Adoption expense claims must be substantiated by a third party who is independent of the employee and the employee's spouse and dependents. The independent third party (e.g., an attorney or adoption agency) must provide information describing the provided services, the date of service, and the amount. Self-substantiation or self-certification of an expense by an employee does not satisfy the substantiation requirements. Additionally, substantiating only a percentage of expenses, or expenses above a certain dollar amount is insufficient. The specific requirements in IRC Sec. 137 must also be satisfied as a condition of reimbursing expenses for qualified benefits.

Use-it-or-lose-it Rule. The balance in the adoption assistance FSA not used to reimburse adoption expenses incurred during the plan year and, if the plan allows, during the 2¹/₂-month (or shorter) grace period, must be forfeited, and the employer may recognize an FSA experience gain.

Withholding and Payroll Reporting

Employer flex credits and employee elective (pretax) contributions to a health FSA are exempt from FIT, FITW, FICA, and FUTA and are not reported as taxable wages on the employee's Form W-2. Qualified medical expense reimbursements under a health FSA also are exempt from FIT, FITW, FICA, and FUTA and are not reported as taxable wages on Form W-2.

Employer flex credits or employee pretax contributions applied to a dependent care assistance FSA must be reported in box 10 of Form W-2. Flex credits and employee contributions up to \$5,000 per year to a dependent care assistance FSA are exempt from FITW, FICA, and FUTA and not reported as taxable wages on the employee's Form W-2. It is up to the employee to determine how much, if any, of the dependent care assistance is includable in income. Any excess over \$5,000 is subject to FIT, FITW, FICA, and FUTA and must be reported in boxes 1, 3 (subject to the maximum social security wage base), and 5 of the employee's Form W-2.

Employers show the total amount paid or reimbursed for qualified adoption expenses furnished to an employee under a Section 137 adoption assistance program in Form W-2, box 12, using Code T. This includes benefits paid or reimbursed from an employee's pretax contributions to an adoption assistance FSA (other than adoption benefits forfeited under the plan), as well as benefits that exceed the \$12,150 (in 2009) exclusion. Flex credits and employee contributions to an adoption assistance FSA are exempt from FITW, FICA, and FUTA, but the actual reimbursement from the FSA of the employee's adoption assistance expenses is subject to FICA and FUTA and must be reported in boxes 3 (subject to the maximum social security wage base) and 5, but not box 1, of Form W-2. It is up to the employee to determine how much, if any, of the reimbursement is includable in income.

Payroll Reporting Requirements for Cafeteria Plans

Certain contributions to a cafeteria plan may be tax-exempt for FIT and FITW purposes, but are taxable for FICA and FUTA purposes. In addition, some contributions may require specific disclosure to the IRS on employment tax returns.

Form 941 Reporting

Pretax contributions under a qualified cafeteria plan generally are not included on Lines 2 (Wages), 5a (social security wages), or 5c (Medicare wages) of Form 941. (Employer's Quarterly Federal Tax Return) However, employee elective 401(k) contributions made and qualifying adoption expenses paid or reimbursed under a cafeteria plan are subject to FICA and must be included on Lines 5a and 5c. Taxable benefits received under the plan are subject to the reporting requirements that apply if the taxable benefits had been offered outside of the cafeteria plan.

Cash for unused flex credits or PTO payments made from a cafeteria plan are considered wages and must be reported on Lines 2, 5a, and 5c of Form 941.

Form 944 Reporting

Certain employers with a total employment tax liability of \$1,000 or less will file Form 944 (Employer's Annual Federal Tax Return) annually instead of filing Form 941 quarterly. Pretax contributions under a qualified cafeteria plan generally are not included on Lines 1 (wages, tips, and other compensation), 4a (taxable social security wages), or 4c (taxable Medicare wages and tips) of Form 944. However, employee elective 401(k) contributions made and qualifying adoption expenses paid or reimbursed under a cafeteria plan are subject to FICA and included on Lines 4a and 4c.

Form W-2 Reporting

In general, pretax contributions to a cafeteria plan, including pretax contributions to a health FSA, are not reported in box 1 (wages), box 3 (social security wages), or box 5 (Medicare wages) of Form W-2 (Wage and Tax Statement). However, employee elective 401(k) contributions made and qualifying adoption expenses paid or reimbursed under a cafeteria plan are subject to FICA and must be reported in box 3 (subject to the maximum social security wage base) and box 5 of the Form W-2. FICA withheld must be reported in box 4 and box 6 of the Form W-2. In addition, employee elective (i.e., pretax) 401(k) contributions are reported in box 12, using Code D, and adoption benefits are reported in box 12 using Code T. At the employer's option, after-tax contributions or tax-free employer contributions to a cafeteria plan may be reported in box 14 (other). Taxable benefits received under a cafeteria plan are reported as though they were offered outside the plan.

Cash payments for unused flex credits or PTO payments by a cafeteria plan are considered wages and are reported in boxes 1, 3 (subject to the maximum social security wage base), and 5 of the Form W-2. At the employer's option, they also may be reported in box 14.

Pretax contributions or flex credits applied to a dependent care assistance FSA must be reported in box 10 of the Form W-2. Any excess over \$5,000 also must be reported in boxes 1, 3 (subject to the maximum social security wage base), and 5. Employer contributions (including employee pretax contributions) to a health savings account (HSA) are reported on Form W-2 in box 12 using Code W. They are not, however, reported in box 1, 3, or 5 of Form W-2 as long as they are within the HSA contribution limits.

Form 940 Reporting

Pretax contributions to a cafeteria plan, including pretax contributions to a health care, dependent care, or adoption assistance FSA or a health savings account, are included on the Form 940 [Employers Annual Federal Unemployment (FUTA) Tax Return], Part 2, line 3, (total payments). Because salary reductions [other than employee elective 401(k) contributions made and qualifying adoption expenses paid or reimbursed] under a cafeteria plan are exempt from FUTA, the total amount of the salary reduction is included in Part 2, line 4, (exempt payments). In

addition, the appropriate box(es) on line 4a should be checked to show the type of exempt payment made. Elective 401(k) contributions made and qualified adoption expenses paid or reimbursed are not included as exempt payments in Part 2, line 4.

Pretax contributions or employer contributions up to \$5,000 per year to a dependent care assistance FSA are exempt from FUTA and are reported in Part 2, line 4, as an exempt payment. The box on line 4d (Dependent care) should be checked to show the type of exempt payment made. Contributions in excess of \$5,000 are FUTA taxable and should not be reported as a FUTA exempt payment in Part 2, line 4, of the Form 940.

Example 1C-1 Payroll reporting of cafeteria plan elective contributions.

Bevo Company allows employees to use pretax contributions to purchase various benefits under the company's cafeteria plan. The following table presents the menu selections for two employees participating in the plan and shows the effects of those choices on the employees and the company:

	<u>Federal Taxable</u>		<u>FICA & FUTA Taxable</u>	
	<u>4th Quarter</u>	<u>Y-T-D</u>	<u>4th Quarter</u>	<u>Y-T-D</u>
John Smith:				
Regular wages	\$ 7,500	\$ 30,000	\$ 7,500	\$ 30,000
Cafeteria items:				
Medical coverage	(750)	(3,000)	(750)	(3,000)
Health FSA	(250)	(1,000)	(250)	(1,000)
Dependent FSA	(125)	(500)	(125)	(500)
401(k)	<u>(500)</u>	<u>(2,000)</u>	<u>—</u>	<u>—</u>
Taxable wages	<u>\$ 5,875</u>	<u>\$ 23,500</u>	<u>\$ 6,375</u>	<u>\$ 25,500</u>
Jane Adams:				
Regular wages	\$ 10,000	\$ 40,000	\$ 10,000	\$ 40,000
Cafeteria items:				
Medical coverage	(750)	(3,000)	(750)	(3,000)
Health FSA	(500)	(2,000)	(500)	(2,000)
Dependent FSA	—	—	—	—
401(k)	<u>(1,000)</u>	<u>(4,000)</u>	<u>—</u>	<u>—</u>
Taxable wages	<u>\$ 7,750</u>	<u>\$ 31,000</u>	<u>\$ 8,750</u>	<u>\$ 35,000</u>
Company totals:				
Taxable wages	<u>\$ 13,625</u>	<u>\$ 54,500</u>	<u>\$ 15,125</u>	<u>\$ 60,500</u>
Withheld employment taxes:				
FITW (15%)	<u>\$ 2,044</u>	<u>\$ 8,175</u>		
OASDI (6.2%)			<u>\$ 938</u>	<u>\$ 3,751</u>
HI (1.45%)			<u>\$ 219</u>	<u>\$ 877</u>

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. Which of the following statements concerning flexible spending accounts is correct?
 - a. The “use-it-or-lose-it” rule applies to cafeteria plan contributions for both FSAs and HSAs.
 - b. FSA funds can now be used for dietary supplements such as vitamins.
 - c. The cafeteria plan may provide for a 3 month grace period concerning the “use-it-or-lose-it” rule.
 - d. An employee’s health FSA reimbursements may exceed their contributions at any time during the plan year.

6. Barbara’s employer provides a cafeteria plan FSA with the maximum grace period for qualified expenditures. At the end of last year, Barbara had \$2,000 remaining in the cafeteria health FSA. Barbara electively deferred \$4,800 toward the health FSA for the current year. Between January 1 and February 15 of the current year, she contributed \$800 to the health FSA in the cafeteria plan. Assuming no other contributions or claims during the current year, how much is available to Barbara for qualified current year health care costs at February 26?
 - a. \$800.
 - b. \$2,800.
 - c. \$6,800.

7. Which of the following statements regarding the adoption assistance flexible spending arrangement (adoption assistance FSA) is most accurate?
 - a. The adoption assistance FSA must provide uniform coverage throughout the coverage period.
 - b. For 2009, the maximum funding for adoption assistance FSA per child; for one-year coverage is \$11,650.
 - c. Adoption expense claims can be substantiated by an adoption agency.
 - d. Generally, adoption reimbursement accounts are funded with employee after-tax contributions.

8. Elective employee 401(k) contributions made under a cafeteria plan are **not** exempt from:
 - a. FICA and FUTA.
 - b. FICA and FITW.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

5. Which of the following statements concerning flexible spending accounts is correct? **(Page 144)**
- The “use-it-or-lose-it” rule applies to cafeteria plan contributions for both FSAs and HSAs. [This answer is incorrect. According to the Internal Revenue Code, the “use-it-or-lose-it” rule does not apply to HSAs even though they may be part of a cafeteria plan.]
 - FSA funds can now be used for dietary supplements such as vitamins. [This answer is incorrect. Per the Internal Revenue Code, Dietary supplements are not covered for FSA reimbursement however, over-the-counter drugs can be reimbursed.]
 - The cafeteria plan may provide for a 3 month grace period concerning the “use-it-or-lose-it” rule. [This answer is incorrect. The appropriate grace period cannot exceed 2½ months.]
 - An employee’s health FSA reimbursements may exceed their contributions at any time during the plan year. [This answer is correct. Under the uniform coverage rule, the maximum health FSA reimbursement amount must be available to the employee at all times during the plan year, regardless of the total employee contribution to that point.]**
6. Barbara’s employer provides a cafeteria plan FSA with the maximum grace period for qualified expenditures. At the end of last year, Barbara had \$2,000 remaining in the cafeteria health FSA. Barbara elected a salary reduction of \$4,800 toward the health FSA for the current year. Between January 1 and February 15 of the current year, she contributed \$800 to the health FSA in the cafeteria plan. Assuming no other contributions or claims during the current year, how much is available to Barbara for qualified current year health care costs at February 26? **(Page 144)**
- \$800. [This answer is incorrect. The health FSA amount of \$800 does not take into account the remaining balance from the prior year that is available during the grace period.]
 - \$2,800. [This answer is incorrect. The health FSA amount of \$2,800 does not take into account the significant rule of uniform coverage throughout the coverage period.]
 - \$6,800. [This answer is correct. Barbara’s remaining health FSA balance is available in addition to her current year designated maximum reimbursement amount regardless of whether or not she has made the required contributions.]**
7. Which of the following statements regarding the adoption assistance flexible spending arrangement (adoption assistance FSA) is most accurate? **(Page 149)**
- The adoption assistance FSA must provide uniform coverage throughout the coverage period. [This answer is incorrect. According to proposed regulations, the uniform coverage rule that applies to health FSAs does not apply to adoption assistance FSAs.]
 - For 2009, the maximum funding for adoption assistance FSA per child; for one-year coverage is \$11,650. [This answer is incorrect. This is the limit for 2008. The per-child limit in 2009 is \$12,150.]
 - Adoption expense claims can be substantiated by an adoption agency. [This answer is correct. Adoption expense claims must be substantiated by a third party who is independent of the employee and the employee’s spouse and dependents. The independent third party (e.g., an attorney or adoption agency) must provide information describing the provided services, the date of service, and the amount.]**
 - Generally, adoption reimbursement accounts are funded with employee after-tax contributions. [This answer is incorrect. Under the adoption assistance FSA, adoption reimbursement accounts are

established for participating employees. Typically, these accounts are funded with employee pretax contributions uniformly withheld from each paycheck throughout the year. The balances in these accounts are used to reimburse qualified adoption expenses incurred during the year, subject to a reimbursement maximum.]

8. Elective employee 401(k) contributions made under a cafeteria plan are subject to: **(Page 149)**
 - a. **FICA and FUTA.** [This answer is correct. Employee elective 401(k) contributions made under a cafeteria plan are subject to FICA and FUTA, per the Internal Revenue Code.]
 - b. FICA and FITW. [This answer is incorrect. Per the IRC, Federal income tax is not withheld on employee elective 401(k) contributions.]

Dependent Care Assistance Programs

A dependent care assistance program (DCAP) is a plan under which the employer reimburses employees for dependent care expenses, makes payments to third parties for dependent care expenses, or provides an in-house dependent care facility.

Dependent care assistance includes employer payments or reimbursements for dependent care services necessary for the employee's gainful employment, including (1) expenses for household services incurred to provide care to a qualifying person and (2) expenses incurred to provide care to a qualifying person outside the employee's home. The expenses must be primarily for the well-being and protection of the qualifying person.

A *qualifying person* is any of the following:

1. A dependent who was under age 13 when the care was provided. The IRS provides a uniform method for determining the age of a child for purposes of certain Code provisions, including IRC Secs. 21 (dependent care credit) and 129 (dependent care assistance programs). Under the ruling, a child attains a given age on the anniversary of the date that the child was born (i.e., on the child's birthday). A child who turned 13 during the year, is an eligible child for the part of the year he or she was under 13. For this purpose, a *dependent* is a son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, legally adopted child, eligible foster child, or a descendent of any such individual who has not provided over half of their own support has the same principal place of abode as the employee for more than half the tax year, and has not filed a joint return (other than only for a claim of refund) with the individual's spouse under IRC Sec. 6013 for the tax year.
2. The employee's spouse who was physically or mentally incapable of self-care and who has the same principal place of abode as the employee for more than half the tax year.
3. A dependent of the employee who was physically or mentally incapable of self-care and who has the same principal place of abode as the employee for more than half the tax year. For this purpose, a dependent is defined in IRC Sec. 152 (i.e., a qualifying child or qualifying relative), determined without regard to IRC Secs. 152(b)(1), (b)(2), and (d)(1)(B), which means that a dependent still qualifies regardless of his or her level of income (for purposes of the qualifying relative definition), whether or not he or she is married and filing a joint return, without regard to the general rule that a dependent of a taxpayer should be treated as having no dependents for the tax year, and without regard to his or her age (i.e., the dependent may be age 13 or older).

Nonhighly compensated employees may exclude the first \$5,000 (\$2,500 for married employees filing separately) of dependent care assistance provided by the employer during the year. Highly compensated employees are eligible for the \$5,000 income exclusion only if the employer maintains a qualified dependent care assistance program (qualified DCAP) under IRC Sec. 129. The excluded amount is exempt from federal income tax withholding (FITW), social security and Medicare (FICA) taxes, and federal unemployment (FUTA) tax and is not reported as taxable wages on the employee's Form W-2.

A qualified DCAP must meet the requirements specified in IRC Sec. 129(d). These requirements are explained in detail in *PPC's Guide to Compensation and Benefits*.

The availability of the income exclusion for both highly compensated and regular employees may be further limited at the employee level under an earned income test. The employee completes Form 2441 (Child and Dependent Care Expenses) if filing Form 1040, or Schedule 2 (Form 1040A) if filing Form 1040A, to calculate the actual amount of income exclusion, including any possible earned income limitation, and then files this form with his or her personal individual income tax return.

Dependent care assistance provided during the year that exceeds the \$5,000 income exclusion cap or that is otherwise ineligible for exclusion is subject to FIT, FITW, FICA, and FUTA and is reported as taxable wages on the employee's Form W-2 in boxes 1, 3 (subject to the maximum social security wage base), and 5. For example, reimbursements or payments of expenses that are not dependent care assistance are not eligible for the \$5,000

income exclusion, nor are benefits paid by a discriminatory plan to a highly compensated employee. Accordingly, such benefits are taxable employee wages subject to FIT, FITW, FICA, and FUTA, and are reportable on Form W-2 in boxes 1, 3 (subject to the maximum social security wage base), and 5.

The \$5,000 income exclusion authorized by IRC Sec. 129(a) applies only to employer payments or reimbursements of expenses that qualify as dependent care assistance. If an employer reimburses an expense that does not qualify as dependent care assistance, the expense will be additional employee compensation subject to FIT, FITW, FICA, and FUTA. Penalties may also be imposed.

Employer Reporting

The employer and the plan must also report certain items annually to the employee.

1. *Employer Reporting.* The employer must provide a written statement by January 31 to the employee showing the total amount incurred for dependent care assistance for that employee under the program.
2. *Plan Reporting.* The plan must furnish a written statement to the employee by January 31 showing the amounts paid or expenses incurred by the employer in providing dependent care assistance to that employee during the previous calendar year.

Reporting the total amount of assistance on Form W-2 in box 10 satisfies both of these requirements. Amounts of assistance that qualify for the \$5,000 income exclusion as well as amounts in excess of the \$5,000 cap must be reported in box 10 of Form W-2. For these purposes, assistance can include the fair market value of benefits provided in-kind by the employer, an amount paid directly to a day-care facility by the employer or reimbursed to the employee to subsidize the benefit (including employer contributions under a Section 125 cafeteria plan), or benefits from pretax contributions made by the employee to a Section 125 cafeteria plan [including a dependent care flexible spending account (FSA)].

Example 1D-1 Reporting dependent care assistance under a qualified DCAP.

Flexsteel, Inc., has a qualified DCAP under which it reimburses employees for up to \$6,000 of dependent care expenses incurred during the calendar year. Highly compensated executive Jerry Kroll (who has two children under the age of 13) and nonhighly compensated employee Roger Hawn (who has three children under the age of 13) incur the following reimbursed amounts of dependent care expenses for the year.

	<u>Jerry</u>	<u>Roger</u>
Dependent care	\$ 3,000	\$ 6,000
Household expenses paid to a housekeeper	700	
Babysitting by Jerry's 17-year-old daughter	300	

The reimbursements to Jerry for dependent care qualify as dependent care assistance, along with reimbursement made for household expenses incurred for a housekeeper to care for Jerry's kids. However, the reimbursement for babysitting by Jerry's 17-year-old daughter does not qualify as dependent care assistance because she is under the age of 19 at the end of the year. The amounts reimbursed that qualify as dependent care assistance are exempt from FITW, FICA, and FUTA and are not reported as taxable wages on Jerry's Form W-2. When Jerry files his individual return, he must determine how much, if any, of the reimbursement is includable in his income. The \$300 reimbursement paid to Jerry that does not qualify as dependent care assistance is subject to FIT, FITW, FICA, and FUTA and is reported as taxable wages on his Form W-2 in boxes 1, 3 (subject to the maximum social security wage base), and 5.

The reimbursements to Roger for dependent care qualify as dependent care assistance. Up to \$5,000 of this amount is exempt from FITW, FICA, and FUTA and is not reported as taxable wages on Roger's Form W-2. When Roger files his individual return, he must determine how much, if any, of the reimbursement is includable in his income. The \$1,000 (\$6,000 – \$5,000 income exclusion cap) excess reimbursement is subject to FIT, FITW, FICA, and FUTA and must be reported as taxable wages on his Form W-2.

Flexsteel must provide each employee with a statement of the amount incurred in providing dependent care assistance during the year. (Jerry and Roger need this information to prepare their personal Form 1040). To satisfy this reporting requirement, Flexsteel specifies in box 10 of their Form W-2 the amount of dependent care assistance provided during the year. Thus, Flexsteel reports \$3,700 of dependent care assistance for Jerry (recall that the \$300 reimbursement for babysitting by Jerry's 17-year-old daughter does not qualify as dependent care assistance) and \$6,000 of dependent care assistance for Roger in box 10 of their respective Forms W-2.

Amount to Report

The amount reported for an employee's dependent care assistance is the amount the employee incurred for dependent care, not necessarily the amount paid. In this regard, the \$5,000 income exclusion cap applies to the amount of dependent care assistance provided by the employer during the tax year even if payment of dependent care assistance for such services occurs in the subsequent year. Direct reimbursements for dependent care assistance and in-kind dependent care are treated somewhat differently for this purpose.

If the employer's cafeteria plan FSA allows employees up to 2¹/₂ months after year-end to use amounts remaining in their dependent care assistant FSAs, the employer can still rely on the reporting rules in Notice 89-111 by reporting in Box 10 of Form W-2 the salary reduction amount elected by the employee for the year for dependent care assistance plus any employer matching contributions. The amount electively contributed by an employee for the year for dependent care assistance (plus any employer matching contributions attributable thereto) will be considered a reasonable estimate.

Example 1D-2 Reporting grace period dependent care assistance for a cafeteria plan FSA.

Employer T's calendar year cafeteria plan permits a grace period for dependent care assistance until March 15 of the subsequent year. An employee elects salary reduction of \$5,000 for dependent care assistance for the 2009 calendar year and elects an additional \$5,000 salary reduction for dependent care assistance for the 2010 calendar year. The employee has \$500 of dependent care contributions remaining unused at the end of the 2009 plan year, which is available to reimburse dependent care expenses incurred during the grace period. For the 2009 calendar year, the employer may report in box 10 of Form W-2 the \$5,000 salary reduction amount elected by the employee for dependent care assistance in 2009. Similarly, for the 2010 calendar year, the employer may report in Box 10 of Form W-2 the \$5,000 salary reduction amount elected by the employee for dependent care assistance in 2010.

An employer can use a debit card to provide benefits under its DCAP, including a dependent care FSA. At the beginning of the plan year or upon enrollment in the DCAP, the employee pays initial expenses to the dependent care provider and substantiates the initial expenses by submitting to the employer or plan administrator a statement from the dependent care provider substantiating the dates and amounts for the services performed. After the employer or plan administrator receives the substantiation, but not before the date the services are provided, the plan may make available through the debit card an amount equal to the lesser of: (1) the previously incurred and substantiated expenses or (2) the employee's total salary reduction amount to date. The amount available through the card may be increased for any additional dependent care expenses only after the additional expenses have been incurred.

Recurring expenses for amounts equal to or less than the previously substantiated amounts may be treated as substantiated without further review. However, if there is an increase in the amounts paid, or the dependent care provider changes, the employee must submit new substantiation before the amounts relating to the increased amounts or new provider may be added to the card.

Direct Reimbursements Are Provided When Expenses Are Incurred. Direct (cash) reimbursements are provided when the employee incurs the expenses for dependent care service. Dependent care expenses are considered to be incurred when the care is provided and not when the employee is billed, charged for, or pays for the dependent care. Reimbursements made during the current year for dependent care expenses incurred in the preceding year must be eliminated in applying the \$5,000 income exclusion cap and reporting the amount of dependent care assistance provided to the employee during the current year. Reimbursements made in a subsequent year for

dependent care expenses incurred during the current year must be included in applying the \$5,000 income cap and reporting the amount of dependent care assistance provided the employee for the current year.

Example 1D-3 Dependent care assistance treated as provided when incurred.

During 2009, unmarried employee Tim Simon incurred (and paid) \$6,000 of dependent care expenses. In 2010, Tim incurred (and paid) \$5,000 of dependent care expenses. During this period, Tim's employer maintained a qualified DCAP. Under the program, the employer reimburses Tim for all his dependent care expenses. However, during 2009, the employer only made \$3,000 of cash reimbursements. During 2010, an additional \$8,000 of cash reimbursements were made.

In applying the \$5,000 income exclusion cap and reporting the amount of dependent care assistance provided Tim during the year, the focus is on when Tim incurs the expense for dependent care assistance, not when the amount is actually reimbursed by the employer. Tim is deemed to receive \$6,000 of dependent care assistance in 2009, even though he only receives \$3,000 of cash reimbursements. Thus, the \$5,000 income exclusion cap is exceeded in 2009 by \$1,000. This \$1,000 is taxable employee compensation for FITW, FICA, and FUTA and is included as wages in Tim's W-2 for 2009. To comply with the reporting requirements of IRS Notice 89-111, Tim's employer reports \$6,000 of dependent care assistance as provided during the year.

In 2010, Tim is deemed to receive \$5,000 of dependent care assistance under the qualified DCAP, even though he actually receives \$8,000 in cash reimbursements. The \$5,000 income exclusion cap is not exceeded for 2010. Thus, all cash reimbursements for 2010 are tax-free. Tim's employer reports \$5,000 of dependent care assistance as provided to Tim during the year.

In-kind Assistance Is Provided When the Service Is Rendered. In-kind dependent care assistance is considered provided as the employer provides the actual services during the year. The amount of dependent care assistance used in computing the \$5,000 income exclusion cap and reporting the amount of dependent care provided during the year is the fair value of the assistance provided by the employer during the year, less any amount paid by the employee on an after-tax basis for such assistance.

For reporting in-kind dependent care assistance, FMV means the employer's reasonable estimate of the amount an employee would pay in an arm's length transaction for dependent care assistance of the type and quality furnished by the employer. If an in-kind program is part of a salary reduction arrangement under a cafeteria plan, the FMV of the dependent care assistance provided by the employer is the amount reported on Form W-2 even if this amount differs from the employee's elective contributions (plus any employer matching contributions) for the year.

For Form W-2 reporting purposes, an employer is permitted, but is not required, to estimate the FMV of in-kind dependent care assistance provided by using 125% of the reasonably estimated direct costs of providing the care as the FMV. For this purpose, direct costs are food, expendable materials and supplies, transportation, staff training, special or additional insurance directly attributable to the dependent care facility, periodic consulting or management fees directly related to the operation of the facility, and the labor cost for personnel who perform services primarily on its premises.

The 125% of direct costs is divided by the total number of dependents the facility is permitted to care for (capacity) and divided further by the number of days it is open. The result is the deemed daily cost per dependent at the facility. This result is then multiplied by the number of days that each dependent of the employee made use of the facility in order to determine the deemed FMV of the in-kind dependent care assistance provided by the employer to the employee during the year. These calculations may be adjusted to consider that individual dependents make use of the facility for only a portion of the full working day.

Example 1D-4 In-kind dependent care assistance exceeds the \$5,000 income exclusion limit.

ABC Computers, Inc., opens an on-site dependent care facility under a qualified DCAP program that is effective as of January 1 of the current year. There is no cost to employees for this benefit. ABC's reasonably estimated direct costs (food, supplies, labor, training, insurance, etc.) related to operating the dependent care facility are \$225,000 for the current calendar year. The facility has the capacity to handle 75 children per day and is open for 250 days during the current calendar year. Using the safe harbor FMV determination set forth

in IRS Notice 89-111, ABC estimates the value of the in-kind dependent care assistance provided to its employees to be \$15 per day per child [$(\$225,000 \times 1.25) \div 75 \text{ children} \div 250 \text{ days}$].

Nonhighly compensated employee Fred Hutton has two children who attend ABC's dependent care facility. Samantha, age 3, uses the facility for 240 days during the current calendar year, while Jimmy, age 10, attends the facility for 150 days. ABC determines the fair value of dependent care assistance provided to Fred as follows:

Samantha (240 days × \$15 per day)	\$ 3,600
Jimmy (150 days × \$15 per day)	<u>2,250</u>
FMV of in-kind dependent care	<u>\$ 5,850</u>

The fair value of Fred's use of the facility exceeds the \$5,000 income exclusion cap by \$850 (\$5,850 – \$5,000). ABC treats \$850 as paid for FIT, FITW, FICA, and FUTA purposes as of December 31 in accordance with the rules of IRS Ann. 85-113. ABC also reports this amount as taxable wages on Fred's Form W-2 in boxes 1, 3 (subject to the maximum social security wage base), and 5. ABC must provide Fred with a statement of the amount of dependent care assistance provided during the year. (Fred needs this information to calculate the proper amount of income to exclude or dependent care credit to claim on his personal Form 1040.) ABC reports \$5,850 of dependent care assistance in box 10 of Fred's Form W-2.

Treatment of Highly Compensated Employees

A nonqualified DCAP is one that does not meet the eligibility requirements of IRC Sec. 129. Under a nonqualified DCAP, a distinction must be made between highly and nonhighly compensated participants. A highly compensated employee is an employee who:

1. was a more-than-5% owner (or a family member of that owner) at any time during the current year or the preceding year; or
2. for the preceding year, (a) had compensation greater than \$80,000 as indexed for inflation (\$105,000 for 2008; \$110,000 for 2009), and (b) if the employer so elects, was in the top-paid group of employees.

Highly compensated employees who receive dependent care assistance under a nonqualified DCAP are not entitled to exclude any reimbursement amount from income. Instead, the entire amount of employer-provided dependent care assistance is subject to FITW, FICA, and FUTA and is reported as taxable wages on the employee's Form W-2.

Employees other than highly compensated employees do not include benefits (up to the exclusion limit) received under a DCAP in income even if the nondiscrimination tests are not met.

Example 1D-5 Reporting dependent care assistance under a nonqualified DCAP.

Assume the same facts as in Example 1D-1 except that Flexsteel chooses to not maintain a qualified DCAP (i.e., the company chooses to not comply with the requirements of IRC Sec. 129). What is the tax treatment of the direct reimbursements made to Jerry and Roger?

The \$3,700 paid to Jerry for dependent care assistance and the \$300 reimbursement that does not qualify as dependent care assistance are both taxable compensation for FIT, FITW, FICA, and FUTA and are included as wages on his W-2 because Jerry is a highly compensated employee. The \$5,000 reimbursement paid to Roger (who is not a highly compensated employee) is exempt from FITW, FICA, and FUTA and is not reported as taxable wages on his Form W-2. However, the \$1,000 (\$6,000 – \$5,000) excess reimbursement paid to him once again is subject to FIT, FITW, FICA, and FUTA and is reported as taxable wages on his Form W-2.

Flexsteel must provide Jerry and Roger with a statement of the amount of dependent care assistance provided during the year to enable them to calculate the proper amount of income exclusion and/or dependent care credit on their individual returns. This reporting requirement is met by including an amount of \$3,700 in box 10 of Jerry's W-2 and \$6,000 in box 10 of Roger's Form W-2.

Employee-level Rules and Reporting Requirements

The employer initiates the \$5,000 income exclusion by reporting the total amount of dependent care assistance in box 10 of the employee's Form W-2 but only reporting the amounts of assistance in excess of \$5,000 in boxes 1, 3 (subject to the maximum social security wage base), and 5. However, the actual amount of the income exclusion is ultimately determined at the employee level. The employee uses Form 2441 (Child and Dependent Care Expenses) or Schedule 2 (Form 1040A) to determine how much to include in income. The coverage in this lesson highlights some important rules and limitations imposed at the employee level.

Employers generally can treat up to \$5,000 of dependent care assistance as excludable unless they have reason to know the amount is not excludable (e.g., because the employee's earned income is less than \$5,000). The employee (not the employer) is responsible for ensuring that the requirements discussed below are met. Nevertheless, it is wise to require employees requesting reimbursement to provide information that the employer can use to determine if the payments are likely excludable.

Employer-provided dependent care assistance is excludable from the employee's income if the employee reports information concerning the dependent care provider on Form 2441 (Child and Dependent Care Expenses) if filing Form 1040, or on Schedule 2 if filing Form 1040A. The amount that can be excluded is limited to the smallest of (1) earned income of the lower-paid spouse, (2) qualified expenses incurred, (3) dependent care benefits received, or (4) \$5,000 (\$2,500 if married filing separately).

Generally, the employee will file either Form 2441 or Schedule 2 (Form 1040A) with his or her individual income tax return. In Part I of Form 2441/Schedule 2, the employee must report the dependent care provider's name, address, taxpayer identification number, and the amount paid to the provider. Otherwise, the income exclusion could be disallowed, unless the employee can show he or she exercised due diligence in trying to get the required information. The employee can use Form W-10 (Dependent Care Provider's Identification and Certification) to obtain the provider's name, address, and taxpayer identification number.

The employee also must complete Part III (Dependent care benefits) of Form 2441/Schedule 2, including providing the information from box 10 of Form W-2. The rest of Part III is used to calculate the employee's excludable dependent care benefits.

Earned Income Limitation for Income Exclusion or Dependent Care Tax Credit. An employee must have earned income to use the \$5,000 income exclusion for employer-provided dependent care assistance or to claim the dependent care credit. The term *earned income* has the same meaning for both the dependent care credit and the dependent care income exclusion provisions. A table that summarizes certain items included and excluded from an employee's earned income for purposes of the income exclusion and the credit is available in *PPC's Guide to Compensation and Benefits*.

If married, both spouses must have earned income to take advantage of the \$5,000 income exclusion or to claim the dependent care credit (and, generally, a joint return must be filed). However, a nonworking spouse who cannot physically or mentally care for him or herself or a spouse who is a full-time student is deemed to have earned \$250 for each such month for one qualifying person, or \$500 for two or more qualifying persons. In order to be a full-time student, the spouse must be enrolled at and attend a school for the number of hours that the school considers full time and must be a student for some part of at least five months during the year. (The months need not be consecutive.) The school must be an educational organization described in IRC Sec. 170(b)(1)(A)(ii), which is a school that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on. Night classes are permitted. Additionally, an organization that offers only online instruction will not qualify, but an organization that has traditional classroom instruction as well as online courses will.

Example 1D-6 Special earned income limitation for spouse who is a full-time student.

Jack and Susy Jacob are married and have one dependent child under age 13. Jack worked full-time in the current year and earned \$40,000. Susy was a full-time college student from January 1 through May 31. The

Jacobs were reimbursed by Jack's employer through a qualified DCAP for \$1,500 in dependent care expenses in that five-month period so Susy could attend school and Jack could work. Susy did not work for the remainder of the year because she was unable to find a suitable job. Nevertheless, Susy is deemed to have earned income of \$250 per month for each of the five months she was a full-time student, for a total of \$1,250. Therefore, they can exclude \$1,250 of the \$1,500 in dependent care assistance.

Double Benefit Not Allowed

To the extent an employee receives tax-free dependent care assistance from an employer-sponsored DCAP to pay dependent care expenses, the employee cannot claim the Section 21 dependent care credit for those expenses. However, since the amount of dependent care expenses that can be considered for the credit is \$6,000 for two or more dependents, employees with more than one dependent who receive \$5,000 of tax-free assistance, but who incur more than that in expenses, will have up to \$1,000 of expenses that qualify for the credit.

Employer-provided Child Care Credit

A tax credit is available to employers for child care assistance provided to employees. The credit is equal to 25% of the employer's qualified child care expenditures and 10% of its qualified child care resource and referral expenditures. The maximum credit allowed for a single tax year is \$150,000. Any amount taxpayers could otherwise claim as a deduction is reduced to the extent claimed as a credit. Similarly, if the credit is taken for acquiring, constructing, rehabilitating, or expanding a facility, the taxpayer's basis in the facility is reduced by the amount of the credit. Additionally, qualified child care services and qualified child care resource and referral expenditures must be provided in a way that does not discriminate in favor of highly compensated employees.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. John Stevens works for Railey Enterprises. Railey provides a DCAP for its employees; the DCAP is not included in a cafeteria plan. Stevens and his wife, Joan, have a 10-year old daughter, Stephanie. John's brother, Gregg, died 3 years ago and his son, Gary, came to live with them when he was 12 years old as an orphan. OASI provides about 25% of Gary's support each year but John and Joan provide the rest. Joan's 80-year old father, Harold, came to live with them last year after a serious financial crisis depleted most of his financial resources. Harold is physically and mentally fit, but John and Joan agree that Joan should stay home to look after him; Joan quit work last December. At the current tax year-end, who is a qualifying person under IRC 152?
- a. Joan.
 - b. Stephanie.
 - c. Gary.
 - d. Harold.
10. Jim's employer provides a DCAP not part of a cafeteria plan. Jim files for and receives reimbursement of the following costs for his 4-year old daughter under the DCAP: day care \$1,200; baby sitter when Jim works late \$400; clothing \$1,500; medicine \$400. How much of this amount will be excluded on Jim's W-2?
- a. \$1,600.
 - b. \$2,000.
 - c. \$3,100.
 - d. \$3,500.
11. Jane Brown is a highly compensated employee of Brown Associates. Brown Associates' only DCAP is not qualified under IRC Sec. 129. Last year, Jane filed for and received \$6,000 in employer reimbursements under the DCAP. Jane and her husband, George, filed separate income tax returns last year. How much of the DCAP reimbursement will be excluded on Jane's 1040?
- a. \$0.
 - b. \$2,500.
 - c. \$5,000.
 - d. \$6,000.
12. Which of the following is considered a highly compensated employee?
- a. One whose compensation for the preceding year (2008) was greater than \$75,000.
 - b. One who has a family member who is more-than-5% owner at any time during the current year.
 - c. One whose compensation for the preceding year (2009) exceeds \$105,000.
 - d. One who is in the mid-range salary of group of employees.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. John Stevens works for Railey Enterprises. Railey provides a Dependent Care Assistance Program (DCAP) for its employees. The DCAP is not included in a cafeteria plan. Stevens and his wife, Joan, have a 10-year old daughter, Stephanie. John's brother, Gregg, died 3 years ago and his son, Gary, came to live with them when he was 12 years old as an orphan. OASI provides about 25% of Gary's support each year but John and Joan provide the rest. Joan's 80-year old father, Harold, came to live with them last year after a serious financial crisis depleted most of his financial resources. Harold is physically and mentally fit, but John and Joan agree that Joan should stay home to look after him; Joan quit work last December. At the current tax year-end, who is a qualifying person under IRC 152? **(Page 154)**
 - a. Joan. [This answer is incorrect. If Joan is capable of caring for Harold, one must conclude that she is also able to care for herself. This means she is ineligible for DCAP.]
 - b. Stephanie. [This answer is correct. Stephanie is 10 years old during the time the care is provided; this is less than the DCAP age ceiling of 13 years. As a result, Stephanie is a qualified person under DCAP.]**
 - c. Gary. [This answer is incorrect. According to the Internal Revenue Code, Gary does not meet the age requirement to be a qualified person for DCAP.]
 - d. Harold. [This answer is incorrect. Harold's financial problems are not considered for DCAP. He is fit both mentally and physically; therefore, he is not a qualified person for DCAP.]

10. Jim's employer provides a DCAP which is not part of a cafeteria plan. Jim files for and receives reimbursement of the following costs for his 4-year old daughter: day care \$1,200; baby sitter when Jim works late \$400; clothing \$1,500; medicine \$400. How much of this amount will be excluded on Jim's W-2? **(Page 154)**
 - a. \$1,600. [This answer is correct. Per the Internal Revenue Code, the day care and sitter costs would be considered necessary to allow Jim to earn a living and provide for the protection and well-being of his daughter.]**
 - b. \$2,000. [This answer is incorrect. Per the Internal Revenue Code, the medicine would not be considered a qualified expenditure under the DCAP and any reimbursement would be considered additional income.]
 - c. \$3,100. [This answer is incorrect. Per the Internal Revenue Code, clothing is not considered a qualified DCAP expenditure and the reimbursement would be included on the W-2.]
 - d. \$3,500. [This answer is incorrect. Per the Internal Revenue Code, certain expenditures listed are not qualified for DCAP reimbursement and would be included on the W-2.]

11. Jane Brown is a highly compensated employee of Brown Associates. Brown Associates' only DCAP is not qualified under IRC Sec. 129. Last year, Jane filed for and received \$6,000 in employer reimbursements under the DCAP. Jane and her husband, George, filed separate income tax returns last year. How much of the DCAP reimbursement will be excluded on Jane's 1040? **(Page 154)**
 - a. \$0. [This answer is correct. Jane is a highly compensated employee and the DCAP is not qualified under IRC Sec. 129.]**
 - b. \$2,500. [This answer is incorrect. According to the IRS, special rules apply to highly compensated employees including that the plan needs to be qualified to allow a \$2,500 exclusion.]
 - c. \$5,000. [This answer is incorrect. The maximum exclusion allowed by IRC Sec. 129 is \$2,500 for a married employee filing separately.]
 - d. \$6,000. [This answer is incorrect. The maximum exclusion allowed by IRC Sec. 129 is \$5,000 under a qualified plan.]

12. Which of the following is considered a highly compensated employee? **(Page 154)**

- a. One whose compensation for the preceding year (2008) was greater than \$75,000. [This answer is incorrect. If the preceding year was 2008, the employee's compensation must exceed \$105,000 per the Internal Revenue Code.]
- b. One who has a family member who is more-than-5% owner at any time during the current year. [This answer is correct. According to the Internal Revenue Code, a highly compensated employee is an employee who was a more-than-5% owner (or a family member of that owner) at any time during the current year or the preceding year.]**
- c. One whose compensation for the preceding year (2009) exceeds \$105,000. [This answer is incorrect. If the preceding year was 2009, the employee's compensation must exceed \$110,000 per the Internal Revenue Code.]
- d. One who is in the mid range salary of group of employees. [This answer is incorrect. A highly compensated employee is an employee who if the employer so elects, was in the top-paid group of employees.]

Employer-provided Educational Assistance General Tax Treatment

Employers may provide employee educational benefits using any of the following educational programs:

1. *Qualified Educational Assistance Programs (Qualified EAPs)*. These are written programs designed to comply with the requirements of IRC Sec. 127 (including nondiscrimination rules). Both job-related and nonjob-related education may qualify. Under a qualified EAP, employees can exclude up to \$5,250 per calendar year of employer payments or reimbursements of qualified educational expenses for undergraduate courses and graduate courses. The federal payroll tax statutes adopt the Section 127 rules for qualified EAPs. Thus, the first \$5,250 of qualified educational assistance provided during the calendar year under a Section 127 program is exempt compensation for federal income tax (FIT), federal income tax withholding (FITW), social security and Medicare (FICA), and federal unemployment (FUTA) tax purposes, and it is not included as wages on the employee's Form W-2. Payments exceeding the \$5,250 limit are taxable employee compensation for FIT, FITW, FICA, and FUTA purposes and are included as wages on the employee's Form W-2.
2. *Job-related Educational Assistance*. Payments or reimbursements for job-related educational expenses may qualify for income exclusion as a working condition fringe under IRC Sec. 132(d). A working condition fringe includes educational assistance to the extent that, if the employee had paid for the educational assistance, it would have been deductible as an employee business expense under Reg. 1.162-5. For example, a course must relate to maintaining or improving the skills required by the employee's job (rather than meeting the minimum skill level required for the job), and the education itself must not lead to the individual qualifying for a new trade or business. The amount of the working condition fringe is exempt compensation for FIT, FITW, FICA, and FUTA and not included as wages on the employee's Form W-2. No dollar limit is imposed on the amount of job-related educational expense that may qualify as a working condition fringe.
3. *Qualified Tuition Reductions*. Educational institutions sometimes offer qualified tuition reductions (i.e., tuition waivers or discounts for classes taken by the employee or dependents at the employer institution). If the requirements of IRC Sec. 117(d) are met, the qualified tuition reduction for undergraduate courses is exempt compensation for FIT, FITW, FICA, and FUTA and is not included as wages on the employee's Form W-2. No dollar cap is placed on the amount of the reduction; however, special rules apply for tuition reductions or discounts for teaching and research assistants.
4. *Qualified Scholarships*. Employers may implement a scholarship program under IRC Sec. 117(b) to provide educational scholarships for employee's and/or their children and other dependents. If the requirements specified in Rev. Proc. 76-47 are met, the cost of qualified scholarships (primarily tuition, fees, and supplies) is deductible by the employer as a business expense, treated as exempt compensation for FIT, FITW, FICA, and FUTA, and not included as wages on the employee's Form W-2.
5. *529 Plans or Qualified Tuition Programs (QTPs)*. A QTP is a program that allows the prepayment of college credits for future use or contribution to an account set up for paying a student's qualified higher education expenses at an eligible educational institution. An employer can make a contribution for the employee to a specified QTP (and report the contribution amount as wages on the employee's Form W-2, subject to FIT, FITW, FICA, and FUTA). Alternatively, an employer can offer employees an after-tax payroll deduction that the employer would then send to a QTP, making it easier for the employee to fund the account. An employer can choose to select one QTP for all employees (i.e., each employee chooses whether to participate in this particular plan) or can send the employee's contributions to any QTP of the employee's choosing. It is easier for the employer to administer the program when a single QTP has been selected, however, this option is not as beneficial for employees because it limits their options. The income on the accounts is not taxable, and distributions used for qualified expenses are tax-free.
6. *Coverdell Education Savings Accounts (Coverdell ESAs)*. Coverdell ESAs are trusts or custodial accounts created to pay for the qualified education expenses of the account's designated beneficiary at an eligible elementary, secondary, or higher education facility. An employer can either make a contribution to a Coverdell ESA designated by an employee (and report the contribution amount as wages on the employee's Form W-2, subject to FIT, FITW, FICA, and FUTA) or it can offer employees an after-tax payroll deduction that the employer then sends to the employee's Coverdell ESA, making it easier for the employee to fund the account.

Qualified Educational Assistance Programs (Qualified EAPs)

Employers can annually provide each employee with up to \$5,250 of tax-free educational assistance (for both undergraduate and graduate courses) if the employer establishes a formal educational assistance program that meets the requirements of IRC Sec. 127(b).

The first \$5,250 of qualified educational assistance provided during the calendar year under a Section 127 program is exempt compensation for federal income tax (FIT), federal income tax withholding (FITW), social security and Medicare (FICA), and federal unemployment tax (FUTA) purposes. An employee cannot avoid the \$5,250 limit by forgoing receipt of reimbursements until another tax year. If the EAP fails the requirements of IRC Sec. 127, all payments are taxable employee compensation unless they qualify as a working condition fringe, qualified tuition reduction, or qualified scholarship.

Educational Assistance Exceeding the \$5,250 Income Exclusion Limit

If more than \$5,250 of educational assistance is provided to an employee in a program year and the educational assistance is provided for courses that are job related, the cost of educational assistance in excess of the \$5,250 income exclusion cap may qualify for tax-free treatment as a working condition fringe benefit. If the educational assistance is provided for courses that are not job related (i.e., do not qualify for working condition fringe benefit treatment), the proper treatment depends on whether the educational assistance is provided in the form of cash payments or in-kind educational assistance:

1. Cash payments (or reimbursements) for educational assistance in excess of the \$5,250 income exclusion cap are taxable employee compensation for FIT, FITW, FICA, and FUTA, and included as wages on the employee's Form W-2. The employer should treat excess assistance as wages when payments to (or on behalf of) the employee exceed the limit. The employee's FITW and FICA should be either collected from the employee or paid by the employer and reflected in a grossed-up wage computation. (If the employee works for more than one employer, the \$5,250 limit applies to the aggregate assistance provided by all employers.)
2. If in-kind educational assistance is provided, the fair value of the cost of educational assistance in excess of the \$5,250 income exclusion cap is taxable compensation for FIT, FITW, FICA, and FUTA and included as wages on the employee's Form W-2. This rule clearly applies to on-site education provided directly by the employer. It also appears to apply to education provided at a school but paid for directly by the employer.

Reg. 1.61-21(b)(3), which addresses the valuation of noncash fringe benefits, provides that when a code provision establishes a limited tax-free exclusion based on the employer's cost (i.e., IRC Sec. 127 provides income exclusion for educational assistance, the cost of which does not exceed \$5,250), the fair market value of the fringe benefit attributable to any excess cost is taxable employee compensation.

Under the noncash fringe benefit reporting rules, the employer is not required to withhold on the taxable amount of a noncash fringe benefit until the end of the calendar year.

Example 1F-1 Educational assistance exceeding the \$5,250 income exclusion limit.

Gleeson Products, Inc. maintains a qualified EAP that meets the requirements of IRC Sec. 127. Gleeson pays all the tuition and related expenses for employees who are pursuing degrees at local colleges and universities, and also reimburses other educational expenses on a 100% basis.

During the year, payroll clerk Sally Jones uses extended vacation leave to pursue an education degree at Private College. (Sally eventually wants to be a math teacher.) She completes 30 hours of course work and Gleeson pays \$6,000 to Private College. Sally also attends a one-week payroll seminar during the year. Registration, course materials, and travel costs equal \$2,000. Sally adequately substantiates her expenses, and Gleeson reimburses her for these costs. Sally's regular salary for the year is \$40,000.

Gleeson's direct payment of Sally's tuition to Private College qualifies as educational assistance under the qualified EAP even though it is not directly related to her current job and, in fact, qualifies her for a new trade

or business. (This education is not a working condition fringe.) The portion of the \$6,000 payment not exceeding the \$5,250 income exclusion limit is treated as exempt compensation for FIT, FITW, FICA, and FUTA, and not included as wages on Sally's Form W-2. The \$750 (\$6,000 – \$5,250) excess cost of qualified educational assistance is taxable employee compensation. Gleeson deducts the \$750 excess cost as compensation expense; subjects it to FITW, FICA, and FUTA, and reports it as taxable wages on Sally's Form W-2.

The \$2,000 reimbursement for Sally's payroll seminar is business-related and, thus, qualifies as a working condition fringe benefit. Gleeson treats this cost as exempt for FIT, FITW, FICA, and FUTA purposes, and does not report this amount as taxable wages on Sally's Form W-2.

Qualified EAPs and Cafeteria Plans

A cafeteria plan allows employees to choose between a benefit (e.g., medical, dental, dependent care assistance) or cash. However, a qualified EAP cannot offer a choice between educational assistance and taxable remuneration. Accordingly, EAPs are expressly prohibited from being included in a cafeteria plan.

Job-related Educational Assistance (Working Condition Fringe)

Job-related education may be furnished directly by the employer, either alone or in conjunction with other employers, or through a third party such as an educational institution or seminar organization. Employer payments or reimbursements for job-related educational expenses are excluded from the employee's income as a working condition fringe. The exclusion is available for any form of educational instruction or training that improves or develops the job-related capabilities of the individual and is otherwise deductible as a working condition fringe.

Spillover Costs under a Qualified EAP as a Working Condition Fringe

An employer who provides educational assistance under a qualified EAP may pay amounts in excess of the \$5,250 income exclusion limit allowed under those rules. If some of the educational assistance is provided for courses that are job-related, these costs—even though they exceed the \$5,250 cap—may qualify for exclusion as a working condition fringe benefit.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. When is an employer required to withhold on the taxable portion of in-kind educational assistance?
 - a. By June 30, and again on December 31.
 - b. When expenditures are incurred.
 - c. As the benefits are received.
 - d. By the end of the calendar year benefitted.

14. John works on the receiving dock for Marlynn Enterprises. Marlynn does not provide any educational assistance for its employees, but John wants to pursue an accounting degree and his employer has verbally agreed to pay for John's courses so long as he maintains a GPA of at least 3.20. Marlynn has also agreed verbally to create an opening for John in the accounting department when he receives his degree. Last year, John maintained a 3.40 GPA and was reimbursed \$6,000 for courses taken. How much of this amount will be included in his taxable wage?
 - a. \$0.
 - b. \$750.
 - c. \$5,250.
 - d. \$6,000.

15. Sallie works for Marvet Inc as a payroll clerk. She decided to pursue a degree in landscaping and began coursework last year. Courses are \$300 per semester credit hour, and each course is worth 3 credit hours. Sallie took 3 courses in the spring semester, 2 courses in each of the 2 summer sessions, and 3 courses in the fall semester. Books totaled \$800 for all courses during the year. Sallie filed for and received reimbursement from Marvet's qualified EAP for the spring and both summer semesters, but elected to wait until January to file for reimbursement related to book costs and the costs of fall registration. How much will be added to Sallie's taxable wage for last year as a result of her educational costs?
 - a. \$0.
 - b. \$1,050.
 - c. \$4,550.
 - d. \$9,800.

16. Max is a welder for Kleeco Industries. Kleeco encourages its employees to continue their education, and provides both in-house education and a qualified EAP. During the year, Max takes a photography course (\$300) and a bookkeeping course (\$300) via the local school's adult community education program. He also receives training to maintain his existing skills valued at \$6,000 via the company in-house training program and takes the company's in-house keyboarding course valued at \$120. How much educational assistance will be excluded from compensation as a working condition fringe?
 - a. \$1,470.
 - b. \$6,120.
 - c. \$6,720.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

13. When is an employer required to withhold on the taxable portion of in-kind educational assistance? **(Page 165)**
- By June 30, and again on December 31. [This answer is incorrect. In-kind educational assistance qualifies as a noncash fringe benefit for purposes of withholding and reporting.]
 - When expenditures are incurred. [This answer is incorrect. Noncash fringe benefit rules apply to in-kind educational assistance.]
 - As the benefits are received. [This answer is incorrect. Under noncash fringe benefit rules, the employer has some flexibility in how benefits are reported for tax purposes.]
 - By the end of the calendar year benefitted. [This answer is correct. Under the noncash fringe benefit reporting rules, the employer is not required to withhold on the taxable amount of a noncash fringe benefit until the end of the calendar year.]**
14. John works on the receiving dock for Marlynn Enterprises. Marlynn does not provide any educational assistance for its employees, but John wants to pursue an accounting degree and his employer has verbally agreed to pay for John's courses so long as he maintains a GPA of at least 3.20. Marlynn has also agreed verbally to create an opening for John in the accounting department when he receives his degree. Last year, John maintained a 3.40 GPA and was reimbursed \$6,000 for courses taken. How much of this amount will be included in his taxable wage? **(Page 165)**
- \$0. [This answer is incorrect. The courses do not qualify as working condition fringe.]
 - \$750. [This answer is incorrect. The verbal agreement does not meet the criteria for qualified EAP exclusion.]
 - \$5,250. [This answer is incorrect. If the agreement met qualified EAP requirements, this would be the maximum annual exclusion.]
 - \$6,000. [This answer correct. The verbal agreement does not meet IRC Sec. 127 requirements for a qualified EAP. The courses qualify John for a new occupation or career rather than maintaining existing skills and so do not qualify as a working condition fringe.]**
15. Sallie works for Marvet Inc as a payroll clerk. She decided to pursue a degree in landscaping and began coursework last year. Courses are \$300 per semester credit hour, and each course is worth 3 credit hours. Sallie took 3 courses in the spring semester, 2 courses in each of the 2 summer sessions, and 3 courses in the fall semester. Books totaled \$800 for all courses during the year. Sallie filed for and received reimbursement from Marvet's qualified EAP for the spring and both summer semesters, but elected to wait until January to file for reimbursement related to book costs and the costs of fall registration. How much will be added to Sallie's taxable wage for last year as a result of her educational costs? **(Page 165)**
- \$0. [This answer is incorrect. None of the costs can be considered a working condition fringe, so the qualified EAP exclusion limitation applies.]
 - \$1,050. [This answer is incorrect. While this answer includes the qualified EAP exclusion limitation, other factors must be considered per IRS regulations.]
 - \$4,550. [This answer is correct. Sallie's costs do not qualify as working condition fringe, so only the qualified EAP exclusion limitation applies; she cannot avoid this limitation by deferring filing for reimbursement until after the year ends.]**
 - \$9,800. [This answer is incorrect. The qualified EAP exclusion limitation must be considered as a factor.]

16. Max is a welder for Kleeco Industries. Kleeco encourages its employees to continue their education, and provides both in-house education and a qualified EAP. During the year, Max takes a photography course (\$300) and a bookkeeping course (\$300) via the local school's adult community education program. He also receives training to maintain his existing skills valued at \$6,000 via the company in-house training program and takes the company's in-house keyboarding course valued at \$120. How much educational assistance may be **excluded** from compensation as a working condition fringe? **(Page 166)**
- a. **\$1,470. [This answer is correct. All employer-reimbursed educational costs and the value of the employer-provided training programs would be included in the qualified EAP and excluded from the employee's W-2, subject to a \$5,250 cap. The spillover beyond the \$5,250 cap may qualify for exclusion from the employee's income as a working condition fringe.]**
 - b. \$6,120. [This answer is incorrect. According to the IRS, some of this amount would be considered excluded from income under the qualified EAP.]
 - c. \$6,720. [This answer is incorrect. According to the IRS, some of these costs would not be considered working fringe. They would be excluded from income under the qualified EAP.]

Dealing with Adoption Assistance Programs

An adoption assistance program is a separate written employer plan under which the employer provides adoption assistance to employees. In 2009, an employee can exclude from income qualified adoption expenses of up to \$12,150 for each eligible child paid by the employer under an adoption assistance program (AAP). For qualified adoption expenses paid or incurred in 2009, the amount excludable from income begins to phase out when the employee's modified AGI exceeds \$182,180 and is fully phased out when modified AGI reaches \$222,180. The employee (not the employer) is responsible for determining how much, if any, of the adoption assistance is taxable.

The \$12,150 limitation is not an annual limitation; instead, it applies to the adoption of each child and is cumulative (with respect to that child) over all tax years. Further, since the limitation applies to each child rather than each taxpayer, it will be the same for both married and unmarried individuals.

An eligible child is an individual who, when a qualified adoption expense is paid or incurred, is either under age 18 or physically or mentally incapable of taking care of himself. The IRS provides a uniform method for determining the age of a child for purposes of certain Code provisions, including IRC Secs. 23 (adoption credit) and 137 (adoption assistance programs). Under the ruling, a child attains a given age on the anniversary of the date that the child was born (i.e., on the child's birthday). A child who turned 18 during the year is an eligible child for the part of the year he or she was under 18.

To qualify for special tax treatment, the adoption assistance program must meet the requirements of IRC Sec. 137(c).

The year the payments under the adoption assistance program are excluded from an employee's income depends on whether the adoption is a foreign or domestic adoption. For domestic adoptions, the payments are excluded in the year that the employer pays the qualified adoption expenses. For foreign adoptions, the exclusion is allowed in the later of the year the adoption becomes final or the year the qualified adoption expenses are paid. If the expenses are paid in a year before the adoption becomes final, the employee includes the payments in income in the year the payments are received and makes an adjustment for the exclusion on Form 1040 for the year the foreign adoption is final. Expenses paid in the year the adoption becomes final are excluded in that same year. If the expenses are paid in a year after the adoption becomes final, the exclusion is allowed in the year of payment.

If an employee is adopting a special needs child, he or she can exclude a total of \$12,150 for 2009 of qualified adoption assistance, even if the actual adoption expenses incurred are less. Any excess exclusion (i.e., the amount needed to bring the total expenses for the adoption up to the maximum exclusion amount) is allowed in the year in which the adoption becomes final.

Claiming an Adoption Credit

Employees can also claim an income tax credit for qualified adoption expenses paid or incurred for the adoption of an eligible child. For amounts paid or incurred in 2009, the credit, like the exclusion, is subject to the \$12,150 and modified AGI limitations mentioned earlier in this lesson. An employee can claim a credit and an income exclusion for the adoption of the same (eligible) child but cannot claim both for the same expense. Additionally, an employee cannot claim a credit for any expense reimbursed by the individual's employer, whether or not reimbursed under an adoption assistance program. Taxpayers who adopt a child with special needs will be deemed to have qualified adoption expenses for tax credit purposes in the tax year in which the adoption becomes final in an amount sufficient to bring their total aggregate expenses for adoption up to the maximum exclusion amount (\$12,150 for 2009).

Including an Adoption Assistance Program in a Cafeteria Plan

An adoption assistance program that meets the requirements under IRC Sec. 137 is a qualified benefit under IRC Sec. 125 and thus may be offered under a cafeteria plan (including a cafeteria plan FSA). However, using pretax employee contributions in a cafeteria plan to fund adoption expenses can be risky for the employee because of the unpredictable timing and amount of adoption expenses (especially for foreign adoptions) and the use-it-or-lose-it rule applicable to cafeteria plans.

Employer's Payroll Tax and Reporting Requirements

All qualified adoption expenses paid or reimbursed by an employer under an AAP are exempt from federal income tax withholding (FITW). This is true even if these benefits exceed the \$12,150 (in 2009) amount excludable by the employee. However, all of the expenses paid or reimbursed are subject to social security and Medicare taxes (FICA) and federal unemployment tax (FUTA). Employers report all qualifying adoption expenses paid or reimbursed under the AAP for each employee for the year in box 12 of the employee's Form W-2. The code "T" is used to identify this amount as qualified adoption expenses. This amount is also included in the totals for social security wages (box 3) subject to the maximum social security wage base, and Medicare wages (box 5). However, it is not included with the employee's wages (box 1). If the adoption assistance program fails to meet the Section 137 requirements, all payments or reimbursements of adoption expenses are taxable employee compensation for FITW, FICA, and FUTA purposes.

Employers show the total amount paid or reimbursed for qualified adoption expenses furnished to an employee under a Section 137 adoption assistance program in Form W-2 box 12, using Code T. This includes benefits paid or reimbursed from an employee's pretax contributions to a Section 125 cafeteria plan (other than adoption benefits forfeited under the plan), as well as benefits that exceed the \$12,150 (in 2009) exclusion. It is up to the employee to make the appropriate adjustment on his or her Form 1040 to include in gross income the taxable portion of employer-provided adoption assistance. The employer is not required to figure the taxable amount and report it on the employee's Form W-2.

Example 1H-1 Payroll tax treatment of employer-provided adoption assistance.

QP, Inc. establishes an AAP on January 1, 2009 that meets the requirements of IRC Sec. 137. During 2009, QP pays \$14,000 of qualified adoption expenses on behalf of employee Jeff Newton in connection with Jeff's efforts to adopt an eligible child. QP's payments for adoption assistance are not reported as taxable wages in Form W-2 box 1 and are exempt from FITW. (Jeff computes the taxable portion of the payments on his Form 1040—see *PPC's 1040 Deskbook* for discussion of the employee reporting rules.) The \$14,000 of adoption assistance payments are, however, treated as wages for FICA and FUTA purposes. Accordingly, QP must withhold FICA and pay its share of those taxes (plus FUTA) on the payments. It also reports the \$14,000 in Form W-2 box 12 using Code T.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

17. Grace adopted Julie, a special needs child, in 2009. Adoption costs totaled \$12,000 and were all incurred in that year. Julie turned 18 years old July 1, 2009. Grace's employer does not have a qualified AAP benefit. What impact will the adoption costs have to Grace's 2009 1040?
 - a. Grace will adjust her taxable income by \$5,390.
 - b. Grace will adjust her taxable income by \$12,150.
 - c. Grace will adjust her tax due by \$12,150.
18. Which of the following statements concerning adoption assistance programs is correct?
 - a. Adoption assistance programs are specifically prohibited from cafeteria plans.
 - b. The employer is responsible for FITW on all AAP reimbursements during the year.
 - c. An AAP eligible child must be less than ten years old or considered special needs.
 - d. The AAP limitation is applied to each child without regard to the taxpayer's marital status.
19. Elsie works for FamilyFriendlyInc (FFI). FFI has an adoption assistance program for its employees. Over the course of 3 years FFI paid \$10,000 of qualified adoption expenses for Elsie to adopt a baby. Who is responsible for determining the amount of adoption assistance taxable to Elsie?
 - a. The employer.
 - b. The employee.
20. Which of the following statements regarding an employer's payroll tax and reporting requirements is most accurate?
 - a. Generally, most qualified adoption expenses paid by an employer under an AAP are exempt from FITW.
 - b. All reimbursed expenses are subject to Medicare taxes.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

17. Grace adopted Julie, a special needs child, in 2009. Adoption costs totaled \$12,000 and were all incurred in that year. Julie turned 18 years old July 1, 2009. Grace's employer does not have a qualified AAP benefit. What impact will the adoption costs have to Grace's 2009 income tax return? **(Page 170)**
- a. Grace will adjust her taxable income by \$5,390. [This answer is incorrect. According to the IRS, the special needs status of the child must be considered.]
 - b. Grace will adjust her taxable income by \$12,150. [This answer is incorrect. The employer does not have a qualified AAP. There was no reimbursement of costs, nor will there be.]
 - c. Grace will adjust her tax due by \$12,150. [This answer is correct. According to the Internal Revenue Code, Grace's employer has no provision for reimbursing adoption costs so there will be no adjustment to taxable income. The adoption credit applies. The child's special needs status overrides any proration of expenses resulting from Julie reaching 18 years old during the year of adoption. The maximum exclusion amount for 2009 is \$12,150. Total aggregate expenses for adoption of a special needs child are always the maximum exclusion amount per the IRC.]**
18. Which of the following statements concerning adoption assistance programs is correct? **(Page 170)**
- a. Adoption assistance programs are specifically prohibited from cafeteria plans. [This answer is incorrect. Adoption assistance programs are a qualified benefit under IRC Section 125. The use-it-or-lose-it rule may create unacceptable levels of risk however.]
 - b. The employer is responsible for FITW on all AAP reimbursements during the year. [This answer is incorrect. Employer payments or reimbursements of qualified expenditures under an AAP are exempt from FITW. The employee is charged with the responsibility of reporting adjustments to gross income on the Form 1040.]
 - c. An AAP eligible child must be less than ten years old or considered special needs. [This answer is incorrect. The child must be less than eighteen years old per the IRS.]
 - d. The AAP limitation is applied to each child without regard to the taxpayer's marital status. [This answer is correct. The limitation is cumulatively applied to all tax years concerning qualified adoption costs for that specific child.]**
19. Elsie works for FamilyFriendlyInc (FFI). FFI has an adoption assistance program for its employees. Over the course of 3 years FFI paid \$10,000 of qualified adoption expenses for Elsie to adopt a baby. Who is responsible for determining the amount of adoption assistance taxable to Elsie? **(Page 170)**
- a. The employer. [This answer is incorrect. Although employers must show the total amount paid for adoption assistance in box 12, using Code T, on the W-2, according to the IRS, the employer is not required to figure the taxable amount and report it on the employee's Form W-2.]
 - b. The employee. [This answer is correct. It is up to the employee to make the appropriate adjustment on her Form 1040 to include in gross income the taxable portion of employer-provided adoption assistance.]**

20. Which of the following statements regarding an employer's payroll tax and reporting requirements is most accurate? **(Page 171)**
- a. Generally, most qualified adoption expenses paid by an employer under an AAP are exempt from FITW. [This answer is incorrect. All qualified adoption expenses paid or reimbursed by an employer under an AAP are exempt from federal income tax withholding (FITW).]
 - b. All reimbursed expenses are subject to Medicare taxes. [This answer is correct. According to the IRS, all of the expenses paid or reimbursed are subject to social security and Medicare taxes (FICA) and federal unemployment tax (FUTA).]**

EXAMINATION FOR CPE CREDIT**Lesson 1 (PRLTG092)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Flex credits are funded by which of the following?
 - a. Employee elective contributions.
 - b. Established employer contributions.
 - c. Employee payroll deductions.
 - d. Employee selling paid time off (PTO).

2. Which of the following concerning benefits purchased under a cafeteria plan is correct?
 - a. Elective contributions to cafeteria plan long-term disability coverage should be taxed as the premiums are paid.
 - b. Excess cafeteria plan group term life coverage is to be reported on the employee's W-2 and FICA is withheld at least annually.
 - c. If allowed by the cafeteria plan, PTO may be bought and carried over no more than one additional plan year.
 - d. In applying employee PTO under a cafeteria plan, elective PTO should take priority over non-elective PTO.

3. From a taxability standpoint, cafeteria plan PTO available for purchase of other qualified plan benefits most closely resembles which of the following?
 - a. Elective benefits.
 - b. Taxable benefits.
 - c. Cash equivalents.
 - d. Flex credits.

4. The value of excess group-term life insurance is which of the following?
 - a. Taxable for purposes of FITW and FICA.
 - b. Excluded for purposes of FICA and FUTA.
 - c. Taxable for purposes of FIT and FICA.
 - d. Excluded for purposes of FIT and FUTA.

5. Which of the following occurs under a health FSA?
- a. The IRS limits employee contributions to \$5,000 for any one year.
 - b. The plan is prohibited from experiencing losses during the plan year.
 - c. An inventory information approval system can provide substantiation.
 - d. Health FSA debit card charges require no further substantiation.
6. Joe works for Gladly Industries. Gladly pays Joe a salary of \$3,000 on the last day of each month and provides a qualified cafeteria plan for its employees, including a dependent care FSA. The maximum Joe can contribute to the dependent care FSA in the current calendar year is \$3,600 and he has this amount deducted in equal installments from his paycheck. Joe began the year with a \$600 fund balance subject to the grace period and had contributed \$900 by the end of March. On April 2, Joe incurred \$4,200 in dependent care costs and filed for reimbursement of the entire amount three days later. How much will Joe receive from the dependent care FSA to reimburse him for these costs?
- a. \$900.
 - b. \$1,500.
 - c. \$3,600.
 - d. \$4,200.
7. Employer flex credits that are applied to a dependent care assistance FSA up to _____ per year are exempt from FITW, FICA, and FUTA and not reported as taxable wages on the employee's Form W-2.
- a. \$2,000.
 - b. \$2,500.
 - c. \$5,000.
 - d. \$5,500.
8. Qualifying adoption expenses reimbursed under a cafeteria plan are subject to which of the following:
- a. FIT and FUTA.
 - b. FUTA and Medicare.
 - c. FUTA and FICA.
 - d. FIT and FICA.

9. Sherry has cerebral palsy; her daughter, Julie, is a healthy 12 year old. Sherry requires significant care because of her disability, so she and Julie came to live with Sherry's step-sister, Gina, five years ago after Gina's divorce. Before he died, Sherry's father established a trust for the benefit of Sherry and Julie, administered by a local CPA. The trust provides income of \$60,000 to Sherry and \$30,000 to Gina each year based on their needs. Annual trust benefits are normally more than sufficient to provide for the needs of the beneficiaries so excess benefits remain in the trust for future distributions. Gina works as a middle-level manager for an employer having a DCAP that is not part of a cafeteria plan. This year she incurs qualified dependent care costs of \$4,000 for Sherry and \$2,000 for Julie, and would like to file for reimbursement of these costs under her employer's DCAP. How much of the reimbursement will be excluded from Gina's W-2?
- \$2,500.
 - \$4,000.
 - \$5,000.
 - \$6,000.
10. Which of the following can be a qualifying dependent for purposes of a DCAP outside a cafeteria plan?
- Grandson.
 - Grandfather.
 - Father-in-law.
 - Son-in-law.
11. Mary is a mid-level branch manager for Jainco. Jainco has had a qualified DCAP for the last 5 years but failed nondiscrimination tests last year. During that year, Mary filed, and received reimbursement for, the following expenses under the DCAP: after-school care for Mary's child—\$1,200; in-home care for Mary's invalid husband—\$2,500; vitamin supplements purchased over-the-counter and recommended by a leading children's health magazine—\$300. How much of Mary's DCAP reimbursements will be excluded from her wages reported for that last year?
- \$0.
 - \$2,500.
 - \$3,700.
 - \$3,730.
12. George works full-time for an employer who offers a DCAP not included in a cafeteria plan. Sue, his wife, attends class full-time for the entire year. George and Sue have one dependent child under the age of 13 and file a joint tax return. During the current year, George incurred \$4,500 of qualified expenditures for their child and received reimbursement under the DCAP. He also received \$600 for expenditures filed under the grace period for the previous tax year. George earned \$40,000. How much will be excluded from George's current year W-2?
- \$3,000.
 - \$4,500.
 - \$5,000.
 - \$5,100.

13. Which employer-provided employee educational assistance program is capped at \$5,250 for exclusion from the employee's W-2?
- a. Qualified EAP.
 - b. QTP.
 - c. Job-related educational assistance.
 - d. Coverdell ESAs.
14. Gemex joined an employer association in August of last year. The association provides training for member employees, funded through member dues. This training is continuing education meant to help employees maintain their skills and meet the demands of their existing jobs. Gemex paid prorated dues of \$10,000 and sent 10 members of its production workforce to the association's training classes. John was one of the Gemex employees sent to these classes. The 4 courses taken by John were valued at \$1,500 each. What amount of these courses will be excluded from John's taxable wage?
- a. \$1,000.
 - b. \$1,500.
 - c. \$5,250.
 - d. \$6,000.
15. Which of the following statements best describes a 529 Plan?
- a. A plan that allows prepayment of college credits for future use.
 - b. Custodial accounts created to pay for qualified educational expenses.
 - c. A working condition that includes educational assistance.
 - d. Reimbursements of qualified educational expenses for undergraduate courses.
16. Why are EAPs specifically prohibited from cafeteria plans?
- a. The DOL does not require reporting or disclosure of EAP benefits.
 - b. The IRS does not require Form 5500 filing regarding EAP benefits.
 - c. Employees cannot choose taxable remuneration in lieu of assistance.
 - d. Employees cannot postpone tax effects by delaying reimbursements.
17. In 2009, an employee can exclude from income qualified adoption expenses of up to _____ for each eligible child paid by the employer under an adoption assistance program (AAP).
- a. \$5,250.
 - b. \$12,150.
 - c. 25% of qualified expenses.
 - d. \$50,000.

18. The qualified AAP exclusion is completely phased out when the taxpayer's modified AGI reaches which of the following?
- a. \$180,820.
 - b. \$182,180.
 - c. \$200,820.
 - d. \$222,180.
19. Tommy is a qualified special needs child. Mark and Jean adopt Tommy in 2009 and all adoption costs were incurred during that year. Total qualified adoption costs were \$3,500. Nonqualified adoption costs were \$2,000. Mark files for and receives reimbursement under his employer's AAP benefit. What amount will be excluded from gross income on the couple's joint 1040?
- a. \$2,000.
 - b. \$3,500.
 - c. \$5,500.
 - d. \$12,150.
20. Jan's employer includes an elective qualified AAP with 100% match as part of its cafeteria plan. Last year, Jan electively contributed \$11,000 to the qualified AAP, then filed, and received reimbursement for \$24,000 in costs. How much should her employer include on her W-2 as taxable wages?
- a. \$0.
 - b. \$10,610.
 - c. \$12,610.
 - d. \$13,000.

Lesson 2: Health Insurance, Life Insurance, and Retirement Plans

INTRODUCTION

A company health plan is an arrangement that pays employees for illness or injury. The employer may contribute to the health plan either by paying the premium or a portion of the premium on a health insurance policy (an insured health plan), or by contributing to a separate fund that provides benefits directly to employees (a self-insured plan).

The rules governing the establishment and operation of health, life insurance, and retirement plans are extraordinarily complex. This lesson provides practical payroll tax guidance in dealing with them, but is not intended to be an exhaustive analysis. See *PPC's Guide to Compensation and Benefits*, *PPC's Guide to Small Employer Retirement Plans*, and *PPC's 5500 Deskbook* for more detailed coverage.

Learning Objectives:

Completion of this lesson will enable you to:

- Explain various issues concerning health plans and related contributions and reimbursements, describe tax requirements, and determine appropriate tax treatments.
- Describe executive supplemental medical reimbursement plans, characterize AD&D insurance, and describe related tax treatment.
- Differentiate between HSAs and FSAs, explain LTC insurance and disability income plans in general terms, and determine appropriate tax treatments related to MSAs, HSAs, FSAs, LTC insurance, and disability income plans.
- Describe rules and requirements related to group-term life and split-dollar life insurance, and determine appropriate tax treatments.
- Identify retirement plan categories, characterize 403(b) plans, and describe related tax issues.

Health Plan Qualifications

The ability to provide employees with tax-favored health coverage and benefits is predicated on the existence of a plan. The existence of a plan is important for the following reasons:

1. Employer premium contributions under a health insurance policy or to a self-insured plan are excludable from the employee's gross income and exempt from federal income tax withholding (FITW) only if paid under an accident or health plan. Similarly, these premiums are exempt from social security and Medicare (FICA) and federal unemployment (FUTA) taxes only if paid under a plan or system established by the employer.
2. Self-insured medical care reimbursements must be received under a health plan maintained for the employees to be excludable from the employee's gross income and exempt from income tax withholding on the same basis as reimbursements under insured plans.
3. Medical care reimbursements received by an employee, through insurance or otherwise, that are paid while the employee remains on the job or are paid within six calendar months following the calendar month in which the employee stops working for the employer, are exempt from FICA and FUTA taxes only if paid under a plan or system of the employer.

Generally, a plan for income tax purposes is also regarded as a plan for FICA and FUTA purposes. However, because these statutes provide somewhat different definitions of what constitutes a plan, this may not always be the case. An examination of what constitutes a plan for each statute is included in this lesson.

Meeting the Plan Requirement for Income Tax Purposes

Although IRC Sec. 106 contains the rules for employer contributions to health plans, it does not define an accident or health plan. However, Reg. 1.105-5 does, and this definition also applies for purposes of IRC Sec. 106. An

accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness. The plan may be either insured or self-insured; however, self-insured plans are subject to nondiscrimination requirements. For purposes of defining a plan, it is immaterial who makes payment of the benefits provided by the plan (which means that payment may be made through insurance, through a self-insured fund, or out of the employer's general assets).

A plan may cover current employees, their spouses, and dependents. A plan may cover one or more employees, and there may be different plans for different employees or classes of employees. However, a plan that covers an individual in a capacity other than as an employee does not constitute a plan. Self-employed individuals, including sole proprietors (including farmers), partners [including members of limited liability companies (LLCs) electing to be treated as partnerships], and more-than-2% S corporation shareholders do not meet the definition of an employee for accident or health plan purposes. However, except in the case of a more-than-2% S corporation shareholder, if an owner's spouse is a bona fide employee, the business can provide coverage to the spouse and the spouse's dependents (including the owner).

The plan may also cover the following individuals:

1. An employee who is laid-off but available to return to work, his or her spouse, and dependents.
2. An employee who is retired, his or her spouse, and dependents.
3. The spouse and dependents of a deceased employee.
4. A reservist called to active duty, his or her spouse, and dependents.
5. A full-time life insurance salesman that meets the special definition established for this purpose and presumably, his or her spouse and dependents.
6. An employee who has terminated employment but has opted for continuation coverage under COBRA, his or her spouse, and dependents.
7. For the exclusion of contributions to an accident or health plan, leased employees who have provided services on a substantially full-time basis for at least a year if the services are performed under the recipient's primary direction or control.

Dependent Defined. A *dependent* is defined under IRC Sec. 152, determined without regard to IRC Secs. 152(b)(1), (b)(2), and (d)(1)(B). Under this definition, a *dependent*, for employer-provided health coverage purposes, is a "qualifying child" or a "qualifying relative" who is a U.S. citizen or national, or a resident of the United States, Canada, or Mexico. However, this nationality test will not exclude a legally adopted child who is not a U.S. citizen or resident if the taxpayer is a U.S. citizen or national and the taxpayer's home is the child's principal place of abode.

An employer may provide benefits to an employee's domestic partner under its group health insurance plan, regardless of gender. However, if the domestic partner does not qualify as a dependent under IRC Sec. 152 or as a spouse of the employee (e.g., where an employee has not contracted a valid common-law marriage), the coverage is taxable to the employee. The IRS has noted that under the Defense of Marriage Act, the word "spouse" refers only to a person of the opposite sex who is a husband or wife within a legal union between one man and one woman. Thus, a same-sex domestic partner cannot qualify for tax-free coverage as a spouse, but can qualify as a dependent. The IRS has indicated it will determine dependency on a case-by-case (facts and circumstances) basis.

When a domestic partner is not a dependent or spouse of the eligible employee, the excess of the FMV of group medical coverage provided by the employer to the domestic partner and the domestic partner's dependents over the amount, if any, paid for such coverage by the employee on an after-tax basis, is taxable income to the employer that is subject to FITW, FICA, and FUTA and reported as taxable wages on the employee's Form W-2, because the value of the coverage does not qualify for exclusion under IRC Sec. 106. Since the coverage's value is included in the employee's income, the actual benefit payments will not be taxable pursuant to IRC Sec. 104(a)(3). Similarly, if the coverage is paid by the employee rather than the employer, IRC Sec. 104(a)(3) provides that the actual benefits are nontaxable.

FICA and FUTA Require a Plan or System of the Employer

The FICA and FUTA statutes require the existence of a plan or system established by the employer that makes provision for its employees generally (and their dependents), or for a class or classes of its employees (or for a class or classes of its employees and their dependents). A plan normally exists if any of the following conditions is present:

1. The plan or system is in writing or is otherwise made known to employees (e.g., through a bulletin board announcement, description in the employee handbook, etc.).
2. There is a reference to the plan or system in the contract of employment.
3. Employees contribute to the plan or system, or the employer is required to make the payments.
4. There is a fund or account for payments, separate and apart from the employer's general salary or wage accounts.

The FICA and FUTA regulations define a dependent to include spouse, children, and any other members of the employee's immediate family. However, the FICA and FUTA regulations do not define the term *class of employees*. Presumably, any reasonable classification should suffice. Because nondiscrimination requirements are not applicable for FICA or FUTA, it appears a plan tailored solely toward highly compensated employees or key executives will satisfy the class of employees requirement.

Employer-Paid Health Insurance Premiums

The fair market value (FMV) of employer-provided coverage under a health plan is excluded from the employee's gross income. The benefit is not reported as wages on the employee's Form W-2 and is exempt from federal income tax withholding (FITW). The employer may contribute to the health plan by paying the premium (or a portion of the premium) on a health insurance policy covering one or more employees. Alternatively, the employer can contribute to a separate trust, fund, or organization that provides health benefits directly or through insurance to one or more employees. [This may include, for example, an employer's or employee's association, a tax-exempt trust under IRC Sec. 501(c)(9) known as a voluntary employees' beneficiary association (VEBA), or some other fund or trust established for this purpose.]

The exclusion for employer-provided coverage also applies for social security and Medicare (FICA) and federal unemployment (FUTA) if the employer's premium contributions (whether for insurance or to a self-insured fund) are made under a plan or system established by the employer that provides for (1) its employees generally (or for its employees generally and their dependents) or (2) a class or classes of its employees (or for a class or classes of its employees and their dependents).

Example 2B-1 Employer-paid premiums are exempt from income and payroll taxes.

Standard Corporation maintains an insured health plan. The company makes monthly premium contributions to an independent insurance company for health insurance coverage for its employees. The FMV of the premium payments is excluded from the employees' gross income, not reported as wages on their returns, and exempt from income tax withholding. Furthermore, since the payments are made under a plan established by the employer that provides for its employees generally, they are also exempt for FICA and FUTA. These same tax results occur if Standard contributes the premiums to a trust fund (possibly a tax-exempt VEBA) under a self-insured health plan.

Payments made directly to employees by an employer to reimburse the employees for health insurance premiums that they paid may also be excluded from an employee's income. Substantiated individual policy health insurance premiums may also be paid or reimbursed through a cafeteria plan (but not through a health FSA). This exclusion also applies to COBRA premium payments made by a former employer. In addition, an employee or former employee may make a pre-tax election to pay for COBRA coverage through a cafeteria plan, including coverage under a former employer's plan. Employers must require proof of prior payment of the premiums as a condition of

the reimbursement. In addition, the exclusion from income applies only if employees do not have a right to receive cash or any other form of cash benefit in lieu of the premium reimbursements.

The IRS, citing Rev. Ruls. 62-199 and 75-539, has concluded that contributions made by an employer that are used exclusively to pay for accident and health coverage of retired employees, and their spouses and dependents, may be excluded from the retirees' income under IRC Sec. 106. The IRS also concluded that the payment and reimbursement of medical care expenses to retired employees, and their spouses and dependents, were excludable from the gross income of retired employees under IRC Sec. 104(a)(3) or 105(b).

Employee Contributions toward Company Health Plan Coverage

Amounts withheld from an employee's pay on an after-tax basis and contributed toward the purchase of company health plan coverage are subject to FITW, FICA, and FUTA and are reported as taxable wages on the employee's Form W-2. However, if the company offers health plan coverage as a qualified benefit under an IRC Sec. 125 cafeteria plan, amounts withheld from the employee's pay on a pretax basis (salary reduction) to purchase health plan coverage are not subject to FITW, FICA, and FUTA and are not reported as taxable wages on the employee's Form W-2.

Example 2B-2 Premiums paid by an employee through salary deduction are subject to income and payroll taxes.

Assume the same facts as in Example 2B-1 except employees adopting family coverage must contribute \$150 per month toward the cost of the coverage. Standard does not maintain a cafeteria plan. Accordingly, the employee's monthly share of the health insurance premiums are deducted from their wages on an after-tax basis (i.e., a salary deduction). The employees' share of the premium is subject to all income and employment taxes, although the employees can claim their share of the premium as an itemized deduction.

Payment of Health Insurance Premiums on Behalf of Self-employed Persons

The accident and health insurance provisions within the Internal Revenue Code do not specify the term *employee* to include self-employed persons. For this purpose, self-employed persons generally include sole proprietors (including farmers), partners, members of limited liability companies (LLCs) electing to be treated as partnerships, and more-than-2% S corporation shareholders. However, the underlying business must be one in which the personal services of the self-employed person are a material income-producing factor. As explained in the following paragraphs, the treatment of accident and health insurance premiums paid on behalf of a self-employed person differs depending on the entity making the payment.

Sole Proprietorships. No business deduction is allowed by a sole proprietorship for accident and health insurance premium payments made on behalf of a sole proprietor (and the sole proprietor's spouse and dependents). Instead, the sole proprietor generally can deduct (as a special above-the-line nonbusiness deduction on his or her individual tax return) 100% of the cost of the premiums. The policy may be in the name of the business or the individual. A sole proprietorship can, however, deduct premium payments for coverage of the sole proprietor's spouse or dependent as long as the spouse or dependent is a bona fide employee of the sole proprietorship.

Partnerships. The proper treatment of accident and health insurance premiums paid on behalf of a partner (and the nonemployee spouses and dependents of partners) vary based on whether the payments are for services rendered in the capacity of a partner and are made without regard to partnership income. There are two potentially acceptable treatments:

1. If the premium payments are for services rendered in the capacity of a partner and made without regard to partnership income, the payments should be reported as guaranteed payments. These payments are deducted on page 1 of Form 1065 (U.S. Partnership Return of Income) and reported as income to the recipient partners on their respective Schedules K-1. Effectively, this guaranteed payment treatment means the partnership deducts the payments and the recipient partners report the payments as taxable income (self-employment income). In addition, these payments should be disclosed on Schedule K-1 to give the partner the information needed to take a deduction on the partner's return.

2. If the premium payments are not for services rendered in the capacity of a partner, or the payments depend upon the partnership's income, the partnership can treat the premium payments as distributions to the recipient partners. Amounts treated as distributions should be reported on line 19 of Schedule K-1. Once again, the payments should be disclosed on Schedule K-1 to give the partner the information needed to take a deduction on the partner's return.

A spouse or dependent of a partner can receive tax-free coverage under a health plan that covers employees as long as the spouse or dependent is a bona fide employee of the partnership.

S Corporations. Accident and health insurance premiums paid on behalf of more-than-2% S shareholder-employees are reported as additional compensation to the shareholders and are considered supplemental wages. The additional compensation is reported as wages on the shareholder-employee's Form W-2 and is deducted as compensation of officer or as wages and salaries on page 1 of the corporation's Form 1120S (U.S. Income Tax Return for an S Corporation). The compensation is subject to federal income tax withholding (FITW), computed using the rules for withholding on supplemental wages. The compensation is not taxable for FICA and FUTA tax purposes if the premium payments are made pursuant to a plan providing accident and health coverage. Under the family attribution rules of IRC Sec. 1372(b), the spouse, children, grandchildren, and/or parents of a more-than-2% S shareholder-employee are considered to own the shareholder's stock. Thus, the spouse, children, grandchildren, and/or parents of a more-than-2% S shareholder-employee are also considered more-than-2% S shareholders and the taxable fringe benefit rules discussed in this paragraph apply.

Example 2B-3 Reporting health insurance premiums paid for a greater-than-2% S shareholder.

Jerry and Al each own 50% of Jerrico, Inc., an S corporation. Jerry is employed full-time by the company, and Al is a passive investor who is not employed by the company. Jerrico paid Jerry a salary of \$60,000 in the current year, and also paid \$4,000 in medical insurance premiums on his behalf. Nonseparately stated business income for the current year is \$144,000 before the \$4,000 deduction for medical insurance premiums.

According to Rev. Rul. 91-26 and Ann. 92-16, Jerry's medical insurance premiums are subject to FITW and are reported as taxable wages on his Form W-2 but are not subject to FICA and FUTA. His Form W-2 reflects gross wages of \$64,000 and FICA wages of \$60,000, while his Schedule K-1 reflects nonseparately stated income of \$70,000 [$50\% \times (\$144,000 - \$4,000 \text{ medical premiums})$]. His Schedule K-1 also contains a disclosure that he may be entitled to an IRC Sec. 162(l) above-the-line deduction for medical insurance paid by a self-employed individual.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Which of the following statements concerning health care coverage is correct?
 - a. Favorable tax treatment of employee health care coverage requires the existence of a health plan.
 - b. Employer contributions to a health plan are not exempt from FITW and FUTA if self-insured.
 - c. Medical care reimbursements paid more than three months after employment termination are subject to FICA.
 - d. Self-insured medical care reimbursements are not excludable from the employee's gross income.

22. Concerning employer-provided health care plans, FICA and FUTA regulations do which of the following?
 - a. Define a dependent in the same way as does IRC Section 152.
 - b. Require that four specific conditions be met to establish the existence of a plan.
 - c. Do not seem to prevent a discriminatory plan tailored for highly paid executives.
 - d. Very specifically define the term "class of employees."

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. Which of the following statements concerning health care coverage is correct? **(Page 183)**
- a. **Favorable tax treatment of employee health care coverage requires the existence of a health plan. [This answer is correct. Without a health care plan, tax-favored treatment is not available for employer contributions and employee reimbursements.]**
 - b. Employer contributions to a health plan are not exempt from FITW and FUTA if self-insured. [This answer is incorrect. If requirements are met, such contributions are exempt in much the same way as they would be if made to a health insurance policy.]
 - c. Medical care reimbursements paid more than three months after employment termination are subject to FICA. [This answer is incorrect. If other requirements are met, such reimbursements are exempt from FICA within six months of employment termination.]
 - d. Self-insured medical care reimbursements are included in the employee's gross income. [This answer is incorrect. If all requirements are met, self-insured medical care reimbursements are excludable from the employee's gross income and exempt from FITW on the same basis as under insured plans.]
22. Concerning employer-provided health care plans, FICA and FUTA regulations do which of the following? **(Page 183)**
- a. Define a dependent in the same way as does IRC Section 152. [This answer is incorrect. IRC Section 152 is quite specific in its definition of a dependent when compared with the same definition under FICA and FUTA regulations.]
 - b. Require that four specific conditions be met to establish the existence of a plan. [This answer is incorrect. Four conditions are listed, but the requirement is for any one, not all, of the conditions to exist.]
 - c. **Do not seem to prevent a discriminatory plan tailored for highly paid executives. [This answer is correct. Nondiscriminatory requirements do not apply, and the term "class of employees" is not defined under FICA and FUTA regulations.]**
 - d. Very specifically define the term "class of employees." [This answer is incorrect. In fact, FICA and FUTA regulations do not define the term at all.]

Reimbursements for Medical Care

Medical care reimbursements are proceeds received by the employee for hospitalization or medical expenses (i.e., medical care) incurred by the employee, his or her spouse, or his or her dependent(s) resulting from sickness or injury. (This does not include accident benefits received under AD&D policies or sick pay.)

Income Tax Treatment

Medical care reimbursements received through accident or health insurance, or through accident or health plans that meet the requirements of Reg. 1.105-5, are excluded from an employee's gross income if such amounts are paid directly or indirectly to the employee as reimbursement for expenses incurred for medical care of the employee, his or her spouse, or his or her dependents. This is also true for medical care reimbursements under health plan coverage offered through an employer-sponsored IRC Sec. 125 cafeteria plan, flexible spending arrangement (FSA), and health savings account (HSA).

The reimbursed expenses must be incurred for medical care as defined in IRC Sec. 2139(d) (i.e., are paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body). Over-the-counter (nonprescription) drugs can be reimbursed on a tax-free basis through an employer's health plan. However, this does not include amounts reimbursed for dietary supplements (e.g., vitamins) that are merely beneficial to the employee's general health.

Generally, medical expenses that may be reimbursed do not include the cost of prescription drugs imported from another country. Medical expenses as defined in IRC Sec. 213(d) include only items that are legally procured. However, prescription drugs approved for importation by the Food and Drug Administration do qualify for reimbursement. In addition, the cost of a prescription drug purchased and consumed in another country qualifies for reimbursement if the drug is legal in both the other country and the United States.

Taxation of Reimbursements to Self-employed Persons. Reimbursements to self-employed persons for qualified medical expenses are excluded from the individual's income if the medical plan is not self-insured. If the medical plan is self-insured, the reimbursements are excluded from the self-employed person's income only if the plan has the characteristics of insurance (e.g., there must be adequate risk shifting). Additionally, if the plan is self-insured and discriminatory, highly compensated employees, which might include self-employed persons, must include certain amounts (referred to as excess reimbursements) in income.

Payroll Tax Treatment

Medical care reimbursements are exempt from income tax withholding if they are excluded from the employees' gross income for federal income tax purposes. They are also exempt from the payment of employment taxes if made under a plan or system of the employer. These exclusions apply whether the medical care reimbursement is received from (1) insurance, (2) a fund under a self-insured plan, or (3) direct reimbursement from the employer's general assets. The following summarizes the applicable rules for purposes of each payroll tax statute:

1. *Federal Income Tax Withholding (FITW).* Medical care reimbursements received by the employee through insurance are exempt from FITW if they are excludable from the employee's income for FIT purposes under IRC Sec. 105 and Reg. 1.105-1. All medical care reimbursements received from self-insured plans are exempt from FITW including amounts constituting excess reimbursements paid to highly compensated participants that are taxable for FIT under IRC Sec. 105. This latter rule is true for reimbursements from a fund and direct payments out of the general assets of the employer.
2. *Social Security and Medicare (FICA) Taxes.* Medical care reimbursements paid to or on behalf of an employee or any of his dependents under a plan or system established by the employer that provides for its employees generally (and their dependents), or for a class(es) of its employees (and their dependents) are exempt from FICA tax. This includes reimbursements through insurance or a self-insured plan. If the employer does not maintain a plan or system for employees, only medical expense reimbursements paid by the employer to, or on behalf of, the employee after the expiration of six calendar months following the last calendar month in which the employee worked for the employer are exempt from FICA tax.
3. *Federal Unemployment Tax (FUTA).* The FUTA statute adopts the FICA provision.

Example 2C-1 Medical expense reimbursements are exempt from taxation.

ABC Corp. maintains a self-insured health care plan for its employees under which ABC contributes to a tax-exempt trust established under the plan. The contributions are used to (1) buy stopgap insurance to protect against large claims, and (2) reimburse employees for medical care expenses up to the specified limits at which the medical (stopgap) insurance kicks in. Employee Sharon Smith (a nonhighly compensated employee) incurs \$3,000 of medical care expenses in May. In July, her medical care provider receives a reimbursement of \$1,000 from the trust established under the self-insured plan. During August, her medical care provider receives a reimbursement of \$2,000 from the insurance company. These medical care reimbursements are excluded from Sharon's gross income, exempt from income tax withholding, and exempt from FICA and FUTA tax.

Example 2C-2 Reimbursements outside of plan are subject to income and payroll taxes.

TBC, Inc. does not maintain a health plan for its employees. Employee Ted Sample is partially paralyzed in a car accident in April and incurs \$25,000 in medical expenses not covered under his individual insurance policy. It is uncertain whether Ted will ever return to his job. Since Ted has been a loyal and hardworking employee for many years, TBC decided to help Ted with a portion of his uncovered medical expenses and paid him \$8,000 in July and \$7,000 in November. Ted's salary prior to the accident is \$30,000.

Because TBC does not maintain a health plan within the meaning of Reg. 1.105-5, the reimbursements are included in Ted's taxable wages and are subject to income tax withholding (FITW). Since TBC does not maintain a plan or system for reimbursing medical or hospitalization expenses incurred due to sickness or injury, the \$8,000 reimbursement made within six months of the last month that Ted worked is subject to FICA and FUTA. However, the \$7,000 reimbursement made after this six-month period is exempt from FICA and FUTA under IRC Secs. 3121(a)(4) and 3306(b)(4).

Health Reimbursement Arrangements (HRAs)

What Is a Health Reimbursement Arrangement? A health reimbursement arrangement (HRA) is an arrangement that:

1. is paid for solely by the employer (HRAs are not available for self-employed individuals) and not provided pursuant to a salary reduction election or otherwise under a Section 125 cafeteria plan;
2. reimburses the employee for qualified medical care expenses incurred by the employee or dependents [i.e., any expenses incurred for medical care as defined in IRC Sec. 213(d)]; and
3. provides reimbursements up to a maximum dollar amount for a coverage period (generally, the calendar year).

Any amount left in an HRA at year-end may be carried over to subsequent years to increase the maximum reimbursement amount available in that future period. In addition, if an employee retires or otherwise terminates employment, employers may (but are not required to) continue to make any unused amount in the former employee's HRA account available to the individual (or dependents) for eligible medical expenses [as defined in IRC Sec. 213(d)(1)(A), (B), and (D) but not long-term care expenses].

Tax Treatment of HRAs. Coverage and reimbursements under an HRA for medical care expenses of the employee and dependents are normally nontaxable to the employee under IRC Secs. 105 and 106. To receive this favorable treatment, an HRA may only provide benefits that reimburse for qualified medical expenses [as defined in IRC Sec. 213(d) including over-the-counter (nonprescription) drugs (but not dietary supplements)]. In addition, each medical care expense submitted for reimbursement must be substantiated and must have been incurred both after the HRA was set up and after the employee enrolled in the HRA. With proper substantiation, employees can exclude from gross income medical and dental expense reimbursements made under HRAs through debit or credit cards or other electronic media (e.g., a stored-value card). The same rules that are explained in Lesson 1 for using credit or debit cards for reimbursements through health FSAs apply to HRAs.

Since an HRA is normally a self-insured medical expense reimbursement plan (i.e., employers generally will not buy insurance to cover the expense of what they contribute to an HRA because it would not be cost-effective), the nondiscrimination rules under IRC Sec. 105(h) and Reg. 1.105-11 apply. Therefore, highly compensated individuals are taxed on their benefits received under the plan if the HRA discriminates in their favor as to eligibility to participate or benefits received.

Self-insured Health Plans Are Subject to Nondiscrimination Requirements for Income Tax Purposes

Self-insured health (medical reimbursement) plans are subject to special nondiscrimination requirements for both eligibility and benefits. These prevent employers from establishing tax-free medical expense reimbursement plans that benefit only highly compensated or key employees. For both highly and nonhighly compensated individuals, premium contributions paid by the employer under a discriminatory plan are excluded from the employee's income. If the nondiscrimination requirements are violated, reimbursements paid to nonhighly compensated individuals remain tax-free; however, highly compensated individuals must include in their gross income any excess reimbursements.

The nondiscrimination rules apply only to self-insured health plans for federal income tax (FIT) purposes. These nondiscrimination rules are not applicable for income tax withholding or employment tax purposes, and insured health plans are not subject to the nondiscrimination requirements for FIT purposes.

Distinguishing Insured and Self-insured Health Plans

A self-insured health plan is a separate written plan for the benefit of employees under which employees are reimbursed for sickness or injury expenses [as referred to in IRC Sec. 105(b)] with the employer's own funds rather than under an insurance policy maintained by the employer. The employer may establish a separate fund or trust to which premium contributions are made and from which medical care reimbursements are paid, or reimburse an employee's medical care directly out of general assets. In either instance, the plan document must identify the medical benefits to be provided. Medical expense reimbursements not described in the plan are not considered paid under the plan and thus are not excludable from the employee's gross income (even if the nondiscrimination rules are met). However, such expenses do not affect the determination of whether the plan is discriminatory.

The shifting of risk is the litmus test for determining whether a plan is self-insured. A plan or arrangement is self-insured unless reimbursement is provided under an individual or group health insurance policy issued by a licensed insurance company, or under a prepaid health care plan regulated under federal or state law in a manner similar to insurance companies.

The nondiscrimination rules apply to the self-insured portion of an employer's medical plan or arrangement even if the plan is in part underwritten by insurance. For example, an otherwise insured plan that reimburses an employee's uninsured expenses or deductible must satisfy the nondiscrimination rules with respect to such reimbursements. However, the portion of the plan that is insured is not subject to these rules, nor is the reimbursement of an employee's insurance premiums.

Special Rules for Sole Proprietorships. Medical benefits paid from a self-insured plan can be excluded from the sole proprietor's income only if the plan or other arrangement has the characteristics of insurance (e.g., there must be adequate risk shifting). If the self-insured plan does not have the characteristics of insurance, medical benefit payments made to a sole proprietor are not deductible by the business nor are they excludable from the sole proprietor's income. This rule applies only if the sole proprietor is the plan participant. It does not apply if such individual's spouse, who is a bonafide employee, is the participant.

Special Rules for Partners and More-than-2% S Corporation Shareholders. Although no direct authority exists, it is believed that medical benefit payments to partners (who provide services to the partnership) and more-than-2% S corporation shareholder-employees under a self-insured plan are deductible by the partnership and S corporation and includable in income by the partners and more-than-2% shareholders using the rationale of Rev. Rul. 91-26 and IRS Notice 2008-1. Since the plan is not insured, the benefits cannot be excluded from income for such partners and more-than-2% S shareholders under IRC Sec. 104(a)(3). Unless the plan or other arrangement has the characteristics of insurance (e.g., there must be adequate risk shifting).

Meeting the Nondiscrimination Requirements

A self-insured medical reimbursement plan satisfies the nondiscrimination rules only if it meets the following two requirements: (1) the plan does not discriminate in favor of highly compensated individuals as to eligibility to participate, and (2) the benefits provided under the plan do not discriminate in favor of participants who are highly compensated individuals. A brief discussion of the nondiscrimination requirements follows.

A highly compensated individual includes an employee who is: (1) one of the five highest paid officers, (2) a shareholder who owns (with the application of IRC Sec. 318) more than 10% in value of the employer's stock, or (3) among the highest paid 25% of all employees. [See IRC Sec. 105(h)(3)(B) for employees who are excluded from the group of the highest paid 25% of all employees.] The status of an employee as an officer or shareholder is determined at the time the benefit is provided.

Eligibility/Participation Requirement. A self-insured plan satisfies the eligibility requirement if the plan benefits (1) 70% or more of all employees, (2) 80% or more of all employees who are eligible to benefit under the plan if 70% or more of all employees are eligible to benefit under the plan, or (3) such employees as qualify under a classification set up by the employer and found by the IRS not to be discriminatory in favor of highly compensated individuals (this is determined based on the facts and circumstances of each case). The IRS provides a safe harbor ratio test that self-insured health plans can use to determine if any classification of employees discriminates in favor of highly compensated individuals. The safe harbor ratio test is satisfied if the percentage of nonhighly compensated individuals benefiting under the plan is at least 70% of the percentage of highly compensated individuals benefiting under the plan.

Benefits Requirement. A self-insured plan does not meet the benefits requirement unless all benefits provided for participants who are highly compensated individuals are provided for all other participants. In addition, the benefits available to dependents of highly compensated participants must also be available on the same basis to dependents of all other employees who are participants. A plan may establish a maximum limit for the amount of reimbursement that may be paid a participant for any single benefit or combination of benefits. However, any maximum limit attributable to employer contributions must be uniform for all participants and for all dependents of employees who may participate, and may not be modified by reason of a participant's age or years of service. In addition, if a plan covers highly compensated individuals, and the type or amount of benefits subject to reimbursement under the plan are proportionate to employee compensation levels, the plan discriminates as to benefits.

The plan also must not discriminate in favor of highly compensated individuals in its actual operation. This determination is made on the basis of the facts and circumstances of each case. A plan is not considered discriminatory merely because highly compensated participants use a broader range of benefits than do other employees participating in the plan.

Calculating Excess Reimbursements under a Discriminatory Self-insured Plan

If the self-insured plan is discriminatory, highly compensated individuals (HCIs) must include certain amounts (referred to as excess reimbursements) in income, while other employees suffer no adverse consequences. How the excess reimbursement is calculated depends on whether the plan is discriminatory as to eligibility, benefits, or both.

1. *Discriminatory as to Eligibility.* If the plan is discriminatory as to eligibility, each HCI's excess reimbursement is calculated as follows:

$$\text{Total Reimbursements to the HCI} \times \frac{\text{Total Reimbursements to All HCIs}}{\text{Total Reimbursements to All Participants}}$$

2. *Discriminatory as to Benefits Provided.* If the plan is discriminatory as to benefits provided, the excess reimbursement equals the HCI's reimbursement for the discriminatory benefit.

3. *Discriminatory as to Both Eligibility and Benefits Provided.* If the self-insured plan is discriminatory as to both eligibility and benefits provided, the first step is to calculate the excess reimbursement for discriminatory benefits. The next step is to calculate the excess reimbursement for eligibility discrimination as follows:

$$\frac{\text{Total Reimbursement to the HCI} \\ \text{Less Excess Reimbursement for} \\ \text{Discriminatory Benefits}}{\times} \frac{\text{Total Reimbursements to All HCIs Less Excess} \\ \text{Reimbursement for Discriminatory Benefits}}{\text{Total Reimbursements to All Participants Less} \\ \text{Excess Reimbursement for Discriminatory Benefits}}$$

Example 2D-1 Calculating the excess reimbursement for discrimination as to eligibility.

Barnes Corporation maintains a self-insured medical reimbursement plan for its employees. The plan has a calendar year. Although it provides the same medical benefits for all participants, the plan failed the eligibility test for the year and, thus, is discriminatory as to eligibility. During the year, the plan paid \$120,000 in total benefits, \$40,000 of which were paid to HCIs and \$6,000 of which were paid to Frank Stevens, a HCI.

Frank’s excess reimbursement is \$2,000 [$\$6,000 \times (\$40,000 \div \$120,000)$]. This amount must be included in Frank’s income and is reported as wages on his Form W-2. However, the \$2,000 is exempt from FITW, FICA, and FUTA since Barnes maintains a plan for a class of employees.

Example 2D-2 Calculating the excess reimbursement for discrimination as to benefits provided.

Steamboat, Inc. maintains a self-insured medical reimbursement plan for its employees. The plan has a calendar year. Although it provides the same medical benefits for all participants, only the five highest paid officers are entitled to dental benefits. During the year, Brenda Smith, one of the five highest paid officers, received \$1,000 of dental benefits. Because dental benefits are only provided for HCIs, the plan discriminates as to benefits provided. Thus, Brenda received an excess reimbursement of \$1,000. This amount must be included in Brenda’s income and is reported on Form W-2. However, it is exempt from FITW, FICA, and FUTA.

Variation: If Steamboat maintained a separate insured (instead of a self-insured) dental plan for the five highest-paid officers, Steamboat would not have to include the \$1,000 of dental benefits in Brenda’s income and the dental benefits would not be reported on Brenda’s Form W-2.

Example 2D-3 Calculating the excess reimbursement for discrimination as to both eligibility and benefits provided.

Swift Manufacturing Company maintains a self-insured medical reimbursement plan for its employees. The plan has a calendar year. Although it provides the same medical benefits for all participants, only the five highest paid officers are entitled to dental benefits. Therefore the plan discriminates as to benefits. Furthermore, the plan failed the eligibility test for the year and, thus, also discriminates as to eligibility. During the year, the plan paid \$50,300 in total benefits, \$30,300 of which were paid to HCIs (which included \$3,000 for dental benefits). Mary Moore, one of the five highest paid officers, received \$300 of dental benefits and \$4,500 of medical benefits under the plan.

Mary received a \$300 excess reimbursement for discriminatory benefits. She also received a \$2,597 excess reimbursement for eligibility discrimination calculated as follows:

$$(\$4,800 - \$300) \times \frac{\$30,300 - \$3,000}{\$50,300 - \$3,000}$$

Thus, the total amount of excess reimbursements includable in Mary’s income is \$2,897 (\$300 + \$2,597). This \$2,897 is exempt from FITW, FICA, and FUTA since Swift maintains a plan for its employees.

Supplemental Medical Expense Reimbursement Plan for Key Executives

An employer can provide selected key employees or executives with coverage under a supplemental medical expense reimbursement plan. Cosmetic surgery or other costs that are not medical expenses as defined in IRC

Sec. 213(d) and the deductible and coinsurance payments required under the group medical plan are expenses commonly covered in a supplemental plan. A supplemental medical expense reimbursement plan is considered a self-insured plan subject to the nondiscrimination requirements of IRC Sec. 105(h). Since the plan is almost always targeted solely at key executives, it often fails the nondiscrimination requirements. All benefits provided under the plan are likely considered discriminatory benefits that are treated as excess reimbursements. Thus, reimbursements received by a key executive under the supplemental plan are included in gross income. However, these benefits are exempt from FITW, and also from FICA and FUTA provided the employer maintains the plan for a class of employees.

Insurance Policies for Accidental Death and Dismemberment (AD&D)

Many employers offer accident insurance through accidental death and dismemberment (AD&D) policies. AD&D policies are hybrid arrangements that combine death benefit insurance with accident insurance. Amounts received under the accident insurance portion of an AD&D policy are based on the nature of the injury (not the period the employee is absent from work) and cover (1) permanent loss of a body member or function, (2) permanent loss of the use of a body member or function, or (3) permanent disfigurement of the body. Most AD&D policies are targeted at nonjob-related accidents since job-related (occupational) injuries typically are covered by workers' compensation insurance.

Tax Treatment of AD&D Policy Coverage

Employer-provided coverage under an AD&D policy is excludable from the employee's gross income and exempt from federal income tax withholding (FITW) under IRC Sec. 106. Similarly, premium payments are exempt from social security and Medicare (FICA) and federal unemployment (FUTA) taxes if paid under a plan or system established by the employer.

The cost of coverage under an AD&D policy that is paid for by the employee with after-tax dollars (salary deduction) is subject to FITW, FICA, and FUTA and reported as taxable wages on the employee's Form W-2. However, if the coverage is offered as a qualified benefit under a cafeteria plan, the cost of AD&D premiums paid for by employees through pretax contributions (salary reduction) is exempt from FITW, FICA, and FUTA and is not reported as taxable wages on the employee's Form W-2.

Tax Treatment of AD&D Benefits

Death Benefits. Accidental death benefits received under the AD&D policy are excluded from the gross income of the employee's beneficiary (and exempt from FITW) as life insurance proceeds payable by reason of the insured's death. In addition, these amounts are exempt from FICA and FUTA taxes.

Dismemberment Benefits. Benefits received by the employee through employer-provided accident insurance are excludable from income to the extent they (1) constitute payment for the permanent loss (or loss of use) of a member or function of the body (or the permanent disfigurement) of the employee, spouse, or dependent and (2) are computed with reference to the nature of the injury without regard to the period the employee is absent from work. Dismemberment payments are excluded from income regardless of whether the employee contributes some or all of the premium payments with pretax or after-tax dollars.

The following dismemberment payments are exempt for FICA and FUTA purposes: (1) any payment made for medical or hospitalization expenses for an accident disability if paid under a plan or system established by the employer; and (2) sickness or injury payments made by an employer after the end of six calendar months after the calendar month the employee last worked for the employer.

Example 2F-1 Dismemberment benefits are exempt from income and payroll taxes.

Major Industries pays the premiums for employee coverage under an AD&D plan. Employee Lisa loses a leg in a motorcycle accident while on vacation. Under the plan, Lisa is paid \$75,000 for the loss of a limb. The dismemberment payment is exempt from FITW, FICA, and FUTA, and is not reported as taxable wages on Lisa's Form W-2. It is excluded from her gross income because it is paid for the permanent loss of her leg (i.e., based on the nature of the injury) and without regard to the period of time she was absent from work.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. Jim, Joe, Sue, and Paula are, or have been, employees of Sand Corp. Each represents a different covered class in Sand's health care plan. Jim is retired, Joe recently left the company, Sue is an executive secretary, and Paula is a highly compensated executive. Jim's coverage includes accident, health, dental, and life insurance in one premium payment; Sand reimburses Jim each month for this expense. Joe is covered by COBRA and Sand sends Joe a check each month to cover the costs of his premiums; no further documentation is required. Sue could opt to receive certain other cash benefits from Sand each month in lieu of premium reimbursement, but chooses to be reimbursed anyway. Sand pays Paula's premiums directly to the health plan insurer each month. Which payments made by Sand can be excluded from the employee's gross wages?
- Jim.
 - Joe.
 - Sue.
 - Paula.
24. Given that R = Total reimbursement to the HCl; RH = Total reimbursements to all HCIs; RA = Total reimbursements to all participants; ER = Excess discriminatory benefit reimbursement to the HCl; and EH = Total excess discriminatory benefit reimbursements to all HCIs, what is the formula to calculate the excess reimbursement under a self-insured health care plan found to be discriminatory as to eligibility?
- $R \times (RH / RA)$.
 - $(R - ER) \times (RH / RA)$.
 - $(R - ER) \times [(RH - EH) / RA]$.
 - $(R - ER) \times [(RH - EH) / (RA - EH)]$.
25. Reimbursements are considered which of the following under a supplemental medical expense reimbursement plan for the key executive class?
- Included in gross income.
 - Subject to FITW.
 - Subject to FUTA.
 - Subject to FICA.
26. Mark's employer maintains an AD&D feature in its cafeteria plan and Mark chose elective participation at \$10 per month. He became eligible after 6 full months of employment. Two years ago at the end of his first full year of employment, Mark was in a serious motorcycle accident that left his right leg permanently paralyzed. The AD&D policy paid \$100,000 immediately upon verifying Mark's medical and hospitalization claim. The policy also paid \$100 per month for physical therapy not to exceed 6 months if Mark was unable to return to work during that time as a result of his injuries. In fact, Mark was unable to return to work for 10 months and was paid at 50% of current salary by his employer according to established company policy while on injury leave; Mark's current salary is \$5,000 per month. How much of Mark's AD&D benefits are includable for FICA?
- \$120.
 - \$600.
 - \$15,000.
 - \$100,000.

27. Which of the following statements concerning accidental death and dismemberment insurance policies is correct?
- a. AD&D insurance combines a death benefit with a form of renewable term life insurance.
 - b. Taxation of AD&D costs depends on whether the employee or the employer pays the premium payments.
 - c. AD&D benefits for loss of limb are not subject to FIT if based on length of employee work absence.
 - d. Taxation of dismemberment benefits depends on the employee elective status of the premium payments.
28. Death benefits from an AD&D policy are included in the beneficiary's gross income but excluded from FUTA and FICA.
- a. True.
 - b. False.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

23. Jim, Joe, Sue, and Paula are, or have been, employees of Sand Corp. Each represents a different covered class in Sand's health care plan. Jim is retired, Joe recently left the company, Sue is an executive secretary, and Paula is a highly compensated executive. Jim's coverage includes accident, health, dental, and life insurance in one premium payment; Sand reimburses Jim each month for this expense. Joe is covered by COBRA and Sand sends Joe a check each month to cover the costs of his premiums; no further documentation is required. Sue could opt to receive certain other cash benefits from Sand each month in lieu of premium reimbursement, but chooses to be reimbursed anyway. Sand pays Paula's premiums directly to the health plan insurer each month. Which payments made by Sand can be excluded from the employee's gross wages? **(Page 191)**
- Jim. [This answer is incorrect. To be excluded from Jim's gross wage, Sand's reimbursement must be exclusively for accident and health coverage.]
 - Joe. [This answer is incorrect. To be excluded from Joe's gross wage, Sand must require substantiation of prior premium payment as a condition of reimbursement.]
 - Sue. [This answer is incorrect. Sand's payment cannot be excluded if the employee has the right to receive cash or cash benefits in lieu of the premium reimbursement.]
 - Paula. [This answer is correct. Substantiation of the premium is satisfied since Sand makes the payment directly to the insurer.]**
24. Given that R = Total reimbursement to the HCl; RH = Total reimbursements to all HCIs; RA = Total reimbursements to all participants; ER = Excess discriminatory benefit reimbursement to the HCl; and EH = Total excess discriminatory benefit reimbursements to all HCIs, what is the formula to calculate the excess reimbursement under a self-insured health care plan found to be discriminatory as to eligibility? **(Page 193)**
- $R \times (RH / RA)$. [This answer is correct. The amount of the reimbursement reported in the HCIs income and reported on the W-2 is based on the proportion of total reimbursements to all HCIs to total reimbursements to all participants.]**
 - $(R - ER) \times (RH / RA)$. [This answer is incorrect. This would understate the amount that should be reported on the HCl's W-2.]
 - $(R - ER) \times [(RH - EH) / RA]$. [This answer is incorrect. This would achieve a disproportionate result and would understate the amount that should be reported on the HCl's W-2.]
 - $(R - ER) \times [(RH - EH) / (RA - EH)]$. [This answer is incorrect. This is a valid formula, but considers factors not required to answer the question asked.]
25. Reimbursements are considered which of the following under a supplemental medical expense reimbursement plan for the key executive class? **(Page 195)**
- Included in gross income. [This answer is correct. Such a plan is considered self-insured and is often found to be discriminatory. Payments are included in gross income, but will be excluded from FITW, FUTA, and FICA if the employer maintains the plan for a class of employees.]**
 - Subject to FITW. [This answer is incorrect. Although often found discriminatory, plan reimbursements will be exempt from FITW if maintained for a class of employees.]
 - Subject to FUTA. [This answer is incorrect. Per the Internal Revenue Code, plan reimbursements will be exempt from FUTA if maintained for a class of employees.]
 - Subject to FICA. [This answer is incorrect. Per the Internal Revenue Code, reimbursements will be exempt from FICA if made under a plan maintained by the employer for a class of employees.]

26. Mark's employer maintains an AD&D feature in its cafeteria plan and Mark chose elective participation at \$10 per month. He became eligible after 6 full months of employment. Two years ago at the end of his first full year of employment, Mark was in a serious motorcycle accident that left his right leg permanently paralyzed. The AD&D policy paid \$100,000 immediately upon verifying Mark's medical and hospitalization claim. The policy also paid \$100 per month for physical therapy not to exceed 6 months if Mark was unable to return to work during that time as a result of his injuries. In fact, Mark was unable to return to work for 10 months and was paid at 50% of current salary by his employer according to established company policy while on injury leave; Mark's current salary is \$5,000 per month. How much of Mark's AD&D benefits are includable for FICA? **(Page 196)**
- a. \$120. [This answer is incorrect. Whether premiums are paid electively or by payroll deduction is irrelevant to AD&D benefit taxation.]
 - b. \$600. [This answer is incorrect. The injury benefit is for physical therapy related to the accident and payable under the employer's established plan; it is therefore not subject to FICA tax.]
 - c. \$15,000. [This answer is correct. Injury leave payments are subject to FICA for up to 6 months after the last calendar month the employee worked for the employer.]**
 - d. \$100,000. [This answer is incorrect. The immediate payment under the AD&D policy is for medical and hospital expenses and is not subject to FICA tax.]
27. Which of the following statements concerning accidental death and dismemberment insurance policies is correct? **(Page 196)**
- a. AD&D insurance combines a death benefit with a form of renewable term life insurance. [This answer is incorrect. AD&D insurance is a combination of death benefit insurance and accident insurance.]
 - b. Taxation of AD&D costs depends on whether the employee or the employer pays the premium payments. [This answer is correct. Taxation of AD&D premium costs depend on whether the employee or the employer pays. If the employee pays, taxation further depends on whether premiums are paid via salary reduction or deduction.]**
 - c. AD&D benefits for loss of limb are not subject to FIT if based on length of employee work absence. [This answer is incorrect. Under the Internal Revenue Code, dismemberment benefits are not subject to FIT if based on nature of injury.]
 - d. Taxation of dismemberment benefits depends on the employee elective status of the premium payments. [This answer is incorrect. Requirements for dismemberment benefits taxation vary with the tax being considered, but the employee elective status of the premium payments is irrelevant.]
28. Death benefits from an AD&D policy are included in the beneficiary's gross income but excluded from FUTA and FICA. **(Page 196)**
- a. True. [This answer is incorrect. Death benefits are exempt from FICA, FUTA, and FITW, and are not included in the gross income of the employee's beneficiary.]
 - b. False. [This answer is correct. Death benefits are excluded from the gross income of the employee's beneficiary.]**

Archer Medical Savings Accounts (Employer-provided Coverage)

Archer medical savings account (Archer MSA) plans were created to encourage small employers and self-employed persons to provide medical coverage for their employees. Under an Archer MSA plan, the employer provides a high-deductible health plan to its employees and then the employer (or employee) makes contributions to the employees' Archer MSAs, withdrawals from which are intended to be used for qualified medical expenses.

Within limits, contributions to an Archer MSA are deductible if made by an eligible individual, or if made by the employer of an eligible individual, are excludable from the employee's income and deductible by the employer. If the employee makes contributions to the employer's plan, the employee can deduct them in accordance with the applicable rules. Contributions for any year may be made by the employer or the employee, but not by both.

New Archer MSA plans cannot be established after 2007. However, health savings accounts (HSAs) were created to eventually take the place of Archer MSAs. Even though new Archer MSA plans cannot be established after 2007, individuals who had an Archer MSA before 2008 are allowed to do all of the following, even after 2007:

1. Retain unspent money in the Archer MSA, tax-deferred, until withdrawn without penalty beginning at age 65, death, or disability.
2. Continue making or receiving Archer MSA contributions if they continue to meet the eligibility requirements.
3. Use tax-free withdrawals from the Archer MSA account to pay for yearly medical expenses.
4. Roll over any balances to a health savings account (HSA). In most cases, it will be advantageous to roll the Archer MSA into the HSA.

Determining Eligibility for an Archer MSA

Self-employed persons and employees of small employers who are covered under a high deductible plan could establish Archer MSAs prior to 2008. Additionally, small employers who established Archer MSA plans for their employees prior to 2008 may permit employees to establish Archer MSA accounts after 2007, even if the employees have never had an Archer MSA account prior to this time. Generally, a small employer is one that employed, on a controlled group basis, no more than 50 employees on average during either of the two preceding calendar years.

For 2009, a high deductible plan is a health plan with an annual deductible of at least \$2,000 and no more than \$3,000 for self-only coverage (or at least \$4,000 but no more than \$6,050 for family coverage). In addition, for 2009 the maximum out-of-pocket expenses (including the deductible) required for covered costs must be no more than \$4,000 for self-only coverage or \$7,350 for family coverage. These dollar amounts have been indexed for inflation. Out-of-pocket expenses include deductibles, co-payments, and other amounts that the participant must pay for covered benefits, but do not include premiums. Archer MSAs are not permitted for individuals who are covered under a health plan other than a high deductible plan.

Nondiscrimination (Comparability) Rules

If an employer provides high deductible health plan coverage and makes contributions to the employees' Archer MSAs, the employer must make a comparable contribution on behalf of all employees with similar health coverage during the same period. Contributions are comparable if they are of the same amount or the same percentage of the deductible under the high deductible plan. The comparability rule is applied separately to employees who customarily work fewer than 30 hours per week, so that the employer has the option of making different contributions (or no contributions) for such part-time employees. A tax equal to 35% of the amount contributed to employees' Archer MSAs for the year is imposed on employers who fail to meet the comparability rule. The tax is reported by filing Form 8928 (Return of Certain Excise Taxes Under Chapter 43 of the Internal Revenue Code) on or before the 15th day of the fourth month following the calendar year in which the noncomparable contributions were made.

Archer Medical Savings Account Contributions

The maximum annual contribution that can be made to an Archer MSA without penalty is (1) 65% of the deductible if the policy provides coverage for one individual, or (2) 75% of the deductible in the case of family coverage. In addition, a self-employed individual's deduction cannot exceed the net self-employment income (including the deduction for half the self-employment tax) of the business that establishes the high deductible plan. Likewise, an employee's deduction (or income exclusion) is limited to no more than the compensation the employee receives from the employer sponsoring the high deductible plan.

Since the maximum amount of deductible a policy can carry for the policyholder to qualify for an Archer MSA for 2009 is \$3,000 (for self-only coverage) and \$6,050 (for family coverage), the maximum annual contributions are (1) \$1,950 ($\$3,000 \times 65\%$) for self-only coverage, and (2) \$4,538 ($\$6,050 \times 75\%$) for family coverage.

Contributions for the year can be made until the due date (not including extensions) of the individual's return for that year. Although the annual limitation is calculated using monthly data, the contribution for the year can be made in one or more payments. However, employer contributions to an Archer MSA (if otherwise allowable as a deduction) are allowed as a deduction only for the tax year in which they are paid.

Income and Payroll Tax Treatment of Archer MSA Contributions

Within limits, contributions to an Archer MSA are excludable from the employee's income if made by the employer. The excludable amount is limited to the lesser of (1) the Archer MSA contribution limit applicable to the individual [i.e., 65% (for self-only coverage); 75% (for family coverage)], or (2) the compensation the employee receives from the employer sponsoring the high deductible plan. The exclusion applies whether or not the employee can choose to have the amounts contributed to an Archer MSA or another health plan.

Example 2G-1 Income tax treatment of employer contributions to an Archer MSA.

SmartCom, Inc. (SCI), an accrual-basis corporation, maintains a high deductible health plan with a deductible of \$2,000 for individual coverage and \$4,000 for family coverage. SCI also offers a monthly Archer MSA contribution to employees participating in the high deductible plan of \$75 for individual coverage and \$175 for family coverage. Employee Steve Roth, who has no other health insurance, receives family coverage under the plan for 2009. During January through December 2009, SCI contributes \$2,100 ($\175×12 months) to Steve's Archer MSA.

SCI's premium payments for coverage under the high deductible health plan are excludable from Steve's income under IRC Sec. 106(b). In addition, the company's contributions to the Archer MSA on behalf of Steve during the year are also excludable up to 75% of the annual deductible under the coverage, or \$3,000 ($\$4,000 \times 75\%$). Since the company's contributions to the Archer MSA for the year are less than this limit, the full amount is excludable from Steve's income.

Employer contributions to an Archer MSA are exempt from federal income tax withholding (FITW), FICA, and FUTA. Employer contributions to an Archer MSA that are excludable from the employee's income and exempt from payroll taxes are not reported as wages on the employee's Form W-2. Employer contributions that are includable in the employee's income must be reported as taxable wages in Form W-2 boxes 1, 3 (subject to the maximum social security wage base), and 5. Employers must report all employer contributions to an Archer MSA (including nonexcludable employer contributions) in box 12 of Form W-2, using Code R.

After-tax dollars withheld from an employee's pay and contributed to an employer-sponsored Archer MSA are subject to FITW, FICA, and FUTA and reported as taxable wages on the employee's Form W-2. Employee after-tax contributions are not reported in Form W-2 box 12. Within the limits described earlier, the employee may deduct these after-tax contributions above the line [i.e., in determining adjusted gross income (AGI)].

Distributions from an Archer Medical Savings Account

Neither earnings on amounts in an Archer MSA nor distributions from the account that are used for qualified medical expenses are taxable to the employee. However, distributions that are not used for such expenses are includable in income and subject to an additional 15% tax unless made after age 65, death, or disability.

Health Savings Accounts (HSAs) (Employer-provided Coverage)

Health savings accounts (HSAs) are targeted to self-employed individuals, small business owners, and employees of small to medium-sized businesses. Tax-free contributions (if made by an employer) or tax-deductible contributions (if made by an employee) can be made in certain circumstances to HSAs. When withdrawn, the contributions are used to pay qualified medical expenses of eligible individuals covered by high-deductible health plans. Earnings accumulate tax-free and distributions are also tax-free when withdrawn for qualified medical expenses. HSAs may be offered as part of a cafeteria plan. Pretax contributions to an employee's HSA through a cafeteria plan are treated as employer contributions. Any balances remaining in the account at the end of the year can be carried over to the next year.

HSAs belong to the individual for whose benefit the account is established. Thus, even if it is employer-funded, the HSA is portable and goes with the individual if they terminate employment with the employer.

Determining Eligibility for an HSA

In order to establish an HSA an individual must meet all of the following conditions with regard to any month:

1. Be covered under a high-deductible health plan on the first day of such month.
2. Not be covered by any other health plan that is not a high-deductible health plan (with certain exceptions for plans providing specific limited types of coverage).
3. Not be enrolled in Medicare for such month, which generally occurs at age 65. Individuals remain eligible to establish and contribute to HSAs after becoming entitled to Medicare, provided they do not enroll in Part A, Part B, or Part D. Individuals who enroll in social security will likely be automatically enrolled in Part A, which will make them not eligible for an HSA.
4. Not have received Veterans Administration medical benefits within the past three months, unless the benefits consisted solely of disregarded coverage or preventive care.
5. Not be claimed as a dependent on another person's tax return for the year.

For self-only coverage in 2009, the qualifying high-deductible health insurance plan must have: (1) an annual deductible of at least \$1,150 and (2) an annual limit on total out-of-pocket costs for covered benefits of no more than \$5,800 (including the deductible amount). For family coverage in 2009, the qualifying insurance must have: (1) an annual deductible of at least \$2,300 and (2) an annual cap on total out-of-pocket costs of no more than \$11,600. These limits have been adjusted for inflation. For 2010, the annual deductible amounts increase to \$1,200 for self-only coverage and \$2,400 for family coverage. The annual out-of-pocket costs increase to \$5,950 for self-only coverage and \$11,900 for family coverage.

Making Contributions to HSAs

For 2009, HSA contributions made by or on behalf of an eligible individual are limited to \$3,000 for self-only coverage and \$5,950 for family coverage. For 2010, the contribution limitations are \$3,050 for self-only coverage and \$6,150 for family coverage.

These amounts are adjusted annually for inflation. Additionally, an individual age 55 and older who is an eligible HSA contributor may annually make an additional contribution of \$1,000 for 2009 and later to his or her HSA. HSA contributions must be made in cash unless they are rollover contributions.

HSA contributions cannot be made by or for an individual for any month when any benefit covered under the high-deductible health plan is also covered under any nonhigh-deductible health plan. In applying this restriction, however, the following types of health-related insurance and coverage are ignored: (1) workers compensation insurance; (2) insurance for a specific disease or illness (for example, cancer, diabetes, or congestive heart failure) as long as the principal health coverage is provided by a high deductible health plan; (3) insurance that pays a fixed

amount per day or other period of hospitalization; and (4) coverage (whether through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

Contributions can be made by or on behalf of an eligible individual for any month that the eligible individual has qualifying high-deductible health coverage as of the first day of that month. When an individual has qualifying high-deductible health coverage for only part of the year, up to $\frac{1}{12}$ of the annual limitation amount discussed previously can be contributed and deducted for each month that the employee has the proper coverage. For example, the monthly limit for 2009 is \$250 ($\$3,000 \div 12$) for self-only coverage and \$495.83 ($\$5,950 \div 12$) for family coverage. However, an individual who is an eligible individual on the first day of the last month of the individual's tax year is treated as having been an eligible individual for the entire year.

Although a person's eligibility to make HSA contributions is determined on a monthly basis, the maximum annual contribution that may be contributed to that individual's account begins on the first day of the tax year. This is advantageous in that more earnings can build up tax-free. However, an individual might not remain an eligible individual the entire year. In this case, the excess contribution may not be deductible (if made by an employee) or excludable (if made by an employer) and may be subject to a 6% excise tax unless the excess contributions and income attributable to them are corrected.

Last-month Rule. An individual who is an eligible individual on the first day of the last month of the individual's tax year (December 1 for calendar-year taxpayers) is treated as having been an eligible individual for the entire year. Thus, the maximum annual contribution, including any catch-up contribution, for such an individual does not have to be prorated based on the number of months of eligibility. However, if an individual who makes contributions or has contributions made on his or her behalf becomes ineligible (except for disability or death) during the testing period (which begins on the first day of the last month of the tax year during which the individual is ineligible for part of the year and ends on the last day of the 12th month following that month), contributions not allowable except for this special rule (i.e., contributions attributable to months preceding the month in which the individual became eligible) are includible in gross income and subject to a 10% penalty tax.

Example 2H-1 Determining the contribution limit when eligible during the last month of the tax year.

Wade's employer, XYZ Corp, offers a cafeteria plan that allows its employees to receive benefits for health coverage and to make pretax contributions to an HSA. Wade, who is a calendar year taxpayer, enrolls in XYZ's high-deductible health plan in October 2009 with self-only coverage and remains an eligible individual during December 2009. Prior to enrolling, he was not an eligible individual. Since Wade is an eligible individual on December 1, he can make HSA contributions as if he had been enrolled in the high-deductible health plan for all of 2009. The maximum contribution that Wade can make is \$3,000 for 2009. Wade's testing period begins on December 1, 2009 and ends on December 31, 2010. If in July 2010, Wade becomes an ineligible individual by discontinuing participation in the high-deductible health plan, an amount equal to his HSA contribution made in 2009 that would not have been made except for the last-month rule must be included in Wade's 2010 income. This amount is \$2,250 [$(\$3,000 \div 12) \times 9$]. In addition, 10% of this includible income is added to Wade's tax for 2010.

Rollover Contributions. Employers are allowed a one-time, tax-free rollover of the unused balance in a health FSA or a health reimbursement arrangement (HRA) to an HSA account. The rollover is (1) excludable from the employee's gross income and wages for employment tax purposes, (2) not taken into account in applying the maximum deduction limitation for HSAs, and not deductible. The transfer must not exceed the lesser of the balance in the health FSA or HRA as of September 21, 2006, or the date of distribution and must be contributed before January 1, 2012. If the employee does not remain eligible for HSAs (for any reason other than death or disability) during the testing period which begins with the month of the transfer and ends on the last day of the 12th month following that month, the transfer is includible in the employee's income and is subject to a 10% penalty tax. The IRS has provided guidance on the procedures that employers should follow in making the rollover to the HSA so that an employee is eligible to contribute to an HSA.

Nondiscrimination Rules

Employers are permitted to make deductible contributions to employees' HSAs—subject to the same dollar limits and eligibility rules previously explained. However, the employer must make comparable contributions for all

employees who have comparable coverage during the same period or face a 35% excise tax on the aggregate amount contributed by the employer to the HSAs. The excise tax is reported by filing Form 8928 (Return of Certain Excise Taxes Under Chapter 43 of the Internal Revenue Code) on or before the 15th day of the fourth month following the calendar year in which the noncomparable contributions were made.

Generally, employer contributions are deemed to be comparable if they are either: (a) the same dollar amount for each employee who is eligible for HSA contributions under the general Section 223 contribution rules and has the same category of high-deductible health plan coverage, or (b) the same percentage of the high-deductible health plan deductible for each employee who is eligible for contributions and who has the same category of high-deductible health plan coverage.

Employers will automatically fail the comparability test if they (1) link employer HSA contributions to employee contribution amounts since there can be no certainty that all employees will contribute the same amount; (2) link HSA contributions to the employee participation in health assessments, disease management, or wellness programs because there can be no certainty that all employees will participate; or (3) make additional HSA contributions for employees who attain a specified age or who meet a years-of-service standard.

Highly compensated employees are not treated as comparable participating employees, but only with respect to nonhighly compensated employees. Thus, highly compensated employees are excluded from comparability testing of employer contributions to nonhighly compensated employees' HSAs. This exception allows employers to make larger HSA contributions for nonhighly compensated employees than for highly compensated employees. The comparability rules do not apply to HSA contributions made through a cafeteria plan. However, the Section 125 Cafeteria Plan nondiscrimination rules apply. In addition, a modified comparability rule applies to the one-time rollover from a health FSA or an HRA into an HSA as discussed earlier.

Tax Treatment of HSA Contributions

An HSA generally is exempt from tax, unless it has ceased to be an HSA. Earnings that accumulate on amounts in an HSA are not includable in gross income. Employer contributions (provided they are within the limits described in this lesson) to an eligible employee's HSA are treated as employer-provided coverage for medical expenses under an accident or health plan and are excludable from the employee's income. Pretax contributions to an employee's HSA through a cafeteria plan are treated as employer contributions. The employee cannot deduct employer contributions on his or her individual income tax return as HSA contributions or as medical expense deductions under IRC Sec. 213.

Employer-funded HSA contributions (provided they are within the limits described in this lesson) are exempt from FICA and FUTA taxes because they are considered to be for an employer-provided accident or health plan.

Partnerships and S Corporations. When a partnership makes contributions to the HSA of a partner and the contributions are treated as distributions to the individual partner, the HSA contributions generally are not included in the partner's gross income but are allowed as an above-the-line deduction on the partner's income tax return. When the contributions are treated as guaranteed payments for services, the HSA contributions are included in the partner's gross income and are allowed as an above-the-line deduction on the partner's income tax return. The guaranteed payments can be deducted by the partnership. Likewise, when an S corporation makes contributions to a more-than-2% shareholder-employee's HSA, the corporation can deduct the contributions as payments for services. The contributions are included in the shareholder's gross income and are allowed as an above-the-line deduction on the shareholder's income tax return. The contributions included in the shareholder's income are exempt from FICA and FUTA because they are considered to be for an employer-provided health plan.

Depositing HSA Contributions

HSA contributions for a tax year can be made at any time prior to the deadline (excluding extensions) for filing the eligible individual's federal income tax return for that year, but not before the beginning of that year. For calendar-year taxpayers, the deadline for making an HSA contribution is April 15 following the year for which the contributions are made.

Excess contributions made by an individual are not deductible. If made by an employer, excess contributions, as well as contributions made for an ineligible individual, are included in the employee's gross income. In addition, a

6% excise tax is imposed on the account beneficiary for each tax year that excess individual and employer contributions are not corrected.

If an employer contributes to an employee's HSA, then discovers that the individual was never eligible to have an HSA, or that the maximum annual contribution allowed was exceeded due to an error, the employer can request that the financial institution return the excess contributions (with earnings, less any administrative fees). If the employer does not receive the funds before the end of the tax year, the excess contributions must be reported as wages on the employee's Form W-2 for the year during which the employer made the contributions.

Reporting HSA Contributions

Employer contributions to an HSA must be reported on the employee's Form W-2 in box 12 using code W. (The one-time rollovers from a health FSA or an HRA to an HSA are not reported in box 12.) Generally, employer contributions to an employee's HSA are not subject to FICA or federal income tax withholding and, therefore, will not be reported in boxes 1, 3, or 5 of Form W-2. The IRS has forms and instructions that HSA trustees use to report HSA contributions and distributions. Copies of the forms [i.e., Form 1099-SA (Distributions From an HSA, Archer MSA, or Medicare Advantage MSA) and Form 5498-SA (HSA, Archer MSA, or Medicare Advantage MSA Information)] are available on the IRS website at www.irs.gov.

Distributions from HSAs

The HSA beneficiary (the individual for whom the account is set up) can take federal-income-tax-free withdrawals to pay for qualified medical expenses of the account beneficiary and his or her spouse or dependents even if the spouse or dependents are not eligible individuals as previously defined. Eligible individuals may use debit, credit, or stored-value cards to receive distributions from an HSA for qualified medical expenses. If a debit card program that restricts payments and reimbursements to health care is used, the HSA beneficiary must also be able to access the HSA funds other than by purchasing health care with the debit card (e.g., through online transfers, withdrawals from ATMs, or check writing). In addition, employers must notify employees that they can access the funds other than through debit cards.

HSAs and Cafeteria Plans

Cafeteria plans are allowed to offer salary-reduction HSA contributions for eligible employees as part of the menu of cafeteria plan choices. Also, an account beneficiary may pay qualified long-term care insurance premiums with distributions from an HSA if contributions to the HSA are made by salary reduction through a cafeteria plan.

The following requirements that apply to health FSAs under a cafeteria plan do not apply to HSAs: (1) the prohibition against a benefit that defers compensation by permitting employees to carry over unused elective contributions or plan benefits from one plan year to another plan year, (2) the requirement that the maximum amount of reimbursement must be available at all times during the coverage period, and (3) the mandatory 12-month coverage period. When an employee elects to make contributions to an HSA through a cafeteria plan, the employer may, but is not required to, contribute amounts to an employee's HSA up to the maximum amount elected by the employee. While any accelerated contribution made by the employer must be equally available to all participating employees throughout the plan year and must be provided to all participating employees on the same terms, the employee must repay the amount of the accelerated contribution by the end of the plan year. In addition, employers can provide negative elections for HSAs if offered through a cafeteria plan.

Long-term Care Insurance Policies (Employer-provided Coverage)

Although most long-term care (LTC) policies are issued by insurance companies directly to individuals, some employers have begun offering group policies to their employees in which the employee pays the premium for the coverage and the policy provides protection not only for the employee and spouse but also for their parents. Employers can also provide LTC insurance coverage as a tax-favored employee benefit by paying the premium cost for the employee under IRC Sec. 7702B. Employer-provided coverage for LTC insurance may be particularly attractive to closely held businesses as a tax deductible employee benefit that is nontaxable to the employees. Partners, members of limited liability companies (LLCs) electing to be treated as partnerships, sole proprietors

(including farmers), and more-than-2% shareholder-employees of S corporations are not eligible for this tax-favored treatment.

Qualified LTC insurance provides coverage for necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services. Maintenance or personal care services, which are required by a chronically ill individual or are provided pursuant to a plan of care prescribed by a licensed health care practitioner also qualify. Qualified LTC insurance cannot provide coverage other than for LTC services, must be guaranteed renewable, cannot provide for a cash surrender value, and must meet several other requirements.

Tax Treatment of LTC Insurance Coverage

An employer plan providing coverage under a qualified LTC insurance contract is treated as an accident and health plan. This means that the cost of premiums paid by the employer for employee coverage is exempt from federal income tax withholding (FITW) and not reported as taxable wages on the employee's Form W-2. Such coverage is also exempt from social security and Medicare (FICA) taxes and federal unemployment (FUTA) taxes if the employer's contributions are made under a plan or system. After-tax dollars deducted from an employee's pay and used to purchase LTC insurance coverage are subject to FITW, FICA, and FUTA and reported as taxable wages on the employee's Form W-2.

Example 2I-1 Employer contributions for long-term care insurance.

Prudent Corp. maintains LTC insurance coverage (an insured plan) for a select group of owner-employees and key executives. The policy covers actual expenses and provides protection not only for the employee but also for the employee's spouse. The policy includes an option allowing the employee to continue the policy privately if employment terminates or if the employer terminates the group policy. Prudent pays 80% of the monthly premium costs with employees contributing the remaining 20% through after-tax contributions withheld from monthly salary. During the current year, Prudent paid \$4,000 in premiums to purchase LTC insurance coverage for its company CEO, Becky Walsh and her husband. A total of \$1,000 was withheld from Becky's salary on an after-tax basis to cover the remaining premium cost for the year.

The \$4,000 in premiums paid by Prudent to purchase LTC insurance coverage for Becky and her husband are excluded from FITW, FICA, and FUTA and are not reported as taxable wages on her Form W-2. (There is no special reporting on Form W-2 for employer-provided long-term care coverage.) The \$1,000 of premium contributions withheld from Becky's paycheck on an after-tax basis are subject to FITW, FICA, and FUTA when withheld and reported as taxable wages on her Form W-2.

LTC insurance and LTC services are specifically excluded from the list of qualified benefits a cafeteria plan is allowed to provide. This means that employees cannot make pretax contributions for their LTC coverage. (Employees can, and often do, make after-tax contributions for such coverage.) However, LTC insurance premiums and expenses for qualified LTC services can be reimbursed through health savings accounts (HSAs), which can be offered under a cafeteria plan. Therefore, employees may make pretax contributions to HSAs offered through cafeteria plans and receive tax-free distributions from the HSAs to pay for LTC insurance premiums (subject to certain limitations) and qualified LTC services, thus achieving approximately the same results as if they were making pre-tax contributions for their LTC coverage.

Tax Treatment of LTC Benefits

A qualified LTC policy is treated as an accident and health insurance contract. Therefore, insurance proceeds received under such a policy normally are excluded from the employee's income as amounts received for personal injuries and sickness (i.e., in the same manner as medical care reimbursements). However, some LTC insurance contracts pay a certain amount per day, regardless of the actual long-term care costs. For persons receiving benefits from these policies, the excludable amount is generally limited to \$280 per day (in 2009) unless actual costs are greater. The limit does not apply if the insured is terminally ill when the insurance payments are received.

For payroll tax purposes, LTC insurance benefits are treated like medical expense reimbursements under a health plan. Thus, payments under a qualified LTC policy are exempt from FITW if they are excluded from the employee's

gross income. They are also exempt from payment of FICA and FUTA tax if made under a plan or system of the employer. These exclusions apply whether the payment is received (1) from insurance, (2) from a fund under a self-insured plan, or (3) as a direct reimbursement from the employer out of the employer's general assets. However, the insurance company must report such payments on Form 1099-LTC (Long Term Care and Accelerated Death Benefits).

Example 2I-2 Tax treatment and reporting on long-term care benefit payments.

Assume the same facts as in Example 2I-1 and that the long-term care policies are purchased from Elder Insurance Company. Elder Insurance pays \$25,000 in benefits during the current year to cover long-term care services for Becky's ailing spouse. Since this is an expense reimbursement policy, there is no limit on the amount of tax-free long-term care insurance benefits. The \$25,000 reimbursement is excludable from Becky's gross income and is exempt from FITW, FICA, and FUTA.

Sick Pay (Disability Income) Plans

Nearly all employers provide employees with compensated time off for sick leave funded through the employer's regular payroll (i.e., sick leave pay). Such sick leave pay is subject to federal income tax withholding (FITW), social security and Medicare (FICA) taxes, and federal unemployment (FUTA) tax when paid and is reported as taxable wages on the employee's Form W-2. Many employers also offer disability income (referred to as sick pay by the IRS) plans that provide payments to an employee who is unable to work because of a disability due to injury or sickness. Typically, plans require a waiting period before a disabled employee is eligible for benefits, and (to encourage employees to return to work) limit benefits to no more than a certain percentage (e.g., 60%) of the employee's regular salary. To the extent payments are made in lieu of lost compensation and are based on the length of time the employee is absent from work, they are considered to be sick pay.

Sick pay plans do not have to comply with IRS nondiscrimination rules. Thus, such plans may discriminate as to eligibility, contributions, benefits, etc., without triggering adverse income tax consequences to the participants or the employer. But sick pay provided under a cafeteria plan is subject to the cafeteria plan nondiscrimination rules. And if the plan is funded through a voluntary employees' beneficiary association (VEBA) trust, it must also meet the VEBA Section 505(b) nondiscrimination requirements. Furthermore, disability benefits provided under a pension plan must meet the applicable pension nondiscrimination rules.

Tax Treatment of Sick Pay Insurance Coverage

Premiums paid by an employer for sick pay insurance under a plan established by the employer (including contributions under a self-insured plan) are excluded from the employee's income and are exempt from FITW. They are also exempt from FICA and FUTA taxes if paid under a definite plan or system of the employer. A definite plan or system exists when sick pay is available to employees generally or to a class or classes of employees (and so excludes benefits provided on a discretionary or occasional basis). The existence of a plan or system can be shown by (1) the presence of a written document, (2) reference to the plan or system in the contract of employment, (3) employer contributions, or (4) segregated accounts for the payment of benefits.

Employee pretax contributions toward disability policies (in the case of benefits offered under a Section 125 cafeteria plan) are exempt from FITW, FICA, and FUTA and are not reported as taxable wages on the employee's Form W-2. Employee after-tax contributions are subject to FITW, FICA, and FUTA and are included in taxable wages on the employee's Form W-2.

Example 2J-1 Contributions toward sick pay insurance coverage.

XYZ Corp. pays 75% of the cost of maintaining sick pay insurance for its employees who contribute toward the remaining portion of the coverage using after-tax dollars withheld from their paychecks. During the current year, XYZ pays \$300 toward the purchase of sick pay coverage for employee Bob Arnold. \$100 is withheld from Bob's salary on an after-tax basis to purchase the remaining portion of the coverage.

The \$300 cost of premiums paid by XYZ for sick pay coverage on Bob's behalf is exempt from FITW, FICA, and FUTA and is not reported as taxable wages on his Form W-2. However, the \$100 withheld from Bob's pay

as a salary deduction and used to purchase coverage under the plan is subject to FITW, FICA, and FUTA and is included in taxable wages on his Form W-2.

Income Tax Treatment of Sick Pay Benefits

Payments to an employee for sick pay are includable in the employee's gross income to the extent attributable to employer contributions. Employee pretax contributions used to purchase sick pay coverage under a cafeteria plan are deemed to be employer contributions, meaning the sick pay is included in the employee's gross income to the same extent as employer funded contributions. On the other hand, if the employee makes after-tax contributions to the cost of the plan, benefits are excludable from gross income to the extent attributable to the after-tax contributions. Therefore, employees may want to purchase sick pay coverage using after-tax contributions to ensure that the benefits received under the plan are exempt from payroll taxes and excludable from gross income.

Calculating the taxability of sick pay benefits is simple if the benefits are fully paid for with employer contributions (in which case benefits are fully taxable) or employee after-tax contributions (in which case benefits are fully excludable). However, the calculations get much more complicated when both employer and employee after-tax contributions are made to the plan. In that case, the calculations vary depending on whether the plan is self-insured or insured under individual or group policies.

Plan Funded with Individual Policies. If the plan is insured under individual policies paid for by both the employer and employee (with after-tax dollars), the taxable portion of any benefits received by the employee is calculated as follows:

$$\text{Taxable Benefits} = \text{Benefits Received} \times \frac{\text{Current Year Employer Premium Payments}}{\text{Total Current Year Premium Payments}}$$

Example 2J-2 Calculating the taxable portion of sick pay received under an individual policy.

Select Corp. maintains a sick pay plan made up of individual insurance policies. The company pays \$800 of premiums on Helen Weaver's (one of its employees) policy and Helen pays \$200 through after-tax payroll deductions. During the current year, Helen is temporarily disabled and receives \$4,000 (two months pay) under the policy. Helen must include \$3,200 [$\$4,000 \text{ total payments} \times \frac{\$800 \text{ (employer premium payments)}}{\$1,000 \text{ (total current year premium payments)}}$] in gross income. The remaining \$800 ($\$4,000 - \$3,200$) is nontaxable because it is attributable to her after-tax contributions.

Plan Funded with Group Policy. If the plan is insured under a group policy paid for by both the employer and employee (with after-tax dollars), the taxable portion of any benefits received by the employee is generally calculated as follows:

$$\text{Taxable Benefit} = \text{Benefits Received} \times \frac{\text{Employer Net Premium Payments for the Last Three Policy Years Known at the Beginning of the Current Calendar Year}}{\text{Total Net Premium Payments for the Last Three Policy Years Known at the Beginning of the Current Calendar Year}}$$

However, if at the beginning of the current calendar year net premium payments are known for at least one but fewer than three prior years, this calculation is made using the known prior years' premium payments (even though fewer than three years). Furthermore, if at the beginning of the current calendar year net premium payments are not known for at least one prior year, this calculation is made using a reasonable estimate of the first year's net premium. Net premiums are premiums less any policy dividends and experience-rated credits.

Self-insured Plan. If the plan is a funded, self-insured plan to which both employer and employee (after-tax) contributions are made, the taxable portion of any benefits received by the employee is generally calculated as follows:

$$\text{Taxable Benefit} = \text{Benefits Received} \times \frac{\text{Employer Contributions for the Prior Three Calendar Years}}{\text{Total Contributions for the Prior Three Calendar Years}}$$

However, if the plan has been in effect for at least one but fewer than three prior calendar years, this calculation is made using the contributions made during calendar years the plan has been in effect. Furthermore, if the plan has not been in effect for at least one prior calendar year, the taxability of benefits is made either by (1) using the current year's contributions made before the benefits were paid to the employee, or (2) calculating the percentage periodically (e.g. monthly or quarterly) and using it through the succeeding period.

Payroll Tax Treatment of Sick Pay

Withholding and paying income and employment taxes on sick pay is complicated by the fact that it can be paid either by the employer, an agent of the employer, or a third party that is not the employer's agent. The following general rules apply:

1. *FITW*. The taxable portion of sick pay paid by the employer (or its agent) is subject to FITW. If the sick pay is paid by the employer, FITW may be calculated using one of the regular payroll withholding methods. Sick pay made by a third party who is an agent of the employer is treated as supplemental wages for FITW purposes and may be eligible for withholding at the supplemental withholding flat rate, rather than at the wage withholding rate. (The supplemental withholding flat percentage rate is 25% unless all supplemental wages paid to an individual exceed \$1 million during the year, in which case the rate on the excess is 35%). A third-party payer is the employer's agent if the third party bears no insurance risk and is reimbursed on a cost-plus-fee basis. Conversely, a third-party payer is not the employer's agent if the third party is paid an insurance premium and not reimbursed on a cost-plus-fee basis. Sick pay paid by a third party that is not an agent of the employer is not subject to mandatory FITW but the employee can elect to have income tax withheld by filing Form W-4S (Request for Federal Income Withholding From Sick Pay) with the third party.
2. *FICA and FUTA*. These taxes apply to the taxable portion of sick pay, but only in the first six calendar months of disability following the last calendar month in which the employee worked. However, the social security portion (6.2%) of FICA and FUTA taxes does not apply to payments of sick pay that, when combined with the regular wages and sick pay previously paid to the employee during the year, exceed the applicable wage base. Payments made after the employee retires due to disability are exempt from both FICA and FUTA if paid under a plan or system established by the employer. In addition, payments are exempt from FICA (but not FUTA) if, at the time such payment is made, (a) the employee is entitled to disability social security benefits, (b) the entitlement began before the calendar year in which the payment is made, and (c) the employee did not perform any services for the employer during the period for which the payment was made. Payments made to the employee's estate or survivor after the calendar year of the employee's death are exempt from both FICA and FUTA.

If the employer (or its agent) is the payer, it must withhold and pay the employer and employee share of FICA and pay FUTA taxes. A third-party payer (other than as an agent of the employer) must withhold and pay the employee share of FICA and pay the employer part of FICA and FUTA taxes. However, a third-party payer can transfer back to the employer the responsibility to pay the employer's share of FICA and FUTA taxes if it promptly withholds the employee portion of the FICA tax, deposits the tax with the IRS, and notifies the employer of the amount of sick pay payments on which taxes were withheld and deposited.

Special Rules for Sole Proprietorships, Partnerships, and S Corporations

Sole Proprietorships. Premium payments made by a sole proprietor for his or her own sick pay insurance are nondeductible personal expenses—not ordinary and necessary business expenses. Note, however, that because the premiums are nondeductible, any benefits received under the policy are excludable from the sole proprietor's income.

Disability payments made from a self-insured plan can be excluded from the sole proprietor's income if the plan or other arrangement has the characteristics of insurance (e.g., there must be adequate risk shifting). If the self-

insured plan does not have the characteristics of insurance, the sick pay plan payments made to a sole proprietor are not deductible by the business nor are they excludable from the sole proprietor's income.

Partnerships and S Corporations. Based on the treatment of medical insurance premiums for partnerships [including limited liability companies (LLCs) electing to be treated as partnerships] and S corporations, it is believed a partnership can deduct the amount of sick pay insurance premiums paid on behalf of a partner, if the premium payments are for services rendered without regard to partnership/LLC income. Likewise, an S corporation can deduct the amount of sick pay insurance premiums paid on behalf of a more-than-2% shareholder-employee. The partner and more-than-2% S shareholder must then include the amount of such premiums in income. Since the premium payments are included in income, the benefit payments from the policy are excludable from the gross income of such partners and more-than-2% S shareholders.

Although no direct authority exists, the authors believe sick pay benefit payments made to partners (who provide services to the partnership) and more-than-2% S corporation shareholder-employees under a self-insured plan are deductible by the partnership and S corporation and includable in income by the partners and more-than-2% S shareholders using the rationale of Rev. Rul. 91-26 and IRS Notice 2008-1. It is also believed since the plan is not insured, the benefits cannot be excluded from income for such partners and more-than-2% S shareholders under IRC Sec. 104(a)(3). However, if the plan or other arrangement has the characteristics of insurance (e.g., there must be adequate risk shifting), the benefits can be excluded from the partner's or more-than-2% S shareholder's income.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

29. Which of the following statements concerning employer-provided coverage under Archer medical savings accounts is correct?
- a. New employees to a company with established Archer MSA accounts cannot establish an account after 2008, but old accounts may continue to be used or may be rolled over to an HSA.
 - b. If the employer so elects, Archer MSAs may be provided for employees covered under a health plan that does not include a high-deductible.
 - c. Qualified out-of-pocket health care expenses for reimbursement cannot include the cost of health insurance premiums under an Archer MSA.
 - d. Out-of-pocket expenses for reimbursement under an Archer MSA cannot include costs paid to meet the health insurance plan deductible.
30. Which of the following statements regarding tax treatment of long-term care (LTC) insurance coverage is most accurate?
- a. For payroll purposes, LTC insurance benefits are treated as an accident and health plan.
 - b. Employees can make pretax and after-tax contributions for their LTC coverage.
 - c. LTC is exempt from Medicare taxes.
31. John became seriously ill and began receiving \$400 per day from his qualified LTC policy on January 1, 2009; his costs at the treatment facility were \$150 per day until April 1 when additional treatments increased costs to \$350 per day. Benefits continued all year. How much of the benefits that John received in 2009 will be excluded from his income?
- a. \$109,750.
 - b. \$120,550.
 - c. \$146,000.
32. Which of the following statements concerning sick pay is correct?
- a. Sick pay plans funded through a VEBA trust are not subject to nondiscrimination rules.
 - b. Premiums paid by an employer under a self-insured plan for sick pay insurance are subject to FUTA tax.
 - c. Employee elective contributions for cafeteria sick pay coverage are deemed employer contributions.
 - d. Taxable benefits calculation under a group sick pay plan requires employer net premiums for the last three policy years.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

29. Which of the following statements concerning employer-provided coverage under Archer medical savings accounts is correct? **(Page 201)**
- New employees to a company with established Archer MSA accounts cannot establish an account after 2008, but old accounts may continue to be used or may be rolled over to an HSA. [This answer is incorrect. The cutoff date for establishing new Archer MSAs is December 31, 2007. However, previously established Archer MSAs can continue. Old accounts may continue to be used or may be rolled over to an HAS. These employers may permit their employees to establish new accounts after the cutoff date.]
 - If the employer so elects, Archer MSAs may be provided for employees covered under a health plan that does not include a high-deductible. [This answer is incorrect. Employers cannot make such an election; employees covered by a health plan that does not include a high deductible as defined by law are ineligible to participate in an Archer MSA.]
 - Qualified out-of-pocket health care expenses for reimbursement cannot include the cost of health insurance premiums under an Archer MSA. [This answer is correct. Allowable out-of-pocket expense can include deductibles, copayments, and other costs for covered benefits, but cannot include health insurance premiums.]**
 - Out-of-pocket expenses for reimbursement under an Archer MSA cannot include costs paid to meet the health insurance plan deductible. [This answer is incorrect. Out-of-pocket health plan expenses such as deductibles and copayments are allowable for reimbursement under an Archer MSA.]
30. Which of the following statements regarding tax treatment of long-term care (LTC) insurance coverage is most accurate?**(Page 203)**
- For payroll tax purposes, LTC insurance benefits are treated as an accident and health plan. [This answer is incorrect. For payroll tax purposes, LTC insurance benefits are treated like medical expense reimbursements under a health plan.]
 - Employees can make pretax and after-tax contributions for their LTC coverage. [This answer is incorrect. Employees cannot make pretax contributions for their LTC coverage, because LTC insurance are specifically excluded from the list of qualified benefits a cafeteria plan is allowed to provide. However, employees can make after-tax contributions for such coverage.]
 - Employer-paid premiums for LTC is exempt from Medicare taxes. [This answer is correct. Per the Internal Revenue Code, LTC coverage paid by the employer is exempt from social security and Medicare (FICA) taxes and federal unemployment (FUTA) taxes if the employer's contributions are made under a plan or system.]**
31. John became seriously ill and began receiving \$400 per day from his qualified LTC policy on January 1, 2009; his costs at the treatment facility were \$150 per day until April 1 when additional treatments increased costs to \$350 per day. Benefits continued all year. How much of the benefits that John received in 2009 will be excluded from his income? **(Page 206)**
- \$109,750. [This answer is incorrect. Total cost of treatment is not the amount excluded from income. Calculation = 90 days × \$150 + 275 days × \$350.]
 - \$121,450. [This answer is correct. John's exclusion of benefits was at the benefit exclusion cap of \$280 per day until his costs were higher than the cap. Calculation = 90 days × \$280 + 275 days × \$350.]**
 - \$146,000. [This answer is incorrect. In this case total amount received will not be excludable from income due to certain per day limitation rules. Calculation = 365 days × \$400.]

32. Which of the following statements concerning sick pay is correct? **(Page 208)**

- a. Sick pay plans funded through a VEBA trust are not subject to nondiscrimination rules. [This answer is incorrect. Sick pay plans are subject to nondiscrimination rules if funded through a VEBA trust or if disability benefits are provided under a retirement plan.]
- b. Premiums paid by an employer under a self-insured plan for sick pay insurance are subject to FUTA tax. [This answer is incorrect. Such premiums are exempt from FUTA, FICA, and FITW, and are not included in the employee's income.]
- c. Employee elective contributions for cafeteria sick pay coverage are deemed employer contributions. [This answer is correct. As a result, the contributions are not subject to FITW, FUTA, or FICA, and are not included in the employee's income.]**
- d. Taxable benefits calculation under a group sick pay plan requires employer net premiums for the last three policy years. [This answer is incorrect. Although employer net premiums for the last three policy years may be required when employer and after-tax employee contributions are mixed, fewer than three policy years may be allowed under the appropriate circumstances.]

Group-term Life Insurance Defined

Employers can provide employees with up to \$50,000 of group-term life insurance coverage on a tax-free basis. To qualify for this special tax treatment, employer-provided group-term life insurance must (1) provide a general death benefit that is excludable from the beneficiary's gross income under IRC Sec. 101(a); (2) generally be provided for a group of at least 10 full-time employees; (3) be provided under a policy carried directly or indirectly by the employer; and (4) provide for each employee an amount of insurance that has been computed under a formula that precludes the employee's selection of the amount of coverage.

For purposes of IRC Sec. 79, the definition of an employee includes current and former common-law employees as well as full-time life insurance salespersons who are current or former statutory employees. It also includes a leased employee who has provided services on a substantially full-time basis for at least a year if the services are performed under the recipient's primary direction or control. If a former employee currently performs services for the employer as an independent contractor, the rules apply only with respect to insurance provided because of the person's former employee services.

The cost of excess (more than \$50,000) group-term life insurance coverage is not the employer's actual premium cost for the excess coverage, but an amount calculated using a uniform premium rate schedule known as the Table I rates.

If employer-provided life insurance does not meet the four requirements previously listed, the taxable amount is not determined using the Table I rates because the life insurance is provided outside the confines of the Section 79 rules. Instead, the employer's cost of the insurance premiums (net of any employee contributions) is included in the employee's gross income, reported as wages on the employee's Form W-2, and subject to payment of social security and Medicare (FICA) tax. However, this amount is exempt from income tax withholding and payment of federal unemployment (FUTA) tax.

Exception for Small Plan Offering Insurance to Full-time Employees

Generally, to qualify as group-term life insurance, a policy must cover 10 or more full-time employees. However, under the small plan exception, a policy covering fewer than 10 employees can still qualify as group-term life insurance if (1) the insurance is provided to all full-time employees who are insurable; (2) the amount of insurance is computed either as a uniform percentage of compensation or on the basis of coverage brackets; and (3) evidence of insurability is limited to a medical questionnaire that does not require a physical examination.

Under the small plan exception, the following employees are not considered for meeting the above requirements: (1) employees who have not been employed for a specified waiting period (not exceeding six months), (2) part-time employees, or (3) employees who have reached the age of 65. (An employee is presumed part-time if his usual employment does not exceed 20 hours in any week, or five months in any year.) Insurance is considered provided to an employee who elects not to receive insurance unless, to receive it, the employee must contribute toward the cost of other benefits.

Group-term Life Insurance (Taxable Compensation)

The following paragraphs explain when employer-provided group-term life insurance coverage is taxable to employees and shows how to calculate the taxable amount. It also explains special withholding rules that may apply. Special rules apply if an insurance policy meeting the Section 79 requirements provides permanent benefits to an employee.

Tax-free Coverage

In the following situations, the cost of all employer-provided group-term coverage, including the cost of coverage in excess of the \$50,000 limit discussed below, is tax-free to the employee:

1. The employee has terminated employment with the employer and is disabled within the meaning of IRC.

2. The coverage is part of a qualified pension, profit sharing, stock bonus, or annuity plan and the proceeds are payable (directly or indirectly) to a participant in the plan or a participant's beneficiary.
3. The employer is directly or indirectly the beneficiary of the policy for the entire period during the year that the employee had the coverage. This exemption can apply for all or a portion of the coverage.
4. The employee names a charitable organization described in IRC Sec. 170(c) as the sole beneficiary of the policy for the entire period during the year that the employee had the coverage. This exemption can apply for all or a portion of the coverage.

Group-term Life Insurance Coverage for Current Employees

The cost of employer-provided group-term life insurance coverage is included in the employee's gross income to the extent the cost of the policy coverage exceeds (1) the cost of \$50,000 of such insurance, plus (2) the after-tax amount (if any) paid by the employee toward the purchase of the insurance. This includes total employee after-tax contributions, whether those contributions were used to purchase coverage below or above the \$50,000 coverage limit.

This rule excludes the first \$50,000 of group-term coverage provided by an employer, plus the cost of additional coverage to the extent of any employee after-tax contributions toward its purchase. The cost of group-term life insurance coverage in excess of this amount (hereinafter referred to as the taxable cost of excess group-term coverage) is included in the employee's gross income, reported as compensation on the employee's Form W-2, and subject to social security and Medicare (FICA) tax. However, this amount is exempt from federal income tax withholding (FITW) and payment of federal unemployment (FUTA) tax. Only one \$50,000 exclusion is available to each employee, regardless of the number of employers offering group-term life insurance.

The cost of group-term life insurance coverage offered is not the employer's actual premium cost for the excess coverage, but an amount calculated using a uniform premium rate schedule provided by the IRS. Under this table (known as Table I), cost is computed with respect to uniform premiums on the basis of five-year age brackets given the employee's age at December 31.

Example 2L-1 Calculating the taxable cost of excess group-term coverage.

In the current year, Sharpline Corporation paid premiums of \$8,000 on a \$300,000 group-term life insurance policy for current employee Stanley Glover. Sharpline's group-term life insurance plan meets the four conditions discussed above. Stanley is 66 years old as of the last day of the year. Using Table I, the cost of \$1,000 of insurance for one month for a 66-year-old individual is \$1.27. Since the face amount of the insurance coverage remains the same throughout the entire year, Sharpline calculates the taxable cost of excess group-term coverage on an annual basis. Assuming Stanley contributes \$150 per month (\$1,800 annually) on an after-tax basis toward the cost of this policy, the taxable cost of Stanley's excess group-term coverage is \$2,016.

Sharpline Corporation must withhold and pay FICA tax on the \$2,016. However, this amount is exempt from FITW and payment of FUTA. The \$2,016 is reported as taxable wages in boxes 1, 3 (subject to the maximum social security wage base), and 5 of Stanley's Form W-2, and is also reported in box 12 using Code C.

For withholding and reporting purposes, the employer may treat the cost of excess group-term coverage as though paid by the pay period, by the quarter, or on any other basis so long as it is treated as paid at least once a year. The employer need not inform the IRS of a formal choice of payment dates; furthermore, the same choice need not be made for each employee. The employer may change methods at any time, so long as all taxable excess coverage is treated as paid no later than December 31 of the calendar year.

Example 2L-2 When taxable excess group-term coverage is deemed paid for withholding and reporting purposes.

Assume the same facts as in Example 2L-1 except Stanley is paid on a semimonthly basis, and Sharpline pays the \$8,000 of premiums in monthly installments. The IRS has prescribed special instructions for when the

taxable cost of excess group-term coverage is deemed to be paid for withholding and reporting purposes (IRS Notice 88-82). Sharpline can treat the cost of the excess group-term coverage as paid on the same basis as Stanley’s pay (semimonthly), or as paid when the premiums are actually remitted to the insurer (monthly), or on any other basis as long as payment is treated as made at least once a year and no later than December 31 of the calendar year.

Sharpline treats the \$2,016 as paid to Stanley on December 31, and so withholds Stanley’s share of the FICA tax and pays its share of this tax for the payroll period ending December 31.

Example 2L-3 Calculating the taxable cost of excess group-term coverage (coverage varies during the year).

Assume the same facts as in Example 2L-1 except Sharpline decreases the coverage amount to \$200,000 on July 1. (Sharpline’s total annual cost of this policy is \$6,000.) Using Table I, the cost of \$1,000 of insurance for one month for a 66-year-old is \$1.27. Since the face amount of the insurance coverage changes during the year, Sharpline calculates the cost of excess coverage on a semiannual basis.

The taxable cost of the excess group-term coverage is calculated as follows:

	<u>Jan.–Jun.</u>	<u>Jul.–Dec.</u>	<u>Total</u>
Total coverage (for the year)	\$ 300,000	\$ 200,000	
Less \$50,000 coverage exclusion	<u>(50,000)</u>	<u>(50,000)</u>	
Monthly balance of excess coverage	<u>\$ 250,000</u>	<u>\$ 150,000</u>	
Cost of excess coverage using Table I:			
1/1–6/30 (250 × \$1.27 × 6 months)	\$ 1,905		\$ 1,905
7/1–12/31 (150 × \$1.27 × 6 months)		\$ 1,143	<u>1,143</u>
Annual cost of excess coverage			<u>3,048</u>
Less employee annual contributions			<u>(1,800)</u>
Taxable cost of excess group-term coverage			<u>\$ 1,248</u>

The \$1,248 is included in Stanley’s gross income, reported as wages on his Form W-2, and subject to FICA. However, this amount is exempt from FITW and the payment of FUTA.

Tax Treatment of Discriminatory Group-term Life Insurance Plans

If the employer’s group-term life insurance plan is discriminatory, key employees are not entitled to the \$50,000 coverage exclusion under IRC Sec. 79. (Nonkey employees continue to be eligible for this exclusion.) In addition, key employees are taxed on the greater of (1) the employer’s actual cost of the coverage for the key employee’s policy, or (2) the cost of the key employee’s coverage under the IRS’s Table I rates. Such amount is reduced by the key employee’s own after-tax contributions toward the insurance purchase.

The employer’s actual cost of the coverage for the key employee’s policy is determined using a series of complex allocation rules set forth in Temp. Reg. 1.79-4T, Q&A-6. These rules have the practical effect of determining the cost of coverage for each key employee using a premium table contained in the employer’s policy or, if the employer’s policy does not contain such a table, the 1960 Basic Group Table published by the Society of Actuaries.

Group-term Life Insurance Coverage for Former or Retired Employees

Prior to 1984, retired employees had an unlimited exclusion from income of the cost of employer-provided group-term coverage. However, starting in 1984, the exclusion is available only when the employee retires and is disabled. Special transitional rules may, however, allow retired employees covered under a group-term life insurance plan of the employer that was in existence on January 1, 1984 to exclude the full amount of employer-provided group-term coverage.

Former or retired employees who do not qualify under one of the transitional rules are considered employees for purposes of the Section 79 exclusion and are treated just like current employees for purposes of making the Section 79 calculations. This means that, at a minimum, the cost of the first \$50,000 of group-term coverage provided by the employer, plus the cost of additional coverage in an amount equal to any after-tax contributions by the former employee toward the purchase of the group-term coverage, is excluded from the employee's gross income. The cost of group-term life insurance coverage in excess of this amount (i.e., the taxable cost of excess group-term coverage) is included in the former employee's gross income, reported as compensation on Form W-2 issued to the former employee, and subject to payment of FICA tax. However, this amount is exempt from FITW and payment of FUTA tax.

A special FICA tax withholding rule applies to the former employee's share of FICA tax due on the cost of excess group-term coverage. Under this rule, the employee's share of the FICA tax must be paid by the employee directly to the IRS. The employer is required to separately state on the Form W-2 provided to the former employee (1) the portion of the employee's wages that consist of payments for group-term life insurance, and (2) the amount of his share of FICA tax due on those wages.

Example 2L-4 Calculating the taxable cost of excess group-term coverage for a former employee.

Employer S maintains a job outplacement program to provide assistance for laid-off employees. S allows terminated employees to continue with the company's group-term life insurance plan for a period of six months following the employee's termination date. However, the employees must cover 50% of the premium cost for coverage during this period. In a cost-cutting move, S lays off manager Janet Humphrey on July 1. At the time, Janet carried \$100,000 of coverage under S's group-term life insurance plan. Janet elects to continue her coverage for the six-month period.

Assume the taxable cost of excess group-term coverage under the Table I rates for Janet's policy was \$500 for the first six months of the year. (Janet was not required to contribute toward the cost of the policy.) In accordance with IRS Notice 88-82, S deems the taxable cost of excess group-term coverage for the first six months to be paid on June 30. This \$500 is included in Janet's gross income, reported as compensation on her Form W-2, and subject to FICA tax on June 30. (S should withhold from Janet's final paycheck her share of the FICA tax due on this amount.) However, the \$500 is exempt from FITW and the payment of FUTA tax.

If after termination Janet's required contribution toward the cost of the policy was \$200, the taxable cost of excess group-term coverage under Janet's policy would be \$300 (\$500 – \$200) for the last six months of the year. In accordance with IRS Notice 88-82, S deems the taxable cost of excess group-term coverage for the last six months to be paid on December 31. This \$300 is included in Janet's gross income and reported as compensation on her Form W-2. While S pays the employer's share of FICA tax due on this compensation deemed paid at December 31, Janet is responsible for paying her share of the FICA tax due on this compensation. There is no FITW withholding or FUTA tax due on this compensation.

S must separately state on Janet's Form W-2 (1) the portion of her wages that consists of taxable compensation attributable to excess group-term life insurance coverage for the post-employment period (reported in box 12, using Code C) and (2) the amount of employee FICA tax due on those wages (reported in box 12, using Code M for the uncollected social security tax and Code N for the uncollected Medicare tax).

Group-term Life Insurance Coverage for Domestic Partners

In Ltr. Rul. 9717018, the IRS was asked to rule on the tax outcome if an employer amended its group-term life insurance plan to provide coverage to domestic partners who are not dependents of eligible employees. The Service concluded that the coverage does not qualify for exclusion under IRC Sec. 79 or as a *de minimis* fringe benefit under IRC Sec. 132(a)(4). Thus, the cost of coverage [computed using Table I of Reg. 1.79-3(d)(2)] for the domestic partner and his or her dependents should be treated as additional compensation to the employee.

Group-term Life Insurance Coverage for Sole Proprietors, Partners, or S Shareholders

Sole Proprietors. Premiums paid by sole proprietors for their own group-term life insurance coverage are nondeductible personal expenses—not ordinary and necessary business expenses. As such, payments are not deduct-

ible. They are also not included in the proprietor's income (even if the coverage is not qualified or exceeds \$50,000).

Partners and S Shareholders. Although the regulations are not entirely clear, based on the treatment of medical insurance premiums for partnerships and S corporations, the authors believe a partnership [including a limited liability company (LLC) electing to be treated as a partnership] can deduct the group-term life insurance premiums paid on behalf of a partner if the premium payments are for services rendered in the capacity of a partner and are made without regard to partnership income. The partner includes the entire amount of the premiums in income. If the premium payments are not for services rendered in the capacity of a partner, or the payments depend upon partnership income, the partnership treats the payments as distributions to the recipient partners. An S corporation can deduct such amounts paid on behalf of the S corporation's shareholders. However, more-than-2% shareholders must then include the entire amount of such premiums in income. Whether the coverage is qualified group-term life insurance or under \$50,000 has no effect, because self-employed persons are not eligible for the special tax treatment allowed for the \$50,000 of qualified coverage.

Treating Dependent Group-term Life Insurance as a *De Minimis* Fringe Benefit

The cost of employer-provided group-term life insurance coverage on the life of an employee's spouse or dependent does not qualify for the Section 79 income exclusion. In addition, the cost of premiums paid by an employer for group-term life insurance on the life of the spouse or dependent of the employee is not a *de minimis* fringe. However, if the face amount of employer-provided group-term life insurance coverage on an employee's spouse or dependent does not exceed \$2,000 each, the cost of the employer-provided coverage is deemed to be a nontaxable *de minimis* fringe benefit.

When determining whether dependent group-term coverage with a higher face amount is *de minimis* (i.e., does not exceed \$2,000), only the excess (if any) of the cost of such insurance [calculated using the Table I rates of Reg. 1.79-3(d)(2)] over the amount the employee paid for it on an after-tax basis is considered. Generally, employer-provided dependent life insurance is not taxable to the employee to the extent the employee pays for the coverage with after-tax dollars.

The cost of employer-provided spouse or dependent group-term life insurance that is not *de minimis* is includable in the employee's gross income, reported as wages on the employee's Form W-2, and subject to FITW and FICA. However, the cost of this employer-provided coverage is exempt from the payment of FUTA. The amount that has to be included in the employee's income (calculated using the Table 1 rates) is reduced by amounts the employee pays for the insurance on an after-tax basis.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

33. Up to \$50,000 in group-term life coverage may be provided to employees by employers on a tax-free basis if certain requirements are met. Which of the following is one of those requirements?
- a. The insurance must provide an excludable death benefit.
 - b. The insurance must be provided to all employees as a group.
 - c. The insurance policy must be carried directly or indirectly by the employee group.
 - d. The insurance coverage amount must be based on formula and employee selections.
34. Gregg, who turned 66 October 31, 2009, participates in his company's qualified group-term life insurance coverage. Related Table I insurance cost per thousand per month is \$1.27. During 2009, Gregg paid \$75 per month through payroll deduction for \$150,000 in coverage; his employer paid \$4,000 for the entire year and the face amount of the coverage did not change during the year. What is the taxable cost of Gregg's excess group-term life insurance coverage for 2009?
- a. \$624.
 - b. \$1,524.
 - c. \$2,286.
 - d. \$3,100.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

33. Up to \$50,000 in group-term life coverage may be provided to employees by employers on a tax-free basis if certain requirements are met. Which of the following is one of those requirements? **(Page 217)**
- a. **The insurance must provide an excludable death benefit. [This answer is correct. The death benefit will be excluded from the beneficiary's gross income under IRC Sec. 101(a).]**
 - b. The insurance must be provided to all employees as a group. [This answer is incorrect. With some exception, the group size may be as small as 10 full-time employees. Group membership must be based on certain commonalities such as age or marital status, or employment-related factors such as years of service, compensation received, or union membership.]
 - c. The insurance policy must be carried directly or indirectly by the employee group. [This answer is incorrect. The employer must carry the policy.]
 - d. The insurance coverage amount must be based on formula and employee selections. [This answer is incorrect. The formula must preclude employee selection. For instance, the coverage amount could be based on age or years of service.]
34. Gregg, who turned 66 October 31, 2009, participates in his company's qualified group-term life insurance coverage. Related Table I insurance cost per thousand per month is \$1.27. During 2009, Gregg paid \$75 per month through payroll deduction for \$150,000 in coverage; his employer paid \$4,000 for the entire year and the face amount of the coverage did not change during the year. What is the taxable cost of Gregg's excess group-term life insurance coverage for 2009? **(Page 217)**
- a. **\$624. [This answer is correct. Gregg's taxable cost of excess group-term coverage is based on the total cost of excess group-term coverage ($100 \times 1.27 \times 12 \text{ months} = \$1,524$) less Gregg's after-tax contribution ($\$75 \times 12 \text{ months} = \900) to the purchase of this coverage ($\$1,524 - \900).]**
 - b. \$1,524. [This answer is incorrect. This represents the total cost of excess group-term coverage.]
 - c. \$2,286. [This answer is incorrect. This answer does not take into account the group-term coverage exclusion.]
 - d. \$3,100. [This answer is incorrect. This answer erroneously considers the actual cost paid by the employer for group-term coverage.]

Split-dollar Life Insurance Arrangements

What Is Split-dollar Insurance?

Split-dollar life insurance is not a type of insurance, but a method of funding premium payments on a whole life or other cash value life insurance policy. (A split-dollar plan cannot be funded with term insurance.) In a typical plan, the employer and employee agree to split the costs and benefits of a policy on the employee's life. The employer is generally responsible for the portion of each year's premium equal to the annual increase in cash surrender value (CSV) while the employee is liable for the balance of the premium, which frequently drops to zero after only a few years.

In return for paying its portion of the premiums, the employer is entitled to some or all of the cash value of the policy at the employee's death (or, if earlier, when the arrangement is terminated). If the policy is in force at the time of death, the employee's designated beneficiaries receive the face amount of the policy less the portion paid to the employer.

Typical Structure of Split-dollar Arrangements

Split-dollar plans typically are structured as follows:

1. *Collateral Assignment Arrangements.* The employee (or an irrevocable trust set up for the benefit of the employee's family) owns the policy, but the employer pays the portion of the premium equal to the annual increase in the policy's cash surrender value (CSV) or "loans" this amount to the employee (or trust) who is then responsible for paying the entire premium. The employer receives a security interest in the policy as collateral for making the premium payments or "loan," which are repaid at the employee's death (or the policy's cancellation). In an equity arrangement, the employer is entitled to receive only its accumulated premiums. Any CSV in excess of this amount (i.e., equity) is provided to the employee. In a nonequity arrangement, the employer receives the larger of its accumulated premiums or the CSV.
2. *Endorsement Arrangements.* The employer owns and pays the premiums on a policy insuring the employee's life and endorses the death benefit in excess of the CSV to the employee's beneficiary. These are usually nonequity plans used to provide death benefits to executives while they are employed. The CSV can then be used by the employer to fund a deferred compensation arrangement when the employee retires.

Employer's Tax Treatment

Because the employer is a partial beneficiary of the policy, no deduction is allowed for any premium payments made or for any amount the employee has to pick up as income. For collateral assignment arrangements treated as loans, the employer records a long-term receivable from the employee for the premiums it pays.

For life insurance contracts issued on or before August 17, 2006, that have not been materially changed, corporate-owned life insurance (COLI) policy benefits are tax-free to the employer when paid. However, for contracts issued after August 17, 2006, an employer must: (1) limit coverage to certain individuals, (2) obtain the covered individuals' informed consent, and (3) annually report to the IRS regarding its COLI policies for the benefits to be tax-free. If the conditions are not satisfied, the tax-free treatment of death benefits is limited to the sum of the premiums and other amounts paid by the employer for the COLI policy.

In addition, employers are required to file Form 8925 (Report of Employer-Owned Life Insurance Contracts), which includes information on the number of employees the policyholder had at the end of the tax year, the number of employees insured, the amount of insurance, and that valid consents were obtained. Form 8925 should be attached to the employer's income tax return for each tax year (other than a change in issuer) the employer has employer-owned life insurance contract(s) in force. Form 8925 is not required for a life insurance contract issued after August 17, 2006, as part of a Section 1035 exchange for a contract issued before August 18, 2006. However, any material increase in the death benefit or other material change to the contract will cause it to be treated as a new contract, and Form 8925 will be required. However, a modification to a split-dollar arrangement will not be treated

as a material change for purposes of IRC Sec. 101(j) if the underlying insurance contract is not modified. This rule applies even if the modification is treated as a material modification for purposes of Reg. 1.61-22.

Additionally, the following are not considered to be material changes for purposes of determining if an existing contract is treated as a new contract: (1) increases in the death benefit that occur as a result of either the operation of IRC Sec. 7702 or the terms of the existing contract (provided the insurer's consent to the increase is not required); (2) administrative changes; (3) changes to or from the general account to the separate account; or (4) changes as a result of the exercise of an option or right granted under the contract as originally issued.

Employee's Tax Treatment of Split-dollar Arrangements Entered into after September 17, 2003

Split-dollar arrangements entered into (or materially modified) after September 17, 2003, are taxed under one of two mutually exclusive regimes (i.e., the economic benefit or the loan regime), neither of which is particularly attractive with regard to equity plans.

Economic Benefit Regime. In the context of employment (or the provision of services), the economic benefit regime applies to all nonequity split-dollar arrangements (i.e., where the employee does not share in the policy's CSV). It also applies to equity arrangements (i.e., where the employee shares in the policy's CSV), if the employer owns the policy (i.e., the endorsement method is used).

Under the economic benefit regime, the employee must include in gross income each year (1) the value of the current term life insurance protection provided to the employee, (2) the value of any CSV to which the employee has current access, and (3) the value of any economic benefits provided to the employee. These amounts are reduced by any consideration paid by the employee. Finally, if the policy is transferred to the employee, any CSV in excess of the amount payable to the employer plus amounts previously included in the employee's income will be taxed under IRC Sec. 83.

The value of the current term life insurance protection provided to the employee equals the excess of the life insurance contract's death benefit (including paid-up additions) over the total amount payable to the employer (including policy loans that would offset amounts payable to the employer), less any amounts previously included in the employee's income or paid for by the employee in the current or a prior taxable year. This amount multiplied by a life insurance premium factor (to be published in the Internal Revenue Bulletins) equals the cost of current term life insurance protection to be included in the employee's gross income.

Loan Regime. The loan regime method applies to equity arrangements where the employee owns the policy (i.e., the collateral assignment method is used). Under the loan regime, the premiums paid by the employer are treated as a series of loans from the employer to the employee, if the employee has an obligation to repay the employer. Such loans are subject to IRC Secs. 1271, 1272, 1273, 1274, and 1275 (the original issue discount rules) and IRC Sec. 7872 (the below-market loan rules that generally will deem the employee to have paid the employer interest on the premium advances, funded by deemed compensation income paid by the employer to the employee). If the employee is not obligated to repay the employer's premium payments, such amounts are treated as compensation income to the employee at the time the premiums are paid by the employer.

Employee's Tax Treatment of Split-dollar Arrangements Entered into before September 18, 2003

In the case of split-dollar life insurance arrangements entered into before September 18, 2003, taxpayers may continue to rely on the transition rules set forth in IRS Notice 2002-8, but only if the arrangement is not materially modified after such date. Under IRS Notice 2002-8, the parties to the agreement can treat the value of the current life insurance protection as an economic benefit provided to the employee, or they can treat the premium payments advanced by the employer as loans.

Economic Benefit Treatment. This is the treatment most employers and employees will choose, as it usually results in the employee recognizing the least income. Under the economic benefit treatment, the value of the current term-life insurance protection provided to the employee (net of any employee payments) is included in the employee's income each year. Also, any portion of the policy's CSV provided to the employee is taxed when it is made available to the employee. (As explained later, this generally will not happen until the arrangement or policy terminates.)

Generally, under the rules set forth in IRS Notice 2002-8, the current term-life insurance protection is valued using the Table 2001 premium rates or, if lower, the insurer's published premium rate that is available to all standard risks for initial-issue one-year term insurance.

In addition to including the value of the term insurance in income each year, IRS Notice 2002-8 requires that any CSV provided to the employee be included in the employee's income when it is made available to the employee. Fortunately, an employee will not be considered as having received a portion of a policy's CSV solely because the interest or other earnings credited to the CSV causes the CSV to exceed what is payable to the employer.

Furthermore, the IRS will not argue an arrangement has terminated (which would potentially cause the employee to be taxed on his or her share of the policy's CSV) so long as the employee continues to be taxed on the value of the current life insurance protection and the employer retains an interest in the policy.

Loan Treatment. When an employer's premium payments are treated as loans, the tax consequences of the payments are subject to IRC Secs. 1271, 1272, 1273, 1274, and 1275 [the original issue discount (OID) rules] and IRC Sec. 7872 (the below-market loan rules that generally will deem the employee to have paid the employer interest on the premium advances, funded by deemed compensation income paid by the employer to the employee). According to IRS Notice 2002-8, the IRS will not challenge reasonable efforts to apply these rules.

Payroll Tax Treatment

Income required to be included in the employee's gross income under these rules is reported as additional wages on the employee's Form W-2 and is subject to FITW. It is not, however, subject to FICA or FUTA taxes. Sometimes, the split-dollar arrangement is structured so the employee pays part of the premiums on the policy. In that case, the employee is entitled to reduce the amount of income by the amount of premiums paid.

Retirement Plans

Qualified retirement plan types can be grouped into three categories: defined benefit plans, defined contribution plans, and employer-sponsored IRAs and SEPs. Defined benefit plans promise employees a specific amount of retirement benefits, while defined contribution plans provide each participant an account to which contributions are credited. Examples of defined contribution plans are profit-sharing plans, stock bonus plans, 401(k) plans, and employee stock ownership plans (ESOPs). Another type of plan being offered by many employers is a cash balance plan which is a defined benefit plan having certain defined contribution characteristics. Additionally, for plan years beginning after 2009, small employers (500 or fewer employees) may establish a combined defined benefit-401(k) plan. Employer-sponsored IRAs, SEPs, and SIMPLE IRA plans offer benefits similar to qualified plans and are the simplest plans to create and maintain.

Income and Payroll Tax Treatment of Contributions

Employer contributions to a qualified retirement plan (including employer matching, nonelective, or voluntary contributions) are excluded from the employee's gross income and are not treated as wages for income or employment tax purposes. Thus, they are not subject to federal income tax (FIT), federal income tax withholding (FITW), social security and Medicare (FICA) taxes, or federal unemployment (FUTA) taxes, and are not included in box 1, 3, or 5 of Form W-2.

Employee after-tax contributions are subject to FIT, FITW, FICA, and FUTA and are reported as taxable wages on Form W-2. Employee pretax contributions (elective deferrals) to 401(k) plans, 403(b) plans, SARSEPs established before 1997, and SIMPLE IRA plans are excluded from the employee's gross income, exempt from FITW, and not reported as taxable wages on Form W-2. However, they are subject to FICA and FUTA and must be reported as FICA wages on Form W-2.

Participants in a qualified retirement plan, SEP, or SIMPLE IRA plan (but not a payroll deduction IRA) are considered active participants in an employer-provided pension plan. Accordingly, the employer must mark the checkbox in Form W-2 box 13 (labeled "Retirement plan") for all participants in a qualified retirement plan. [In such case, the IRA deduction that can be claimed by the participant or his or her spouse for the year is reduced (but not below zero) where the participant's or couple's adjusted gross income (AGI), as modified, exceeds the applicable dollar limit for the year.

Example 2N-1 Income and payroll tax treatment of contributions to a profit-sharing plan.

ABC Corp. maintains a profit-sharing plan. During the current year, Jenny's salary is \$30,000, and she contributes \$1,000 to the plan using after-tax dollars (i.e., deducted from her pay after all other deductions). Assuming that ABC contributes \$2,000 to the profit-sharing plan on Jenny's behalf, its \$2,000 contribution is exempt from FIT, FITW, FICA, and FUTA and is not reported as taxable wages on her Form W-2. Jenny's \$30,000 of wages (which includes her \$1,000 after-tax contribution) is reported in Form W-2 boxes, 1, 3, and 5. ABC marks the checkbox on Form W-2 box 13 labeled "Retirement plan" to show that she is an active participant for the year. ABC also has the option of reporting its \$2,000 and Jenny's \$1,000 contribution in box 14 of Jenny's Form W-2.

The employer does not include employer contributions and employee pretax deferrals to a qualified retirement plan on line 2 of its Form 941 (Employer's Quarterly Federal Tax Return) or line 1 of Form 944 (Employer's Annual Federal Tax Return) as taxable wages. But it does include the pretax deferrals (but not employer contributions) on Form 941 lines 5a and 5c (lines 4a and 4c of Form 944) as taxable social security and Medicare wages. The pretax deferrals must also be included in part 2, line 3 (Total payments to all employees) of the employer's Form 940 [Employer's Annual Federal Unemployment (FUTA) Tax Return].

Treatment of 401(k) Plan Contributions

Employer nonelective (matching) contributions and employee elective deferrals (including excess deferrals and catch-up contributions) to a 401(k) plan are not included in box 1 of Form W-2. (The employer reports distributions of excess deferrals or excess contributions as gross income on Form 1099-R (distributions from pension annuities, retirement or profit-sharing plans, IRAs, insurance contracts, etc. generally subject to FITW withholding.) However, the employee elective deferrals are reported in Form W-2, boxes 3 (subject to the maximum social security wage base) and 5 as FICA wages, and also must be reported in box 12 of Form W-2 using Code D. Employer contributions and employee after-tax contributions are not included in the box 12 total. The IRS's instructions for Form W-2 permit employers to report employer nonelective (or matching) contributions and employee after-tax contributions in box 14, Other.

Participants in a 401(k) plan are considered active participants in an employer-provided retirement. Accordingly, the employer must mark the checkbox in box 13 of Form W-2 labeled "Retirement plan."

Example 2N-2 Income and payroll tax treatment of contributions to a 401(k) plan.

George (40 years old) works for Steelco, Inc., which has a matching 401(k) plan. George earned \$100,000 during the year, and elected to defer \$15,600 of his salary (i.e., the full 2009 elective deferral limit) to his 401(k) account, to which Steelco matched 50% (\$8,250). George also made \$1,000 of employee after-tax contributions to the plan.

George's \$16,500 elective deferrals are not included in wages for federal income tax purposes and are not subject to FITW. However, they are taxable wages for FICA and FUTA purposes. Steelco must withhold the FICA taxes from George's salary and pay its share of those taxes (plus FUTA) on the elective deferrals. The \$16,500 elective deferrals are not included in box 1, "Wages," of George's Form W-2, but are included in boxes 3 (subject to the maximum social security wage base) and 5. In addition, the \$16,500 elective deferrals are reported in box 12 as Code D.

Steelco's matching contribution is exempt from FIT, FITW, FICA, and FUTA and is not reported as taxable wages in W-2 boxes 1, 3, or 5. George's \$1,000 of employee after-tax contributions are subject to FIT, FITW, FICA, and FUTA and are included in taxable wages reported on W-2 boxes 1, 3 (subject to the maximum social security wage base), and 5. (Although not required, Steelco uses box 14, "Other," to report George's after-tax and its matching contributions.) The "Retirement plan" checkbox in box 13 is marked to indicate George's participation for the year.

The employer does not include employer contributions and employee elective deferrals to a 401(k) plan on line 2 of its Form 941 (Employer's Quarterly Federal Tax Return) or line 1 of Form 944 (Employer's Annual Federal Tax Return) as taxable wages. But it does include the elective deferrals (but not employer contributions) on Form 941 lines 5a and 5c (lines 4a and 4c on Form 944) as taxable social security and Medicare wages. The elective deferrals must also be included in Part 2, line 3 (Total payments to all employees) of the employer's Form 940 [Employer's Annual Federal Unemployment (FUTA) Tax Return].

Qualified Roth Contribution Program

A 401(k) plan may permit an employee to elect to make designated Roth 401(k) contributions to a qualified Roth 401(k) contribution program in lieu of all or a portion of the elective deferrals. Even though the Roth contributions are taxable wages to the employee in the year of deferral and are subject to FIT, FITW, FICA, and FUTA, qualified distributions to the employee and earnings on the contributions are excluded from income. Designated Roth 401(k) contributions are included in the amount of taxable wages reported in boxes 1, 3 (subject to the maximum social security wage base), and 5 of the employee's Form W-2 and must also be reported in box 12 using Code AA [instead of Code D, which is used for regular 401(k) contributions]. Because Roth 401(k) contributions are treated as elective 401(k) contributions, they are subject to the maximum 401(k) deferral limit of \$16,500 in 2009 (\$22,000 if the participant is age 50 or older).

Treatment of SIMPLE IRA Contributions

Employer nonelective (matching) contributions to a SIMPLE IRA plan are excluded from the employee's gross income and are not treated as wages for income or employment tax purposes. Therefore, they are not subject to federal income tax (FIT), federal income tax withholding (FITW), social security and Medicare (FICA) taxes, or federal unemployment (FUTA) taxes. Employee elective deferrals are excluded from the employee's gross income for federal income tax purposes and are exempt from FITW. They are, however, included in the employee's wages for FICA and FUTA purposes. This means that the employer must withhold the employee's share of FICA and pay FUTA and its share of FICA on the contribution at the same time.

Because employer contributions and employee elective deferrals to a SIMPLE IRA plan are not wages subject to FIT and FITW, they are not included in box 1 of Form W-2; however, the elective deferrals are reported in Form W-2, boxes 3 (subject to the maximum social security wage base) and 5 as FICA wages. Elective deferrals (but not employer contributions) also must be reported in box 12 of Form W-2 using Code S. Participants in a SIMPLE IRA plan are considered active participants in an employer-provided pension plan, and so the employer must check the "Retirement plan" box on the employee's Form W-2.

Example 2N-3 Income and payroll tax treatment of contributions to a SIMPLE IRA.

Judy's salary is \$40,000, and she elects for the year to make \$5,000 of salary reduction contributions to her SIMPLE IRA. Her employer, Fast-Gro, contributes \$1,200 to the plan on her behalf (3% employer matching contribution). Judy's \$5,000 of elective deferrals are not included in wages for FIT purposes and are not subject to FITW. However, they are taxable wages for FICA and FUTA purposes, so Fast-Gro must withhold FICA taxes from Judy's salary and pay its share of those taxes (plus FUTA) on the elective deferrals.

The elective deferrals are not included in box 1, "Wages," of Judy's Form W-2, but are included in boxes 3 (subject to the maximum social security wage base) and 5 and reported in box 12 using Code S. Fast-Gro's \$1,200 contribution is exempt from FIT, FITW, FICA, and FUTA and is not reported as taxable wages in Form W-2, boxes 1, 3, or 5. Fast-Gro chooses not to report its \$1,200 contribution in box 14. The "Retirement plan" checkbox in box 13 is marked to indicate Judy's participation.

The employer does not include employer contributions and employee elective deferrals to a SIMPLE IRA plan on line 2 of its Form 941 (Employer's Quarterly Federal Tax Return) or line 1 on Form 944 (Employer's Annual Federal Tax Return) as taxable wages. However, it does include the elective deferrals (but not employer contributions) on Form 941 lines 5a and 5c (lines 4a and 4c of Form 944) as taxable social security and Medicare wages. The elective deferrals must also be included in Part 2, line 3 (Total payments to all employees) of the employer's Form 940 [Employer's Annual Federal Unemployment (FUTA) Tax Return].

Payroll Deduction IRAs (or Roth IRAs)

Employers who choose not to sponsor a qualified retirement plan are encouraged to set up a payroll deduction system to help employees save for retirement by directly depositing payroll deductions to employee IRAs (IRS Ann. 99-2). Employers collect the IRA contributions from the employees' wages through payroll deductions and transmit them to the custodian or trustee. Payroll deduction contributions can be deposited into either traditional or Roth IRAs.

Employee contributions made by payroll deduction are included in the employee's income, but the employee may deduct such amounts if paid to a traditional IRA (Roth IRA contributions are nondeductible) under the rules that normally apply to traditional IRA deductions. Employees may adjust their federal income tax withholding (via their Form W-4) for deductible contributions to traditional IRAs in order to receive a more immediate tax benefit from their contributions.

Participants in a payroll deduction IRA are not considered active participants in an employer-provided pension plan. Thus, the employer should not mark the checkbox in Form W-2 box 13 (labeled "Retirement plan") for these participants, unless they also participate in one of the earlier-discussed plans.

Deemed IRAs

A qualified retirement plan can maintain a separate account to receive voluntary employee contributions. If the separate account otherwise meets the requirements of a traditional IRA or Roth IRA, it is deemed a traditional IRA or Roth IRA. A deemed IRA is subject to IRA rules and not to qualified plan rules. Also, the deemed IRA and contributions to it are not taken into account in applying qualified plan rules to any other contributions under the plan.

Voluntary employee contributions must be designated as such by employees covered under the plan and are subject to the general IRA contribution limit of \$5,000 (\$6,000 if age 50 or older) for 2009. Like payroll deduction IRAs, the contributions are includable in the employee's income, but the employee can deduct them under the rules that normally apply to IRAs.

Qualified Retirement Plan Distributions

Qualified retirement plan distributions are taxable income to the recipient to the extent attributable to employer contributions or employee pretax contributions (elective deferrals). Distributions of investment earnings of the plan also are taxable income to the recipient. Benefits attributable to employee after-tax contributions (i.e., amounts contributed by employees from wages on which income and payroll taxes were withheld) are not taxable income.

Minimum Distribution Rules

Unless the plan permits and the participant elects otherwise, the payment of qualified plan benefits must begin no later than the 60th day after the close of the plan year in which the latest of the following occurs: (1) the participant reaches the earlier of age 65 or the plan's normal retirement age, (2) the participant completes 10 years of plan participation, or (3) the participant terminates service with the employer. These rules only describe the latest date on which benefit payments may start. A plan may provide for benefits to start sooner than the date determined under these rules. In fact the minimum distribution rules may require an earlier payout. They set out a specific date when distributions must begin and dictate the minimum amount and latest date that benefits may be distributed. The plan administrator is responsible for calculating and paying the minimum required distribution amount. However, for IRAs, including employer plans funded by them (SEPs, SIMPLE IRAs, deemed IRAs, and payroll deduction IRAs), the individual account owner (the employee) must do the calculations.

To satisfy the minimum distribution rules, a qualified retirement plan must require participants to receive (or begin receiving) plan benefits no later than their required beginning date. The required beginning date for a qualified plan participant other than a 5% owner is April 1 of the year following the later of the calendar year in which the participant turns age 70^{1/2} or retires from the employer sponsoring the plan. A participant reaches age 70^{1/2} on the date six months after the participant's 70th birthday.

The required beginning date for IRA owners (including SEP-IRA and SIMPLE IRA owners) and qualified plan participants who are 5% owners is April 1 of the year following the year in which they turn 70^{1/2}, even if they have not retired.

Individuals are 5% owners if they or a family member own more than 5% of the employer maintaining the plan, including any commonly controlled entities, trades or businesses under IRC Sec. 414(b), (c), or (m). For this purpose, family members include the individual's spouse, children, grandchildren, and parents.

Example 20-1 Determining when to start distribution of benefits after participant reaches age 70^{1/2}.

John worked for Lake Corp., where he participated in a profit-sharing plan. He turned 70^{1/2} during 2010 and retired. The plan must commence his benefits by April 1, 2011. If John had not retired during 2010, the plan would not have to commence John's benefits until April 1 of the year following the year he retired (assuming the plan allowed such a deferral and John is not a 5% owner of the corporation).

Variation: If John had retired in January 2009, he would not have to receive a distribution for 2009 by April 1, 2010 since legislation waived minimum distributions for 2009.

Tax-sheltered Annuity [403(b)] Plans

A tax-sheltered annuity [otherwise known as a 403(b)] plan is a special type of retirement arrangement that enables certain tax-exempt and governmental employers to purchase annuity contracts or contribute to custodial accounts for eligible employees. The two types of employers that are eligible to establish 403(b) plans are public educational organizations (public schools) and organizations that are tax-exempt under IRC Sec. 501(c)(3).

The primary benefits of 403(b) plans are similar to those of qualified retirement plans; namely, employees are not taxed on contributions made to the plan on their behalf or any related earnings until they receive their distributed benefits. However, they receive their special tax status and are subject to their own separate requirements under IRC Sec. 403(b) [i.e., outside of the regular Section 401(a) qualified retirement plan rules].

Section 403(b) plans can be funded via any combination of employee salary reduction contributions, employer nonelective (matching) contributions, or employee after-tax contributions [although it is rare for a 403(b) plan to allow employee after-tax contributions]. The most common type of 403(b) plan is one funded solely by employee salary reduction contributions.

Tax Treatment of Contributions

Employer contributions to 403(b) plans are excluded from the employee's gross income and are not treated as wages for income or employment tax purposes. Therefore, they are not subject to federal income tax (FIT), federal income tax withholding (FITW), social security and Medicare (FICA) taxes, or federal unemployment (FUTA) taxes. Employee elective deferrals are exempt from FITW, but are included in the employee's wages for FICA and FUTA purposes. Employee after-tax contributions are subject to FIT, FITW, FICA, and FUTA, and are included in the amount of taxable wages reported in boxes 1, 3 (subject to the maximum social security wage base), and 5 of the employee's Form W-2.

Employer contributions and employee elective deferrals (including excess deferrals and catch-up contributions) to a 403(b) plan are not included in box 1 of Form W-2. The elective deferrals, however, are reported in Form W-2, boxes 3 (subject to the maximum social security wage base), and 5 as FICA wages. Elective deferrals (including excess deferrals and catch-up contributions) also must be reported in box 12 of Form W-2 using Code E. Employer contributions and employee after-tax contributions are not reported in box 12. Additionally, since 403(b) partici-

pants are considered to be active participants in an employer-provided pension plan, the employer must mark the checkbox in box 13 of Form W-2 labeled "Retirement plan."

Example 2P-1 Income and payroll tax treatment of contributions to a 403(b) plan.

We Help Elderly (WHE) maintains a qualified 403(b) plan. During the current year, Sammy earns \$30,000 and elects to defer \$2,000 of his salary to the 403(b) plan. WHE contributes \$1,000 to the 403(b) plan on Sammy's behalf.

WHE must withhold FICA taxes from Sammy's salary and pay its share of those taxes (plus FUTA) on the elective deferrals. The elective deferrals are not included in box 1, Wages, of Sammy's Form W-2, but are included in boxes 3 and 5. In addition, the elective deferrals are reported in box 12 using Code E. WHE's \$1,000 contribution is exempt from FIT, FITW, FICA, and FUTA and is not reported as taxable wages in Form W-2 boxes 1, 3, or 5. WHE chooses not to report its \$1,000 contribution in box 14. The "Retirement plan" checkbox in box 13 is marked to indicate Sammy's participation.

The employer does not include employer contributions and employee elective deferrals to a 403(b) plan on line 2 of its Form 941 (Employer's Quarterly Federal Tax Return) or line 1 of Form 944 (Employer's Annual Federal Tax Return) as taxable wages. However, it does include the elective deferrals (but not employer contributions) on Form 941 lines 5a and 5c (lines 4a and 4c of Form 944) as taxable social security and Medicare wages. The elective deferrals must also be included in Part 2, line 3 (Total payments for all employees) of the employer's Form 940 [Employer's Annual Federal Unemployment (FUTA) Tax Return].

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

35. Which of the following is correct concerning split-dollar life insurance?
- a. In a collateral assignment arrangement, the employer owns the policy and pays the policy premiums.
 - b. The employer and employee generally share an inverse relationship concerning premium payments.
 - c. Under an endorsement arrangement, the employee owns the policy and endorses it to the employer.
 - d. Term life is the most cost-effective vehicle for providing employees with split-dollar insurance.
36. The economic benefit regime applies to which of the following?
- a. Nonequity split-dollar arrangements.
 - b. Equity arrangements.
37. Which of the following is one of the three categories of retirement plan types?
- a. Profit-sharing plan.
 - b. Employee stock ownership plan.
 - c. Cash balance plan.
 - d. Employer-sponsored SEP.
38. Which of the following contributions to a qualified retirement plan is **not** subject to FUTA tax?
- a. Employer nonelective contributions to a 401(k) plan.
 - b. Employee deductions to a profit-sharing plan.
 - c. Employee elective contributions to a 403(b) plan.
 - d. An active participant's contribution to a qualified employer-provided SEP.
39. Gary's father is sole owner of Everly Company. Everly provides a 401(k) for its employees, of which Gary is a member. Gary completed 10 years of service with Everly December 18, 2008 and retired May 5, 2010 on his 71st birthday. Under minimum distribution rules, when must Gary begin receiving plan benefits?
- a. April 1, 2009.
 - b. April 1, 2010.
 - c. November 5, 2009.
 - d. April 1, 2011.
40. Which of the following statements concerning tax-sheltered annuity plans is correct?
- a. A 501(c)(3) organization is eligible to establish a 403(b) retirement plan.
 - b. A 403(b) plan is subject to IRC Sec 401(a) and its requirements.
 - c. Employers cannot contribute nonelectively to a 403(b) plan.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

35. Which of the following is correct concerning split-dollar life insurance? **(Page 225)**
- a. In a collateral assignment arrangement, the employer owns the policy and pays the policy premiums. [This answer is incorrect. The employee owns the policy in a collateral assignment arrangement.]
 - b. The employer and employee generally share an inverse relationship concerning premium payments. [This answer is correct. The employer pays the CSV portion of the premium, which increases over time; the employee pays the remainder.]**
 - c. Under an endorsement arrangement, the employee owns the policy and endorses it to the employer. [This answer is incorrect. The employer owns the policy in an endorsement arrangement, pays the premiums, and retains death benefits equal to the CSV; benefits in excess of CSV are endorsed to the employee's beneficiary.]
 - d. Term life is the most cost-effective vehicle for providing employees with split-dollar insurance. [This answer is incorrect. Term life does not build cash value. CSV is a critical element in a split-dollar plan.]
36. The economic benefit regime applies to which of the following? **(Page 225)**
- a. Nonequity split-dollar arrangements. [This answer is correct. In the context of employment (or the provision of services), the economic benefit regime applies to all nonequity split-dollar arrangements. It also applies to equity arrangements, if the employer owns the policy (i.e., the endorsement method is used).]**
 - b. Equity arrangements. [This answer is incorrect. The loan regime method applies to equity arrangements where the employee owns the policy (i.e., the collateral assignment method is used). Under the loan regime, the premiums paid by the employer are treated as a series of loans from the employer to the employee, if the employee has an obligation to repay the employer.]
37. Which of the following is one of the three categories of retirement plan types? **(Page 227)**
- a. Profit-sharing plan. [This answer is incorrect. This is an example of a defined contribution plan.]
 - b. Employee stock ownership plan. [This answer is incorrect. An ESOP is one of several examples of a defined contribution plan.]
 - c. Cash balance plan. [This answer is incorrect. A cash balance plan is a hybrid combination of a defined contribution plan and a defined benefit plan.]
 - d. Employer-sponsored SEP. [This answer is correct. The three categories are the defined contribution plan, the defined benefit plan, and the employer-sponsored IRA and SEP.]**
38. Which of the following contributions to a qualified retirement plan is **not** subject to FUTA tax? **(Page 227)**
- a. Employer nonelective contributions to a 401(k) plan. [This answer is correct. Employer contributions to a qualified retirement plan are not subject FIT, FITW, FUTA, or FICA, whether nonelective, voluntary, or matching.]**
 - b. Employee deductions to a profit-sharing plan. [This answer is incorrect. Employee deductions to a profit-sharing plan are after-tax, and so are subject to FIT, FITW, FUTA, and FICA.]
 - c. Employee elective contributions to a 403(b) plan. [This answer is incorrect. Employee elective contributions to a 403(b) plan are not subject to FIT and FITW, but are subject to FUTA and FICA.]
 - d. An active participant's contribution to a qualified employer-provided SEP. [This answer is incorrect. An active participant's contribution to a qualified employer-provided SEP may or may not be subject to FUTA depending on the character of the employee contribution.]

39. Gary's father is sole owner of Everly Company. Everly provides a 401(k) for its employees, of which Gary is a member. Gary completed 10 years of service with Everly December 18, 2008 and retired May 5, 2010 on his 71st birthday. Under minimum distribution rules, when must Gary begin receiving plan benefits? **(Page 230)**
- a. April 1, 2009. [This answer is incorrect. This date does not reflect the latest qualifying event under minimum distribution rules.]
 - b. April 1, 2010. [This answer is correct. As a family member of a more than 5% owner, Gary must begin receiving plan benefits on April 1 following his attaining 70 ½ years of age, whether or not he has retired.]**
 - c. November 5, 2009. [This answer is incorrect. Gary attained 70 ½ years of age on this date. This is a key date in determining when he must begin to receive plan benefits, but it is not the date required by minimum distribution rules.]
 - d. April 1, 2011. [This answer is incorrect. Gary retired May 5, 2010, but this is not the event considered by minimum distribution rules to be the key factor in determining when he must begin to receive benefits.]
40. Which of the following statements concerning tax-sheltered annuity plans is correct? **(Page 231)**
- a. A 501(c)(3) organization is eligible to establish a 403(b) retirement plan. [This answer is correct. Public educational organizations and 501(c)(3) organizations are eligible to establish 403(b) retirement plans.]**
 - b. A 403(b) plan is subject to IRC Sec 401(a) and its requirements. [This answer is incorrect. A 403(b) retirement plan derives its tax-favored status from, and is subject to the requirements of, IRC Sec. 403(b).]
 - c. Employers cannot contribute nonelectively to a 403(b) plan. [This answer is incorrect. Employers can make nonelective matching contributions to 403(b) plans.]

EXAMINATION FOR CPE CREDIT**Lesson 2 (PRLTG092)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

21. Which of the following statements concerning health plans is correct?
- a. Both insured and self-insured health care plans are subject to non-discrimination tests.
 - b. Health care plan benefits must be paid from specially designated funds if the plan is self-insured.
 - c. IRC Section 106 defines health and accident plans and sets forth the rules for employer contributions.
 - d. Sole proprietors do not meet the definition of an employee for health and accident plan purposes.
22. Which statement concerning plan requirements for income tax purposes is correct?
- a. For purposes of defining a health plan, a plan cannot cover an individual functioning in a capacity not considered to be an employee of the organization.
 - b. FICA statutes require the employer to make payments to the health care system in order to provide evidence of the existence of a plan.
 - c. FUTA statutes require the employer to make payments to the health care system in order to provide evidence of the existence of a plan.
 - d. Health care payment funds must be segregated, but may be combined with the employer's general salary and wage accounts.
23. Coverage under an HRA covers all of the following **except**:
- a. Dental expenses.
 - b. Over-the-counter medication.
 - c. Medical expenses.
 - d. Dietary supplements.
24. Which of the following statements is correct concerning self-insured health care plans?
- a. The rules for insured and self-insured plans are virtually identical.
 - b. Nondiscrimination rules apply to both insured and self-insured plans.
 - c. Nondiscrimination rules apply to FIT, but not to FITW, FUTA, or FICA.
 - d. A qualified self-insured plan must shift risk away from the employer.

25. Endeavor Corp. has a group medical plan for its employees which is subject to a \$1,000 deductible and an 80/20 copay. In addition, Endeavor maintains a supplemental medical expense reimbursement plan for its executive class of employees. The executive can file and receive reimbursement for both the deductible and the copay. During the previous year, Emma had \$10,000 of elective surgery not covered by other company insurance. Emma is covered by the executive supplemental plan. She files and receives the maximum reimbursement. How much of the foregoing will be included in Emma's gross income?
- a. \$7,200.
 - b. \$8,000.
 - c. \$9,000.
 - d. \$10,000.
26. Which of the following statements concerning AD&D insurance policies is correct?
- a. Most AD&D policies cover both occupational and recreational injuries.
 - b. Employer-provided AD&D coverage is excludable from the employee's gross income.
 - c. Dismemberment benefit taxation depends on employee elective status of premiums.
 - d. Dismemberment benefits exclude permanent loss of use of a limb.
27. Approximately how many months must an injured employee be absent from work and receive sickness or injury payments before the dismemberment payments become exempt from FUTA?
- a. 3.
 - b. 6.
 - c. 9.
 - d. 12.
28. Dismemberment benefits under an employer-provided AD&D policy providing payment to the employee for the temporary or permanent loss of the use of a limb, and for the permanent loss of a limb are excludable from the employee's income.
- a. True.
 - b. False.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.

29. Marjorie Lane is an LLC with 25 full-time and 10 part-time employees. Part-time workers are not allowed to work more than 25 hours per week. Lane provides an Archer MSA for its employees and contributes annually to the employee accounts. All employees are participating although there is some disparity between contributions for full-time versus part-time employees since contributions to full-time employee accounts are based on 2% of annual compensation while part-time employee accounts receive a flat contribution of \$20 per month. During 2009, Lane contributed \$38,640 to Archer MSAs. How much tax will Lane be assessed as a result of the disparity?
- \$0.
 - \$840.
 - \$12,684.
 - \$13,524.
30. Which of the following concerning health savings accounts is correct?
- The maximum amount of HSA reimbursement must be available throughout the plan year.
 - HSA contributions may be made at any time during or before the plan year to which they pertain.
 - A 6% penalty is imposed on the employer for each year in which an excess plan contribution exists.
 - Elective employee contributions to a cafeteria HSA are treated as employer contributions for tax purposes.
31. Which of the following statements concerning long-term care insurance is correct?
- LTC insurance is specifically included in listed qualified cafeteria plan benefits.
 - LTC policies can provide protection along descendant, but not ancestral, lines.
 - Qualified LTC insurance policies cannot provide for a cash surrender value.
 - LTC coverage provides tax-favored treatment for LLPs and closely-held companies.
32. In relation to plans funded with group policy, the calculation for net premiums does which of the following?
- Excludes policy dividends and experience-rated credits in a calculation of taxable sick pay benefits.
 - Is a required element to calculate taxable sick pay benefits in a plan funded with individual policies.
 - Is a required element to calculate taxable sick pay benefits in a self-insured plan.
 - Do not select this answer choice.
33. The small plan exception does which of the following?
- Allows a policy with as few as 20 full-time employees to qualify as group-term life insurance.
 - Excludes employees 65 and older and part-time employees from plan requirements testing.
 - Requires full-time employees to contribute to the cost of other benefits to receive coverage.
 - Do not select this answer choice.

34. Which of the following statements concerning group-term life insurance is most accurate?
- Employers may remit tax on excess coverage at any time during the year so long as the timing of remittance is consistent for all employees.
 - The \$50,000 coverage exclusion is denied to the plan as a whole if the plan fails requirements for nondiscrimination testing.
 - The cost of excess coverage for a retired employee is subject to FICA, which must be remitted to the IRS by the employee.
 - Coverage premiums paid by sole proprietors for themselves are included in their income to the extent such coverage exceeds \$50,000.
35. Which of the following statements concerning split-dollar arrangements is correct?
- Preferential tax treatment of split-dollar COLI policy benefits is currently limited if certain requirements are not met.
 - In a split-dollar plan, the deduction is limited to an amount equal to that which the employee has to declare as income.
 - As applicable, split-dollar plans are taxed under the economic benefit regime, the loan regime, or a combination of both.
 - The economic benefit regime applies to equity split-dollar arrangements where the employer has all rights to the policy's CSV.
36. A split-dollar plan determined to be NQDC is subject to which of the following?
- FIT and FITW.
 - FIT and FUTA.
 - FITW and FICA.
 - FICA and FUTA.
37. Which qualified retirement plan type is the easiest to set up and maintain?
- A 401(k).
 - An employer-sponsored SEP.
 - An employee stock ownership plan.
 - A profit-sharing plan.
38. To which qualified retirement plan are employee contributions treated as elective, yet still subject to FITW?
- SIMPLE IRA.
 - 403(b).
 - Profit-sharing.
 - Roth 401(k).

39. For purposes of minimum distribution rules and company ownership, which of the following is considered a family member?
- a. Maternal uncle.
 - b. Brother.
 - c. Paternal granddaughter.
 - d. Paternal nephew.
40. Employee elective contributions to a 403(b) plan are subject to FUTA tax.
- a. True.
 - b. False.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.

GLOSSARY

Accidental Death & Dismemberment (AD&D): Many employers offer accident insurance through AD&D policies, which are hybrid arrangements that combine death benefit coverage with accident insurance. Most AD&D policies are targeted at nonjob-related injuries, since job-related injuries typically are covered by worker's compensation insurance.

Adoption Assistance Program: Employers can provide qualifying employees who are adopting an eligible child with up to \$10,000 (as adjusted for inflation, \$11,390 in 2007) per child of qualified adoption expenses. The amount of qualified adoption assistance is excludable from the employee's gross income as a fringe benefit if provided as part of a qualified adoption assistance program. The qualified adoption assistance is, however, subject to FICA and FUTA.

Archer Medical Savings Accounts (Archer MSAs): IRC Sec. 220 permits qualifying individuals to contribute to a tax-exempt Archer MSA. Archer MSAs are intended to pay medical expenses in conjunction with a high-deductible health plan, and depending on whether the individual or the individual's employer contributes to the Archer MSA, such contributions are deductible by or excludable from the individual's gross income. No Archer MSAs may be established after 2007.

Cafeteria Plan: A tax-favored way of offering employees a variety of fringe benefits under a single plan. Both income and employment taxes can be reduced when the employee uses elective contributions (i.e., employee contributions funded by reducing salary on a pretax basis) to pay the portion of benefit premiums or expenses that would otherwise be paid with after-tax dollars. Also known as a flexible benefits plan.

Cash or Deferred Arrangement (CODA): An arrangement allowing employees to choose between making a pretax contribution to a qualified plan (such as a profit-sharing or stock-bonus plan) or receiving cash or another taxable benefit. Also known as 401(k) plans or arrangements.

Dependent Care Assistance Program: Employers can annually provide each employee with up to \$5,000 of tax-free dependent care assistance (e.g., to pay for care for the employee's children or disabled spouse) if the requirements of IRC Sec. 129 are met. This means, in part, that the program must be in writing and must meet various nondiscrimination tests.

Educational Assistance Program: Employers can annually provide each employee with up to \$5,250 of tax-free educational assistance for any instruction (graduate or undergraduate) or training that improves or develops the employee's capabilities (i.e., need not relate to the employee's current job), if the requirements of IRC Sec. 127 are met.

Flexible Spending Arrangement (FSA): Allows employees to pay medical, dependent care, or adoption expenses using pretax rather than after-tax dollars. Employees enter into a salary reduction agreement for an amount equal to the annual estimated cost of their expenses, and are then reimbursed on a tax-free basis as the expenses are incurred throughout the year.

Fringe Benefits: Includes work-related benefits and incidental goods and services provided to employees that generally are governed by IRC Sec. 132. Examples of work-related fringe benefits include use of an employer-provided auto and reimbursement of business expenses. Examples of incidental goods and services are qualified employee discounts and no-additional-cost services.

Group-term Life Insurance: Up to \$50,000 of employer-provided coverage is nontaxable under IRC Sec. 79 if (1) the insurance is provided for a group of at least 10 full-time employees and is provided under a policy carried directly or indirectly by the employer; (2) the amount of insurance provided each employee is based on age, years of service, compensation, position, etc.; and (3) the death benefit is excludable from the beneficiary's gross income.

Health Savings Account (HSA): IRC Sec. 223 permits eligible individuals to create an HSA in conjunction with a high-deductible health plan to which tax-free contributions (if made by an employer) or tax-deductible contributions (if made by an employee) can be made in certain circumstances to pay qualified medical expenses. Earnings accumulate tax free and distributions are also tax-free when withdrawn for qualified medical expenses. HSAs were designed to replace Archer MSAs.

Medical Care Reimbursement: Includes amounts received by an employee for hospitalization or medical care for the employee, spouse, and dependents, other than sick pay or payments under AD&D policies. Reimbursement can be paid to the employee or the provider of the medical care and can be funded via insurance, a self-insured plan, or directly from the employer's general assets.

Salary Reduction Arrangement: A plan or arrangement allowing eligible employees to elect to reduce their compensation in order to have that amount contributed to a qualified retirement or other benefit plan.

Self-insured Health (or Medical) Plan: A written plan under which employees are reimbursed for expenses incurred in treating sickness or injury from the employer's own funds (from a separate trust or its general assets) rather than an insurance policy maintained by the employer.

Sick Pay: Amounts paid to an employee (by the employer through its regular payroll) while the employee is temporarily absent from work due to sickness. In addition, many employers also offer disability income plans (referred to as "sick pay" by the IRS) that provide payments to an employee who is unable to work because of a disability due to injury or sickness.

SIMPLE Retirement Plan: Savings incentive match plans for employees (or SIMPLE plans for short) can be used by employers who maintain no other qualified plans, and they are intended to allow small employers to provide retirement income for employees through salary reduction and matching contributions made to individual retirement accounts (IRAs) or 401(k) plans.

Split-dollar Life Insurance: A method of funding premium payments on cash value life insurance in which the employer, typically, pays the annual premium to the extent of the increase in cash surrender value (CSV), and the employee pays the balance, if any. If the employee dies during the term of the policy, a portion of the proceeds is allocated to the employer with the remainder paid to the employee's designated beneficiaries.

Supplemental Medical Expense Reimbursement Plan: Such plans are typically made available to key employees or executives to pay for expenses not covered under the group medical plan. Cosmetic surgery or other costs that are not medical expenses as defined in IRC Sec. 213(d), and any deductibles or coinsurance payments required under the group medical plan, are commonly covered by a supplemental plan.

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Payroll Tax Deskbook—Course 1—Employer Liability, Employee Sharing and Leasing, and Exempt Employment (PRLTG091)

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3. ○	○	○	○	13. ○	○	○	○	23. ○	○	○	○	33. ○	○	○	○
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Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.
3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of \$79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is \$225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is \$284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is \$336 (a 15% discount on all five courses or more).
4. To receive CPE credit, completed answer sheets must be postmarked by **December 31, 2010**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional \$24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.
5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS**. Be sure to keep a completed copy for your records.
6. Please direct any questions or comments to our Customer Service department at (800) 323-8724.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

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CPE Examination Questions (Lesson 1)	177
CPE Examination Questions (Lesson 2)	237

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Payroll Tax Deskbook—Course 2—Benefit Plans (PRLT092)

CTEC Course No. 3039-CE-0230

Price \$79

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: Add \$24.95

CTEC No.: _____

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ○ ⊗ ⊙ .

- | a | b | c | d | a | b | c | d | a | b | c | d | a | b | c | d |
|-------|---|---|---|-------|---|---|---|-------|---|---|---|-------|---|---|---|
| 1. ○ | ○ | ○ | ○ | 11. ○ | ○ | ○ | ○ | 21. ○ | ○ | ○ | ○ | 31. ○ | ○ | ○ | ○ |
| 2. ○ | ○ | ○ | ○ | 12. ○ | ○ | ○ | ○ | 22. ○ | ○ | ○ | ○ | 32. ○ | ○ | ○ | ○ |
| 3. ○ | ○ | ○ | ○ | 13. ○ | ○ | ○ | ○ | 23. ○ | ○ | ○ | ○ | 33. ○ | ○ | ○ | ○ |
| 4. ○ | ○ | ○ | ○ | 14. ○ | ○ | ○ | ○ | 24. ○ | ○ | ○ | ○ | 34. ○ | ○ | ○ | ○ |
| 5. ○ | ○ | ○ | ○ | 15. ○ | ○ | ○ | ○ | 25. ○ | ○ | ○ | ○ | 35. ○ | ○ | ○ | ○ |
| 6. ○ | ○ | ○ | ○ | 16. ○ | ○ | ○ | ○ | 26. ○ | ○ | ○ | ○ | 36. ○ | ○ | ○ | ○ |
| 7. ○ | ○ | ○ | ○ | 17. ○ | ○ | ○ | ○ | 27. ○ | ○ | ○ | ○ | 37. ○ | ○ | ○ | ○ |
| 8. ○ | ○ | ○ | ○ | 18. ○ | ○ | ○ | ○ | 28. ○ | ○ | ○ | ○ | 38. ○ | ○ | ○ | ○ |
| 9. ○ | ○ | ○ | ○ | 19. ○ | ○ | ○ | ○ | 29. ○ | ○ | ○ | ○ | 39. ○ | ○ | ○ | ○ |
| 10. ○ | ○ | ○ | ○ | 20. ○ | ○ | ○ | ○ | 30. ○ | ○ | ○ | ○ | 40. ○ | ○ | ○ | ○ |

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: December 31, 2010

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Payroll Tax Deskbook—Course 2—Benefit Plans Course Acronym: PRLTG092

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
 Fill in like this not like this .

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. How would you rate the examination related to the course material?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. Does the examination consist of clear and unambiguous questions and statements?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. Were the stated learning objectives met?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. Were the course materials accurate and useful?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. Was the time allotted to the learning activity appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
8. If applicable, was the technological equipment appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
10. If applicable, how well did the audio/visuals contribute to the program?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
 (Please print legibly):

Additional Comments:

1. What did you find **most** helpful? _____
2. What did you find **least** helpful? _____
3. What other courses or subject areas would you like for us to offer? _____
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes/No**

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _____