



1995

Publication 1407-A

1996 Publication 15-A

Advance Proof Copy

This advance proof is subject to change.

Attached is an advance proof copy of the new **Publication 15-A**, Employer's Supplemental Tax Guide.

Publication 15-A is the result of a 2-year project to simplify the presentation of employment tax information. Last year we developed the core Circular E (Publication 15), which is designed to meet the needs of the small business employer. It provides basic employment tax information for all employers, including the income tax withholding tables. This year we developed Publication 15-A, which includes specialized information applicable to a smaller percentage of employers. This publication contains specialized employment tax information formerly in—

Publication 15—Employer's Tax Guide

Publication 493—Alternative Tax Withholding Methods and Tables

Publication 937—Employment Taxes

Publication 952—Sick Pay Reporting

Publications 493, 937, and 952 will be eliminated. By combining and reorganizing the employment tax information previously contained in four publications into two, Publications 15 and 15-A, we will make it more accessible to employers.

If you have comments about our effort to provide general and specialized employment tax publications or about the new Publication 15-A, please let us know by September 15, 1995. Write to: Tax Forms Committee, Early Release, Internal Revenue Service, Room 5577, 1111 Constitution Ave., NW, Washington DC 20224. Although we may be unable to give detailed responses to your comments, we will carefully consider each suggestion.

If you need additional copies of this package, please write to: Internal Revenue Service, P.O. Box 25866, Richmond, VA 23289-5866.





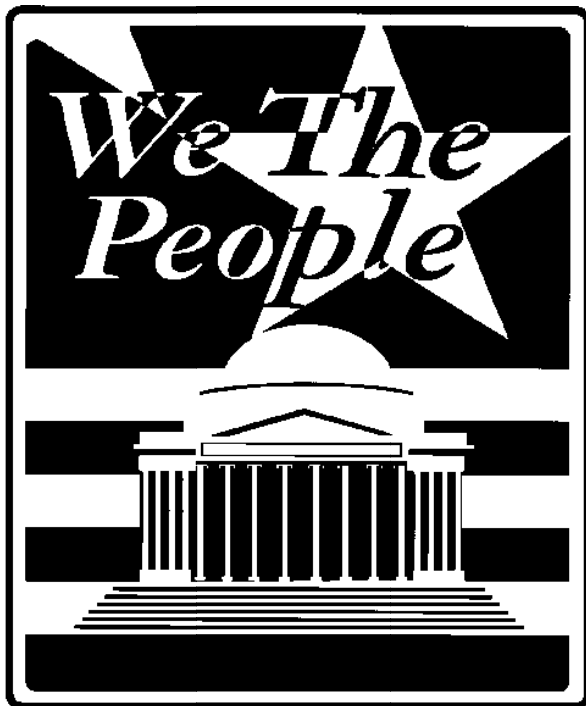
Department of the Treasury
Internal Revenue Service

Publication 15-A

(January 1996)
Cat. No. 21453T

Employer's Supplemental Tax Guide

**(Supplement to Circular E,
Employer's Tax Guide,
Publication 15)**



Contents

1. Who Are Employees?	2
2. Employee or Independent Contractor?	3
3. Employees of Exempt Organizations	6
4. Religious Exemptions	7
5. Wages and Other Compensation	7
Employee Achievement Awards	7
7. Scholarship and Fellowship Payments	7
Outplacement Services	7
Withholding for Idle Time	8
Backpay Under a Statute.....	8
Supplemental Unemployment Benefits.....	8
Excessive Termination Payments.....	8
Interest-Free and Below-Market Rate Loans	8
Group-Term Life Insurance	8
Workers' Compensation—Public Employees	8
Leave Sharing Plans	8
Cafeteria Plans	8
Deferred Compensation Arrangements	8
Employee Stock Options	9
Tax-Sheltered Annuities	9
Contributions to a Simplified Employee Pension (SEP) Plan	9
6. Employee Fringe Benefits	9
7. Sick Pay Reporting	10
8. Special Rules for Paying Taxes	14
Common Paymaster	14
Third Party Liability for Paying Taxes	14
Employee's Portion of Taxes Paid by Employer.....	15
9. Pensions and Annuities	15
10. Alternative Methods for Figuring Withholding	17
Formula Tables for Percentage Method Withholding	18
Wage Bracket Percentage Tables	22
Combined Income Tax, Employee Social Security Tax, and Employee Medicare Tax Withholding Tables	32
11. Tables for Withholding on Distributions of Indian Gaming Profits to Tribal Members	53
Index	54

Important Change for 1996

Electronic deposit of taxes.— Generally, if your total deposits of social security, Medicare, and withheld income taxes during calendar years 1993 or 1994 exceeded \$47 million you are required to deposit all Federal taxes through an electronic funds transfer (EFT) system, called TAXLINK, beginning in 1996. Use TAXLINK to deposit taxes reported on any of the following tax forms:

- **Form 720**, Quarterly Federal Excise Tax Return
- **Form 940** or **940-EZ**, Employer's Annual Federal Unemployment Tax Return
- **Form 941**, Employer's Quarterly Federal Tax Return
- **Form 943**, Employer's Annual Tax Return For Agricultural Employees
- **Form 945**, Annual Return of Withheld Federal Income Tax
- **Form 990-C**, Farmer's Cooperative Association Income Tax Return
- **Form 990-PF**, Return of Private Foundation or Section 4947(a)(1) Charitable Trusts Treated as a Private Foundation
- **Form 990-T**, Exempt Organization Business Income Tax Return
- **Form 1042**, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
- **Form 1120** or **1120-A**, U.S. Corporation Income Tax Return
- **Form CT-1**, Employer's Annual Railroad Retirement and Unemployment Repayment Tax Return

Employers not required to make deposits by EFT may enroll in the system, which will allow tax deposits without coupons, paper checks, or visits to an authorized depository. For more information, call 1-800-829-5469 (for TAXLINK information only) or write to:

Internal Revenue Service
Cash Management Site Office
P.O. Box 47669, Stop 295
Doraville, GA 30362

Important Reminder

Nonpayroll income tax withholding.— Nonpayroll income tax withholding must be reported on **Form 945**, Annual Return of Withheld Federal Income Tax. Form 945 is an annual tax return and the return for 1995 is due January 31, 1996. Separate deposits are required for payroll (Form 941) and nonpayroll (Form 945) withholding. Nonpayroll items include the following:

- Pensions, annuities, and IRAs
- Military retirement
- Gambling winnings
- Indian Gaming Profits
- Backup withholding

All income tax withholding reported on Forms 1099 or W-2G must be reported on Form 945. All income tax withholding reported on Form W-2 must be reported on Form 941 or 943. For example, because distributions from nonqualified pension plans and some other deferred compensation plans are treated as wages and are reported on Form W-2, they must be reported on Form 941 or 943, not Form 945. For details on depositing and reporting nonpayroll income tax withholding, see the separate **Instructions for Form 945**.

Introduction

This publication supplements **Circular E**, Employer's Tax Guide (Pub. 15). It contains specialized and detailed employment tax information supplementing the basic information provided in Circular E. It also contains:

- Alternative methods and tables for figuring income tax withholding.
- Combined income tax, employee social security tax, and employee Medicare tax withholding tables.
- Tables for withholding on distributions of Indian gaming profits to tribal members.

Ordering publications and forms.— To order free publications and forms, call 1-800-TAX-FORM (1-800-829-3676). You may also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address.

Telephone help.— You can call the IRS with your tax question Monday through Friday during regular business hours. Check your telephone book for the local number or call 1-800-829-1040.

Telephone help for hearing-impaired persons.— If you have access to TDD equipment, you can call 1-800-829-4059 with your tax question or to order forms and publications. See your tax package for the hours of operation.

Useful Items

You may want to see:

Publication

- 15** Circular E, Employer's Tax Guide
- 51** Circular A, Agricultural Employer's Tax Guide
- 515** Withholding of Tax on Nonresident Aliens and Foreign Corporations
- 535** Business Expenses
- 583** Taxpayers Starting a Business
- 1635** Understanding Your EIN

1. Who Are Employees?

Before you can know how to treat payments you make for services, you must first know the business relationship that exists between you and the person performing the services. The person performing the services may be—

- 1) An independent contractor.
- 2) A common-law employee.
- 3) A statutory employee.
- 4) A statutory nonemployee.

This discussion explains these four categories. A later discussion, **Employee or Independent Contractor?**, points out the differences between an independent contractor and an employee and gives examples from various types of occupations. If an individual who works for you is not an employee under the common-law rules (see **Employee or Independent Contractor?** later), you generally do not have to withhold Federal income tax from that individual's pay. However, in some cases you may be required to backup withhold on these payments. See Circular E for more information on backup withholding.

Independent Contractors

People such as lawyers, contractors, subcontractors, public stenographers, auctioneers, etc., who follow an independent trade, business, or profession in which they offer their services to the public, are generally not employees. However, whether such people are employees or independent contractors depends on the facts in each case. The general rule is that an individual is an independent contractor if you, the payer, have the right to control or direct only the result of the work and not the means and methods of accomplishing the result.

Common-Law Employees

Under common-law rules, every individual who performs services subject to the will and control of a payer, as to both **what** must be done and **how** it must be done, is an employee. It does not matter that the employer allows the employee discretion and freedom of action, as long as the employer has the **legal right** to control both the method and the result of the services. For a discussion of the factors that indicate whether sufficient control is present to establish an employer-employee relationship, see **Employee or Independent Contractor?** later.

Two usual characteristics of an employer-employee relationship are that the employer has the right to discharge the employee and the employer supplies the employee with tools and a place to work.

If you have an employer-employee relationship, it makes no difference how it is described. It does not matter if the employee is called an employee, partner, co-adventurer, agent, or independent contractor. It does

not matter how the payments are measured, how they are made, or what they are called. Nor does it matter whether the individual is employed full time or part time.

For employment tax purposes, no distinction is made between classes of employees. Superintendents, managers, and other supervisory personnel are all employees. An **officer of a corporation** is generally an employee, but a director is not. An officer who performs no services or only minor services, and neither receives nor is entitled to receive any pay, is not considered an employee.

You generally have to withhold and pay income, social security, and Medicare taxes on wages you pay to common-law employees. However, the wages of certain employees may be exempt from one or more of these taxes. See **Employees of Exempt Organizations** and **Religious Exemptions** sections later.

Leased Employees Under certain circumstances, a corporation furnishing workers to various professional people and firms is the employer of those workers for employment tax purposes. For example, a professional service corporation may provide the services of secretaries, nurses, and other similarly trained workers to its subscribers. The service corporation enters into contracts with the subscribers under which the subscribers specify the services to be provided and the fee to be paid to the service corporation for each individual furnished. The contracts provide that the service corporation has the right to control and direct the worker's services for the subscriber including the right to discharge or reassign the worker. The service corporation hires the workers, pays their wages, provides them with unemployment insurance and other benefits, and is the employer for employment tax purposes. For information on employee leasing as it relates to pension plan qualification requirements, see **Employee leasing in Pub. 560, Self-Employed Retirement Plans**.

Nonbusiness (Personal) Services by Employees

Noncash payments by an employer for personal services by employees, not in the course of the employer's business, are not subject to employment taxes.

Cash payments by an employer, however, for personal services by employees not in the course of the employer's business, such as making repairs on the employer's home, are subject to the following rules:

- 1) Payments are subject to income tax withholding and Federal unemployment taxes if the employee earns \$50 or more in cash in a calendar quarter performing personal services for the employer, and works 24 or more days in that quarter or in the preceding quarter performing services not in the course of the employer's business.
- 2) Payments are subject to social security and Medicare taxes if the employee receives \$100 or more in cash in a calendar year from the employer for personal services.

These rules do not apply to corporate employees. They also do not apply to household employees and farmworkers.

Additional information.— For more information about the treatment of special types of employment, the treatment of special types of payments, and similar subjects, get a free copy of Circular E or Circular A (for agricultural employers) from the IRS.

Statutory Employees

Workers in the following four categories are called statutory employees:

- 1) A driver who distributes beverages (other than milk), meat, vegetable, fruit, or bakery products, or who picks up and delivers laundry or dry cleaning, if the driver is your agent or is paid on commission.
- 2) A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.
- 3) An individual who works at home on materials or goods that you supply and that must be returned to you or to a person you name, if you also furnish specifications for the work to be done.
- 4) A full-time traveling or city salesperson who works on your behalf and turns in orders to you from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for you must be the salesperson's principal business activity. See **Salespersons** in section 2.

Social security and Medicare taxes.— Withhold social security and Medicare taxes from statutory employees' wages if all three of the following conditions apply.

- The service contract states or implies that almost all of the services are to be performed personally by them.
- They have little or no investment in the equipment and property used to perform the services (other than an investment in transportation facilities).
- The services are performed on a continuing basis for the same payer.

Federal unemployment tax.— For Federal unemployment tax, the term **employee** means the same as it does for social security and Medicare taxes, except that it does not include categories 2 and 3 above. Thus, any individual who is an employee under category 1 or 4 is also an employee for Federal unemployment tax purposes and subject to FUTA.

Income tax.— Do not withhold income tax from the wages of statutory employees.

Reporting payments to statutory employees.— Furnish a Form W-2 to a statutory employee, and check *Statutory employee* in box 15. Show your payments to the employee as other compensation in box 1. Also, show social security wages in box 3, social security tax withheld in box 4, Medicare wages in box 5, and Medicare tax withheld in box 6. The statutory employee can deduct his or her trade or business expenses from the payments shown on Form W-2. He or she reports earnings as a statutory employee on line 1 of Schedule C (Form 1040). (A statutory employee's business expenses are not subject to the reduction by 2% of his or her adjusted gross income that applies to common-law employees.)

Statutory Nonemployees

There are two categories of statutory nonemployees: **direct sellers** and **licensed real estate agents**. They are treated as self-employed for Federal income tax and employment tax purposes if:

- 1) Substantially all payments for their services as direct sellers or real estate agents are directly related to sales or other output, rather than to the number of hours worked, and
- 2) Their services are performed under a written contract providing that they will not be treated as employees for Federal tax purposes.

Direct sellers. Direct sellers are persons:

- 1) Engaged in selling (or soliciting the sale of) consumer products in the home or at a place of business other than in a permanent retail establishment, or
- 2) Engaged in selling (or soliciting the sale of) consumer products to any buyer on a buy-sell basis, a deposit-commission basis, or any similar basis prescribed by regulations, for resale in the home or at a place of business other than in a permanent retail establishment.

Direct selling includes activities of individuals who attempt to increase direct sales activities of their direct sellers and who earn income based on the productivity of their direct sellers. Such activities include providing motivation and encouragement; imparting skills, knowledge, or experience; and recruiting.

For more information on direct sellers, see **Pub. 911**, Tax Information for Direct Sellers.

Licensed real estate agents.— This category includes individuals engaged in appraisal activities for real estate sales if they earn income based on sales or other output.

Misclassification of Employees

Penalty for treating an employee as an independent contractor.— If you classify an employee as an independent contractor and you had no reasonable basis for doing so, you can be held liable for employment taxes for that worker (the relief provisions, discussed below, will not apply). Further, if you do not withhold income, social security, and Medicare taxes from his or her wages, you may be held personally liable for a penalty equal to taxes that should have been paid if you are the person responsible for the collection and payment of withholding taxes. See **Trust Fund Recovery Penalty** in section 12 of Circular E.

Relief provisions.— If you have a reasonable basis for not treating a worker as an employee, you may be relieved from having to pay employment taxes for that worker. To get this relief, you must file all required Federal tax returns, including information returns, on a basis consistent with your treatment of the worker. You (or your predecessor) must not have treated any worker holding a substantially similar position as an employee for any periods beginning after 1977. For further information, see Revenue Procedure 85-18, in Internal Revenue Cumulative Bulletin 1985-1, page 518.

Technical service specialists.— This relief provision does not apply to a worker who provides services to another business (the client) as a technical specialist under an arrangement between the business providing the worker, such as a technical services firm, and the client. A technical service specialist is an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.

This rule does not automatically convert technical service specialists to employees for employment tax purposes. The common-law standards control whether the specialist is treated as an employee or an independent contractor. However, if you directly contract with a technical service specialist to provide services for your business rather than for another business, you may still be entitled to the relief provision. See **Employee or Independent Contractor?** in section 2.

2. Employee or Independent Contractor?

An employer must generally withhold income taxes, withhold and pay social security and Medicare taxes, and pay unemployment taxes on wages paid to an employee. An employer does not generally have to withhold or pay any taxes on payments to independent contractors.

Common-law rules.— To help you determine whether an individual is an employee under the common-law rules, the IRS has identified 20 factors that are used as guidelines to determine whether sufficient control is present to establish an employer-employee relationship.

These factors should be considered guidelines. Not every factor is applicable in every situation, and the degree of importance of each factor varies depending on the type of work and individual circumstances. However, all relevant factors are considered in making a determination, and no one factor is decisive.

It does not matter that a written agreement may take a position with regard to any factors or state that certain factors do not apply, if the facts indicate otherwise. If an employer treats an employee as an independent contractor and the relief provisions discussed earlier do not apply, the person responsible for the collection and payment of withholding taxes may be held personally liable for an amount equal to the taxes that should have been withheld.

The 20 factors indicating whether an individual is an employee or an independent contractor follow.

- 1) **Instructions.** An employee must comply with instructions about when, where, and how to work. Even if no instructions are given, the control factor is present if the employer has the right to control how the work results are achieved.
- 2) **Training.** An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods and receive no training from the purchasers of their services.
- 3) **Integration.** An employee's services are usually integrated into the business operations because the services are important to the success or continuation of the business. This shows that the employee is subject to direction and control.
- 4) **Services rendered personally.** An employee renders services personally. This shows that the employer is interested in the methods as well as the results.
- 5) **Hiring assistants.** An employee works for an employer who hires, supervises, and pays workers. An independent contractor can hire, supervise, and pay assistants under a contract that requires him or her to provide materials and labor and to be responsible only for the result.
- 6) **Continuing relationship.** An employee generally has a continuing relationship with an employer. A continuing relationship may exist even if work is performed at recurring although irregular intervals.
- 7) **Set hours of work.** An employee usually has set hours of work established by an employer. An independent contractor generally can set his or her own work hours.

- 8) **Full-time required.** An employee may be required to work or be available full-time. This indicates control by the employer. An independent contractor can work when and for whom he or she chooses.
- 9) **Work done on premises.** An employee usually works on the premises of an employer, or works on a route or at a location designated by an employer.
- 10) **Order or sequence set.** An employee may be required to perform services in the order or sequence set by an employer. This shows that the employee is subject to direction and control.
- 11) **Reports.** An employee may be required to submit reports to an employer. This shows that the employer maintains a degree of control.
- 12) **Payments.** An employee is generally paid by the hour, week, or month. An independent contractor is usually paid by the job or on a straight commission.
- 13) **Expenses.** An employee's business and travel expenses are generally paid by an employer. This shows that the employee is subject to regulation and control.
- 14) **Tools and materials.** An employee is normally furnished significant tools, materials, and other equipment by an employer.
- 15) **Investment.** An independent contractor has a significant investment in the facilities he or she uses in performing services for someone else.
- 16) **Profit or loss.** An independent contractor can make a profit or suffer a loss.
- 17) **Works for more than one person or firm.** An independent contractor is generally free to provide his or her services to two or more unrelated persons or firms at the same time.
- 18) **Offers services to general public.** An independent contractor makes his or her services available to the general public.
- 19) **Right to fire.** An employee can be fired by an employer. An independent contractor cannot be fired so long as he or she produces a result that meets the specifications of the contract.
- 20) **Right to quit.** An employee can quit his or her job at any time without incurring liability. An independent contractor usually agrees to complete a specific job and is responsible for its satisfactory completion, or is legally obligated to make good for failure to complete it.

Form SS-8.— In doubtful cases, the facts will determine whether or not there is an actual employer-employee relationship. If you want the IRS to determine whether a worker is an employee, file **Form SS-8**, Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding, with your District Director.

Industry Examples

The following examples may help you properly classify your workers.

Building and Construction Industry

Example 1. John Brown has an oral agreement with Ace Building Co. to do carpentry work on any house designated by the company. He supplies his own handtools. The Ace Building Co. supplies the material for each job. He has to do the work himself and he works on a full-time basis for the company. For some work he is paid on a piecework basis and for some on an hourly basis. He has no assistants, does not have an office, and does not advertise in newspapers or otherwise hold himself out to the public as being in the carpentry business. The Ace Building Co. can discharge him any time before he finishes a job without contractual liability. John is an employee of the Ace Building Co.

Example 2. Ron Smith, a mason, has an oral agreement with Jiffy, Inc., a contractor, to face a building with brick. Jiffy supplies all material for the job. Ron supplies only his handtools. He has to do the work himself and is paid on an hourly basis. Jiffy employs two other masons on the job, who are supervised by Ron. Detailed supervision over him is neither necessary nor warranted because of his skill in the work. He can quit the job at any time, or Jiffy can discharge him at any time. He has no investment or proprietary interest in a business that offers the general public services similar to those he does for Jiffy. Ron is an employee of Jiffy, Inc.

Example 3. Sarah Green is a painting subcontractor who has contracted to paint 264 houses. She hired 40 painters to do the work for her, although only about 15 are on the job at any one time. She supplies all the paint, brushes, and ladders. She designates the house to be painted and either pays the painters per house or by the hour. Detailed instructions about the work are not necessary because of the painters' skill in their trade. Sarah inspects the work and requires them to repaint any unsatisfactory work. The painters cannot engage helpers without her consent. She can discharge them for any reason, and they are free to resign at any time. The painters are under no legal obligation to complete the painting of the houses. They assume no business risks and have no capital investment. None of them has an established business. The painters are employees of Sarah Green.

Example 4. Jerry Jones has an agreement with Wilma White to supervise the remodeling of her house. She did not advance funds to help him carry on the work. She makes direct payments to the suppliers for all necessary materials. She carries liability and workers' compensation insurance covering Jerry and others he engaged to assist him. She pays them an hourly rate, and exercises almost constant supervision over the work. Jerry is not free to transfer his assistants to other jobs. He may not work on other jobs while working for Wilma.

He assumes no responsibility to complete the work and will incur no contractual liability if he fails to do so. He and his assistants perform personal services for hourly wages. They are employees of Wilma White.

Example 5. Milton Manning, an experienced tilesetter, orally agreed with a corporation to perform full-time services at construction sites. He uses his own tools and performs services in the order designated by the corporation and according to its specifications. The corporation supplies all materials, makes frequent inspections of his work, pays him on a piecework basis, and carries workers' compensation insurance on him. He does not have a place of business or hold himself out to perform similar services for others. Either party can end the services at any time. Milton Manning is an employee of the corporation.

Example 6. Wallace Black agreed with the Sawdust Co. to supply the construction labor for a group of houses. The company agreed to pay all construction costs. However, he supplies all the tools and equipment. He performs personal services as a carpenter and mechanic for an hourly wage. He also acts as superintendent and foreman, and engages other individuals to assist him. The company has the right to select, approve, or discharge any helper. A company representative makes frequent inspections of the construction site. When a house is finished, Wallace is paid a certain percentage of its costs. He is not responsible for faults, defects of construction, or wasteful operation. At the end of each week, he presents the company with a statement of the amount he has spent, including the payroll. The company gives him a check for that amount from which he pays the assistants, although he is not personally liable for their wages. Wallace Black and his assistants are employees of the Sawdust Co.

Example 7. A local plumbers' union and a contractors' association agreed to set up an apprenticeship program. The program is financed by the contractors and is administered by a joint apprenticeship committee. Trainees are enrolled first in a preapprenticeship program, in which they attend vocational school full time 5 days a week for 6 to 8 weeks. During this period, they are paid an hourly rate and are furnished with all materials and supplies used in school.

After completion of the preapprenticeship program, the trainees are assigned to work for local contractors as apprentice plumbers. The apprentices must attend training classes related to the trade 1 day a week for 2 years. The apprenticeship program pays them for the time spent in attending classes at the same hourly rate they earn working for their contractor-employers.

While in the preapprenticeship program, the trainees are not employees. Their payments from the program are not subject to Federal income tax withholding or social security, and Medicare taxes. The contractors and the administrators of the preapprenticeship program are not liable for Federal unemployment tax. However, the apprentices assigned to contractors as apprentice

plumbers are considered employees, even when attending classes under the apprenticeship program. Their payments from the program are subject to income tax withholding, social security and Medicare taxes, and Federal unemployment tax.

Example 8. Bill Plum contracted with Elm Corporation to complete the roofing on a housing complex. A signed contract established a flat amount for the services rendered by Bill Plum. Bill is a licensed roofer and carries workers' compensation and liability insurance under the business name, Plum Roofing. He hires his own roofers who are treated as employees for Federal employment tax purposes. If there is a problem with the roofing work, Plum Roofing is responsible for paying for any repairs. Bill Plum, doing business as Plum Roofing, is an independent contractor.

Example 9. Vera Elm, an electrician, submitted to a job estimate a housing complex for electrical work at \$16 per hour for 400 hours. She is to receive \$1,280 every 2 weeks for the next 10 weeks. This is not considered payment by the hour. Even if she works more or less than 400 hours to complete the work, Vera Elm will receive \$6,400. She also performs additional electrical installations under contracts with other companies, which she obtained through advertisements. Vera is an independent contractor.

Trucking Industry

Example 1. Drivers for Rover Trucking Co. often engage laborers to unload their trucks with the express consent of the company. The drivers pay the unloaders from funds provided by the company. The unloaders are company employees. This also would be true if the drivers had only the implied consent of the company.

Example 2. A company engages Phil Blue to haul products to its customers. The company has legal ownership and control of the trucking equipment. Phil can be required, on an hour's notice, to make deliveries at times and places specified by the company. Refusal can jeopardize his relationship with the company. He has to operate and maintain the equipment and provide the necessary operators and helpers. He is not allowed to use the company's equipment to haul for others. He is paid on a tonnage basis and is not guaranteed a minimum amount of compensation. He has to pay the operators and helpers out of his tonnage receipts as well as pay for all insurance coverage required by the company. Phil and any operators or helpers engaged to assist him are employees of the company.

Example 3. Rose Trucking contracts to deliver material for Forest Inc. at \$140 per ton. Rose Trucking is not paid for any articles that are not delivered. At times, Jan Rose, who operates as Rose Trucking, may also lease another truck and engage a driver to complete the contract. All operating expenses, including insurance coverage, are paid by Jan Rose. All equipment is owned or rented by Jan and she is responsible for all maintenance. None of the drivers are provided by Forest Inc.

Jan Rose, operating as Rose Trucking, is an independent contractor.

Fishing Industry

Example 1. Harry Rose is the captain of one of the Pan Fishing Co.'s schooners. He engages a crew of 15 to operate the schooner. He offers to pay each crew member on the *lay* (sharing of the profit) basis. He and the crew members (except the engineer, who is paid a straight fee) are jointly liable for any losses resulting from a voyage.

The schooner is an American vessel of more than 10 net tons. He and the Pan Fishing Co. entered into a contract of service within the United States.

After the voyage, Captain Rose sells the catch through a fish exchange, which deducts its fees from the proceeds. After deducting certain specified expenses (such as fuel, oil, etc.), he turns one-fourth of the proceeds over to Pan Fishing Co., less 5%, which he keeps as his commission. From the remaining three-fourths, the expenses of food, bait, etc., are deducted. The remainder is then equally divided among the members of the crew, including himself.

Because the crew is normally made up of 10 or more individuals, the members of a crew engaged under these circumstances are employees of either the captain (if he is not an agent of the vessel owner) or of the vessel owner. Their lays are in the nature of wages, and the agreements under which the crews are engaged in these circumstances are contracts of hire.

In this example, Captain Rose is acting as an agent of Pan Fishing Co. Therefore, the company is the employer. As an employer of a crew working on an American vessel under a contract entered into in the United States, the company must withhold Federal income, social security, and Medicare taxes from the entire crew's wages, including the wages of Captain Rose and the engineer. The company must also pay the employer's portion of social security and Medicare taxes.

Because the schooner is a vessel of more than 10 net tons with a crew of more than nine members, the company must also pay Federal unemployment (FUTA) tax on these wages.

The value of *meals and lodging furnished to the crew* is not subject to income tax withholding, social security and Medicare taxes, and Federal unemployment tax because the company must furnish meals and lodging on board the vessel so the crew can do its work.

Federal unemployment (FUTA) tax.— The work of catching fish is exempt from Federal unemployment tax **except** for:

- 1) Work related to catching salmon or halibut for commercial purposes, or
- 2) Work performed on a vessel of more than 10 net tons.

However, work that is not exempt under this rule may qualify as exempt if the four conditions under **Certain**

crew members considered self-employed, discussed next, are met.

Certain crew members considered self-employed.— Wages paid to members of a crew on a fishing boat are not subject to income tax withholding, social security and Medicare taxes, or the FUTA tax if all the following conditions are met.

- 1) The members neither get nor are entitled to any money for their work (other than as provided in condition 2 below).
- 2) The members get shares of the catch or of the proceeds from the sale of the catch.
- 3) Each member's share depends on the size of the catch.
- 4) The operating crew of the boat (or each boat from which a member gets a share for a fishing operation involving more than one boat) is normally fewer than 10 persons.

Each member of the crew who meets these four conditions is considered self-employed. The earnings of these crew members are considered trade or business income and therefore subject to self-employment tax. See **Pub. 533**, Self-Employment Tax.

Example 2. Mike Jones, an owner of a fishing boat of more than 10 net tons, employs a captain and eight others to work as crew members. The proceeds from the sale of the catch offset boat operating expenses, such as fuel, bait, and ice. Of the balance, 60% is divided among the captain and the crew members, and 40% between Mike and the captain. Between voyages the crew members do not receive any additional compensation, but they must do certain work, such as repairing nets, splicing cable, and transporting the catch. However, the mate, the engineer, and the cook receive an additional payment of \$100 each. This payment does not depend on the boat's catch. Since the mate, the engineer, and the cook receive payment other than a share of the catch, they are not considered self-employed. The \$100 payment and their share of the proceeds from the catch are subject to income tax withholding, social security and Medicare taxes, and the FUTA tax.

The other six crew members, including the captain, are considered self-employed because they do not receive any additional pay and are members of an operating crew of fewer than 10 members. Mike does not have to withhold income tax or social security and Medicare taxes from their pay. They must pay self-employment tax on their earnings. Also, because the boat has a crew of fewer than 10 members and they meet the other three conditions mentioned above under **Certain crew members considered self-employed**, Mike does not have to pay the FUTA tax for the other six crew members, even though the boat was more than 10 tons.

Example 3. Assume the same facts as in Example 2, except that, in addition to receiving a share of the catch, the captain and the other crew members are entitled to receive \$10 per hour for repairing nets, constructing new

nets, splicing cable, and other incidental work while in port. Since the crew members are entitled to receive payment other than a share of the catch, they are not considered self-employed. The \$10 per hour payment and their share of the proceeds from the catch are subject to income tax withholding, social security and Medicare taxes, and the FUTA tax.

Shrimp Processing

Example. The Capital Shrimp Processing Co. hired Shirley Gray to devein shrimp. She works on a seasonal, part-time basis on the company's premises. The company pays her on a piecework basis. She or the company may end her services at any time. The percentage of her time spent in working for the Capital Shrimp Processing Co. varies. She also deveins shrimp under similar conditions for other processing firms. Shirley Gray is an employee of the Capital Shrimp Processing Co.

Automobile Industry

Example 1. Donna Lee is a salesperson employed on a full-time basis by Bob Blue, an auto dealer. She works 6 days a week and is on duty in Bob's showroom on certain assigned days and times. She appraises trade-ins, but her appraisals are subject to the sales manager's approval. Lists of prospective customers belong to the dealer. She has to develop leads and report results to the sales manager. Because of her experience, she requires only minimal assistance in closing and financing sales and in other phases of her work. She is paid a commission and is eligible for prizes and bonuses offered by Bob. Donna is an employee of Bob Blue.

Example 2. Sam Sparks performs auto repair services in the repair department of an auto sales company. He works regular hours and is paid on a percentage basis. He has no investment in the repair department. The sales company supplies all facilities, repair parts, and supplies; issues instructions on the amounts to be charged, parts to be used, and the time for completion of each job; and checks all estimates and repair orders. Sam is an employee of the sales company.

Example 3. An auto sales agency furnishes space for Helen Smith to perform auto repair services. She provides her own tools, equipment, and supplies. She seeks out business from insurance adjusters and other individuals and does all the body and paint work that comes to the agency. She hires and discharges her own helpers, determines her own and her helpers' working hours, quotes prices for repair work, makes all necessary adjustments, assumes all losses from uncollectible accounts, and receives, as compensation for her services, a large percentage of the gross collections from the auto repair shop. Helen is self-employed and the helpers are her employees.

Attorney

Example. Donna Yuma is an attorney who is engaged in the private practice of law. She received a \$10,000 annual retainer from Wilson Corporation starting in 1993. In return for the fee, Donna must defend the corporation against any suit brought against it. In 1993, Donna represented the corporation in two suits. In 1994, she was not called upon to perform any services for the retainer she received for 1994. During 1993, Wilson Corporation provided Donna with an office on its premises in order to efficiently prosecute the suits. Donna Yuma is engaged in her own trade or business and is an independent contractor with regard to the services she performs for Wilson Corporation.

Taxicab Driver

Example. Tom Spruce rents a cab from Taft Cab Co. for \$150 per day. He pays for all maintenance and gas on the cab. Tom keeps all fares. Although he has use of the two-way radio communication, dispatcher, and advertising media provided by Taft Cab Co., these items are equally important to the interests of both Taft Cab Co. and Tom Spruce. They enhance their profits by promoting more cab rental business and efficiency. Tom Spruce is an independent contractor.

Salesperson

To determine whether salespersons are employees under the usual common-law rules, you must evaluate each individual case. If a salesperson who works for you does not meet the tests for a common-law employee, discussed earlier, you do not have to withhold income tax from his or her pay (see **Statutory Employees** earlier). However, even if a salesperson is not an employee under the usual common-law rules, his or her pay may still be subject to social security and Medicare taxes and FUTA taxes. To determine whether a salesperson is an employee for social security, Medicare, and FUTA tax purposes, you must apply the statutory employee tests. A salesperson is an employee for social security, Medicare, and FUTA tax purposes if he or she:

- 1) Works full time for one person or company except, possibly, for sideline sales activities on behalf of some other person,
- 2) Sells on behalf of, and turns his or her orders over to, the person or company for which he or she works,
- 3) Sells to wholesalers, retailers, contractors, or operators of hotels, restaurants, or similar establishments,
- 4) Sells merchandise for resale, or supplies for use in the customer's business,
- 5) Agrees to do most of this work personally;
- 6) Has no substantial investment in the facilities used to do the work, other than in facilities for transportation, and

- 7) Maintains a continuing relationship with the person or company for which he or she works.

3. Employees of Exempt Organizations

Many **nonprofit organizations** are exempt from income tax. Although they do not have to pay income tax themselves, they must still withhold income tax from the pay of their employees. However, there are special social security, Medicare, and Federal unemployment tax rules that apply to the wages they pay their employees.

Section 501(c)(3) organizations.— Nonprofit organizations described in section 501(c)(3) of the Internal Revenue Code include any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals. These organizations are usually corporations and are exempt from income tax under section 501(a).

Social security and Medicare taxes.— Wages paid to employees of section 501(c)(3) organizations are subject to social security and Medicare taxes unless one of the following situations applies:

- 1) The organization pays an employee less than \$100 in a calendar year.
- 2) The organization is wholly owned by a state or its political subdivision. Such an organization should contact the appropriate state official for information about reporting and getting social security and Medicare coverage for its employees.
- 3) The organization is a church or church-controlled organization opposed to the payment of social security and Medicare taxes for religious reasons and has filed **Form 8274**, Certification by Churches and Qualified Church-Controlled Organizations Electing Exemption from Employer Social Security and Medicare Taxes, to elect exemption from social security and Medicare taxes. The organization must have filed for exemption before the first date on which a quarterly employment tax return would otherwise be due.

An employee of a church or church-controlled organization that is exempt from social security and Medicare taxes must pay self-employment tax if the employee is paid \$108.28 or more in a year. However, an employee who is a member of a qualified religious sect can apply for an exemption from the self-employment tax by filing **Form 4029**, Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits. See **Members**

of recognized religious sects opposed to insurance, in section 4.

Federal unemployment tax.— An organization described in section 501(c)(3) of the Internal Revenue Code that is exempt from income tax is also exempt from the Federal unemployment tax. This exemption cannot be waived.

Other than section 501(c)(3) organizations.— Nonprofit organizations that are not section 501(c)(3) organizations may also be exempt from income tax under section 501(a) or section 521. These organizations are not exempt from withholding income, social security, or Medicare tax from their employees' pay, or from paying Federal unemployment tax. However, two special rules for social security, Medicare, and Federal unemployment taxes apply.

- 1) If an employee is paid less than \$100 during a calendar year, his or her wages are not subject to social security and Medicare taxes.
- 2) If an employee is paid less than \$50 in a calendar quarter, his or her wages are not subject to Federal unemployment tax for the quarter.

The above rules do not apply to employees who work for pension plans and other similar organizations described in section 401(a).

4. Religious Exemptions

Special rules apply to the treatment of ministers for social security purposes. An exemption from social security is available for ministers and certain other religious workers and members of certain recognized religious sects. For more information on getting an exemption, or revoking an exemption, see **Pub. 517**, Social Security and Other Information for Members of the Clergy and Religious Workers.

Ministers.— Ministers are individuals who are duly ordained, commissioned, or licensed by a religious body constituting a church or church denomination. They are given the authority to conduct religious worship, perform sacerdotal functions, and administer ordinances and sacraments according to the prescribed tenets and practices of that religious organization.

A minister who performs services for you subject to your will and control is your employee. The common-law rules discussed in section 1 should be applied to determine whether a minister is your employee or is self-employed. The earnings of a minister are not subject to social security and Medicare tax withholding. They are subject to self-employment tax. You do not withhold these taxes from wages earned by a minister. However, you may agree with the minister to voluntarily withhold

tax to cover the minister's liability for self-employment tax and income tax.

Form W-2.— If your employee is an ordained minister, report all taxable compensation as wages on Form W-2. Include in this amount expense allowances or reimbursements paid under a nonaccountable plan, discussed in section 5 of Circular E. Do not include a parsonage allowance (excludable housing allowance) in this amount. You may report a parsonage allowance (housing allowance), including any allowances for utilities and the rental value of housing provided, in a separate statement or as "Other" in box 14 on Form W-2. Do not show any amount as social security or Medicare wages, or any withholding for social security or Medicare. If you withheld tax from the minister under a voluntary agreement, this amount should be shown as income tax withholding. For more information on ministers, see Pub.517.

Exemptions for ministers and others.— Certain ordained ministers, Christian Science practitioners, and members of religious orders who have not taken a vow of poverty, who are subject to self-employment tax (to pay contributions for social security and Medicare), can apply to exempt their earnings from the tax on religious grounds. The application must be based on conscientious opposition to public insurance because of personal religious considerations. Self-employed individuals and their employees who are members of certain recognized religious sects opposed to insurance can also apply for an exemption from the tax. The exemption applies only to qualified services performed for the religious organization.

To apply for the exemption, the employee should file **Form 4361**, Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners. See Pub. 517 for more information about Form 4361.

Members of recognized religious sects opposed to insurance.— If you belong to a recognized religious sect or a division of such sect that is opposed to insurance, you may qualify for an exemption from the self-employment tax. To qualify, you must be conscientiously opposed to accepting the benefits of any public or private insurance that makes payments because of death, disability, old age, or retirement, or makes payments toward the cost of, or provides services for, medical care (including social security and Medicare benefits). If you buy a retirement annuity from an insurance company, you will not be eligible for this exemption. Religious opposition based upon the teachings of the sect is the only legal basis for the exemption. In addition, your religious sect (or division) must have existed since December 31, 1950.

Self-employed.— If you are self-employed and a member of a recognized religious sect opposed to insurance, you can apply for exemption by filing **Form 4029**, Application for Exemption From Social Security and

Medicare Taxes and Waiver of Benefits, and waive all social security benefits.

Employees.— The social security and Medicare tax exemption available to the self-employed who are members of a recognized religious sect opposed to insurance is also available to their employees who are members of such a sect. This applies to partnerships only if each partner is a member of the sect. This exemption for employees applies only if both the employee and the employer are members of such a sect, and the employer has an exemption. To get the exemption, the employee must file Form 4029.

An employee of a church or church-controlled organization that is exempt from social security and Medicare taxes can also apply for an exemption on Form 4029.

See Revenue Procedure 91-20, 1991-1 C.B. 524, for guidelines to determine whether an organization is a religious order or whether an individual is a member of a religious order.

5. Wages and Other Compensation

Circular E provides a general discussion of taxable wages. The following topics supplement that discussion.

Employee Achievement Awards

Do not withhold income, social security, or Medicare taxes on the fair market value of an employee achievement award if it is excludable from your employee's gross income. To be excludable from your employee's gross income, the award must be tangible personal property (not cash or securities) given to an employee for length of service or safety achievement, awarded as part of a meaningful presentation, and awarded under circumstances that do not indicate that the payment is disguised compensation. Excludable employee achievement awards also are not subject to Federal unemployment taxes.

Limits.— The most you can exclude for the cost of all employee achievement awards to the same employee for the year is \$400. A higher limit of \$1,600 applies to qualified plan awards. These awards are employee achievement awards under a written plan that does not discriminate in favor of highly compensated employees. An award cannot be treated as a qualified plan award if the average cost per recipient of all awards under all your qualified plans is more than \$400.

If during the year an employee receives awards not made under a qualified plan and also receives awards under a qualified plan, the exclusion for the total cost of all awards to that employee cannot be more than \$1,600. The \$400 and \$1,600 limits cannot be added together to exclude more than \$1,600 for the cost of awards to any one employee during the year.

Scholarship and Fellowship Payments

Only amounts you pay as a qualified scholarship to a candidate for a degree may be excluded from the recipient's gross income. A qualified scholarship is any amount granted as a scholarship or fellowship that is used for tuition, fees, books, supplies, and equipment. Any amounts you pay for room and board, and any amounts you pay for teaching, research, or other services required as a condition of receiving the scholarship, are not excludable from the recipient's gross income. A qualified scholarship is not subject to social security, Medicare, and Federal unemployment taxes, or income tax withholding. For more information, see **Pub. 520**, Scholarships and Fellowships.

Outplacement Services

If you provide outplacement services to your employees to help them find new employment (such as career counseling, resume assistance, skills assessment, etc.), the value of these benefits may be income to them and subject to all withholding taxes. However, the value of these services will not be subject to any employment taxes if:

- 1) You derive a substantial business benefit from providing the services (such as improved employee morale or business image) separate from the benefit you would receive from the mere payment of additional compensation, and
- 2) The employee would be able to deduct the cost of the services as employee business expenses if he or she had paid for them.

However, if you receive no additional benefit from providing the services, or if the services are not provided on the basis of employee need, then the value of the services is treated as wages and is subject to income tax withholding and social security and Medicare tax. Similarly, if an employee receives the outplacement services in exchange for reduced severance pay (or other taxable compensation), then the amount the severance pay is reduced is treated as wages for employment tax purposes.

Withholding for Idle Time

Payments made under a voluntary guarantee to employees for *idle time* (any time during which an employee performs no services) are wages for the purposes of social security, Medicare, and Federal unemployment taxes, and the withholding of income tax.

Backpay Under a Statute

Treat backpay as wages and withhold and pay employment taxes as appropriate. If backpay was awarded by a court or government agency to enforce a Federal or State statute protecting an employee's right to employment or wages, special rules apply for reporting those

wages to the Social Security Administration. These rules also apply to litigation actions, and settlement agreements or agency directives that are resolved out of court and not under a court decree or order. Examples of pertinent statutes include, but are not limited to, the National Labor Relations Act, Fair Labor Standards Act, Equal Pay Act, Civil Rights Act, and Age Discrimination in Employment Act. Get **Pub. 957**, Reporting of Backpay Awards to the Social Security Administration, for details.

Supplemental Unemployment Benefits

If you pay, under a plan, supplemental unemployment benefits to a former employee, all or part of the payments may be taxable, depending on how the plan is funded. Amounts that represent a return to the employee of amounts previously subject to tax are not taxable and are not subject to withholding. You should withhold income tax on the taxable part of the payments made, under a plan, to an employee who is involuntarily separated because of a reduction in force, discontinuance of a plant or operation, or other similar condition. It does not matter whether the separation is temporary or permanent.

Withholding on taxable supplemental unemployment benefits must be based on the withholding certificate (Form W-4) the employee gave you. See **Pub. 525**, Taxable and Nontaxable Income, for more information about the taxability of supplemental unemployment benefits.

Excessive Termination Payments (Golden Parachutes)

A golden parachute is a contract entered into by a corporation and key personnel under which the corporation agrees to pay certain amounts to the key personnel in the event of a change in ownership or control of the corporation. Payments under golden parachute contracts, like any termination pay, are subject to social security, Medicare, and Federal unemployment taxes, and income tax withholding.

Beginning with payments under contracts entered into, significantly amended, or renewed after June 14, 1984, no deduction is allowed to the corporation for excess parachute payments. The employee is subject to a 20% nondeductible excise tax to be withheld by the corporation on all excess payments. The payment is generally considered an excess parachute payment if it equals or exceeds three times the average compensation of the recipient over the previous 5-year period. The amount over the average is the excess parachute payment.

Example. An officer of a corporation receives a golden parachute payment of \$400,000. This is more than three times greater than his or her average compensation of \$100,000 over the previous 5-year period. The excess parachute payment is \$300,000 (\$400,000 minus \$100,000). The corporation cannot deduct the

\$300,000, and must withhold the excise tax of \$60,000 (20% of \$300,000).

Exempt payments.— Most small business corporations are exempt from the golden parachute rules. See IRC section 280G for more information.

Interest-Free and Below-Market-Interest-Rate Loans

If an employer lends an employee (or an independent contractor) more than \$10,000 at less than the applicable Federal interest rate, the employer is considered to have paid additional compensation to the employee equal to the difference between the applicable Federal interest rate and the interest rate charged. This rule applies to any such loan, regardless of amount, if one of its principal purposes is the avoidance of Federal tax.

This additional compensation to the employee is subject to social security, Medicare, and Federal unemployment taxes, but not to income tax withholding. Include it in compensation on Form W-2 (or Form 1099-MISC for an independent contractor). For more information, see chapter 8 in Pub. 535.

Group-Term Life Insurance

Include in wages for income, social security, and Medicare tax purposes, the cost of group-term life insurance you provided to an employee for coverage over \$50,000, or for coverage that discriminated in favor of the employee. This amount is subject to withholding for social security and Medicare, but not income tax. This taxable insurance cost can be treated as paid by the pay period, by the quarter, or on any basis as long as the cost is treated as paid at least once a year.

Monthly cost.— You determine the monthly cost of group-term life insurance by multiplying the number of thousands of dollars of insurance coverage (figured to the nearest 10th) by the appropriate cost per thousand per month. You determine age on the last day of the tax year. If you provide group-term life insurance for a period of coverage of less than 1 month, you prorate the monthly cost over that period. The monthly cost of each \$1,000 of group-term life insurance protection is as follows:

<u>Age</u>	<u>Cost</u>
Under 30	\$.08
30 through 3409
35 through 3911
40 through 4417
45 through 4929
50 through 5448
55 through 5975
60 through 64	1.17
65 through 69	2.10
70 and over	3.76

Plan requirements.— For you to exclude the cost of life insurance benefits from the income of your employees, your plan must meet certain eligibility and nondiscrimination requirements. For more information, see chapter 5 in Pub. 535.

Former employees.— For coverage of taxable group-term life insurance provided to former employees (including retirees), the former employees must pay the employee's share of social security and Medicare taxes with their income tax returns. The employer must separately include on the Form W-2 the portion of wages that consists of payments for group-term life insurance and the amount of social security and Medicare taxes owed by the former employee for coverage provided after separation from service.

Workers' Compensation—Public Employees.

State and local government employees, such as police officers and firefighters, sometimes receive payments due to injury in the line of duty under a statute that is *not* the general workers' compensation law of a state. If the statute limits benefits to work-related injuries or sickness and does not base payments on the employee's age, length of service, or prior contributions, the statute is "in the nature of" a worker's compensation act. Payments under the statute are not subject to Federal unemployment tax or income tax withholding, but they are subject to social security and Medicare taxes to the same extent that the employee's regular wages are subject to social security and Medicare taxes.

Leave Sharing Plans

If you establish a leave sharing plan for your employees that allows them to donate leave to other employees for medical emergencies, the amounts paid to the recipients of the leave are considered wages. These amounts are includible in the gross income of the recipients and are subject to social security, Medicare, and Federal unemployment taxes, and income tax withholding. Do not include these amounts in the income of the donors.

Cafeteria Plans

Cafeteria plans, including flexible spending arrangements, are benefit plans under which all participants are employees who can choose from among cash and certain qualified benefits. If the employee elects qualified benefits, employer contributions are excluded from his or her wages if the benefits are excludable from gross income under a specific section of the Internal Revenue Code (other than scholarship and fellowship grants under section 117, educational assistance programs under section 127, and employee fringe benefits under section 132). The cost of group-term life insurance that

is includible in income only because the insurance exceeds \$50,000 of coverage or is on the life of the employee's spouse or children is considered a qualified benefit under a special rule.

Qualified benefits under a cafeteria plan are not subject to social security, Medicare, and Federal unemployment taxes, or income tax withholding. If an employee elects to receive cash instead of any qualified benefit, it is treated as wages subject to all employment taxes. For more information, see chapter 5 in Pub. 535.

Deferred Compensation Arrangements

Employer contributions to a cash or deferred compensation arrangement that is part of a qualified profit-sharing or stock bonus plan are included in social security and Medicare wages even though they may not be included in the gross incomes of the employees.

An amount deferred under a nonqualified deferred compensation plan is treated as social security and Medicare wages when the services are performed or when the employee no longer has any substantial risk of forfeiting the right to the deferred compensation, whichever is later.

Employee Stock Options

There are two classes of stock options, statutory (covered by a specific Code provision) and nonstatutory. Generally, statutory stock options are not taxable to the employee either when the option is granted or when it is exercised (unless the stock is disposed of in a disqualifying disposition). However, nonstatutory stock options normally are taxable to the employee as wages when the option is exercised (see Regulation section 1.83-7). These wages are subject to social security and Medicare taxes, income tax withholding, and Federal unemployment (FUTA) tax.

Tax-Sheltered Annuities

Employer payments made by an educational institution or a tax-exempt organization to purchase a tax-sheltered annuity for an employee are included in the employee's social security and Medicare wages if the payments are made because of a salary reduction agreement.

Contributions to a Simplified Employee Pension (SEP) Plan

An employer's SEP contributions to an employee's individual retirement arrangement (IRA) are excluded from the employee's gross income. These excluded amounts are not subject to social security, Medicare, and Federal unemployment taxes, or income tax withholding. However, any employer SEP contributions paid under a salary reduction agreement are included in wages for purposes of social security and Medicare taxes and the Federal unemployment tax.

See **Pub. 590**, Individual Retirement Arrangements, for more information about SEP plans.

6. Employee Fringe Benefits

The following fringe benefits provided by an employer are excluded from the employee's gross income. The benefits are not subject to social security, Medicare, and Federal unemployment taxes, or income tax withholding.

- 1) A no-additional cost service, which is a service offered for sale to customers in the course of the employer's line of business in which the employee works. It is provided at no substantial additional cost, including lost revenue, to the employer. Examples include airline, bus, and train tickets and telephone services provided free or at reduced rates by an employer in the line of business in which the employee works.
- 2) A qualified employee discount that, if offered for property, is not more than the employer's gross profit percentage. If offered for services, the discount is not more than 20% of the price for services offered to customers.
- 3) A working condition benefit that is property or a service the employee could deduct as a business expense if he or she had paid for it. Examples include a company car for business use and subscriptions to business magazines. Under special rules, all of the use of a demonstrator car by an auto salesperson is excluded if there are substantial restrictions on personal use.
- 4) A de minimis benefit that is a service or an item of such small value (after taking into account how frequently similar benefits are provided to employees) as to make accounting for the benefit unreasonable or administratively impracticable. Examples include typing of a personal letter by a company secretary, occasional personal use of a company copying machine, occasional parties or picnics for employees, occasional supper money and taxi fare for employees working overtime, holiday gifts with a low fair market value, occasional tickets for entertainment events, and coffee and doughnuts furnished to employees. Also exclude from the employee's income meals at an eating facility operated by the employer for the employees' benefit on or near the employer's business premises if the income from the facility equals or exceeds the direct operating costs of the facility.
- 5) A qualified transportation benefit, which includes transit passes, transportation in a commuter highway vehicle to and from work, and qualified parking

at or near the place of work. The combined exclusion for the transit passes and transportation cannot exceed \$60 per month. The exclusion for parking cannot exceed \$160 per month for 1995 (\$XXX per month for 1996). For more information, on this transportation fringe benefit, see chapter 4 in Pub. 535.

- 6) A qualified moving expense reimbursement, which includes any amount received, directly or indirectly, by an employee from an employer as a payment for, or reimbursement of, expenses that would be deductible as moving expenses, if paid or incurred by the employee. For more information on expenses that qualify for a deduction, see **Pub. 521**, Moving Expenses.
- 7) An on-premises gym or other athletic facility provided and operated by the employer if substantially all the use is by employees, their spouses, and their dependent children.
- 8) A qualified tuition reduction, which an educational organization provides its employees for education, generally below the graduate level. For more information on a qualified tuition reduction, see Pub. 520.

Note: *In order to be excluded from the income of highly compensated employees, all of these fringe benefits except a working condition benefit or a de minimis benefit (other than eating facilities) must be offered to employees on a nondiscriminatory basis.*

Special fringe benefit rules for airlines and their affiliates.— Employees of a qualified affiliate of an airline (a member of a group in which another member operates the airline) who are directly engaged in providing airline-related services may exclude from their income as a no-additional-cost service the fair market value of air transportation provided by the other member. Airline-related services means providing any of the following services in connection with air transportation: catering, baggage handling, ticketing and reservations, flight planning and weather analysis, service at restaurants and gift shops located at an airport, and similar services.

Any use of air transportation provided by an airline to parents of the airline's employees is also treated as use by the employees. The employees are entitled to exclude the fair market value of such transportation from their income as a no-additional-cost service.

More information.— For more detailed information on fringe benefits, see chapter 4 in Pub. 535.

Withholding on and Reporting Taxable Noncash Fringe Benefits

Use the following guidelines for reporting and withholding tax on taxable noncash fringe benefits.

Valuation of fringe benefits.— Generally, you must determine the value of fringe benefits no later than January 31 of the next year. Prior to January 31, you may reasonably estimate the value of the fringe benefits for purposes of withholding and depositing on time.

Choice of period for withholding, depositing, and reporting.— For employment tax and withholding purposes, you can treat fringe benefits (including personal use of employer-provided highway motor vehicles) as paid on a pay period, quarter, semiannual, annual, or other basis. But the benefits must be treated as paid no less frequently than annually. You do not have to choose the same period for all employees. You can withhold more frequently for some employees than for others.

You can change the period as often as you like as long as you treat all the benefits provided in a calendar year as paid no later than December 31 of the calendar year.

You can also treat the value of a single fringe benefit as paid on one or more dates in the same calendar year, even if the employee receives the entire benefit at one time. For example, if your employee receives a fringe benefit valued at \$1,000 in one pay period during 1996, you can treat it as made in four payments of \$250, each in a different pay period of 1996. You do not have to notify the IRS of the use of the periods discussed above.

Transfer of property.— The above choice for reporting and withholding does not apply to a fringe benefit that is a transfer of tangible or intangible personal property of a kind normally held for investment, or a transfer of real property. For this kind of fringe benefit, you must use the actual date the property was transferred to the employee.

Withholding and depositing taxes.— You can add the value of fringe benefits to regular wages for a payroll period and figure income tax withholding on the total. Or you can withhold Federal income tax on the value of fringe benefits at the flat 28% rate applicable to supplemental wages.

You must withhold the applicable income, social security, and Medicare taxes on the date or dates you chose to treat the benefits as paid. Deposit the amounts withheld as discussed section 11 of Circular E.

Amount of deposit.— To estimate the amount of income and employment taxes and to deposit them on time, make a reasonable estimate of the value of the fringe benefits provided on the date or dates you chose to treat the benefits as paid. Determine the estimated deposit by figuring the amount you would have had to deposit if you had paid cash wages equal to the estimated value of the fringe benefits and withheld taxes from those cash wages. Even if you do not know which employee will receive the fringe benefit on the date the deposit is due, you should follow this procedure.

If you underestimate the value of the fringe benefits and deposit less than the amount you would have had to

deposit if the applicable taxes had been withheld, you may be subject to a penalty.

If you overestimate the value of the fringe benefit and overdeposit, you can either claim a refund or have the overpayment applied to your next employment tax return.

If you deposited the required amount of taxes but withheld a lesser amount from the employee, you can recover from the employee the social security, Medicare, or income taxes you deposited on the employee's behalf, and included on the employee's Form W-2. However, you must recover the income taxes before April 1 of the following year.

Special accounting rule.— You can treat the value of benefits provided during the last 2 months of the calendar year, or any shorter period within the last two months, as paid in the next year. Thus, the value of benefits actually provided in the last 2 months of 1995 would be treated as provided in 1996 together with the value of benefits provided in the first 10 months of 1996. This does not mean that all benefits treated as paid during the last 2 months of a calendar year can be deferred until the next year. Only the value of benefits actually provided during the last 2 months of the calendar year can be treated as paid in the next calendar year.

Limitation.— The special accounting rule cannot be used, however, for a fringe benefit that is a transfer of tangible or intangible personal property of a kind normally held for investment, or a transfer of real property.

Conformity rules.— Use of the special accounting rule is optional. You can use the rule for some fringe benefits but not others. The period of use need not be the same for each fringe benefit. However, if you use the rule for a particular fringe benefit, you must use it for all employees who receive that benefit.

If you use the special accounting rule, your employee must use it also and for the same period as you use it. But your employee cannot use the special accounting rule unless you do.

You do not have to notify the IRS if you use the special accounting rule. You can also, for appropriate reasons, change the period for which you use the rule without notifying the IRS. But you must report the income and deposit the withheld taxes as required for the changed period.

Special rules for highway motor vehicles.— If an employee uses the employer's vehicle for personal purposes, the value of that use must be determined by the employer and included in the employee's wages. The value of the personal use must be based on fair market value or one of three special valuation rules:

- The automobile lease valuation rule.
- The vehicle cents-per-mile rule.

- The commuting valuation rule (for commuting use only).

See Pub. 535 for information on these special valuation rules.

Election not to withhold income tax.— You can choose not to withhold income tax on the value of an employee's personal use of a highway motor vehicle you provided. You do not have to make this choice for all employees. You can withhold income tax from the wages of some employees but not others. You must, however, withhold the applicable social security and Medicare taxes on such benefits.

You can choose not to withhold income tax by:

- 1) Notifying the employee as described below that you choose not to withhold; and
- 2) Including the value of the benefits in boxes 1, 3, and 5 on a timely furnished Form W-2.

The notice must be in writing and must be provided to the employee by January 31 of the election year or within 30 days after a vehicle is first provided to the employee, whichever is later. This notice must be provided in a manner reasonably expected to come to the attention of the affected employee. For example, the notice may be mailed to the employee, included with a paycheck, or posted where the employee could reasonably be expected to see it. You can also change your election not to withhold at any time by notifying the employee in the same manner.

Amount to report on Forms 941 and W-2.— The actual value of fringe benefits provided during a calendar year (or other period as explained under **Special accounting rule** earlier) must be determined by January 31 of the following year. You must report the actual value on Forms 941 and W-2. If you choose, you can use a separate Form W-2 for fringe benefits and any other benefit information.

For 1995, include the value in box 1 of Form W-2. Also include it in boxes 3 and 5 if applicable. Show the total value of the fringe benefits provided in the calendar year or other period in box 12 of Form W-2. If you provided your employee with the use of a highway motor vehicle and included 100% of the value of the vehicle in the employee's income, you must also report it separately in box 12. If there is not enough space on the Form W-2, you must report the value to the employee on a separate schedule so that the employee can compute the value of any business use of the vehicle.

If you use the special accounting rule, you must notify the affected employees of the period in which you used it. You must give the notice at or near the date you give the Form W-2 but not earlier than with the employee's last paycheck of the calendar year.

7. Sick Pay Reporting

Sick pay generally means any amount paid under a plan because of an employee's temporary absence from work due to injury, sickness, or disability. Sick pay may also be called payments on account of sickness or accident disability. It may be paid by either the employer or a third party, such as an insurance company. Sick pay includes both short and long-term benefits. It is often expressed as a percentage of the employee's regular wages.

This section does not discuss disability retirement payments. Those payments are subject to the rules for income tax withholding from pensions and annuities. See page xx for information.

Social Security, Medicare, and FUTA Taxes on Sick Pay

Employer.— If you pay sick pay to your employee, you must generally withhold employee social security and Medicare taxes from the sick pay. You must timely deposit employee and employer social security and Medicare taxes and Federal unemployment (FUTA) tax. There are no special deposit rules for sick pay. See section 11 of Circular E for more information on the deposit rules.

Employer's agent.— An employer's agent is a third party that bears no insurance risk and is reimbursed on a cost-plus-fee basis for payment of sick pay and similar amounts. A third party may be your agent even if the third party is responsible for determining which employees are eligible to receive payments. For example, if a third party provides administrative services only, the third party is your agent. If the third party is paid an insurance premium and is not reimbursed on a cost-plus-fee basis, the third party is not your agent. Whether an insurance company or other third party is your agent depends on the terms of the agreement with you.

A third party that makes payments of sick pay as your agent is not considered the employer and generally has no responsibility for employment taxes. This responsibility remains with you. However, under an exception to this rule, the parties may enter into an agreement that makes the third-party agent responsible for employment taxes. In this situation, the third-party agent should use its own name and EIN (rather than your name and EIN) for the responsibilities it has assumed.

Third party not employer's agent.— A third party that makes payments of sick pay *other than as an agent of the employer* is liable for the employee part of the social security and Medicare taxes. The third party is also liable for the employer part of the social security and Medicare taxes and the FUTA tax, unless the third party transfers this liability to the *employer for whom the employee normally works*. This liability is transferred

to the employer for whom the employee normally works if the third party takes the following steps.

- 1) Withholds the **employee** social security and Medicare taxes from the sick pay payments,
- 2) Makes timely deposits of the **employee** social security and Medicare taxes, and
- 3) Notifies the employer for whom the employee normally works of the payments on which employee taxes were withheld and deposited. The third party must notify the employer within the time required for the third party's deposit of the employee part of the social security and Medicare taxes. For instance, if the third party is a monthly depositor, it must notify the employer by the 15th day of the month following the month in which the sick pay payment is made, because that is the day by which the deposit is required to be made. For multi-employer plans, see the special rule discussed next.

Multi-employer plan timing rule.— A special rule applies to sick pay payments made to employees by a third-party insurer under an insurance contract with a multi-employer plan established under a collectively bargained agreement. If the third-party insurer making the payments complies with steps 1 and 2 above and gives the plan (rather than the employer) the required timely notice described in step 3 above, then the plan (not the third-party insurer) must pay the employer part of the social security and Medicare taxes and the FUTA tax. Similarly, if, within 6 business days of the plan's receipt of notification, the plan gives notice to the employer for whom the employee normally works, the employer (not the plan) must pay the employer part of the social security and Medicare taxes and the FUTA tax.

Amounts not subject to social security, Medicare, or FUTA taxes.— The following payments, whether paid by you or a third party, are not subject to social security, Medicare, or FUTA taxes (different rules apply to income tax withholding):

- 1) Amounts paid under a definite plan or system, as defined earlier, on or after the termination of the employment relationship because of death or disability retirement.
However, even if there is a definite plan or system, amounts paid to a former employee are subject to social security, Medicare, and FUTA taxes if they would have been paid even if the employment relationship had not terminated because of death or disability retirement. For example, a payment to a disabled former employee for unused vacation time would have been made whether or not the employee retired on disability. The payment is therefore wages for social security, Medicare, and FUTA tax purposes.
- 2) Payments to the employee's estate or survivor after the calendar year of the employee's death.

- 3) Payments to an employee when the employee is entitled to disability insurance benefits under section 223(a) of the Social Security Act. This rule applies only if the employee became entitled to the Social Security Act benefits before the calendar year in which the payments are made, and the employee performs no service for the employer during the period for which the payments are made. **Note:** *These payments are subject to FUTA tax.*
- 4) Payments that exceed the applicable wage base. The social security tax wage base for 1995 is \$61,200. There is no wage base for Medicare tax. The FUTA tax wage base is \$7,000. For example, if an employee receives \$59,000 in wages from an employer in 1995, and then receives \$3,000 of sick pay, only the first \$2,200 of the sick pay is subject to social security tax. All of the sick pay is subject to Medicare tax. None of the sick pay is subject to FUTA tax. See **Example of Figuring and Reporting Sick Pay**, later.
- 5) Payments made on account of sickness or accident disability more than 6 calendar months after the last calendar month in which the employee worked. For example, if the employee's last day of work was December 11, 1994, payments of sick pay made after June 30, 1995, are not subject to social security, Medicare, or FUTA taxes. If the employee returns to work for 1 day on February 17, 1995, the 6-month period would begin again, and only those payments made after August 31, 1995, would not be subject to these taxes.
- 6) Payments received under a workers' compensation law. This exception does not apply to payments to state and local government employees under a statute *in the nature* of a workers' compensation act, even though these payments are exempt from income tax and income tax withholding. See **Workers' Compensation—Public Employees** earlier.
- 7) Payments of medical and hospitalization expenses of employees, spouses, and dependents, and insurance premiums for this coverage, if paid under a definite plan or system.
- 8) Payments, or parts of payments, attributable to **employee contributions** to a sick-pay plan made with **aftertax** dollars. (Contributions to a sick-pay plan made on behalf of employees with employees' **pretax** dollars under a cafeteria plan are **employer contributions**.)

Group policies rule. Special rules apply to situations in which both you and your employees contribute to a group insurance policy. If, at the beginning of the calendar year in which sick pay is paid, the net cost for group insurance coverage for 3 or more policy years is known, the part of the sick pay attributable to your contributions is determined by multiplying the sick pay by a fraction. The numerator of the fraction is the net premiums you contributed for the

last 3 policy years. The denominator is the net premiums contributed by you and all your employees for those years.

If the net premiums for group coverage for 3 or more policy years are not known at the beginning of the calendar year, but are known for at least 1 policy year, the determination is made by using the net premiums for the coverage that are known at the beginning of the calendar year. If the net premiums for the coverage are not known at the beginning of the calendar year for even 1 policy year, the determination is made by using either (1) a reasonable estimate of the net premiums for the first policy year or (2) the net premiums for a policy year, if the net premiums are ascertained during the calendar year. Also, see **Example of Figuring and Reporting Sick Pay** later.

- 9) Accident or health insurance payments unrelated to absence from work. These include payments for permanent—
 - a) Loss of a member or function of the body,
 - b) Loss of the use of a member or function of the body, or
 - c) Disfigurement of the body,
 but only if the payments are based on the nature of the injury and not the period the employee is absent from work. See **Example of Figuring and Reporting Sick Pay** later.

Reliance on information supplied by the employer.— To determine the amounts not subject to employment taxes, the third party may need to request information from you relating to some of the exceptions listed earlier. Unless the third party has reason not to believe the information, the third party may rely on it as to the following items:

- 1) The total wages you paid the employee during the calendar year.
- 2) The last month in which the employee worked for you.
- 3) The employee contributions to the sick-pay plan made with aftertax dollars.

The third party should not rely on statements regarding these items made by the employee.

Income Tax Withholding on Sick Pay

The requirements for income tax withholding on sick pay and the methods for figuring it differ depending on whether the sick pay is paid by:

- 1) You,
- 2) Your agent (defined earlier), or
- 3) A third party that is not your agent.

Liability for the withheld income tax is determined under the same rules that apply to withheld employee

social security and Medicare taxes. See **Social Security, Medicare and FUTA Taxes on Sick Pay** earlier.

Employer or employer's agent.— Sick pay paid by you or your agent is subject to mandatory income tax withholding. An employer or agent paying sick pay generally determines the income tax to be withheld based on the employee's Form W-4. The employee cannot choose how much will be withheld by giving you or your agent a Form W-4S. Sick pay paid by an agent is treated as supplemental wages. If the agent does not pay regular wages to the employee, the agent may choose to withhold income tax at a flat 28% rate, rather than at the wage withholding rate.

Third party not an agent.— Sick pay paid by a third party that is not your agent is not subject to mandatory income tax withholding. However, an employee may elect to have income tax withheld by filing Form W-4S with the third party.

If Form W-4S has been filed, the third party should withhold income tax on all payments of sick pay made 8 or more days after receiving the form. The third party may, at its option, withhold income tax before 8 days have passed.

The employee may request on Form W-4S to have a specific whole dollar amount withheld. However, if the requested withholding would reduce any net payment below \$10, the third party should not withhold any income tax from that payment. The minimum amount that the employee can specify is \$20 a week.

If a particular payment is less than or greater than a regular payment, the amount withheld must be in the same proportion to the particular payment as the regular withholding is to a regular payment. For example, if \$25 is withheld from a regular full payment of \$100, then \$20 should be withheld from a partial payment of \$80.

Amounts not subject to income tax withholding.— The following amounts, whether paid by you or a third party, are not wages subject to income tax withholding.

- 1) Payments received under a workers' compensation law or a statute in the nature of a workers' compensation act.
- 2) Payments, or parts of payments, attributable to employee contributions made to a sick-pay plan with aftertax dollars under the rules discussed earlier under **Amounts not subject to social security, Medicare, or FUTA taxes.**
- 3) Accident or health insurance payments unrelated to absence from work explained earlier under **Amounts not subject to social security, Medicare, or FUTA taxes.**
- 4) Amounts received by an employee, spouse, or dependent under an accident or health plan as a reimbursement of medical expenses. (**Note:** *A medical expense reimbursement may be subject to Federal income tax if the expenses were deducted on the*

employee's income tax return for a prior year. See Pub. 502, Medical Expenses).

- 5) Payments made to the employee's estate or survivor at any time after the employee's death.

Depositing and Reporting

This section discusses who is liable for depositing social security, Medicare, FUTA, and withheld income taxes on sick pay. These taxes must be deposited under the same rules that apply to deposits of taxes on regular wage payments. See Circular E for information on the deposit rules.

This section also explains how sick pay should be reported on Forms W-2, W-3, 940 or 940-EZ, and 941. For additional information covering specific line numbers and box numbers on these forms, see **Reporting Sick Pay on Forms 941, W-2, and W-3** later.

Employer or agent of employer.— If you or your agent (defined earlier) makes sick pay payments, you deposit taxes and file Forms W-2, W-3, 940, and 941 under the same rules that apply to regular wage payments.

However, the agreement between the parties may require your agent to carry out responsibilities that would otherwise have been borne by you. In this situation, the your agent should use its own name and EIN (rather than yours) for the responsibilities it has assumed.

Third party.— The rules for a third party that is not your an agent depend on whether liability has been transferred as discussed under **Social Security, Medicare, and FUTA Taxes on Sick Pay** earlier.

To figure the due dates and amounts of its deposits of employment taxes, a third party should combine:

- 1) The liability for the wages paid to its own employees, and
- 2) The liability for payments it made to all employees of all its clients. This does not include liability transferred to the employer.

Liability Not Transferred

If the third party does not satisfy the requirements for transferring liability for FUTA tax and the employer's part of the social security and Medicare taxes, the third party reports the sick pay on its own Forms 940 and 941. In this situation, you have no tax responsibilities for sick pay.

The third party must deposit social security, Medicare, FUTA, and withheld income taxes using its own name and EIN. The third party must give each employee to whom it paid sick pay a Form W-2 by January 31 of the following year. The Form W-2 must include the third party's name, address, and EIN; the employee's name, address, and social security number; and the following information:

- 1) Sick pay the employee must include in income (box 1).
- 2) Any Federal income tax withheld from the sick pay (box 2).
- 3) Sick pay subject to employee social security tax (box 3).
- 4) Employee social security tax withheld from the sick pay (box 4).
- 5) Sick pay subject to employee Medicare tax (box 5).
- 6) Employee Medicare tax withheld (box 6).
- 7) Any amount not subject to Federal income tax because the employee contributed to the sick-pay plan (box 13, enter Code J).

Liability Transferred

Generally, if a third party satisfies the requirements for transferring liability for the employer part of the social security and Medicare taxes and for the FUTA tax, the following rules apply.

Deposits.— The third party must make deposits of withheld employee social security and Medicare taxes and withheld income tax using its own name and EIN. You must make deposits of the employer part of the social security and Medicare taxes and the FUTA tax using your name and EIN. In applying the deposit rules, your liability for these taxes begins upon receiving the third party's notice of sick pay payments.

Form 941.— The third party and you must each file Form 941. Line 9 of each Form 941 must contain a special adjusting entry for social security and Medicare taxes. These entries are required because the total tax liability for social security and Medicare taxes (employee and employer parts) is split between you and the third party.

Employer. You must include third-party sick pay on lines 2, 6a, and 7 of Form 941. After completing line 8, subtract on line 9 the employee social security and Medicare taxes withheld and deposited by the third party. Enter the sick pay amount on line 9 and in the space provided on the left. If line 9 includes adjustments unrelated to sick pay, show those amounts in the spaces provided, and the total is shown in the line 9 box on the right.

Third party. The third party must include on Form 941 the employee part of the social security and Medicare taxes (and income tax, if any) it withheld. The third party does not include on line 2 any sick pay paid as a third party, but does include on line 3 any income tax withheld. On line 6a, the third party enters the total amount it paid subject to social security taxes. This amount includes both wages paid to its own employees and sick pay paid as a third party. The third party completes line 7 in a similar manner. On line 9, the third party subtracts the part of the social security and Medicare taxes you must pay. The third party enters the sick pay amount on line 9 and in the space provided to the left for

sick pay. If line 9 includes adjustments unrelated to sick pay, the third party shows those amounts in the spaces provided and enters the total of all adjustments in the line 9 box.

Dummy Forms W-2 and W-3.— The third party must prepare “dummy” Forms W-2 and a “dummy” Form W-3. These forms do not reflect sick pay paid to individual employees, but instead show the combined amount of sick pay paid to all employees of all clients of the third party. The dummy forms provide a means of reconciling the wages shown on the third party's Form 941. However, see **Optional Rule for Form W-2** later.

The third party fills out the dummy Form W-2 as follows:

Box b – the third party's EIN.

Box c – the third party's name and address.

Box e – “Third-party sick pay” in place of the employee's name.

Box 1 – total sick pay paid.

Box 2 – any Federal income tax withheld from the sick pay.

Box 3 – the sick pay subject to employee social security tax.

Box 4 – employee social security tax withheld from sick pay.

Box 5 – the sick pay subject to employee Medicare tax.

Box 6 – the employee Medicare tax withheld from the sick pay.

The third party attaches the dummy Form W-2 to a separate Form W-3, of which only boxes b, e, f, g, 1, 2, 3, 4, 5, 6, 13, and 14 are completed. The third party makes no entry in box 15 of Form W-3. You provide information in box 15 of your Form W-3.

Sick-pay statement.— The third party must furnish you with a sick-pay statement by January 15 of the year following the year in which the sick pay was paid. The statement must show the following information about each employee who was paid sick pay:

- 1) The employee's name.
- 2) The employee's SSN (if social security, Medicare, or income tax was withheld).
- 3) The sick pay paid to the employee.
- 4) Any Federal income tax withheld.
- 5) Any employee social security tax withheld.
- 6) Any employee Medicare tax withheld.

Form W-2.— You must generally prepare Forms W-2 for the sick pay, but see **Optional Rule for Form W-2** later. You may either combine the sick pay with other wages and prepare a single Form W-2 for each employee or you may prepare separate Forms W-2 for

each employee, one reporting sick pay and the other reporting regular wages. A Form W-2 must be prepared even if all the sick pay is nontaxable. All Forms W-2 must be given to the employees by January 31.

The Form W-2 filed for the sick pay must include the following information:

- 1) Employer's name, address, and EIN.
- 2) Employee's name, address, and SSN.
- 3) Sick pay the employee must include in income (box 1).
- 4) Any Federal income tax withheld from the sick pay (box 2).
- 5) Sick pay subject to employee social security tax (box 3).
- 6) Employee social security tax withheld from the sick pay (box 4).
- 7) Sick pay subject to employee Medicare tax (box 5).
- 8) Employee Medicare tax withheld (box 6).
- 9) Any amount not subject to Federal income tax because the employee contributed to the sick-pay plan (box 13, enter Code J).

Form 940 or 940-EZ.— You, not the third party, must prepare Form 940 or 940-EZ for sick pay.

Optional Rule for Form W-2

You and the third party may choose to enter into a legally binding agreement designating the third party to be your agent for purposes of preparing Forms W-2 reporting sick pay. The agreement must specify what part, if any, of the payments under the sick-pay plan is excludable from the employees' gross incomes because it is attributable to their contributions to the plan. If you enter into an agreement, the third party prepares the actual Forms W-2, not dummy Forms W-2 as discussed earlier, for each employee who receives sick pay from the third party. If the optional rule is used:

- 1) The third party does not provide you with the sick-pay statement described earlier, and
- 2) You (not the third party) prepare dummy Forms W-2 and W-3. These dummy forms are needed to reconcile the sick pay shown on your Form 941.

Example of Figuring and Reporting Sick Pay

Alan, an employee, was seriously injured and lost an eye in a car accident on January 1, 1995. Alan's last day of work was December 30, 1994. The accident was not job-related.

Key, an insurance company that was not an agent of the employer, paid Alan \$2,000 each month for 10 months, beginning in January 1995. In March 1995, Alan received a lump-sum of \$5,000 from Key as compensation for the loss of his eye. This payment was determined

according to the type of injury and qualifies as a payment unrelated to absence from work, as discussed earlier. Alan filed a Form W-4S with Key, requesting \$210 be withheld from each payment for Federal income tax. Alan received no payments from Edgewood, his employer, from January 1995 through October 1995. Alan returned to work in November 1995.

For the policy year in which the car accident occurred, Alan paid a part of the premiums for his coverage, and Edgewood paid the remaining part. The plan was, therefore, a "contributory plan." During the 3 policy years before the calendar year of the accident, Edgewood paid 70% of the total of the net premiums for its employees' insurance coverage and its employees paid 30%. No part of the premiums was paid with pretax dollars under a cafeteria plan.

Social security and Medicare taxes.— No part of the \$5,000 lump-sum payment for loss of the eye is included in wages for social security and Medicare tax purposes, because the payment was determined according to the type of injury and qualifies as a payment unrelated to absence from work. For social security and Medicare tax purposes, taxable sick pay was \$8,400 (\$2,000 per month \times 70% = \$1,400 taxable portion per payment; \$1,400 \times 6 months = \$8,400 total taxable sick pay). Only the six \$2,000 checks received by Alan from January through June are included in the calculation. The check received by Alan in July (the seventh check) was received more than 6 months after the month in which Alan last worked.

Of each \$2,000 payment Alan received, 30% (\$600) is not subject to social security and Medicare taxes because the plan is contributory and Alan's aftertax contribution is considered to be 30% of the premiums during the 3 policy years before the calendar year of the accident.

FUTA tax.— No part of the \$5,000 lump-sum payment is included in wages for FUTA tax purposes. Of the \$8,400 taxable sick pay (figured the same as for social security and Medicare taxes), only \$7,000 is subject to the FUTA tax because the FUTA contribution base of \$7,000.

Income tax withholding.— No part of the \$5,000 lump-sum payment is subject to income tax withholding. Of each \$2,000 payment, \$1,400 (\$2,000 \times 70%) is subject to voluntary income tax withholding. In accordance with Form W-4S, \$210 was withheld from each payment (\$2,100 for the 10 payments made during 1995).

Liability transferred.— For the first 6 months following the last month in which Alan worked, Key was liable for social security, Medicare, and FUTA taxes on any payments that constituted taxable wages. However, Key could have shifted the liability for the employer part of the social security and Medicare taxes (and for the FUTA tax) during the first 6 months by withholding Alan's part of the social security and Medicare taxes, timely depositing the taxes, and notifying Edgewood of the payments.

If Key shifted liability for the employer part of the social security and Medicare taxes to Edgewood and provided Edgewood with a sick-pay statement, Key would not prepare a Form W-2 for Alan. However, Key would prepare dummy Forms W-2 and W-3. Key and Edgewood must each prepare Form 941. Edgewood must also report the sick pay and withholding for Alan on Forms W-2, W-3, and 940.

As an alternative, the parties could have followed the optional rule described under **Optional Rule for Form W-2** earlier. Under this rule, Key would prepare Form W-2 even though liability for the employer part of the social security and Medicare taxes had been shifted to Edgewood. Also, Key would not prepare a sick-pay statement, and Edgewood, not Key, would prepare the dummy Forms W-2 and W-3 reflecting the sick pay shown on Edgewood's Form 941.

Liability not transferred.— If Key did not shift liability for the employer part of the social security and Medicare taxes to Edgewood, Key would prepare Forms W-2 and W-3 as well as Forms 941 and 940. In this situation, Edgewood would not report the sick pay.

Payments received after 6 months.— The payments received by Alan in July through October are not subject to social security, Medicare, or FUTA taxes, because they were received more than 6 months after the last month in which Alan worked (December 1994). However, Key must continue to withhold income tax from each payment because Alan furnished Key a Form W-4S. Also, Key must prepare Forms W-2 and W-3, unless it has furnished Edgewood with a sick-pay statement. If the sick-pay statement was furnished, then Edgewood must prepare Forms W-2 and W-3.

Reporting Sick Pay on Forms 941, W-2, and W-3

As explained above, the taxable portion of the \$2,000 monthly payments for sick pay was \$1,400 per payment. Taxable sick pay for each of the first two quarters of 1995 was \$4,200 (\$1,400 x 3 months).

Third party transfers liability to employer.— The optional rule for Form W-2 (discussed above) was not used. Edgewood and Key complete Forms 941, W-2, and W-3 as follows:

Employer (Edgewood).— Edgewood reports sick pay on Form 941 (for the first two quarters of 1995) as follows:

Line 2 - includes \$4,200 sick pay in wages (\$1,400 x 3 payments received in quarter).

Line 3 - does not include withholding from sick pay because the third party payer (Key) withheld and deposited the income tax.

Line 6a - includes \$4,200 sick pay in social security wages.

Line 7 - includes \$4,200 sick pay in Medicare wages.

Line 9 - reports an adjustment to social security and Medicare taxes for sick pay because Key withheld and deposited the employee's share of these taxes (\$321.30). Edgewood enters \$321.30 on line 9 and in the space marked "Sick pay" at the left.

By January 31, 1996, Edgewood issues a Form W-2 to the employee (Alan). The sick pay is reported on Form W-2 as follows:

Box 1 - includes the \$14,000 sick pay in wages (\$1,400 x 10 payments).

Box 2 - includes the \$2,100 income tax withheld on sick pay (\$210 x 10 payments).

Box 3 - includes the \$8,400 sick pay in social security wages (\$1,400 x 6 payments received in 6 months).

Box 4 - includes the \$520.80 social security tax withheld on sick pay (\$8,400 x 6.2%).

Box 5 - includes the \$8,400 sick pay in Medicare wages (\$1,400 x 6 payments received in 6 months).

Box 6 - includes the \$121.80 Medicare tax withheld on sick pay (\$8,400 x 1.45%).

Even though these amounts were withheld by the third party (Key), Edgewood must include them on the Form W-2 issued to Alan. On Form W-3, Edgewood shows the income tax withheld by Key on Alan's sick pay in box 15, *Income tax withheld by third-party payer*.

Third party payer (Key)— On Form 941 for the first 2 quarters of 1995, Key does not report the sick pay paid for its clients on line 2. Key includes on line 3 income tax withheld from sick pay for its clients. Key also includes the third-party sick pay on lines 6a and 7. Because Key transferred the employer tax liability to its clients, it enters the employer's share of social security and Medicare tax on third-party sick pay on line 9 in the space marked "Sick pay" at the left.

By February 29, 1996, Key files a dummy Form W-2 to report all sick pay it paid employees of its clients in 1995. It writes "Third-party sick pay" in box e of the dummy Form W-2. Key prepares two Forms W-3, one for the dummy Form W-2 and one for its own employees.

Third party does not transfer liability to employer.— Edgewood reports on Form 941 only the wages it paid to its employees. Edgewood does not include on lines 2, 6a, and 7 the sick pay Key paid the employees.

Key includes on lines 2, 6a, and 7 of Form 941 the sick pay paid to insured employees. It also reports income tax withholding on the sick pay on line 3.

Edgewood and Key must each issue a Form W-2 to each employee who received wages from Edgewood and sick pay from Key. The employee's Form W-2 from

Edgewood reflects only the paid wages and taxes withheld by Edgewood. The Form W-2 from Key reflects only the sick pay paid and the taxes withheld by Key.

8. Special Rules for Paying Taxes

Common Paymaster

If two or more related corporations employ the same individual **at the same time** and pay this individual through a common paymaster, which is one of the corporations, the corporations are considered a single employer. They have to pay, in total, no more in social security and Medicare taxes than a single employer would.

Each corporation must pay its own part of the employment taxes and may deduct only its own part of the wages. The deductions will not be allowed unless the corporation reimburses the common paymaster for the wage and tax payments.

Third Party Liability for Paying Taxes

Any lender, surety, or other third party who pays wages directly to the employees of an employer, or to the employee's agent, is responsible for any required withholding on those wages. This includes the withholding of income, social security, Medicare, and railroad retirement taxes. The third party is also liable for any interest and penalties accruing on these accounts.

If a third party supplies funds to an employer so that the employer can pay the employees' wages, and if the third party knows that the employer will not pay or deposit the taxes that are required to be withheld when due, then the third party must pay the taxes withheld from the employee's wages but not paid by the employer. However, the third party does not have to pay more than 25% of the amount that is specifically supplied for paying wages. The third party supplier must also pay interest on the taxes if they are paid after the due date of the employer's return.

Third parties are liable only for payment of the employees' parts of payroll taxes. They are not liable for the employer's part. The employer must file an employment tax return for wages that he or she or a third party pays and must furnish statements to employees of wages paid and taxes withheld. The employer also remains liable for any withholding taxes not paid by the third party.

Liability of trustee in bankruptcy.— A trustee in bankruptcy must withhold, report, and pay income, social security, and Medicare taxes from the payment of priority claims for employee's wages earned prior to, but unpaid at the time of, an employer's bankruptcy.

How to pay withheld tax.— Third parties who pay employment taxes must file two copies of **Form 4219**, Statement of Liability of Lender, Surety, or Other Person

for Withholding Taxes. A separate set of forms must be filed for each employer and calendar quarter.

Form 4219 must be filed with the IRS Service Center where the employer for whom wages were paid, or funds were supplied, files Federal employment tax returns.

Each Form 4219 should be accompanied by a check or money order made out to the Internal Revenue Service. To avoid interest, full payment should be made on or before the due date of the employer's Federal employment tax return.

Employee's Portion of Taxes Paid by Employer

If you are not a household or agricultural employer and you pay your employee's liability for social security and Medicare taxes without deducting them from the employee's pay, you must include the amount of the payments in the employee's wages for social security, Medicare, and Federal unemployment taxes, and income tax withholding. This increase in the employee's wage payment for your payment of the employee's social security and Medicare taxes is also subject to employee social security and Medicare taxes. This again increases the amount of the additional taxes you must pay.

To figure the employee's increased wages in this situation, you divide the stated pay (the amount you pay without taking into account your payment of employee social security and Medicare taxes) by a factor for that year. This factor is determined by subtracting from 1 the combined employee social security and Medicare tax rate for the year the wages are paid. For 1995, the factor is .9235 (1 — .0765). If the wages are more than \$56,518.20, follow the procedure described under **Stated pay of more than \$56,518.20 in 1995** later.

Stated pay of \$56,518.20 or less in 1995.— For an employee with wages of \$56,518.20 or less in 1995, figure the correct wages (wages plus employer-paid employee taxes) and withholding to report by dividing the wages by .9235. This will give you the social security and Medicare wages to report in boxes 3 and 5 of Form W-2. Also include this amount in box 1.

To figure the correct social security tax to enter in box 4 and Medicare tax to enter in box 6, multiply the amounts in boxes 3 and 5 by the withholding rates for those taxes and enter the results in boxes 4 and 6.

Example. Donald Devon hires Lydia Lone for only 1 week during 1995. He pays her \$200 for that week. Donald agrees to pay Lydia's part of the social security and Medicare taxes. To figure her reportable wages, he divides \$200 by .9235. The result, \$216.57, is the amount reported as wages in boxes 1, 3, and 5 of Form W-2. To figure the amount to report as social security tax, Donald multiplies \$216.57 by the social security tax rate of 6.2% (.062). The result, \$13.43, is entered in box 4 of Form W-2. To figure the amount to report as Medicare tax, Donald multiplies \$216.57 by the Medicare tax rate of 1.45% (.0145). The result, \$3.14, is entered in box 6 of Form W-

2. Although he did not actually withhold these amounts from Lydia, he will report these amounts as taxes withheld on Form 941 and is responsible for matching these amounts with the employer share of these taxes.

For FUTA and income tax withholding, Lydia's weekly wages are \$216.57.

Stated pay of more than \$56,518.20 in 1995.— For an employee with stated pay of more than \$56,518.20 in 1995, the correct social security wage amount is \$61,200 (the first \$56,518.20 of wages ÷ .9235). The stated wages in excess of \$56,518.20 are not subject to social security tax because the tax only applies to the first \$61,200 of wages (stated pay plus employer-paid employee taxes). Enter \$61,200 in box 3 of Form W-2.

To figure the correct Medicare wages to enter in box 5 of Form W-2, subtract \$56,518.20 from the stated pay. Divide this amount by .9855 and add \$61,200. For example, if stated pay is \$100,000, the correct Medicare wages are figured as follows:

$$\begin{aligned} \$100,000 - \$56,518.20 &= \$43,481.80 \\ \$43,481.80 \div .9855 &= \$44,121.56 \\ \$44,121.56 + \$61,200 &= \$105,321.56 \end{aligned}$$

The Medicare wages are \$105,321.56. Enter this amount in box 5. The social security tax to enter in box 4 is \$3,794.40 ($\$61,200 \times .062$). The Medicare tax to enter in box 6 is \$1,527.16 ($\$105,321.56 \times .0145$).

Although these employment tax amounts are not actually withheld, you reports them as withheld on Form 941, and are responsible for paying equal amounts as the employer's share of the social security and Medicare taxes. If the wages for income tax purposes in the preceding example are the same as for social security and Medicare purposes, the correct wage amount for income tax withholding is \$105,321.56 ($\$100,000 + \$3,794.40 + \$1,527.16$), which is included in box 1 of Form W-2.

9. Pensions and Annuities

Generally, pension and annuity payments are subject to Federal income tax withholding unless the recipient elects not to have tax withheld. The withholding rules apply to the **taxable** part of payments from an employer pension, annuity, profit-sharing, stock bonus, or other **deferred compensation plan**. The rules also apply to payments from an individual retirement arrangement (IRA), an annuity, endowment, or life insurance contract issued by a life insurance company. There is no withholding on any part of a distribution that is not expected to be includible in the recipient's gross income.

Recipients of payments described above can choose not to have withholding apply to their pensions or annuities (however, see **Mandatory Withholding** below). The election remains in effect until the recipient revokes

it. The payer must notify the recipient that this election is available.

Withholding

Periodic Payments

Generally, periodic payments are those payments for more than 1 year that are not eligible rollover distributions (see discussion below). Periodic payments include substantially equal payments made at least once a year over the life of the employee and/or beneficiaries or for 10 years or more. For withholding purposes, these payments are treated as if they are wages. You can figure withholding by using the income tax withholding tables and methods in Circular E or the alternative tables and methods in this booklet.

Recipients of periodic payments can give you a Form W-4P to specify the number of withholding allowances and any additional amount they want withheld. They may also claim exemption from withholding on Form W-4P or revoke a previously claimed exemption. If they do not submit a Form W-4P, you must figure withholding by treating a recipient as married with three withholding allowances. See Form W-4P for more information.

Nonperiodic Payments

Withhold 10% of a nonperiodic payment that is not an eligible rollover distribution. The recipient may request additional withholding on Form W-4P or claim exemption from withholding.

Mandatory Withholding

Payments delivered outside the United States.—

The election to be exempt from income tax withholding does not apply to any periodic payment or nonperiodic distribution delivered outside the United States or its possessions to a U.S. citizen or resident alien. See Form W-4P for more information.

Nonresident aliens can elect exemption from withholding only if they certify to the payer that they are not (1) a U.S. citizen or resident alien or (2) an individual to whom Internal Revenue Code section 877 applies (concerning expatriation to avoid tax). The certification must be made in a statement to the payer under penalties of perjury. However, nonresident aliens who choose such exemption will be subject to withholding under Code section 1441. See **Pub. 515**, Withholding of Tax on Nonresident Aliens and Foreign Corporations.

Eligible rollover distributions.— Withhold 20% of an eligible rollover distribution unless the recipient elected to have the distribution paid in a direct rollover to an eligible retirement plan, including an IRA. An eligible rollover distribution is the taxable part of any distribution from a qualified plan or tax-sheltered annuity (but not an IRA) except:

- 1) One of a series of substantially equal periodic payments (at least annually) made for the life or life expectancy of the employee and the employee's beneficiary or for a specified period of 10 years or more, and
- 2) Any part of a distribution that is a minimum distribution required by Code section 401(a)(9).

Other exceptions may apply.

You are not required to withhold 20% of an eligible rollover distribution that, when added to other rollover distributions made to one person during the year, is less than \$200.

A recipient of an eligible rollover distribution cannot claim exemption from the 20% withholding. It is not necessary to claim exemption from withholding on a direct transfer to an IRA or other pension plan since withholding is not required in this situation. Therefore, do not provide the recipient Form W-4P for eligible rollover distributions.

Notice to recipient.— You must provide a written explanation to the recipient within a reasonable period of time before making an eligible rollover distribution. You must explain the rollover rules, special tax treatment for lump-sum distributions, direct rollover option, and mandatory 20% withholding rule. Notice 92-48, 1992-2 C.B. 377, contains a model notice you can use to satisfy this requirement.

Similar rules apply to distributions from tax-sheltered annuities. The IRS has issued temporary regulations on these requirements under sections 401(a)(31), 402, 403(b), and 3405 (Treasury Decision 8443, 1992-2 C.B. 80).

Depositing and Reporting Withholding

Report income tax withholding from pensions and annuities on **Form 945**, Annual Return of Withheld Federal Income Tax. Do not report these liabilities on Form 941. You must furnish the recipients and the IRS with **Form 1099-R**, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

Deposit withholding from pensions and annuities combined with any other nonpayroll withholding reported on Form 945 (e.g., backup withholding) at an authorized financial institution. Be sure to mark the "Form 945" checkbox on **Form 8109**, Federal Tax Deposit Coupon. Do not combine the Form 945 deposits with deposits for payroll taxes. See Circular E and the instructions for Form 945 for information on the deposit rules.

10. Alternative Methods for Figuring Income Tax Withholding

You may use various methods of figuring income tax withholding. The methods described below may be used instead of the common payroll methods. Use the method that best suits your payroll system and employees.

Annualized wages.— Using your employee's annual wages, figure the withholding using the Percentage Method, TABLE 7—ANNUAL Payroll Period, in Circular E. Divide that amount by the number of payroll periods and the result will be the amount of withholding for each payroll period.

Average estimated wages.— You may withhold the tax for a payroll period based on estimated average wages, with necessary adjustments, for any quarter. For details, please see Regulations section 31.3402(h)(1)-1.

Cumulative wages.— An employee may ask you, in writing, to withhold tax on cumulative wages. If you agree to do so, and you have paid the employee for the same kind of payroll period (weekly, biweekly, etc.) since the beginning of the year, you may figure the tax as follows:

Add the wages you have paid the employee for the current calendar year to the current payroll period amount. Divide this amount by the number of payroll periods so far this year including the current period. Figure the withholding on this amount, and multiply the withholding by the number of payroll periods used above. Use the percentage method shown in Circular E. Subtract the total withholding calculated from the total tax withheld during the calendar year. The excess is the amount to withhold for the current payroll period. (See Rev. Proc. 78-8, 1978-1 C.B. 562, for an example of the cumulative method.)

Part-year employment.— A part-year employee who figures income tax on a calendar-year basis may ask you to withhold tax by the part-year employment method. The request must be in writing and must contain the following information:

- 1) The last day of any employment during the calendar year with any prior employer.
- 2) A statement that the employee uses the calendar year accounting period.
- 3) A statement that the employee reasonably anticipates he or she will be employed for a total of no more than 245 days in all *terms of continuous employment* (defined below) during the current calendar year.

Complete the following steps to figure withholding tax by the part-year method:

- 1) Add the wages to be paid the employee for the current payroll period to any wages you have already paid the employee in the current term of continuous employment.
- 2) Add the number of payroll periods used in step 1 to the number of payroll periods between the employee's last employment and current employment. To find the number of periods between the last employment and current employment, divide (a) the number of calendar days between the employee's last day of earlier employment (or the previous December 31, if later) and the first day of current employment by (b) the number of calendar days in the current payroll period.
- 3) Divide the step 1 amount by the total number of payroll periods from step 2.
- 4) Find the tax in the withholding tax tables on the step 3 amount. Be sure to use the correct payroll period table and to take into account the employee's withholding allowances.
- 5) Multiply the total number of payroll periods from step 2 by the step 4 amount.
- 6) Subtract from the step 5 amount the total tax already withheld during the current term of continuous employment. Any excess is the amount to withhold for the current payroll period.

(See Regulations section 31.3402(h)(4)-1(c) for examples of the part-year method.)

Term of continuous employment.— A term of continuous employment may be a single term or two or more following terms of employment with the same employer. A continuous term includes holidays, regular days off, and days off for illness or vacation. A continuous term begins on the first day an employee works for you and earns pay. It ends on the earlier of the employee's last day of work for you or, if the employee performs no services for you for more than 30 calendar days, the last workday before the 30-day period. If an employment relationship is ended, the term of continuous employment is ended, even if a new employment relationship is established with the same employer within 30 days.

Other methods.— You may use other methods and tables for withholding taxes, as long as the amount of tax withheld is about the same as it would be under the percentage method shown in Circular E. If you develop an alternative method or table, you should test the full range of wage and allowance situations to be sure that they meet the tolerances contained in Regulations section 31.3402(h)(4)-1 as shown in the chart below.

If the tax required to be withheld under the annual percentage rate is —

Less than \$10
\$10 or more but under \$100
\$100 or more but under \$1,000
\$1,000 or more

The annual tax withheld under your method may not differ by more than —

\$0.99
\$0 plus 10% of the excess over \$10
\$9 plus 3% of the excess over \$100
\$6 plus 1% of the excess over \$1,000

Formula Tables for Percentage Method Withholding (for Automated Payroll Systems)

Two formula tables for percentage method withholding are on pages X and X. Employers with automated payroll systems may find these tables useful. The differences in the Alternative Percentage Method formulas and the steps for figuring withheld tax for different payroll systems are shown in this example.

MARRIED PERSON (Weekly Payroll Period)

If wages exceeding the allowance amount are over \$123 but not over \$828:

Method:	Income Tax To Be Withheld:
Percentage	15% of excess over \$123
Circular E	
Alternative 1	15% of such wages minus
(Page XX)	\$18.45
Alternative 2	Such wages minus \$123, 15%
(Page XX)	of remainder

When employers use the percentage method in Circular E or the formula tables for percentage method withholding in this publication, the tax for the pay period may be rounded to the nearest dollar. If rounding is used, it must be used consistently. Withheld tax amounts should be rounded to the nearest whole dollar by (1) dropping amounts under 50 cents and (2) increasing amounts from 50 to 99 cents to the next higher dollar. For example, \$2.30 becomes \$2 and \$2.80 becomes \$3. Such rounding will be deemed to meet the tolerances under section 3402(h)(4).

Wages Bracket Percentage Method Tables (for Automated Payroll Systems)

The **Wage Bracket Percentage Method Tables** show the gross wage brackets that apply to each withholding percentage rate for employees with up to nine withholding allowances. These tables also show the computation factors for each number of withholding allowances and the applicable wage bracket. The computation factors are used to figure the amount of withholding tax by a percentage method.

Two kinds of **Wage Bracket Percentage Method Tables** are shown. Each has tables for married and single persons for weekly, biweekly, semimonthly, and monthly payroll periods. Employers with automated payroll systems may find these tables useful.

The difference between the two kinds of tables is the reduction factor subtracted from wages before multiplying by the applicable percentage withholding rate. In the tables for **Computing Income Tax Withholding From Gross Wages**, the reduction factor includes both the amount for withholding allowances claimed and a rate adjustment factor as shown in the **Alternative 2—Tables for Percentage Method Withholding Computations**. In the tables for **Computing Income Tax Withholding From Wages Exceeding Allowance Amount**, the reduction factor does not include an amount for the number of allowances claimed.

Use the kind of wage bracket table that best suits your payroll system. For example, some pay systems automatically subtract from wages the allowance amount for each employee before finding the amount of tax to withhold. The tables for **Computing Income Tax Withholding From Wages Exceeding Allowance Amount** can be used in these systems. The reduction factors in these tables do not include the allowance amount that was automatically subtracted before applying the table factors in the calculation. For other systems that do not separately subtract the allowance amount, use the tables for **Computing Income Tax Withholding From Gross Wages**.

When employers use the **Wage Bracket Percentage Method Tables**, the tax for the period may be rounded to the nearest dollar. If rounding is used, it must be used consistently. Withheld tax amounts should be rounded to the nearest whole dollar by (1) dropping amounts under 50 cents and (2) increasing amounts from 50 to 99 cents to the next higher dollar. For example, \$2.30 becomes \$2 and \$2.80 becomes \$3. Such rounding will be deemed to meet the tolerances under section 3402(h)(4).

Combined Income Tax, Employee Social Security Tax, and Employee Medicare Tax Withholding Tables

If you want to combine amounts to be withheld as income tax, employee social security tax, and employee Medicare tax, the combined tables may be convenient.

Combined withholding tables for single and married taxpayers are shown for weekly, biweekly, semimonthly, monthly, and daily or miscellaneous payroll periods. The payroll period and marital status of the employee determine the table to be used.

If the wages are greater than the highest wage bracket in the applicable table, you will have to use one of the other methods for figuring income tax withholding described in this publication or in Circular E. For wages that do not exceed \$XX,XXX, the combined social security tax rate and Medicare tax rate is 7.65% each for both the employee and the employer for wages paid in 1996. You can figure the employee social security tax by multiplying the wages by 6.2%, and you can figure the employee Medicare tax by multiplying the wages by 1.45%.

The combined tables give the correct total withholding only if wages for income tax withholding, social security, and Medicare are the same. When you have paid more than the maximum amount of wages subject to social security tax (\$XX,XXX in 1996) in a calendar year, you may no longer use the combined tables. Also, do not use the combined tables in other cases when the wages are not the same.

If you use the combined withholding tables, use the following steps to find the amounts to report on your **Form 941**, Employer's Quarterly Federal Tax Return.

- 1) Employee social security tax withheld. Multiply the wages by 6.2%.
- 2) Employee Medicare tax withheld. Multiply the wages by 1.45%.
- 3) Income tax withheld. Subtract the amounts from steps 1 and 2 from the total tax withheld.

You can figure the amounts to be shown on **Form W-2**, Wage and Tax Statement, in the same way.

11. Tables for Withholding on Distributions on Indian Gaming Profits to Tribal Members

Beginning January 1, 1995, if you make certain payments to members of Indian tribes from gaming profits, you must withhold Federal income tax. You must withhold if (1) the total payment to a member for the year is over \$6,400 and (2) the payment is from the net revenues of class II or class III gaming activities (classified by the Indian Gaming Regulatory Act) conducted or licensed by the tribes.

A class I gaming activity is **not subject to this new withholding requirement**. Class I activities are social games solely for prizes of minimal value or traditional forms of Indian gaming engaged in as part of tribal ceremonies or celebrations.

Class II.— Class II includes (1) bingo and similar games, such as pull tabs, punch boards, tip jars, lotto, and instant bingo, and (2) card games that are authorized by the state or that are not explicitly prohibited by the state and played at a location within the state.

Class III.— A class III gaming activity is any gaming that is not class I or class II. Class III includes horse racing, dog racing, jai alai, casino gaming, and slot machines.

Withholding Tables

To figure the amount of tax to withhold each time you make a payment, use the table on page X for the period for which you make payments. For example, if you make payments weekly, use table 1; if you make payments monthly, use table 4. If the total payments to an individual for the year are \$6,400 or less, no withholding is required.

Example: A tribal member is paid monthly. The monthly payment is \$5,000. Using Table 4, Monthly Distribution Period, compute the withholding as follows:

1. Payment	\$5,000.00
2. Tax to withhold from Table 4:	
a.	\$291.90
\$5,000 – 2,479 = \$2,521 × .28	+
b. =	<u>705.88</u>
c. Total tax	<u>\$ 997.78</u>

Depositing and reporting withholding.— Combine the Indian gaming withholding with all other nonpayroll withholding (e.g., backup withholding and withholding on gambling winnings). Generally, you must deposit the amounts withheld in an authorized financial institution using **Form 8109**, Federal Tax Deposit Coupon. See **Circular E**, Employer's Tax Guide, for a detailed discussion of the deposit requirements.

Report Indian gaming withholding on **Form 945**, Annual Return of Withheld Federal Income Tax. For more information, see Form 945 and its instructions. Also, report the payments and withholding to tribal members and the IRS on **Form 1099-MISC**, Miscellaneous Income (see **Instructions for Forms 1099, 1098, 5498, and W-2G**).

Proof as of
July 21, 1995
(subject to change)

Proof as of
July 21, 1995
(subject to change)